

**THE WEST'S RESPONSE TO THE DEBT CRISIS  
OF THE THIRD WORLD IN THE 1980s**

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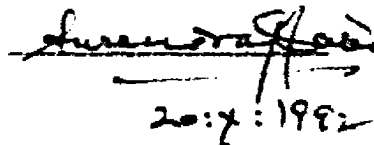
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**Canada**

**I would like to dedicate this thesis to  
Thomas, Philomena and Margaret McGarvey  
whose words and letters of support will be  
remembered for years to come.**

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## **ABSTRACT**

### **RECYCLING THE DEBT CRISIS: THE WEST'S STRATEGIC RESPONSE TO THE DEBT CRISIS**

This thesis attempts to examine the debt crisis from a political and institutional perspective. Using the political-economy approach it reveals that the West's reaction to the crisis in international payments has not been an ad hoc process of "muddling through". Rather, it has been a carefully crafted response that has consistently put the interests of the banking community ahead of those of the debtor countries. The objective of this strategy has been to stabilize the international creditor banks by recycling LDCs' new loans back to the banks in the form of interest payments from debtor countries. In this way debts are serviced on time and banks avoid any major disruptions to their stock values or profit margins.

I have chosen the Baker and Brady plans and the International Monetary Fund to demonstrate the means by which the American have attempted to enforce their debt containment strategy. The Baker and Brady plans were diplomatic measures to renew voluntary lending to LDC's through stabilizing economies and sharing the burden of new lending between official and private lending institutions. The IMF's efforts to normalize and stabilize relations between debtor countries and their creditor banks have been an intrinsic part of the West's overall effort to maintain the flow of new capital to the debtor countries.

In conclusion, I suggest that debt and interest rate reduction must become the primary objective in the West's efforts to stabilize Third world debts. If it does not, the economies of the debtor countries will continue to erode as will their peoples' faith in their democratically elected governments.

September 30 1992

Susan McGarvey

## **CHAPTER 1: INTRODUCTION**

Though much has been written on the debt crisis, few 30 studies have gone beyond examining its financial and economic aspects. As a result many works are narrowly focused and irrelevant to the realities involved in the management and resolution of the international debt crisis. However, this situation shows signs of changing. A number of authors have now begun to examine the interaction of the political and institutional aspects of Third world debt with its economic and financial dimensions. This emerging body of literature has dealt with such topics as the political and economic impact of external debts on Third world countries, the politics of debt renegotiations and the role of multilateral organizations in the development and stabilization of the debt crisis.<sup>1</sup> Because so much of this literature is new, it has not yet developed into a sophisticated body of knowledge. This is particularly true for the research that has been done on the Western response to Third world debt. No author has as yet produced a definitive account of how and why Western nations

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<sup>1</sup> Vinod K. Aggarwal. INTERNATIONAL DEBT THREAT: BARGAINING AMONG CREDITORS AND DEBTORS IN THE 1980'S. Berkley, California: 1987, Miles Kahler (ed.). THE POLITICS OF INTERNATIONAL DEBT, Ithaca, New York: Cornell University Press, 1986. Karen Lissakers. "Dateline Wall Street: Faustian Finance" FOREIGN POLICY, Summer, 1983. James A. Meigs. "Regulatory Aspects of the World Debt Problem" CATO JOURNAL, Vol. 4, No.1, 1984. Jackie Roddick. THE DANCE OF THE MILLIONS: LATIN AMERICA AND THE DEBT CRISIS. London: Latin American Bureau, 1988

and institutions have responded to the crisis in international payments. Most writers have chosen to rely on descriptions, rather than analysis, when discussing debt renegotiations and as a result have never investigated the consistencies that underlie all debt renegotiations. The work of Stephanie Griffith-Jones and Osvaldo Sunkel is a case in point. In their work, "Debt and Development Crises in Latin America: End of an Illusion", they describe the leadership role assumed by creditor governments, central banks and multilateral organizations as one of the main structural features of Western management of Third world debts.<sup>2</sup> No mention is made of the tactics adopted by these actors to contain international debt, the extent to which they have coordinated their efforts, or the reasons for their mutual cooperation.

Sunkel and Griffith-Jones view the provision of involuntary private lending to debtor countries as the second major element in the West's response to Third world debts. While they describe a number of examples of forced lending to debtor countries they fail to examine how involuntary lending relates to the overall response of Western nations and institutions to the debt crisis. Furthermore, they neglect to ask by what means the banks have been forced into involuntary lending and who has benefitted from this policy.

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<sup>2</sup> Stephanie Griffith-Jones and Osvaldo Sunkel. DEBT AND DEVELOPMENT CRISES IN LATIN AMERICA: THE END OF AN ILLUSION. New York: Clarendon Press, 1986:111

Marko Milivojevic's book "The Debt Rescheduling Process", while devoted primarily to examining the genesis of the debt crisis and its consequences for debtor countries, does attempt an analysis of the politics of debt rescheduling.<sup>3</sup> Milivojevic, in examining the differences between pre- and post-1982 sovereign debt renegotiations, concluded that between 1982 and 1984 three factors characterized the West's handling of LDCs' debts; the size and occurrence of bridging loans, involvement of the IMF in coordinating debt negotiations and supplying of high-conditionality, IMF loans to debtor countries.<sup>4</sup> Milivojevic's conclusion does not address the inter-relationships between these three aspects of debt management. For example, he does not examine the important role of bridging loans to the process of debt renegotiations, timely servicing of foreign debts and the creation and imposition of structural adjustment programs. Nor does he reveal how these three factors were enforced nor whether they are part of an ad hoc or coordinated policy response to the problem of Third world debts. Milivojevic also ignores the issue of the legitimacy of state or multilateral organizations involving themselves in the financial affairs of sovereign nations.

Benjamin J. Cohen's, in his work, "A Global Chapter 11", fails, like many other authors, to fully develop the implications of his conclusions on the Western response

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<sup>3</sup> Marko Milivojevic. THE DEBT RESCHEDULING PROCESS. New York: St. Martin's Press, 1985

<sup>4</sup> Milivojevic 57-63



to the debt crisis. He implies that the international creditor banks and their home governments have conspired to put concern for the soundness of financial institutions above all other considerations in the resolution of the debt crisis.<sup>5</sup> Cohen identifies the United States government, and large American commercial banks as the leading figures in this conspiracy.<sup>6</sup> Foremost among this cabal are, according to Cohen, the Department of the Treasury, Federal Reserve Board and major money-centre banks of New York, Chicago and California.<sup>7</sup> Where Cohen's conclusion falters is in its failure to identify how these groups have coordinated their activities and their impact on debt renegotiation agreements. Rather than address these questions, he merely restates some of the well-worn arguments on structural adjustment programs and criticizes their costs in human and economic terms.

Studies that attempt detailed examinations of the Western response to the debt crisis are often diminished by a reliance on only one or two case studies for their conclusions. For example, Elmar Alvater's examination of the Mexican debt renegotiations in 1982 and 1983 lead him to conclude that the form of crisis management employed by Western officials was "wholly in the interests of leading

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<sup>5</sup> Benjamin J. Cohen. "A Global Chapter 11" FOREIGN POLICY, Summer, 1989:118

<sup>6</sup> IBID

<sup>7</sup> IBID

groups in the industrialized countries".<sup>8</sup> Because of Alvater's reliance on only the Mexican example he was unable to address a number of questions that require a broader perspective to answer, such as who these "leading groups" were, their objectives and what influence they have had on other debt renegotiations.

Jackie Roddick's conclusions on Western management of the debt crisis are also weakened by a reliance on only one case study. She states that the essence of the Reagan administration's approach to the Mexican rescue was to sustain the flow of interest payments in order to avoid a "collapse of confidence" in the international banking system.<sup>9</sup> This was achieved by rescheduling Mexico's debts and enforcing an IMF-sponsored adjustment program.<sup>10</sup> A vital part of this approach, according to Roddick, was to coordinate the authority and financial power of the International Monetary Fund, with that of the U.S. Treasury and U.S. Federal Reserve Board.<sup>11</sup> Combining their efforts, these three institutions worked to enforce Western objectives on recalcitrant creditor bankers and debtor governments. Roddick's conclusion, fails to address some of the same fundamental questions that are left unanswered by so many studies, such as how these bodies have coordinated their efforts, what their

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<sup>8</sup> Elmar Alvater et al. THE POVERTY OF THE NATIONS: A GUIDE TO THE DEBT CRISIS FROM ARGENTINA TO ZAIRE. Atlantic Heights, New Jersey: Zed Books, 1991:27

<sup>9</sup> Roddick 39

<sup>10</sup> Roddick 41

<sup>11</sup> IBID

objectives are and the degree to which they have influenced subsequent debt reschedulings.

For writers who believe the West has pursued a coordinated and united response to the debt crisis, there still exists disagreement over whether the adjustment of debtor's economies or stabilization of the creditor banks has been the primary objectives of debt management. Pedro-Pablo Kuczynski and William A. Eskridge represent the two opposing views in this debate. Kuczynski contends that since the Mexican rescue effort of 1982 the West's prime objective has been to impose austerity measure in debtor countries.<sup>12</sup> He argues that Western officials justify adjustment measures on the grounds that an imminent global economic recovery will allow reformed economies to decrease their external debts and return to credit-worthiness in 3 to 5 years.<sup>13</sup> Kuczynski concludes that these adjustment measures are the most successful and effective aspect of Western management of the debt crisis.<sup>14</sup>

William A. Eskridge asserts that the management of Third world debts by the creditor banks, International Monetary Fund, Bank for International Settlements, U.S. government and other Western nations has been designed to "first and foremost"

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<sup>12</sup> Pedro-Pablo Kuczynski, LATIN AMERICAN DEBT, Baltimore, Maryland: John Hopkins University Press, 1988:95

<sup>13</sup> IBID

<sup>14</sup> IBID

keep money flowing into debtor countries so as to enable the servicing of external debts and avoid a large-scale disruptions of the creditor banks.<sup>15</sup> The underlying assumption of this strategy, according to Eskridge, is that the debt crisis is a crisis of liquidity and the supplying of interim financing will provide debtor countries with the opportunity to increase their exports, revive their domestic economies and acquire the foreign currency needed to service their debts.<sup>16</sup> The adoption of IMF austerity programs is seen by Eskridge as a means to encourage and support these development in the medium-term.<sup>17</sup>

In contrast to authors such as Eskridge and Kuczynski are those writers who claim that the West has never "managed" the crisis. They argue that Western response has been "ad hoc" and a process of "muddling through". Sidney Dell, a Senior Fellow at the United Nation's Institute for Training and Research, states that there has been a conspicuous absence of any real principles of debt relief displayed by the international actors involved in the debt crisis. Consequently, no minimum standards of debt relief has ever been created.<sup>18</sup> He believes that opportunities for generalized approaches to debt management have not arisen because Western

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<sup>15</sup> William N. Eskridge. DANCE ALONG THE PRECIPICE: THE POLITICAL AND ECONOMIC DIMENSIONS OF THE INTERNATIONAL DEBT CRISIS. Lexington, Mass.: Lexington Books, 1985: 155-156.

