A CONCERTED SOLUTION FOR THE DEBT CRISIS

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Prefácio ao livro que Jeffrey Sachs e Bresser-Pereira projetavam organizar em 1988, mas que, afinal, não se concretizou, *Alternative Solutions for the Debt Crisis*.

Albert Hirschman once said "understanding of a problem and motivation to attack it are two necessary inputs into policymaking and problem-solving, but that 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 widely known, but the motivation to solve the crisis has not yet been sufficient. This is the situation, at least, in the creditor countries. By contrast, in the highly indebted countries, the motivation exists, but the understanding of the alternative solutions is poor and the political will to exert pressure on the creditors is weak.

Among the creditors a consensus is forming that the external debt of the heavily indebted countries is a fundamental, though certainly not sole, cause of the fiscal crisis that plagues the highly indebted countries. And it is recognized that this fiscal crisis - characterized by a large public deficit that can only be financed by printing money, and by 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 of the inflation rates that characterize the highly indebted countries in the past decade.

It is also clear that the "finance and adjustment strategy" initially adopted to solve the problem is not realistic. That strategy, based on new lending coupled with arduous austerity programs, has not allowed the debtor governments to break out of their financial crisis. The best evidence is provided by the market itself. The debt of the developing countries trades in the secondary market at a deep discount relative to face value, suggesting the widespread expectation that the debts will never be fully serviced on market terms. Countries such as Brazil, Mexico, and Venezuela, are widely expected to service half or less of their debts; countries such as Bolivia, Costa Rica, and Peru, not much more than 10 percent.

And so it is increasingly 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, is still limited. They see some of the advantages in a scheme of deep debt reduction via new forms of securitization, but many in the creditor world still believe that the costs would exceed the benefits. Many of the leading banks, at least, continue to believe that they can do better without a new global approach.

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 foreign money holdings leaving them well protected against the virulent depreciations of the currency, and a decrepit tax system leaving their financial wealth untouched and untouchable.

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 position defined by the U.S. government and implemented by the multilateral agencies in basic agreement with the major U.S. banks; (2) the official but mildly dissenting position of Japan, France and Italy; and (3) an increasing number of dissenters outside the executive branch of the creditor governments, especially in the U.S. Congress, favorable to a significant reduction of the debt. In the debtor countries we should distinguish the position of (1) nationalists and populists; (2) government officials and business elites subordinated to foreign interests; and (3) an increasing group of citizens that favor the adoption of a combination of pressures by the debtor governments, including unilateral measures, oriented to capture the discount in the secondary market in a concerted manner. The authors of this introduction identify themselves with the third group between respectively the debtor and the creditor countries.

The position of the official creditor community, including the governments and the international financial institutions, has evolved over time. In the early years of the crisis, when major banks were at risk of insolvency, the official creditor approach was focused almost solely on saving the banks by pressuring the debtor countries to pay the debts, no matter how desperate was the situation in the debtor countries. Over time, as the banks recovered while the debtor countries sank deeper into economic disarray, 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 interests of foreign policy of the creditor governments have remained in competition throughout the process.

But even today, the creditors' strategy must still be generally defined as a "muddling through approach" - a strategy of 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 structural reform. In 1987 and 1988, this evolved into the “menu of options” approach: the banks can choose from a “menu” that includes not only new finance, but various forms of debt relief, such a swap of their debt for exit bonds.

With the speech of the new U.S. Secretary of the Treasury, Nicholas F. Brady, the “menu” approach put an increased focus on “voluntary debt reduction” through securitization as a key feature on the menu. Notably, Secretary Brady suggested the use of IMF and World Bank resources to provide guarantees and other “enhancements” on the new securities, to spur the process of debt reduction — the phase of voluntary securitization (debt-bond conversion) of the debt with guarantees for the new bonds offered by the IMF and World Bank - inaugurated in the March 1989 speech of the new Secretary of the Treasury, Nicholas Brady. The position of Japan, France and Italy was 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. The third group, that received an increasing number of adherents as the official strategy failed, never accepted the liquidity approach, underlined the self-defeating nature of internal adjustment policies, and supported a global solution for capturing the discount existing in the secondary market tied with limited debt relief.

Among the debtor’s 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 countries - 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 increasing number of dissenters of the official position in the creditor countries, but it was also obvious that, besides this support it is essential to use the only bargaining power a debtor country possess: the possibility of suspending payments of interests.

