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Symposium on New Institutions for Developing Country Debt

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The developing-country debt crisis has been the dominant factor in North-South relations for more than eight years. The authors in this symposium discuss some of the bargaining problems underlying the debt crisis, and debate whether new institutions are needed for dealing with it.

Two authors, Peter Kenen and Jeffrey Sachs, recommend the creation of a new multilateral lending institution to buy up deeply-discounted Third World debt and pass the discounts on to troubled middle-income debtors. Kenen pioneered this approach in 1983 with his proposal for an International Debt Discount Corporation; here he updates his plan and answers some of its critics. Jeremy Bulow and Kenneth Rogoff contend that the debt crisis is better viewed as a symptom rather than the cause of poor growth in many developing countries, and that multilateral aid should be directed at rewarding good behavior in habitat preservation, population control and drug interdiction. They propose an International Citizenship Fund as a vehicle for accomplishing this. According to Jonathan Eaton's assessment, the principal difficulty underlying the debt crisis is a murky contract enforcement structure, and adding a new international organization will not in itself do much to improve the situation.

A Brief Synopsis of the Debt Problem

Crudely stated, the debt problem is that the governments of many developing countries are balking at having to repay the hundreds of billions of dollars they

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Table 1
Highly indebted countries

	Government and government guaranteed (billions of 1988 dollars)			
	Total External Debt	*Debt to Commercial Banks*	*Total Debt /GNP (1987)*	*Secondary Market Prices of Bank Debt (7/20/89)*
Argentina	60	35	.74	.18
Bolivia	6	0.4	1.34	.11
Brazil	114	76	.39	.32
Chile	19	11	1.25	.64
Colombia	17	7	.50	.60
Costa Rica	5	0.9	1.16	.14
Côte d'Ivoire	14	3	1.44	.06
Ecuador	10	5	1.07	.14
Jamaica	4	0.6	1.76	.42
Mexico	100	69	.78	.44
Morocco	21	5	1.32	.44
Nigeria	30	9	1.23	.24
Peru	19	5	.40	.04
Philippines	29	12	.86	.54
Uruguay	4	2	.59	.55
Venezuela	36	25	.94	.40
Yugoslavia	22	9	.39	.54
TOTAL	510	275		

Sources: The World Bank, *World Debt Tables*, 1988–89 ed. The World Bank, *Quarterly Review*, June 1989. Salomon Brothers, *Indicative Prices for Developing Country Debt*, July 1989.

borrowed from commercial banks in industrialized countries during the 1970s and early 1980s. Many of these debtor countries are quite fragile politically, and they find it extremely burdensome to transfer a few percent of GNP abroad each year. Table 1 illustrates the broad dimensions of the problem. Thus far the debtors have generally been reluctant to invoke total repudiation, but many have forced their foreign creditors to reschedule obligations far into the future. Secondary market prices for government and government-guaranteed bank debt are listed in Table 1; discounts range from 36 percent for Chile to 96 percent for Peru. Clearly, private investors are skeptical that these rescheduled debts will ever be repaid in full.

One aspect of the debt crisis, possibly sociological, requires mention: The problem debtor governments are heavily concentrated in Latin America. Coincidentally (or is it a coincidence?), Latin American governments also led the last great wave of sovereign defaults in the 1930s, and the preceding wave in the 19th century. Asian debtors, on the other hand, have been considerably more successful in meeting their obligations, with the most notable exception being the Philippines (a former Spanish colony!). The debts of low-income African nations are also not generally considered a

major issue, largely because most of their debt is to official creditors (governments and multilateral lending institutions such as the International Monetary Fund and the World Bank) who appear unlikely to try to enforce substantial repayments.

After the defaults of the 1930s, few developing countries were able to borrow large amounts prior to 1970. Table 3 in the Bulow and Rogoff paper shows the sharp growth in debt since then. During the period 1970–1982, low real interest rates, rising commodity prices, and (according to some of the symposium participants) changes in the developed-country legal environment, combined to engender an explosion of borrowing. But as commodity prices plummeted and real interest rates soared in the early 1980s, lending came to an abrupt halt. In August 1982, Mexico suddenly found itself unable to roll over its debts, and shortly thereafter a slew of countries entered debt renegotiations.