<sup>16</sup> Eskridge 156

<sup>17</sup> IBID

<sup>18</sup> Sidney Dell. "Crisis Management and the International Debt Problem" INTERNATIONAL JOURNAL, Vol. XL, No. 4, August 1985:669

institutions have dealt with each debtor country on a case-by-case basis, which precludes the application of standardized principles of debt relief.<sup>19</sup>

Dell's conclusions arise, in part, from an inability to view the management of international debt in its entirety. He fails to realize that the case-by-case approach is only one aspect of a much larger debt containment strategy that is designed to put Western interests above those of the debtor countries. Dell, like many writers ignores, the fact that despite the tailoring of renegotiation and adjustment packages to debtors' needs, debt rescheduling agreements have an underlying consistency. None of the rescheduling packages address debtors' need for debt and interest rate reductions. Debt servicing problems are consistently relieved by increasing private and public financing to indebted LDC's and forcing debtor countries to adopt IMF-supported adjustment programs. No suggestion is made for principle or interest rate reductions. Lastly, calls for the establishment of an international debt facility through which to process Third world debts have been repeatedly dismissed by Western governments. It is naive of Dell and others like him to suggest that Western nations would not have devised standardized procedures, let alone a detailed agenda, for dealing with LDCs' external debts.

The questions raised in the foregoing literature review provides the overall framework for this thesis. The first issue to be addressed is a fundamental one, whether or not Western nations, in association with international financial

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<sup>19</sup> IBID

institutions, have devised a strategy for containing Third world debt. This thesis demonstrates that Western nations, along with the International Monetary Fund, have indeed devised a strategy for the stabilization of international debts, one that has had a consistent set of objectives. My examination of the Brady and Baker plans will prove that foremost among these objectives has been the stabilization of the international banking community through the recycling of new commercial credit from the banks to the indebted countries and back to the banks in the form of interest payments.

The assumption of an orchestrated Western response to Third world debts raises the second question that will be dealt with in this thesis. The question is, what has been the motivating force behind the West's united response to the problem of Third world debt? I prove that Western unity stems from a shared desire to uphold the soundness of the international banking community and the global financial system as a whole and American leadership from Western countries and banks' willingness to forego this role in favour of the much more experienced Americans.

The next issue to be addressed is the one most often neglected in the literature, how has the West enforced its strategy for the containment of Third world debts? My response is that the International Monetary Fund has become one of the chief means through which Western objectives for debt management have been realized. Since the debt crisis began in 1982 the Fund has taken a number of unprecedented measures designed to normalize relations between banks and indebted

developing countries and in the process foster an increased level of commercial lending to developing countries.

All of these issues will be examined within the theoretical framework of political-economy. The methodology of political-economy is particularly well-suited to an examination of the political and economic aspect of international debt. It provides the underlying principle that politics and economics are mutually interdependent, something that is well borne out by the debt crisis. No financial decisions taken in regards to LDCs' external debts are without their political implications. Nor are any major debt reschedulings accomplished without the cooperation of political institutions.

The concept of power among political-economists is particular relevant to a study of Western containment of developing country debt. Political-economists argue that state and institutional power emerges when individuals and groups realize that united, rather than individual action, is more conducive to the achievement of common goals. This realization is then reinforced by mutual beliefs and common political and economic interests. In the international arena long-term cooperation between states and institutions depends heavily on a shared obligation to protect an ideological and/or moral creed against a common threat or enemy. Cooperation between states and institutions, whether on the national or international stage, eventually pushes to the fore a person or institution that takes command to direct a united response to external change or disequilibrium. Eventually this entity

institutionalizes its authority and develops a residual common purpose, usually consisting of military, economic or political action against a common foe.

Throughout the debt crisis the abovementioned ideas on state and institutional power have been realized on an international scale. A high level of cooperation has developed among creditor governments and institutions as a result of their realization that a strategic agenda for debt management can only be achieved through joint action rather than individual initiatives. The cooperation of Western nations in the face of potential sovereign defaults has been strengthened by a common ideology based on capitalist principles and a shared obligation to protect the free flow of capital and ensure that the international banks and the global capitalist system are maintained in proper working order.

The United States, as anticipated by the tenants of political-economy, has emerged as the leading force among Western respondents to the debt crisis. It has used its political prestige and economic power to direct debt management to the almost exclusive benefit of Western nations and institutions. The creation and promotion of the Baker and Brady plans marked the institutionalization of America's strategic control over management of the debt crisis and revealed the means by which it was to be achieved.

The relationship between the state and business interests has been defined by a number of political-economist as a symbiotic one, in which the modern corporation is rooted in an economy that is controlled by the state. This alliance is reinforced



by shared ideologies and economic objectives, both of which can lead to joint political and economic action.

Symbiosis is an apt description of the relationship that has developed between states and businesses involved in the management of LDCs' external debts. International banks are an integral part of the international financial system that is based upon and guided by the policies of the major industrial nations. Therefore, in the face of a major threat to international finance such as the debt crisis, Western governments and banks have collaborated in order to maintain the system. Their cooperative alliance has been furthered by a shared concern for the maintenance of the international capitalist system and a desire to ensure the stability of one of its most important elements, the international banking community.

The basic objective of this thesis is to present an analysis of the debt crisis that differs from conventional approaches in that it examines the political and institutional aspects of the crisis, rather than just its financial and economic dimensions. The focus of attention will be on the West's strategic response to the problem of Third world debt. A response that has been impelled by concerns for the international banking community and achieved through political and institutional means. Overall, this thesis will demonstrate that the debt crisis is not simply a matter of economic and financial affairs. But rather, a very complex event, whose impact has touched upon the economic, financial and political affairs of creditor and debtor countries, multilateral institutions and international creditor banks.

## **CHAPTER 2:      WESTERN UNITY AND AMERICAN LEADERSHIP IN THE FACE OF THE DEBT CRISIS**

Mexico's announcement in August of 1982 that it was unable to service its foreign debts unleashed a torrent of speculation over the potentially disastrous consequences of widespread sovereign defaults. Because of this intense concern there arose among creditor governments and institutions a willingness to cooperate that eventually led to the United States leading the effort to stabilize the Third world's payments crisis.

Initially, the gravest concern was directed towards the stability of the private creditor banks. Just two months prior to Mexico's announcement, bank claims on developing countries stood at \$268.3 billion.<sup>20</sup> The largest sovereign debtors were in Latin American, with Argentina, Brazil and Mexico owing the most, at respectively \$25.3 billion, \$55.3 billion and \$64.4 billion.<sup>21</sup> All combined, this amounted to 83.6% of the total capital of all the 171 major international banks that reported to the Bank for International Settlements.<sup>22</sup> If all 115 non-oil producing debtor countries had defaulted within one year of Mexico's announcement these

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<sup>20</sup> Charles N. Brower and James B. Hurlock. SOVEREIGN DEBT: RECENT REGULATORY AND LENDING ISSUES AND PRACTICES. New York: Law and Business, Inc./Harcourt Brace Jovanovich, 1983:234, Table 11

<sup>21</sup> Brower and Hurlock 234, Table 111

<sup>22</sup> Brower and Hurlock 234, Table II, 240.

banks would have had a combined deficit of \$27.3 billion and been forced into insolvency.<sup>23</sup>

American banks stood to lose the most from widespread sovereign defaults. They held 36.7% of the total foreign debts of the developing world, and managed an average of 42% of Latin America's loans, compared to the Japanese' 10% and the Europeans and Canadians' combined 48%.<sup>24</sup> The nine largest American banks held \$30.5 billion in Argentinean, Brazilian and Mexican debts, amounting to 112.5% of their total capital.<sup>25</sup> The next fifteen largest American banks also had 81.1% of their capital invested in loans to Mexico, Brazil and Argentina.<sup>26</sup> The banks' position was made even more precarious by the fact that lenient American banking regulations stipulated that banks had to set aside only 1% of their total assets as a provision against debtor defaults.<sup>27</sup> Consequently, banks such as Citibank had an exposure of \$10 billion in South American, but only \$680 million in their loan loss

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<sup>23</sup> James Barth et al. "The International Debt Crisis: Rhetoric vs. Reality" JOURNAL OF SOCIAL, POLITICAL AND ECONOMIC STUDIES Vol.9, No.4, 1984:461.

<sup>24</sup> Barbara Stallings. "The Reluctant Giant: Japan and the Latin American Debt Crisis" JOURNAL OF LATIN AMERICAN STUDIES, Vol.22, Part 1, February 1990:4.

<sup>25</sup> Brower and Hurlock 238.

<sup>26</sup> Brower and Hurlock 240.

<sup>27</sup> Milivojevic 29.

reserves.<sup>28</sup> In contrast Swiss banks were forced to set aside 5% of their capital, while 2-3 % was considered the norm in the rest of Europe.<sup>29</sup>

Official concerns over bank solvency were intensified by the threat of mass withdrawals from the creditor banks. American bankers were concerned that a loss in investor confidence would lead to a rash of depositor withdrawals, particularly by large corporations whose substantial deposits could be withdrawn in the space of a few hours. Furthermore, U.S. banking regulations stipulate that American banks publish a report of their profits every three months, thus making them particularly vulnerable to public perceptions about their financial viability. For all creditor banks, large scale withdrawals and the resultant depreciation of stock values would seriously erode the creditor banks' capital base and assets to capital ratios.

Government and banking officials in the industrialized world were well aware that a loss in the capital base of their international banks, whether due to debt repudiations, interruptions in interest payments or large-scale depositor withdrawals, would have serious economic consequence. William Cline estimated that a decline of \$8 billion in bank capital, caused by one year's loss of income from Brazilian, Argentinean and Mexican loans, would require the nine largest U.S. banks to cut

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<sup>28</sup> IBID.