In this book the ideas of the two “third groups”, in the creditor and in the debtor countries, are present. James Robinson III and Arjun Sengupta’s papers are detailed proposals, while in most of the other papers the approach that we are calling the concerted reduction of the debt is thoroughly discussed. This approach is based in a set of propositions about the nature of’ the debt crisis and in the proposal of a basic strategy to solve the crisis.

1. Basic propositions about the debt crisis

The propositions about the debt crisis could be summarized in this way:

First, 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.

Second, the debt crisis is the major, but not the only cause for the stagnation and the high rates of inflation that characterize almost always the highly indebted countries.

Third, populist policies, trying to promote development at any cost and to distribute income in the short run through wage increases (taxes), are a second reason.

Fourth, 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.

Fifth, fiscal and monetary adjustment policies, designed to create a trade surplus that permit to pay the interest of the debt, reduce imports, represent a huge transference of real resources, and have as consequence the long term reduction in the saving and investment capacity of the country.

Sixth, the real devaluations of the local currency, that is necessary to achieve high trade surpluses, accelerate strongly the prevalent high inflation rates, that are subsequently inertialized through formal and informal indexation systems.

Seventh, inertial inflation is resistant to conventional monetary and fiscal policy.

Eighth, since the private sector in the highly indebted countries was able to transfer the external 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, turning ineffective the efforts to reduce the public deficit.

Ninth, the resulting economic stagnation, besides reducing standards of living already very low and increasing infant mortality, endangers seriously the stability of the new democracies that have been established in these countries in the beginning of the 80s in part as a result of this same debt crisis.

Tenth, 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.

Eleventh, the strategy of the creditor countries is changing in the right direction - debt reduction - but its last manifestation, the Brady Plan, albeit should be welcomed, is a timid and insufficient move to solve the debt crisis.

2. Two alternative strategies

In order to understand the limited character of the Brady Plan is necessary in this Introduction 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 two years ago, today is widely accepted. Securitization is the basic strategy to achieve this result. The problem is how and at what pace to proceed the reduction of the debt. On one side we have the ones, among which include ourselves, that favor a concerted and global reduction of the debt based on the creation of an International Debt Facility that will administer the whole process on a case-by-case method. On the other side we have the major American and English banks, and more recently the U.S. government, that now favor "voluntary", market controlled, debt reduction.[1] 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, that is present in most of the papers in this book, can be summarized in this way:

[1] The position 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")

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.

If the creditor governments adopt this approach, it is possible to envisage the resolution of the debt crisis in the next two years. If, however, the creditors limit themselves to the Brady Plan, that is, to the market or free rider approach, without the creation of the IDF and without supplying the Fund and the Bank with special funds to back the guarantees, we 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.

3. The ineffectiveness of the voluntary approach

The banks, that are specialists in semantics, like to call their present approach to the debt 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 also favor 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 meager. 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 creditworthness* 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 refinance interest payments in new concerted lending packages;* (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.

Of the 16 U.S. banks that held Bolivian exposure at the time of the Bolivian buyback (and that did not otherwise dispose of their debt in the secondary market), 13 banks sold out entirely, while the 3 largest creditors (Bank of America, Citicorp, and Morgan Guaranty) held on to most of their claims. Their motivation for holding on was mainly to avoid setting a precedent for other countries, but the implication for Bolivia is clear: these few banks and several like them abroad, have so far frustrated a full settlement of Bolivia's debt problem.

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 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 creditworthiness 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 creditworthiness is indeed restored. Thus, under certainty, there would be no motivation for an individual creditor who 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 is proved formally by Helpman (1988) for example, 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 Corporation[2] 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

[2] 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.

IDDC would have to find some means of ensuring almost complete participation by the creditors (1987: 320-321).

We 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.

4. 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? 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).

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 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. Fourth, there is a strong resistance of the large American banks to debt writedowns 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.

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. This 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 profits.[3]

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.

[3] For a more complete discussion of this problem see Bresser-Pereira, 1989.

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.

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. Especially 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.

These obstacles to a concerted reduction of the debt should not be underestimated. But, on the other hand, the movement towards an effective solution of the debt crisis is gaining new adepts every day in the debtor and in the creditor countries. We hope that this book will be a contribution is this direction.

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