Were commercial bankers foolish to make these loans, at least without charging higher risk premiums? Certainly it was difficult to forecast the massive shocks to interest rates and commodity prices which occurred in the 1980s. On the other hand, one can argue that the banks had good reason to hope for a government bailout in the event of trouble, given the existence of federal deposit insurance and the importance of bank intermediation in world trade. Early on in the debt crisis, there was indeed considerable concern that a widespread repudiation of sovereign debts would bankrupt a number of thinly-capitalized major banks. As time has passed, however, banks have been able to strengthen their balance sheets, and today the main focus is on the stagnating economies of the highly indebted countries.

Contrasting Views

One central issue in the debate here is the extent to which the debt problem is responsible for low growth in some of the major debtor countries. Sachs and Kenen both argue that the overhang of external debt creates a significant tax on new investment; the debtor country realizes that creditors will be able to bargain for a share of any economic growth. In the extreme, there may even be a debt Laffer curve, in which case creditors can actually gain by forgiving part of the debt, since the prospects for repaying the remainder would increase so dramatically. Bulow and Rogoff note that a large fraction of the shortfall in Latin American growth occurred in 1980 to 1983 before the region was required to make any significant net repayments. They also point out that Latin American citizens began withdrawing their capital from the region on a massive scale long before the banks tried to withdraw.

Eaton observes that if there is a debt Laffer curve, then private creditors have been passing up on a free lunch for quite some time. The explanation for this, according to Sachs and Kenen, is that coordination problems among the creditor banks make it very difficult for them to reach an efficient bargain. It is this friction which provides scope for government intervention. Bulow and Rogoff argue that the involvement of deep-pocketed official creditors in private debt negotiations has in fact ossified negotiating positions.

Another major issue is the expected cost to creditor-country taxpayers of underwriting an International Debt Discount Corporation. Sachs calculates that the cost to U.S. taxpayers would be quite small, since initially they would only have to pay in a couple billion dollars to help capitalize the institution. Bulow and Rogoff view the likely cost as being much higher. They believe that the developing countries will not be willing to make any substantial net repayments once their debts have been transferred to official hands, and that creditor-country taxpayers will be called on to honor their guarantees of the new agency's debt.

Each of the authors offers a different opinion on the extent to which the debtor countries should be allowed to regain access to capital markets. Eaton cautions against any policy predicated on the assumption that pre-debt crisis situation should be restored. Bulow and Rogoff concur, noting that many of the loans to developing-country governments were used to finance private capital flight and glaringly ill-conceived government investment projects. They recommend legal reforms aimed at steering adjudication of future sovereign loans into debtor-country courts, even if this makes it more difficult for countries to borrow large amounts. Sachs, on the other hand, sees restored access to debt markets as an important aim, given the enormous potential efficiency gains from world capital market integration.

Finally, Sachs believes that a resolution of the debt crisis will alleviate the plight of the poor in Latin America by restoring growth to the region. Bulow and Rogoff, and Eaton, question the equity grounds for a Latin bailout. They point out that per capita GNPs are still generally much higher in Latin America than in Asia and Africa, and that the private citizens of Latin America hold a very substantial quantity of capital abroad.

None of the authors is particularly satisfied with current official policy, the so-called "Brady plan," which was first (hazily) articulated in a speech by U.S. Treasury Secretary Nicholas Brady in March 1989. The Brady plan appears to involve having industrialized country governments help "good behaviors" buy back some of their debt at discount, with Mexico serving as the test case. As this is being written, virtually every debtor country is trying to get itself included in the "Brady bunch." But there is considerable debate within the academic community over how much countries benefit from buyback programs. Bulow and Rogoff are critical of the Brady plan on this account; they contend that buybacks at market discount involve an enormous leakage of aid to creditor banks. Sachs and Kenen view the Brady plan as too piecemeal, beset by problems of coordinating negotiations between many separate banks and debtor countries. Both Eaton, and Bulow and Rogoff, question whether the middle-income countries first in line for Brady plan aid are necessarily the most worthy aid recipients.

The developing-country debt crisis is one of the most emotionally charged issues in world politics today, and virtually every leading statesman has taken a position on it. There is little disagreement among the participants in this symposium, however, that the major objective of any approach should be to help the world's poorest citizens. Most of the differences in their recommendations can be traced to alternative views on the bargaining mechanisms underlying debt negotiations, a topic very much on the cutting edge of research today in international economics.