<sup>29</sup> IBID.

loans outstanding by approximately \$160 billion, thereby reducing the amount of lending capital available to regional banks, business and individual consumers.<sup>30</sup>

The retreat of many banks from the Third world lending market was another reason for official concern. In the U.S. many small or "outlier" banks, were extremely reluctant to participate in sovereign debt reschedulings and refinancings. They preferred to sell off their Third world debts in the secondary market and concentrate their efforts on consumer and business lending and providing services previously monopolized by investment bankers, brokerage houses, insurance agents and real estate firms.<sup>31</sup> In contrast, the large international creditor banks were firmly committed to the Third world lending market. To be otherwise would have endangered debtor countries' ability to service their debts, lowered banks' profit and stock values and further eroded their available lending capital.

Once the initial concerns over sovereign defaults had subsided, officials in the industrialized West, particularly in the U.S., began to realize that a widespread payments crisis would have serious political and economic consequences for the industrialized world. Harsh adjustment measures in debtor countries could cause the overthrow of newly elected Latin American governments and their replacement by

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<sup>30</sup> William Cline. INTERNATIONAL DEBT: SYSTEMIC RISK AND POLICY RESPONSE. Cambridge, Mass: MIT Press, 1984:38

<sup>31</sup> United States Congress House Committee on Foreign Affairs. PROBLEMS OF INTERNATIONAL DEBT. Washington, D.C.: Government Publications Office, August 1 and 8, 1984 :86

right or left-wing extremists. Worse still, in the eyes of Western governments and bankers, was the prospect of civilian governments repudiating, either fully or partially, their external debts or demanding more lenient terms for the refinancing and rescheduling of their sovereign debts.

The prospect of political upheavals in Latin America was of a far greater concern to the Americans than their European, Canadian or Japanese allies. Latin America has great strategic importance for the United States. Any disruption in its political stability or international payments threatened to sour relations between the two areas and force a confrontation over domestic and international interests. Also, American political feared that any large-scale political or economic disruption in Mexico would lead to a tidal wave of immigrants and illegal drugs across the Mexican-American border.<sup>32</sup> Consequently, many politicians felt that unless some benefits were forthcoming to the Latin Americans for their economic sacrifices, there was the possibility that their recent gains towards democracy and economic adjustment would be lost.<sup>33</sup>

The Americans were equally distressed over the potential impact of the payments crisis on their export and labour markets. The debtor countries' policy of

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<sup>32</sup> United States Congress House Committee on Banking, Finance and Urban Affairs. Subcommittee on International Development Institutions, Finance, Trade and Monetary Policy THIRD WORLD DEBT LEGISLATION. Washington, D.C.: Government Publications Office, March 12, 18, 19 and 20, 1986:90,97.

<sup>33</sup> United States Congress House Committee on Foreign Affairs. August 1,8, 1984:58.

servicing their debts by restricting their imports and expanding their exports threatened to have adverse consequences for American's export industries. A considerable proportion of U.S. exports went to the developing world. In 1980, American exports to the Third world accounted for 25% of their total exports.<sup>34</sup> One in three acres of U.S. agricultural land is devoted to exports, which amounts to 40% of U.S. agricultural production.<sup>35</sup> The manufacturing industry, amounting to two thirds of American exports, sent 39% of its products to the Third world in 1980.<sup>36</sup>

Export industries are also an important source of jobs for American labourers. In 1982 exports accounted for five million American jobs, including one out of every eight jobs in the manufacturing industry.<sup>37</sup> On average, it is estimated that for every \$1 billion increase in American exports, 24,000 jobs are created.<sup>38</sup>

Americans' fears over the impact of the debt crisis on their export and labour markets were realized within a year of the Mexican payments crisis. American exports to seven of the largest debtor nations declined from \$34 billion in 1981 to \$18 billion in 1983, amounting to nearly half of the total decline in U.S. exports during

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<sup>34</sup> Brower and Hurlock 79.

<sup>35</sup> IBID.

<sup>36</sup> IBID.

<sup>37</sup> IBID

<sup>38</sup> IBID

that period.<sup>39</sup> Between 1980 and 1985 American trade with Latin American fell by 30.6%, creating a loss of 632,000 jobs by 1985.<sup>40</sup> Furthermore, another 930,000 jobs have been lost which would have been created had LDCs' growth trend of the 1970's continued after 1980.<sup>41</sup>

The potential political and economic consequences of the debt crisis convinced major creditor nations that in order to protect their interests and those of their banks, it was necessary to unite in the pursuit of a common strategy for stabilizing LDCs' debts.

Since the U.S. government and banks had the most to lose from sovereign defaults they assumed responsibility for the creation and implementation of a plan to stabilize Third world debts. The United States was and still is considered by the majority of Western governments and banking officials to be the ideal candidate for this position of leadership. It has the diplomatic skill and management expertise to guide debt renegotiations and the political and financial clout to enforce them. American banks bore the greatest financial exposure to the largest debtors, Mexico,

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<sup>39</sup> United States Congress House Committee on Banking, Finance Urban Affairs Subcommittee on International Development Institutions, Finance, Trade and Monetary Policy. March 12, 18, 19, 20, 1986:10

<sup>40</sup> United States House Congress Committee on Banking, Finance and Urban Affairs Subcommittee on International Development Institutions, Finance, Trade and Monetary Policy. March 12, 18, 19, 20, 1986:10, 170

<sup>41</sup> IBID



Brazil and Argentina, and so were expected by Europeans, Canadians and Japanese bankers to take control of debt renegotiations. As a result, the bank advisory committees that represent the interests of all creditor banks during debt renegotiations are always chaired by an American banker and the majority of the committee members are Americans.<sup>42</sup> There are generally one or two Europeans or Canadians on these committees, with one official from the Bank of Tokyo representing the interest of the Japanese banks.<sup>43</sup>

The Germans and British supported American leadership in order to protect their own financial interests. German and British banks had substantial deposits with the major U.S. creditor banks.<sup>44</sup> So they were reluctant to obstruct the Americans' debt management strategy since it protected their U.S. deposits. The Europeans, Japanese and Canadians were also unwilling to challenge U.S. leadership in the areas of international finance and Latin American relations, since both were considered to be traditional areas of American influence. Latin America was outside the expertise of the Europeans, Canadians and Japanese, so they naturally looked to the U.S. for guidance and leadership in stabilizing Latin America's debts. The Europeans were primarily interested in Eastern Europe's external debts, while the Japanese concerned themselves with the newly industrializing countries of the Far East.

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<sup>42</sup> Stallings 12

<sup>43</sup> IBID

<sup>44</sup> Elmar Altavater et al 57

## **CHAPTER 3: THE POLITICAL RESPONSE TO THE DEBT CRISIS: THE BAKER AND BRADY PLANS**

Within one year of Mexico's payments crisis the United States government and major American creditor banks had, with the full support of the Europeans, Canadians and Japanese, positioned themselves to assume full leadership in the containment of Third world debts. This endeavour involved the combined leadership of the White House, State Department, U.S. Treasury and the U.S. Federal Reserve. Together, these bodies, in consultation with other creditor governments and the international banks, devised a set of priorities that have since become the guiding principles for the West's strategic response to the debt crisis. These principles are as follows:

- debtor countries must expand their export and debt servicing capabilities in order to service their external debts. Industrial nations must contribute to this expansion by improving their own levels of growth and reducing protectionism
- to achieve growth, debtor nations must undergo economic reforms. These reforms must include the privatization of public enterprises, increased domestic and foreign investment, trade liberalization and the reduction of imports
- to fund the economic growth that is required to service and eventually reduce external debts, debtor countries need a continuing supply of external financial resources from commercial banks and official agencies

Western nations viewed this last principle, the supply of external credits, as the key to achieving the successful implementation of the strategy for containing international debts. New bank loans were particularly important in this matter. Commercial credit was expected to facilitate capital formation and economic growth in LDC's, while lessening the adverse effects of structural adjustments. An increase in short-term lending would finance the difficult transition to a more efficient and market-oriented economy and ensure that foreign currency was available to purchase the inputs necessary for the increased production of exports. Multi-year commitments of commercial financing would assist in underwriting the medium and long term-structural adjustment programs necessary for a return to higher economic growth. In addition, new lending by commercial banks would promote the integrity of the banks' Third world assets by allowing for debts to be serviced in a timely manner.

The U.S. Treasury expected dire consequences if the banks halted both short and medium-term lending to the Third world. They foresaw countries being forced to rely on their own internal savings and capital flows from official sources, neither of which could finance LDCs' needed economic reforms. International financial institutions were not expected to willingly accept the role of perpetual supplier of new credit to indebted LDC's, especially if it resulted in a dangerously high level of exposure to unstable Third world debtors. The Treasury Department did not want

American taxpayers being left with the responsibility of bailing out the IMF or World Bank.

Despite the Treasury Department's warnings, few banks were convinced to increase their lending to indebted Third world countries. Many of the small regional banks viewed the provisioning of new capital or even the refinancing of old sovereign debts as "throwing good money after bad". Even the major international banks, though publicly committed to their Third world borrowers, privately voiced concern over the LDC's increasing inability to service their debts.

Bankers' growing antipathy towards the debtor countries threatened to seriously decrease the amount of private lending to developing countries and undermine the West's efforts to impose a framework for the stabilization of international debts. In response to this predicament, the Americans devised a proposal that would combine the West's strategic objective of increasing the level of private commercial lending to LDC's, with the need to ensure the financial integrity of the international banking community. This plan came to be called the Baker Plan.

## **THE BAKER PLAN**

The Baker Plan was first announced before the joint annual meeting of the IMF and the World Bank on October 8, 1985 in Seoul, South Korea. The Plan was not a formal set of guidelines, but rather a series of ideas that the American administration hoped would be voluntarily adopted by debtors and creditors. The Plan's two basic principles were as follows:

- debtor countries should strive for genuine economic adjustments over the medium to long term and direct their economic policies towards development
- the top priority in economic adjustment programs should be the reduction of state intervention in the economy, promotion of market mechanisms, private initiatives and foreign direct investment

Baker expected these goals to be achieved within the context of an expansion of lending to indebted countries. To encourage this Baker called for private and multilateral lending institutions to provide \$29 billion in loans to developing countries over a three year period. The commercial banks would provide \$20 billion and the World Bank and Inter-American Bank for Development, \$9 billion. These funds were to be allocated to the 15 most heavily indebted countries. These countries, called the "Baker 15", included Argentina, Brazil, Mexico, Venezuela, Uruguay, Chile, Ecuador, Colombia, Peru, Bolivia and the Philippines.

