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Dieter Bender\*

# Financial Innovation and International Debt Problems

*Financial innovations are viewed almost universally as a new dimension in international debt management. The following article analyses the direct and indirect effects of using various types of new financial instrument to ease the debt burden. It considers the question whether new forms of international debt management might increase the effectiveness of debt relief programmes and examines specifically whether financial innovations such as debt-equity swaps, debt-bond swaps and similar arrangements at the level of intergovernmental debtor-creditor relations can help overcome international debt problems.*

Contrary to earlier more optimistic forecasts, the growth in the external debt of Third World countries again accelerated rapidly in 1985 and 1986 and slowed down only slightly in 1987 (see Table 1).

The debt ratio (debt as a percentage of exports of goods and services) rose from 82 in 1980 to 169 in 1986 and the debt service ratio (interest and redemptions as a percentage of export earnings) increased from 13 to 22 over the same period. Although the figures for 1987 were below these record levels (158 and 20 respectively), it is still too early to speak of an easing of the international debt problem; the data are too global and too short-term to be taken as proof of a lasting improvement.

The debt situation is far worse than these global figures imply in Latin America, where the debt ratio rose from 183 in 1980 to 349 in 1986 and the debt service ratio increased from 33 to 45, and in African developing countries, where it is mainly the Sub-Saharan states that are facing debt problems. It is these countries in particular that contributed to the rise in the regional debt ratio from 92 in 1980 to 241 in 1987 and in the regional debt service ratio from 14 to 25 over the same period.

A breakdown according to country (see Tables 2a and 2b) shows that the debt indicators for the problem debtor countries are considerably higher than the overall regional figures and do not always follow the regional trend. This can be seen, for example, in the ratio of debt to exports for Argentina, Peru, Brazil and Mexico in Latin America and for Burundi, Madagascar, Mali and

Somalia in Africa, and recently also in the ratio for Nigeria.

## Debt Crises: Symptoms and Causes

The symptoms of a developing crisis in the commercial external borrowing of certain countries are apparent in debtor behaviour, creditor reactions and the adjustment process in the credit markets:

- during the eighties some debtor countries have unilaterally declared a temporary suspension of interest and redemption payments in order to exert pressure for negotiations on rescheduling (the conversion of credits into long-term loans with grace periods and more favourable interest rate terms) and partial debt remission;
- creditor banks wrote down doubtful external claims and created provisions to guard against the risk of future losses. This practice has been particularly marked in those creditor countries (such as Germany) where a portion of unrealised losses in the form of default risks can be converted into tax savings, an option not available in the US tax system;
- the international credit markets have witnessed the emergence of so-called secondary markets in which parts of the creditor banks' portfolios of high-risk claims are traded at prices up to 50% below face value.

The causes of these adverse developments have changed since 1982-83. The sharp rise in international interest rates and the appreciation of the US dollar in the first half of the eighties were followed from 1985 onwards by an improvement in these external factors.

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Interest rates on loans were falling<sup>1</sup> and the depreciation of the dollar raised the international price competitiveness of exports to the non-dollar area by those developing countries whose currencies were pegged directly or indirectly to the dollar. Nevertheless, debt ratios increased, in some cases by a considerable amount (see Tables 1, 2a and 2b), because in the debtor countries the slowdown in export growth outweighed the effect of the decline in international interest rates. Low or even negative rates of export growth were the result of falling export prices for important primary products and inadequate growth in the volume of exports, in some cases even a contraction. These trends can no longer be blamed on the deterioration in world economic conditions (weak growth and protectionism in the industrial countries, the period of high international interest rates, overvaluation of the dollar). Continued protectionism may have contributed to the poor export performance of many debtor countries, but there are also clear indications that it was due to unresolved macro-economic and structural adjustment problems at national level.

In many cases the high inflation rate, and hence the real appreciation of the national currency, is a significant domestic cause of the debt problems brought on by the

weakness of exports. Other domestic factors are insufficient export diversification, which makes export receipts too vulnerable to movements in the price of a single commodity, and an excessive budget deficit in relation to gross domestic product, which restricts the scope for efficient private investment projects and reinforces the monetary stimulus to inflation. Comparing the situation of these countries with that of the group of Asian countries without debt problems confirms that domestic causes are the dominant factors;<sup>2</sup> the Asian countries generally have lower and more stable inflation rates, higher investment ratios, more diversified exports and more rapid growth in real GDP and real exports.

Against this background let us now investigate whether financial innovations can help overcome these causes of international debt problems. The financial innovations in question are:

- arrangements for converting existing debt into equity (debt-equity swaps) or into negotiable securities (debt-bond swaps), developed by private capital markets in response to the emergence of secondary markets;
- the replacement of existing debt by new forms of official bilateral or multilateral capital aid (counterpart funds, debt repurchase funds) via secondary markets.

The new tools of international debt management must dovetail with a comprehensive debt relief programme

<sup>1</sup> The London Interbank Offered Rate (LIBOR), the base rate for commercial external loans to debtor countries, fell from 8.6% in 1985 to 6.9% in 1986; see Bank for International Settlements: Annual Report 1986/87.

<sup>2</sup> See R. Dornbusch: Policy and Performance Links between LDC Debtors and Industrial Nations, Brookings Papers on Economic Activity, Washington 1985, pp. 303-356; J. Sachs: External Debt and Macroeconomic Performance in Latin America and East Asia, Brookings Papers on Economic Activity, 1985, pp. 523-573.