The Baker proposal attempted to address some of the key factors that were impeding the flow of commercial loans to the Third world. The first of these was the

uncertainty over debtors' economic stability and their resultant capacity to service their external debts. Attention was focused on the middle-income developing countries of Latin America since their excessive sovereign debts posed a very serious threat to the international banking community. Western observers were distressed that, despite some economic gains in 1983, many Latin American debtors were still undergoing a severe economic crisis that weakened their ability to attract private commercial lending. By 1984 general commodity prices were at an unprecedented low level. The dollar prices for non-oil primary commodities were about 11% lower in 1984 than in 1980. Oil prices, the lifeblood of the Mexican and Venezuelan economies, dropped 16.6% between 1981 and 1985. Furthermore many developing countries were plagued by high inflation and slow growth. In Latin America inflation more than doubled between 1981 and 1984, averaging 117% in 1984. Meanwhile, rising interest rates intensified debtors' struggles to service their debts. As of early 1986 interest rates were 6% higher than inflation, making the cost of servicing debts extremely high in real terms.

Baker thought he could solve debtors' economic problems as well as their failure to attract new commercial credits by calling for private and official financing to the Baker 15 countries to be tied to their implementation and maintenance of sound economic adjustment programs.<sup>45</sup> He believed that increased lending to

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<sup>45</sup> James Baker, "The Baker Initiative", Pedro-Pablo Kuczynski (ed.), Baltimore, Maryland: John Hopkins University Press, 1988:212

debtor countries would only take place where a country had "reasonable prospects" for economic growth.<sup>46</sup> Therefore, he called upon international financial institutions, such as the World Bank and IMF, to renew their efforts to enforce balance of payments adjustments in debtor countries.<sup>47</sup> The IMF was expected to increase its lending in support of the adoption of market-oriented economic policies.<sup>48</sup> While the World Bank's fast-disbursing lending to support growth-oriented policies and institutional and sectoral reforms was to be expanded so as to serve as a "catalyst for commercial bank lending".<sup>49</sup>

Baker was convinced that bankers' reluctance to lend to the debtor countries would disappear once economic reform policies were introduced and countries were able to properly service their external debts.<sup>50</sup> Therefore, he set a goal of \$20 billion in increased private lending to these countries over the three years following the announcement of this plan, 1986-1989.<sup>51</sup>

The second major obstacle to increasing private lending to LDC's was the issue of equal burden sharing. The international creditor banks balked at the idea

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<sup>46</sup> Baker 211

<sup>47</sup> Baker 211

<sup>48</sup> IBID

<sup>49</sup> Baker 214

<sup>50</sup> Baker 216

<sup>51</sup> IBID

of being the primary source of new lending to the LDC's. They felt that the financial burden and risks of restructuring LDCs' debts should be shared equally among all creditor banks and official financial institutions. Large scale lending was becoming too risky to be attempted by an increasingly small number of banks. Since 1982, outlier banks had begun a steady withdrawal from debt renegotiation packages and Third world lending as a whole. For all U.S. banks reporting on the Federal Reserves' "Country Exposure Lending Survey", exposure to the Baker 15 countries declined from 136% of capital in June of 1982 to 54% in December of 1988.<sup>52</sup> By 1985 private lending to LDC's had stagnated, with the rate of new lending being considerably below the 5-7% annual increase called for by the IMF and Bank for International Settlements. The only exception to this was the multi-billion dollar credit packages organized under the auspices of the IMF and involving primarily the large creditor banks. Lou Schirano, Senior Vice President of First Interstate Bank Ltd., spoke for many regional bankers when he said outlier banks could no longer penalize their shareholders by supporting unsound economies within the Third world with increased extensions of credit.<sup>53</sup> He also stated that it was unwise to

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<sup>52</sup> Edwin Truman, "U.S. Policy on the Problems of International Debt" **FEDERAL RESERVE BULLETIN**, November, 1989:731

<sup>53</sup> United States Congress House. Committee on Banking, Finance and Urban Affairs Subcommittee on International Development Institutions, Finance, Trade and Monetary Policy. **THIRD WORLD DEBT LEGISLATION**, Washington, D.C.: Government Publications Office, February 4 and March 9, 1988:38



participate in debt renegotiations packages when international lending was no longer an important part of many regional banks' overall business strategy.<sup>54</sup>

James Baker felt that the problem of equal burden sharing could be solved by supplementing private lending with official lending. He suggested that official lending institutions establish facilities to support commercial lending to the debtor countries. He proposed that the World Bank guarantee a proportion of the principle that was due towards the end of the loan's maturity date. This guarantee was to apply to only principle and not interest. Bankers would obtain this guarantee by paying a fee. The added cost of which would be compensated for by the increased probability that the loan would not fall into default.

Baker also suggested that the World Bank expand its co-financing operations in order to "increase the effectiveness of the Bank in helping its borrowers to attract private financing".<sup>55</sup> These co-financing operations allowed commercial banks to participate with the World Bank in syndicated loans, or to join the World Bank in offering a floating rate credit with a level payment<sup>56</sup>. If interest rates on these loans should increase the World Bank would refinance any outstanding principle at the end of the maturity date, thus ensuring the timely servicing of debts. Co-

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<sup>54</sup> *IBID*

<sup>55</sup> Baker 215

<sup>56</sup> *Syndicate loans* are loans, usually amounting to more than 1 billion, to a single borrower from a consortium of banks.

financing loans offer bankers a potential advantage in that the official financial community is considering imposing a rule whereby any loan from the World Bank be serviced and repaid before all others, regardless of their seniority. Therefore, in the near future banks would stand a far greater chance of having their loans serviced and repaid if they co-finance them with the World Bank rather than commercial banks.

Despite Baker best efforts, his plan proved unworkable for the majority of debtor countries and was rejected by many of the commercial banks. Most of the Baker 15 countries failed to perform economically in a manner that was consistent with the tenant of the Baker Plan. While there had been some improvement in their current account balances, their underlying domestic policies were not consistently directed towards free-market reforms. There were often long delays in negotiating stabilization and structural adjustment programs with the IMF and World Bank and when programs were agreed to governments frequently failed to meet their commitments. Many of these countries resorted to arrears on their external debt payments, rather than negotiate arrangements that would permit the servicing of their contractual obligations. By 1987 the Baker 15 countries had accumulated an estimated \$4.6 billion in interest arrears to commercial banks.

The arrears on interest, coupled with LDCs' economic instability only intensified many bankers resolve to withdraw from the restructuring of LDC's external debts. The share of bank debt in the Baker 15 countries fell from 67% in

1982 to 56% by the end of 1989, while the share of IMF and multilateral development banks' more than doubled during this period, from 7% to 18%.<sup>57</sup>

In the face of debtors' inability to adjust their economies and many bankers refusal to lend new money, Western nations, lead by the U.S., were forced to reconsider the debt management strategy as embodied in the Baker Plan. What was needed was a new plan that would respond to the realities of the Third world lending market, while still maintaining a commitment to economic reforms and increased private lending to debtor countries. After much consultation with creditors and debtors, the U.S. devised the Brady Plan.

Nicholas Brady, Secretary of the U.S. Treasury under the Bush administration, presented his plan on March 10, 1989 at a conference on Third world debt sponsored by the Brookings Institute and the Bretton Woods Committee.

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<sup>57</sup> United States. Committee.House.Committee on Banking, Finance and Urban Affairs. Subcommittee on International Development, Finance, Trade and Monetary Policy. **THIRD WORLD DEBT: PUBLIC REACTION TO THE BRADY PLAN**. Washington, D.C.: Government Publications Office, 1989: 69

## **THE BRADY PLAN**

The Brady Plan called for international efforts to be focused on achieving more rapid and broadly based debt reductions in order to improve LDCs' prospects for strong economic growth. Brady acknowledged in his plan the continuing need for new lending from the private sector, while also placing stronger emphasis on new investment flows and the repatriation of capital flight. The IMF and World Bank were to play a major role by encouraging debtors' economic policy reforms and catalyzing external financial support. The Brady Plan called for a redirection and increase of IMF and World Bank resources towards programs designed to support debt and debt service reduction transactions that had been agreed upon by the commercial banks and debtor nations.

Brady's new strategy resembled Baker's in that one of its central goals was to increase or at least maintain the level of private lending to LDC's. To achieve this the Brady Plan had to surmount the two obstacles that continued to plague American efforts to increase commercial lending to the LDC's; the failure of economic adjustments in debtor countries and the continuing withdrawal of banks from the Third world lending market.

In order to solve these two problems, high level officials in the U.S. first had to admit that LDCs' debt overhang was a serious impediment to their economic reforms and was eroding the economic gains that had been achieved in the late

1970's and early 1980's. Between 1981 and 1988 real per capita income declined in absolute terms in almost every country in South America.<sup>58</sup> Many countries living standards have fallen to level of the 1950's and 1960's. Real wages in Mexico declined by about 50% between 1980 and 1988, while investment in Mexico and Latin America as a whole all but collapsed.<sup>59</sup> The Americans confronted this problem by calling for economic reforms to be combined with debt reductions. In 1989 Assistant Secretary of the U.S. Treasury, David C. Mulford, stated before the U.S. Congress that there would have to be an easing of LDCs' debt burden in order to bring about sustained growth in debtor countries, especially in Latin America.<sup>60</sup> He said that negotiated reductions in debt and debt service burdens must be coupled with new lending in order to stabilize debtors' economies and enable the orderly and timely servicing of their external debts.<sup>61</sup>

Brady believed debt and debt service reductions due to a belief that they would lead to a renewal of economic growth in LDC's and the orderly and timely servicing of external debts. In addition, he expected that a decrease in LDCs' debt

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<sup>58</sup> Jeffrey Sachs. "Making The Brady Plan Work" FOREIGN AFFAIRS, Summer, 1989:93

<sup>59</sup> IBID

<sup>60</sup> United States Congress House. Committee on Banking, Finance and Urban Affairs. Subcommittee on International Development Institutions, Finance, Trade and Monetary Policy. THIRD WORLD DEBT: REPORTS AND THE BRADY PLAN. Washington, D.C.: Government Publications Office, 1989:11

<sup>61</sup> IBID

overhang would foster new investment in LDC's, the repatriation of capital flight and an increase in the flow of new commercial capital to the debtor countries.

The Brady Plan supported the need for debt reductions by encouraging the liberalization of debt rescheduling packages. Brady requested that creditor nations increase their rescheduling of interest as well as principle on official debts. This actions would, indirectly, provide new money and more relief than banks reschedulings. Creditor nations were also called upon to increase their use of Multi-year Rescheduling Agreements (MYRA) during the renegotiations of Third world debts.<sup>62</sup> These agreements would ease a country's debt load and conserve its foreign reserves by placing a cap on the interest payments of external debts and extending the repayment period of the loan. In addition, debtor countries could forego costly debt renegotiation fees and produce more accurate plans for medium-term economic development. The Brady Plan arranged for debt reduction measures to be supported by the infusion of new capital from the industrialized world. The Japanese government was the most generous in this respect. It agreed to provide \$10 billion in support of the financing packages scheduled for Mexico, Costa Rica,

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<sup>62</sup> Multi-year rescheduling agreements are agreements between creditors and debtors to renew a debt renegotiation agreement if the debtor has fulfilled certain conditions, in this case the maintenance of a structural adjustment program.

Venezuela and the Philippines.<sup>63</sup> Also, the American government, through the United States Agency for International Development, pledged to provide concessional resources to both the Philippines and Costa Rica in support of their debt and debt service reductions.<sup>64</sup>

The World Bank and IMF were to contribute to lowering LDCs' debts by redirecting their resources to support debt and debt service reductions by the commercial banks. Brady called for both institutions to provide debt and debt service reductions funding, as part of their policy-based lending programs.<sup>65</sup> He suggested that a portion of these policy-based loans be used to finance some debt reduction measures, such as the buyback of bank debt and the purchase of collateral for debt and debt service reduction instruments and the provision of limited interest support for such instruments.<sup>66</sup> However, Brady stipulated that these financial concessions should only be made available to those countries who were undergoing structural adjustment programs administered by the IMF or World Bank.

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<sup>63</sup> United States Congress House Committee on Banking, Finance and Urban Affairs. Subcommittee on International Development Institutions, Finance, Trade and Monetary Policy. THIRD WORLD DEBT STRATEGY, Washington, D.C.: Government Publications Office, March 21, 1990:21

<sup>64</sup> IBID

<sup>65</sup> Nicholas Brady, "Dealing With the International Debt Crisis", DEPARTMENT OF STATE BULLETIN, May, 1989:55

<sup>66</sup> Brady 20

The commercial banks were the last and most hostile audience that Brady faced in his efforts to increase lending to indebted Third world countries. The U.S. Treasury was quite open instating that the Brady Plan was designed to "harness commercial banks willingness to engage in debt and debt service reductions for the benefit of debtor countries".<sup>67</sup> Brady's means of achieving this was to adopt his plan to the realities of the Third world lending market. This required proposing the use of exit mechanisms as a means for the small and medium-sized banks to withdraw from debt reschedulings in a controlled and structured manner. In making this decision, Brady was responding to the overall trend of banks to reduce their exposure to Third world countries. Between 1986 and 1990 American bank provisions against their developing country loans rose from a minuscule 5% in 1986 to an average of 50% in June of 1990.<sup>68</sup> In Britain, during this same period, they rose from 6-10% to 52-84%, Germany 35-70% to 50-78% and in Japan from 5% to 25-30%.<sup>69</sup> Banks had further reduced their exposure through the use of exit mechanisms, such as debt-for-equity swaps and the selling of Third world loans on the secondary market. On average the nine largest American banks, most of whom carried

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<sup>67</sup> Brady 20

<sup>68</sup> Provisions or loan-loss reserves are those funds a bank sets aside in reserves to cover any major loan defaults.

<sup>69</sup> See the WORLD DEBT TABLES, published by the World Bank.



substantial Third world loans, reduced their exposure to the Baker 15 countries from 201% in 1986 to 92% in 1990.

Brady suggested the use of three mechanisms for debt reductions; exit bonds, buyback of loans with cash and debt-for-equity swaps.<sup>70</sup> A debtor country can get an exit bond by exchanging its bank loans for bonds which have a reduced principle and/or interest rate. Essentially the buyer exchanges a high-risk, high-return asset for a low-risk, low-return one. The purchases, being the debtor country, benefits by avoiding costly debt renegotiations and lowering its debt overhang.

Debt buyback are when a debtor country buys back its own debt, thus gaining the full and immediate benefits of the secondary market price for its sovereign debt.<sup>71</sup>

Debt-for-equity swaps are transactions in which a potential investor buys country debt on the secondary market and then trades it in at the debtor's central banks for local currency which is then used for an equity investment. A bank can exchange its Third world debts in a similar manner by selling its Third world loans to an investor at a secondary market price. The investor then cashes them in for investment capital at the debtor country's central bank.

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<sup>70</sup> Shafiqul Islam. "Going Beyond the Brady Plan". **CHALLENGE** July/August, Vol 32, 1989:44

<sup>71</sup> **Secondary market** is the international market for the selling of Third world debts. The market price for the debt is determined by the debtor's perceived ability to service the loan.

While Brady's plan accommodated those banks wanting to withdraw from Third world lending, it still made provisions for increasing lending from those banks Brady hoped would continue to lend to the Third world. He stated before the Bretton Woods conference that he expected the banks to "remain interested in providing new money" and provide "diverse, active and timely support" in order to facilitate the repayment of commercial bank loans.<sup>72</sup> What Brady essentially wanted was for the major creditor banks to lend new capital to the debtor countries so that economic adjustments could be financed and interest payments sustained.

Brady attempted to achieve this objective by including in his Plan a broader range of alternative for financially supporting commercial lending to LDC's than had been previously offered by the Baker Plan.<sup>73</sup> These alternatives included, in addition to debt and debt serviced reductions, special purpose loans such as trade credits and projects, club loans by a groups of banks and new lending that involved re-lending a portion of the interest due on the existing loan.<sup>74</sup> Through the use of these financial innovations and principle and interest rate reductions, the U.S. Treasury expected that in the three years following the announcement of Brady's plan

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<sup>72</sup> Brady 55

<sup>73</sup> Brady 54

<sup>74</sup> Committee on Banking, Finance and Urban Affairs. Sub-committee on International Development Institutions, Finance, Trade and Monetary Policy. 1989:13 and Mike Faber. "The Shaping of the Brady Proposals" IDS BULLETIN, Vol.21, No.2, 1990:19

the banks would cut about \$70 billion for the \$340 billion owed to them by the 39 countries slated as candidates for the Brady Plan.<sup>75</sup>

The Brady Plan was not widely accepted within the banking community. Many bankers strongly protested Brady's suggestion of combining debt reduction with new lending to LDC's. Some of Britain's most important bankers accused Brady of "living in a dream world" and one top Canadian bankers said that the Brady proposal was "banking under the influence of marijuana".<sup>76</sup> Many of the non-U.S. banks are clearly biased against the suggestion of new lending to the debtor countries. This partly reflects their concern over debtors' economies and a reluctance to enlarge their loan loss reserves to cover any new lending.<sup>77</sup> In addition, they fear that debtor forgiveness would set an unwelcome precedent for future negotiations with debtor countries.<sup>78</sup> The major creditor banks worried that the Brady proposal would create a "free-rider" problem because of its reliance on voluntary debt reduction. A free-rider problem occurs when the partial extinguishing of a country's sovereign debt strengthens the value of other banks' Third world loan portfolios and decreases their incentive to participate in future debt reschedulings. The potential for a free-rider

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<sup>75</sup> Suzanna Andrews, "Slouching Towards Forgiveness" INSTITUTIONAL INVESTOR, May, 1989:88.

<sup>76</sup> Frank Vogl, "Who Cares About Third World Debt", ASIAN FINANCE, May 15, 1990:39

<sup>77</sup> IBID

<sup>78</sup> IBID

problems points to one of the main weaknesses of the Brady Plan. It did not provide for a mediator to organize debt reduction in the most efficient manner possible, so as to ensure that all commercial and official creditors shared equally in the reduction of developing countries's external debts.

Despite these criticisms the Brady Plan was an improvement over the Baker Plan. It had far greater potential to stabilize debtors' economies and to bring them back into the voluntary lending market. However, its central, being a reliance on the banks voluntary participation in debt reductions, precluded its acceptance by the banking community. Very few banks willingly accepted the idea of debt reduction and even few were likely to participate in such an endeavor, especially within the European and Canadian banking communities.

## **CHAPTER 4: THE STABILIZING INFLUENCE OF THE INTERNATIONAL MONETARY FUND**

What little success the Baker and Brady plans had in encouraging bankers to increase or maintain their level of lending to indebted Third world countries was due, in part, to the intervention of multilateral lending institutions, particularly the International Monetary Fund. Since the beginning of the debt crises the IMF has instituted a number of innovations that have been instrumental in ensuring that the flow of private loan capital to the Third world was maintained. The Fund accomplished this through three means: increasing the amount of available economic and financial data on debtor countries, enhancing LDCs' creditworthiness by imposing conditionalities and enforcing debtor countries' medium-term commitment to economic reforms.

The IMF has, since 1982, deliberately altered its country reports in order to make them of more assistance to commercial banks in their evaluating of the risks involved in lending to debtor countries. Bankers call this process of evaluation country risk analysis. Country risk analysis, or CRA, consists of judging the risks associated with investing within a given country and involves analysing any national or international obstacles to a country's timely servicing of its external loans. Such obstacles cover a wide array of economic, social or political forces, such as interest

rate management, external debt obligations, foreign exchange controls, balance of payments deficits, political disruptions or natural disasters.

Previous to 1982, CRA was a poorly defined discipline that was accorded little attention within the international banking community. Few attempts were made to improve information resources and so country risk was often assessed on a bare minimum of knowledge. What information the banks did have was often inaccurate due to the deliberate alteration or obscuring of facts and statistics by borrowing countries and the genuine shortcomings in information gathering in most Third world countries. Many developing countries used inadequate sampling techniques to measure such figures as GNP and exports and imports and just as many maintained only vague figures on their level of sovereign debt. Consequently, bankers were unable to devise precise medium-term economic and financial projections on their borrowers and so could not accurately assess countries' ability to service foreign debts over the medium-term.

Compounding bankers' attempts to assess nations' debt servicing abilities was the paucity of accurate data on sovereigns' external debts. Some countries' bank secrecy laws or regulations prevented banks from releasing information on their customers and precluded national bank supervisors from divulging to other supervisory authorities information which they had acquired in the course of their duties. As a result, bankers lent blindly to countries that were already heavily

indebted and would be perilously close to default if a major disruption occurred in the global economy or international financial system.

The lack of information on external debts was only made worse by the shortcomings within the information provided by multilateral institutions. The Bank for International Settlements publishes quarterly and semi-annual reports on bank lending to various countries, but because of the time lag between data collection and publication, the information is often out of date by four to eight months. Likewise, the World Bank's World Debt Tables, which can be outdated by as much as two years. The country reports that the World Bank compiles are for its own use and not readily available to outside sources.

The Organization for Economic Cooperation and Development provides annually in their report, "External Debts of Developing Countries", a comprehensive list of public and private debts outstanding. But, like the World Bank's data, it is not unusual for there to be two years between the collection of data and its publication in the OECD's report.

The International Monetary Fund produces a monthly report called, "International Financial Statistics" which incorporates regular data on member countries' balance of payments and gold and foreign exchange reserves. While these statistics are an important data source for the banks they represented only a small portion of the country data that the Fund was willing to publish in the years preceding the debt crisis. The IMF's tradition of confidentiality with its member

countries and the need to protect a country's bargaining position during negotiations for new loans, necessitated a distant relationship with commercial banks. Consequently, aside from its publications and press releases, it had no formal agreement to share information with outside organizations, regardless of the economic or financial status of the member country.<sup>79</sup> The shortcomings in bankers' CRA became of international importance when Mexico announced its payments difficulties in 1982. Western governments, especially the United States, became intent on seeing that new and more accurate country data was made available to LDCs' creditors. They feared that if this information was not forthcoming banks would overestimate LDCs' debt servicing problems and withdraw totally from the Third world lending market.

Since it was the American banks that were expected to be at the forefront of new lending to debtor countries it was their government, under Ronald Reagan, that took the initiative in calling for the freer exchange of country information. In May of 1983 it passed the Bretton Woods Agreements Act Amendments. This act stipulated that the "Fund should adopt necessary and appropriate measures to ensure that more complete and timely financial information" be made available.<sup>80</sup> The

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<sup>79</sup> Irving S. Friedman. THE WORLD DEBT DILEMMA: MANAGING COUNTRY RISK. Philadelphia, Pennsylvania: Robert Morris, 1983:65

<sup>80</sup> Charles N. Brower and James B. Hurlock. SOVEREIGN SOVEREIGN: RECENT REGULATORY AND LENDING ISSUES AND PRACTICES. Philadelphia, Pennsylvania: Robert Morris, 1983:57



U.S. Executive Director at the Fund was instructed, as part of the Act, to initiate discussions with other Fund directors on the adoption of new procedures designed to "disseminate publicly" information garnered in the course of Fund analysis.<sup>81</sup> This would provide an enhanced informational base upon which international borrowing and lending decisions could be made.<sup>82</sup> Furthermore the Executive Director was to propose to the Fund's other executive directors that the Fund intensify its examination of the trend and volume of the external indebtedness of private and public borrowers within member countries.<sup>83</sup>

The American banks joined their government in calling for the IMF to be more liberal in its dissemination of sensitive country data. An number of bankers demanded that the IMF provide more data about borrowing countries to the banks.<sup>84</sup> Rimmer de Vries, Senior Vice-President of Morgan Guaranty Trust, argued that the Fund could help the international lending market by providing the country data and information that was essential to bankers' assessment of credit risk and the making of sound loans.<sup>85</sup> Other bankers went further by calling for the

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<sup>81</sup> Brower and Hurlock 58

<sup>82</sup> IBID

<sup>83</sup> Brower and Hurlock 67

<sup>84</sup> Lawrence Rout. "Some Commercial Banks Press the IMF To Provide Data on Borrowing Nations" WALL ST. JOURNAL, April, 1, 1983:16

<sup>85</sup> Richard J. Herring. MANAGING INTERNATIONAL RISK. Cambridge, England: University of Pennsylvania Press, 1982:183

Fund to set lending ceilings on debtor countries as part of their structural adjustment programs and establish mechanisms by which bankers could be warned of impending difficulties in debtor countries.<sup>86</sup> Karen Lissakers viewed the IMF as the "natural one" to relay these warnings to the commercial banks.<sup>87</sup>

## **COUNTRY DATA**

### **BANKING ACTIVITY**

In light of the declining activity in the Third world lending market and the demands of the American banks and government, the IMF had little choice but to expand its analysis of country data and widen the pool of institutions receiving this information. One of the first shortcomings in country data that it addressed was bank activity. In 1984 the Fund initiated an organized system for monitoring international banking activity. It began discussions with the leading bankers of certain countries about the regional flows of private capital between creditor banks and debtor nations.<sup>88</sup> In the same year the Fund introduced, in its "International Financial Statistics", international banking statistics that assessed the external liabilities and assets of the banking system of each member country. This information provides an

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<sup>86</sup> Rout 16

<sup>87</sup> IBID

<sup>88</sup> Paul Mentre, THE FUND, COMMERCIAL BANKS AND MEMBER COUNTRIES, Washington, D.C.: International Monetary Fund, 1984:25

extensive database for the measuring and analysing of international banking activity. Its timeliness is ensured by the fact that there are only three months between the collection and publication of data. To achieve a high level of accuracy this information is compared to other data supplied by member countries and international banking centres.<sup>89</sup> The Fund has made these statistics more comprehensive by integrating them with other data sources, including the World Bank's "Debtor Reporting System", which comprises information on public and publicly guaranteed long-term sovereign debt and the OECD's information on sovereigns' official development assistance and guaranteed export credits.<sup>90</sup>

## ECONOMIC AND FINANCIAL COUNTRY DATA

The second informational gap in CRA that the IMF confronted was that of the economic and financial status of member countries. In 1984 the Fund introduced into its staff reports on developing countries two innovations that were its first step in broadening the scope and accuracy of its coverage of countries' economic and financial activities. The first of these innovations was the inclusion of information on the country's relations with the World Bank, at times including the Bank's assessment

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<sup>89</sup> Hassanali Mehran. EXTERNAL DEBT MANAGEMENT. Washington, D.C.: International Monetary Fund, 1983:166

<sup>90</sup> International Monetary Fund. "Fund's Compilation of International Bank Data Will Aid in Debt Activities" IMF SURVEY, June 18, 1984:187

of the country's investment or development program and other policy issues studied by the Bank.<sup>91</sup> Second, was a review of the development and policies changes that had taken place in the country since its last consultation with the Fund.<sup>92</sup> Particular emphasis was laid assessing the countries' implementation of Fund-supported structural adjustment programs.

The Fund's also began to pursue closer ties with the World Bank. It now regularly attends the World Bank's consultative group meetings that are designed to promote aid flows to individual developing countries. At these meetings, the Fund is responsible for providing an overview of country's macroeconomic situation.<sup>93</sup> In turn, the World Bank provides assistance to the IMF in judging developing countries' public sector investment programs, public enterprise operations, pricing policies, tariff reforms, import liberalization and sectoral productivity analysis.<sup>94</sup>

Fund surveillance and later, enhanced surveillance provided the existing framework for the IMF's establishment of a more thorough method of investigating member's economic and financial status and improving the available information base for the banks' employment of country risk analysis. Country surveillance consists of

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<sup>91</sup> International Monetary Fund. ANNUAL REPORT. Washington, D.C.: International Monetary Fund, 1985:46

<sup>92</sup> IBID

<sup>93</sup> IBID

<sup>94</sup> IBID

consultations between Fund and country officials every year and a half to two years. During these meetings are reviewed member's policies and all institutional and statistical information aspects of their balance of payments. Consultations are followed by evaluations of the effectiveness of the country's economic policies since the last consultation and advice is given to members about how their policies might be modified in the coming year.

By the mid to late 1980's the IMF began to alter its country surveillance in order to meet its widening obligations in the area of country data collection. The Executive Board decided that the scope of surveillance would be expanded to include assessments of members' domestic economic policies. Fund staff reports on regular surveillance would now provide "candid appraisals" of member's economic policies and clearly outline the analytical basis for these policies.<sup>95</sup> Also, the coverage of information notices, used to monitor key developments that occurred between regular surveillance, was enlarged in 1987 to cover a greater range of changes within member economies.<sup>96</sup> Indicators would be employed to act as guidelines in identifying countries' economic policies and to help in detecting deviations from accepted methods of structural adjustment.<sup>97</sup> Economic indicators were expanded to

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<sup>95</sup> International Monetary Fund. ANNUAL REPORT. Washington, D.C.: International Monetary Fund, 1986:34

<sup>96</sup> IBID

<sup>97</sup> International Monetary Fund. ANNUAL REPORT, 1986:34

measure economic performance, including output growth, inflation, unemployment and the balance of payments, while policy indicators now covered, among other things, monetary growth and fiscal deficits.<sup>98</sup>

The Fund's creation of Enhanced surveillance was its second attempt to improve country data. Enhanced surveillance reports provide vital country data that is not available except during regular surveillance periods. The reports are produced in between surveillance periods and present a wide array of indepth information on countries' financial situation, major macroeconomic objectives and economic reform policies. These papers are supplemented by Fund staff reports on the viability of the country's structural adjustment program.<sup>99</sup> Since enhanced surveillance, as well as surveillance, reports are now passed directly onto a country's commercial creditors, they greatly enhance the banks' ability to accurately judge a country's debt servicing capabilities and provide a reliable database on which to make sound lending decisions.<sup>100</sup>

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<sup>98</sup> **IBID**

<sup>99</sup> International Monetary Fund. "Enhanced Surveillance". **IMF SURVEY**, September, 1989:8

<sup>100</sup> International Monetary Fund. **ANNUAL REPORT**, Washington, D.C: International Monetary Fund, 1987:42.

## DEBT STRUCTURE

Within two years of Mexico's payments crisis, the Fund began to adopt measures to improve its information on countries' external debt structure. The first initiative in this area was the formation of a working group of multilateral institutions charged with the task of collecting data on countries' external debts. This group, called the "International Compilers' Working Group on External Debt Statistics", agreed in March of 1984 to develop a common framework for external debts statistics and to explain to the public the concepts and coverage of measures published by each organization.<sup>101</sup> Among its objectives was to achieve the freer exchange of information on external debts between multilateral organizations and to publish annually a report on each member countries' level of foreign debt.<sup>102</sup> Most importantly for bankers was the group's decision to concentrate its efforts on those liabilities on which a contractual obligation to repay existed, thus covering all sovereign debts to private banks.<sup>103</sup> Upon the conclusion of the meeting it was agreed that the Fund would begin to receive from the OECD information on guaranteed export credits granted to individual developing countries. This information

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<sup>101</sup> Mehran:35

<sup>102</sup> Mehran:170

<sup>103</sup> IBID

would enable the Fund to publish a more detailed breakdown of countries' external debts.<sup>104</sup>

The IMF further enhanced its information on country's debt structure by making a decision in 1984 to include in its surveillance reports more "in-depth and systematic" information on countries' debt position.<sup>105</sup> All consultation reports on countries involved in large-scale external borrowings would now contain a review and analysis of the country's external debts and a technical projection on the country's ability to service its debts in the medium-term.<sup>106</sup> These technical projections provide banks and multilateral institutions with the proper background with which to judge member countries' debt policies and debt servicing capabilities.

The Fund's efforts to compensate for the shortcomings in bankers' CRA would have been of little consequence had it not abandoned its once distant relationship with the commercial banks. In 1984 the Fund started to seek out more direct contacts with commercial banks. In most cases the purpose of these contacts was to gain a better insight into the relationship between private creditors and sovereign debtors and the capital flows of particular countries.<sup>107</sup> Less formal contacts between Fund and bank officials often took the form of ad hoc or casual meetings between

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<sup>104</sup> IBID

<sup>105</sup> Mentre 23

<sup>106</sup> IBID

<sup>107</sup> Mentre 25



bank officials and the Fund's capital market specialists, heads of departments or even the Managing Director.<sup>108</sup>

By 1987 these casual arrangements proved incapable of satisfying the banks' growing need for information on debtor countries' economic and financial status. Consequently, the Executive Board of the Fund decided that with its authorization, staff reports or individual country data, including consultation reports and papers presenting a member's request for the use of Fund resources, could be released to creditor banks.<sup>109</sup> Furthermore, the Executive Board made the decision in 1991 to allow institutions assisting member countries with economic reforms access to a wider range of Fund country documents, but only on the condition that remained confidential.<sup>110</sup>

## CONDITIONALITY

As a result of the debt crisis the conditionality on Fund loans has taken on unprecedented importance within the international banking community. To bankers, conditionality has become an important measure of a country's creditworthiness. If a country is implementing one of the Fund's adjustment programs bankers view it as

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<sup>108</sup> IBID

<sup>109</sup> International Monetary Fund. ANNUAL REPORT 1987:35

<sup>110</sup> IBID

a more appropriate candidate for new lending than a country not undergoing structural adjustment.

Fund conditionality has achieved this status because of the extreme uncertainty that has characterized Third world lending since 1982. The near default of some of the world's largest sovereign debtors and the implications for the banking community convinced most bankers of the importance of having a standardized format for judging a country's creditworthiness. Such sentiments were the first of their kind for the international banking community. Prior to 1982 sovereign creditworthiness, like CRA, was not given much attention by commercial bankers. There existed a confusing array of methods to assess nations' ability to service their debts. Some analysts tried to transfer the tenants of corporate creditworthiness to countries by arguing that a country was insolvent only when its real interest payments on foreign borrowings exceeded its national income. A liquidity problem only arose when a country was unable to obtain the foreign exchange necessary to servicing external debts. Other bankers insisted that one take into account the country's political stability, domestic economic policies and willingness to service its debts. Some took a different approach by suggesting that expectations on the proper servicing of debt depended not so much on the borrowers, as on the banks' spreading the risk of sovereign lending by using syndicate loans, geographically diversifying lending and withdrawing loans or at least reducing banks' exposure before debt servicing was interrupted.

The careless nature of sovereign creditworthiness procedures changed almost overnight when Mexico announced its payments crisis in 1982. Bankers became convinced that debtor countries would have to adopt certain reforms measures if they were to be considered creditworthy and eligible for new loans. In essence these reforms became the new criteria for assessing debtor country's creditworthiness.

The first of these criteria was the efficient use of new credit. It was extremely important to the banks that new money lent to indebted countries not be lost to corruption, capital flight or unproductive ventures. Secondly, bankers wanted debtor countries to institute a series of neo-classical economic policies designed to garner the foreign capital with which to service external debts. Lastly, bankers required assurances that countries would adhere to these economic reforms over the life of a medium-term loan, usually 3-5 years. They felt that without a set of proper economic guidelines debtors' balance of payments and foreign currency reserves would fluctuate and debt servicing would become extremely unpredictable. Such a situation would leave bankers very reluctant to lend debtor countries anything but very short-term loans, if even that.

With these new criteria in mind, bankers began to look towards the Fund as the institution best suited to devising and enforcing improved standards of creditworthiness in indebted developing countries. The Fund was the only real candidate for this position. Only it had the political influence, technical expertise and

financial resources to carry out such a task and it already had in place a system for legally enforcing changes within debtors' economies, namely, conditionality.

Conditionality, while it provided the basic framework for economic reforms, was too lenient to enforce the extensive economic changes demanded by the international financial community. So it became necessary for the Fund to increase the scope and enforcement of conditionality in order to satisfy debtors' need for economic reforms and the banks' new, stricter standards of sovereign creditworthiness. The Fund achieved this by creating two new facilities, the Structural Adjustment Facility and the Enhanced Structural Adjustment Facility and altering two existing facilities, the Compensatory Financing Facility and the Extended Fund Facility.

#### **EFFICIENT USE OF NEW LENDING CAPITAL**

The Fund employed a number of means to meet the bankers' criteria for the efficient use of new capital in member countries. The first of these were the changes made to the Compensatory Financing Facility in 1988 (here after it will be called by its present name, the Compensatory and Contingency Financing Facility, or CCF). The most important of these changes was the introduction of measures to strengthen Fund control over the efficient use of the contingency part of the loan. Now a limit is set to the maximum amount of contingency funds that can be disbursed in the case of unfavourable external developments which threaten a nation's economic reforms.

No funds can be released until the IMF is satisfied that the country is making viable progress towards adjusting its economy.<sup>111</sup> The Fund has sole control over the maximum amount of contingency financing that is available if the recipient veers from its adjustment program. In order to ensure that the amount of conditional funding released is not excessive in relation to the member's needs the Fund includes in CCFF agreements the stipulation that the amount of contingency financing be determined by the amount of the country's balance of payments deficit in a given period of time.<sup>112</sup>

Equally strict measures have been instituted by the Fund over the use of financing under the Structural Adjustment Facility. Structural Adjustment Facility, or SAF, loan agreements stipulate that the amount of funding supplied over the three years of the agreement be determined before the money is released, rather than on an annual basis.<sup>113</sup> The annual releasing of the financing is only permitted if the Fund approves of the member's efforts to adjust and if the country can prove that the money is required for balance of payments assistance.<sup>114</sup> If neither of these

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<sup>111</sup> International Monetary Fund. ANNUAL REPORT. Washington, D.C.: International Monetary Fund, 1989:86

<sup>112</sup> IBID

<sup>113</sup> International Monetary Fund. ANNUAL REPORT, 1986:96

<sup>114</sup> IBID

criteria are met than the Fund halts financing, regardless of its commitment to a three year lending period.<sup>115</sup>

The use of Policy Framework Papers on SAF loans allows the Fund even further control over the use of its credit. Policy framework papers are prepared by country members seeking to receive a SAF loan. These papers contain detailed descriptions of the country's major economic problems and priorities, structural adjustment policies and most importantly, estimates of its external financing needs and the sources of such funding.<sup>116</sup> Policy framework papers help the Fund to set a limit on the size of its SAF loan and avoid a situation in which a sudden influx of excessive concessional financing leads to the inefficient use of capital and the weakening of a country's structural adjustment program.

Fund indicators are another check on a country's use of IMF loans. Indicators evaluate the efficacy of a member's economic reforms by assessing them against a wide range of benchmarks, including a country's level of indebtedness, number of arrears, growth performance and recent and projected behaviour of current account reserves.<sup>117</sup> Indicators are usually integrated into the country reports of those nations undergoing structural adjustments. These reports are then made available to the country's commercial creditors.

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<sup>115</sup> IBID

<sup>116</sup> International Monetary Fund. ANNUAL REPORT, 1986:93

<sup>117</sup> IBID

## **DOMESTIC ECONOMIC REFORMS**

The IMF felt that bankers' demands for economic reforms in debtor countries could be met by the replacement of LDCs' statist economic policies with free-market economic reforms designed to generate the foreign reserves with which to service external debts. These reforms hold out the promise that in an environment of global economic growth developing countries will be able to re-invigorate their economies through the privatization of inefficient government enterprises, expansion of export industries and eventual return to a level of creditworthiness acceptable to the banking community. With these expectations in mind, IMF officials vigorously pursued the expansion of conditional lending, with the result that the vast majority of the financial disbursements since 1982 have had medium to high conditionalities on them.

The IMF achieved this high proportion of conditional lending through the alteration of its Contingency and Extended Fund facilities and the creation of the Structural Adjustment Facility and Extended Structural Adjustment Facility. The Extended Fund Facility, or EFF, was originally created in 1974 to assist member countries in meeting external payments problems over a longer period and in larger amounts than were available under stand-by arrangements. In 1988 the Interim Committee of the Fund decided that increased EFF funding would only go to those members who were undergoing strong adjustment efforts supported by the

Fund.<sup>118</sup> To make this change more palatable to member countries the Committee extended the life of a EFF loan from three to four years.<sup>119</sup> Michel Camdessus, formerly Managing Director of the Fund, stated that with these changes, the EFF would become a more effective instrument for supporting the Fund's adjustment programs in member countries and catalyzing other sources of financing for members, primarily commercial credit.<sup>120</sup>

The Compensatory and Contingency Financing Facility underwent similar changes. It, in addition to providing the traditional compensation for shortfalls in export receipts or excesses in the prices of cereal imports, would now provide members with extra financing, but only if they were already pursuing strong adjustment measures.<sup>121</sup> The Fund stated openly upon creating the CCFF that it was now geared towards helping countries to maintain the momentum of their adjustment measures in the face of adverse external shocks.<sup>122</sup>

The SAF and the ESAF were deliberately created for the purpose of propping up economic reform packages in debtor countries. The SAF, developed in March of

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<sup>118</sup> International Monetary Fund. "Fund to Launch External Contingency Mechanisms; Revamps EFF" IMF SURVEY, April 18, 1988:118

<sup>119</sup> IBID

<sup>120</sup> International Monetary Fund. "The IMF: Facing New Challenges: An Interview with Michel Camdessus" FINANCE AND DEVELOPMENT, June, 1988:3

<sup>121</sup> International Monetary Fund "Fund's General Resources Available to Members Under Various Policies", IMF SURVEY, September 1988:11

<sup>122</sup> IBID



1986, provides resources on concessional terms to only those low-income member countries that are facing protracted balance of payments problems as a result of implementing a structural adjustment program.<sup>123</sup> Its objectives are to help member countries establish the conditions for sustained growth, strengthen their balance of payments position and facilitate orderly relations with creditors.<sup>124</sup> These loans are disbursed annually over a three year period, but only if members can prove that they are adhering to their agreed structural adjustment program.<sup>125</sup> If the Fund believes that adjustment programs have not worked and that corrective measures are necessary, the program will be altered and reinforced during the next annual review process.<sup>126</sup>

The ESAF resembles its predecessor, the SAF, in its objectives, eligibility and basic program features. Where it differs is in the intensity of the provisions it uses to force members to adhere to their agreed structural adjustment program. Recipients of ESAF loans must not only devise a policy framework paper and a detailed annual program, but also undergo Fund surveillance throughout the three year life of the agreement. This surveillance consists of quarterly benchmarks, semi-

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<sup>123</sup> International Monetary Fund. "Enhanced Surveillance" IMF SURVEY, September 1989:2

<sup>124</sup> International Monetary Fund. "Compensatory and Contingency Financing Helps Members Adjust to External Shocks" IMF SURVEY, August 1989:12

<sup>125</sup> IBID

<sup>126</sup> International Monetary Fund. ANNUAL REPORT, 1986-94

annual performance reports and in most cases, mid-year reviews.<sup>127</sup> Countries receiving these loans are expected to be enforcing strong adjustment efforts aimed at fostering growth and achieving a substantially strengthened balance of payments positions.<sup>128</sup> Because of the strong adjustment measures that are capable under the ESAF the Executive Board of the Fund decided in 1990 that countries should be encouraged to adopt programs warranting ESAF support "as early as possible".<sup>129</sup> In this way the IMF has a far greater opportunity to monitor the track record and viability of member's adjustment measures than if the country was under a SAF loan.<sup>130</sup>

#### COMMITMENT TO STRUCTURAL ADJUSTMENTS

Fund officials are aware that bankers view the agreement to adopt economic reforms as only the first move in a debtor country's return to creditworthiness. A second and more important step is the country's medium to long-term commitment to these reforms. In order to achieve this criteria the Fund has integrated into CCFF, SAF and ESAF agreements conditions which are designed to monitor the

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<sup>127</sup> International Monetary Fund. "Enhanced Surveillance" IMF SURVEY, September, 1989:2

<sup>128</sup> IBID

<sup>129</sup> International Monetary Fund. ANNUAL REPORT, Washington, D.C: International Monetary Fund, 1991:51

<sup>130</sup> IBID

enforcement of a country's commitment to structural adjustments over the medium-term.

The SAF and ESAF both last three to four years, which coincides with the banks' perception of a medium-term lending period. The SAF and ESAF both employ the use of benchmarks. Structural benchmarks address key structural policies, while financial benchmarks are employed every three months to measure monetary, fiscal and external debt variables.<sup>131</sup> Any deviations from these benchmarks would be taken into account in assessing subsequent annual programs.<sup>132</sup> Benchmarks help the Fund, as well as creditors, to assess a countries' commitment to structural adjustments and if necessary, to reinforced these reforms over the life of the loan period.

In addition to having to meet certain benchmarks, countries receiving SAF and ESAF loans must also undergo a periodic assessments of their economic adjustments, annual surveillance reviews and in the case of the ESAF, semi-annual performance reviews and mid-year assessments.

The CCFF has no specified monitoring techniques. Instead the Fund chose to leave the choice of monitoring techniques up to the discretion of the officials responsible for constructing each three year CCFF loan agreement. The rules of these agreements give Fund officials wide enforcement options by stipulating that

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<sup>131</sup> IBID

<sup>132</sup> IBID

purchases made under the contingency financing section of the CCFE are subject to the observance of "any applicable performance criteria" as is thought necessary by Fund officials.<sup>133</sup>

Monitoring techniques such as surveillance reports and performance reviews, help to reassure bankers that at least in the medium-term, countries' commitment to structural adjustments will be closely monitored and enforced by the IMF.

Despite the Fund's accomplishments in bringing a heightened degree of order and stability to Third world lending, there are still many areas of concern that have yet to be addressed. Bankers fear that structural adjustment programs may conflict with their needs and encourage debtors to seek medium to long-term loans before their economies are fully stabilized. Also, the very ability of structural adjustment programs to reform debtors' economies and generate increased foreign reserves has been questioned by a number of analysts. Unfortunately it is impossible for the Fund, as a public institution, to respond fully to these and other concerns of private institutions such as banks. Bankers can only be assured of the full servicing of their loans when both the developed and developing worlds return to a increased level of economic growth.

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<sup>133</sup> International Monetary Fund. **ANNUAL REPORT**. Washington, D.C.: 1989:87

## **CHAPTER 5: CONCLUSION**

When Mexico announced its payments crisis in 1982 many feared that the ensuing debt crisis would bankrupt many of the largest creditor banks. This environment of uncertainty forced Western nations and their banks into an unprecedented alliance designed to enforce a debt management strategy that would minimize the risks to the creditor banks by ensuring an uninterrupted flow of debt payments from the debtor countries to their creditor banks.

The Baker and Brady plans attempted to enforce this strategy by overcoming the major obstacles to continued private lending to the debtor countries. Baker believed that by tying new lending to economic structural adjustments he could ease bankers' concerns over the interruption of debt servings due to LDCs' economic instability. Baker sought to address the issue of equal burden sharing by encouraging the IMF and World Bank to join commercial banks in new lending to developing countries. Brady faced the same problems as Baker, but took a more realistic approach to their resolution. He persisted in calling for the reform of debtors' economies, but recognized that principle and interest payments reductions were a precursor to the successful adjustment of debtors' economies. Brady arranged for reduction efforts to be supported by the IMF, World Bank and American and Japanese governments. He was convinced that by reducing LDCs' debt overhangs

he could promote debtors' structural reforms and return them to an acceptable level of creditworthiness on the international lending market.

The IMF's role in Western management of the debt crisis has been to act as a stabilizing force. It has returned some degree of normalcy to Third world lending and established a new set of criteria by which banks can conduct their lending to Third world countries. Through its country data gathering efforts and the use of conditionality it has brought a greater degree of order and stability to relations between the banks and Third world sovereign lenders. Because of the Fund's efforts to expand and improve the accuracy of its country data, banks are now able to make responsible lending decisions based on reasoned analysis and not anxious speculation. The IMF's country data is at present the only readily available data base that is consistent from country to country and comprehensive enough to meet the needs of the banking community. Fund conditionality, in the form of structural adjustment programs, provides bankers with the first internationally recognized format for assessing the creditworthiness of Third world borrowers. In addition, conditionalities provide the lending community with at least some assurance that their new money loans to LDC's will be used efficiently and for economic adjustment that will provide for the servicing of external debts over the medium-term.

The West's successful stabilization of Third world debts now affords both creditors and debtors the opportunity to address the most debilitating aspect of the

debt crisis, LDCs' debt overhangs. No debtor country can make any substantial gains towards economic growth until their external debts are reduced.

Debt reductions need no longer be viewed as a threat to the creditor banks. The banks are now in position to absorb substantial losses on their Third world loans without any risk to their continuing operations or solvency. Since 1989 U.S. money-centred banks have had, on average, 30% of their Third world loans covered by loans loss reserves, while in Europe, banks have 90-100% of their Third world portfolio covered by their reserves.<sup>134</sup> Selling off part of their Third world portfolio would not lower the value of banks' remaining loans since the value of the market has already recognized their value. In 1989 the secondary market price for Mexico's debts was .40 cents on the U.S. dollar, Brazil's, .32 cents and Argentina's .18 cents.<sup>135</sup> In addition, the banks have a moral obligation to take responsibility for their overlending of the 1970's. Neither First or Third world taxpayers have an obligation to bail out the banks for their bad loans. Furthermore, future bankers may be more cautious in their lending if they are forced to accept responsibility for their previously irresponsible lending. Contrary to bankers' arguments, debt reductions offer them an important advantage. Debt reductions can improve the economic performance of the debtor countries and thereby the ultimate value of their creditors' portfolio. They will also end the uncertainty around banks' Third world loans and

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<sup>134</sup> Jeremy Main. "A Latin Debt Plan That Might Work". **FORTUNE**, April 24, 1989:208.

<sup>135</sup> **IBID**

allow the banks to collect what payments they can while debtor countries are still able to service their debts. A number of banks have begun to recognize the value of debt reduction. The American Express Bank unveiled in 1988 a plan for massive debt write-offs by the commercial banks and relief for debtor countries.<sup>136</sup> The plan suggested that banks sell off their Third world debt to an international debt facility at the current secondary market price, which would be on average .50 cents on the American dollar.<sup>137</sup> The Bank believes that if developing countries were forced to service their full debts, their ability to pay would seriously deteriorate and the value of bank-held debts would fall to as low as .25 cents or .20 cents on the American dollar.<sup>138</sup>

The Japanese have been particularly strong supporters of debt reduction for the developing world. They are eager to settle Latin America's debt problems so that they can expand their export markets into this area and become a major source of commercial capital to the Latin Americans.<sup>139</sup> Japanese bankers are now beginning to pressure their governments into giving them larger tax breaks for sovereign loans that have been written down.<sup>140</sup>

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<sup>136</sup> Jeffrey Sachs. "The Debt Crisis at a Turning Point". CHALLENGE, May-June, 1988:22.

<sup>137</sup> IBID

<sup>138</sup> Sachs 23

<sup>139</sup> Main 208

<sup>140</sup> The Economist. "Japanese Banks and Brady: A Yen For Bradizawa". THE ECONOMIST. March 25, 1989:91



Debt reductions should be instituted as part of the World Bank or IMF's structural adjustment programs. This would provide the institutional setting necessary for overcoming the free-rider problem. These debt reductions must be negotiated through comprehensive agreements between all or most of a country's official and private creditors. This would ensure that the writedown of debts is shared evenly among all creditors, both official and private. Debt reductions should be of a size that allows debtors to forego future debt reschedulings and return them to an acceptable level of sovereign creditworthiness. There should also be strict conditionalities on debt reductions. It makes little sense to reduce the level of LDC's debts if the money saved is not used wisely and responsibly towards rebuilding debtors' economies and reversing the deterioration in the living standards of the poor and middle class.

However, debt reductions do not offer the final solution. Debtor countries will never fully recover from their payments crisis unless there is a renewal of economic growth in the industrialized world. Until this happens all that debtors and creditors can do is to mitigate the consequences of the crisis and ensure that debtors' are in a position to quickly exploit any renewal of growth in the industrialized world.

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