<sup>3</sup> See inter alia R. Dornbusch, op. cit.; H. E. Nödinger: Verschuldung von Entwicklungs- und Schwellenländern, Grösch 1987; M. Selowsky and H. G. van der Tak: The Debt Problem and Growth, in: World Development, No. 14, 1986; L. Sjaastad: The Debt Problem and External Shocks, in: H. Giersch (ed.): The International Debt Problem, Tübingen 1986, pp. 23-36.

**Table 1**  
**Developing Countries' Debt Ratios and Debt Service Ratios, 1980-87**

(as a percentage of exports of goods and services)

	1980	1981	1982	1983	1984	1985	1986	1987
Total debt (in billions of US dollars)	634	748	849	900	949	1012	1100	1217
Debt ratios	82	95	120	134	134	148	169	158
by region:								
Africa	92	119	154	170	170	185	231	241
Asia	72	75	88	94	89	101	100	91
Europe	127	137	147	150	145	162	172	168
Middle East	27	33	46	60	70	82	123	110
Western hemisphere	183	210	273	292	277	293	349	341
Debt service ratios	13	16	19	18	19	21	22	20
by region:								
Africa	14	17	21	23	26	29	29	25
Asia	9	10	12	11	11	13	14	14
Europe	25	22	23	21	22	25	26	25
Middle East	4	5	6	8	10	10	14	12
Western hemisphere	33	42	52	41	41	40	45	38

Source: IMF Annual Report for 1988.

## INDEBTEDNESS

aimed at permanently reducing the borrowing countries' debt ratios. Since the growth in external debt is essentially the result of net capital inflows needed to finance current account deficits because foreign exchange reserves are low or non-existent, the starting point for any programme of debt reduction is to improve the balance on current account (net exports of goods and services less interest payments on existing external debt). It can therefore be deduced that the following

requirements must be met if debt policy objectives are to be achieved:<sup>3</sup>

- to reduce the effective interest burden (per dollar of external debt);
- to speed up the growth of (dollar) export earnings to a rate higher than nominal borrowing rates; this is synonymous with the demand that the rate of growth in the volume of exports be higher than real interest rates

**Table 2a**  
**Debt<sup>1</sup> as a Percentage of Exports, 1980-87**

	1980	1981	1982	1983	1984	1985	1986	1987
<b>Latin America</b>								
Argentina	226.4	286.9	434.3	461.4	474.7	470.0	547.9	660.7
Brazil	303.1	298.4	391.6	400.5	347.3	363.3	445.7	432.2
Chile	192.5	279.0	335.9	374.6	412.2	436.7	378.3	327.4
Columbia	117.1	170.5	204.3	273.9	223.0	301.6	219.3	220.3
Mexico	233.3	257.1	311.1	325.2	292.2	325.7	426.7	362.5
Paraguay	122.3	148.6	163.6	238.3	223.9	275.7	255.2	234.4
Peru	207.0	243.5	293.5	313.5	331.1	361.5	469.6	503.3
Uruguay	104.1	117.8	157.1	223.4	237.6	291.3	245.4	255.6
<b>Africa</b>								
Algeria	124.9	113.0	112.0	106.3	99.6	108.7	210.3	217.7
Burundi	179.8	183.8	210.5	311.5	335.9	362.9	365.8	686.5
Egypt	179.6	217.8	217.4	209.1	230.3	296.7	347.2	343.1
Madagascar	242.0	401.2	496.9	577.5	540.8	732.4	734.6	813.1
Mali	223.6	335.1	381.8	411.9	485.5	581.2	576.9	620.4
Nigeria	32.0	61.2	100.2	171.1	150.7	150.2	353.1	369.0
Somalia	294.1	410.9	452.3	716.6	1,497.3	1,622.0	1,988.1	-
Togo	179.4	193.7	209.0	249.4	205.6	265.2	263.9	269.7

**Table 2b**  
**Debt Service<sup>2</sup> as a Percentage of Exports, 1980-87**

	1980	1981	1982	1983	1984	1985	1986	1987
<b>Latin America</b>								
Argentina	16.6	17.3	23.1	24.5	24.9	40.6	51.8	45.3
Brazil	34.6	33.7	43.3	28.8	25.0	26.7	34.1	26.7
Chile	21.9	29.6	19.8	18.1	25.7	26.3	28.6	21.1
Columbia	8.9	13.1	17.3	21.9	20.1	29.9	26.4	30.7
Mexico	32.1	28.1	34.1	40.0	34.8	35.7	37.2	30.1
Paraguay	10.2	9.2	10.2	14.3	17.7	23.9	25.5	21.3
Peru	31.1	44.8	36.3	19.8	15.9	17.8	14.4	12.5
Uruguay	12.4	10.0	13.4	20.6	29.8	30.0	21.1	24.4
<b>Africa</b>								
Algeria	25.8	24.6	28.6	31.8	32.8	32.5	51.0	46.8
Burundi	6.7	5.5	5.3	7.7	16.8	18.9	20.6	38.5
Egypt	13.2	18.5	16.6	15.2	15.8	17.7	15.9	12.7
Madagascar	11.1	16.5	20.1	12.7	11.1	30.1	27.2	35.5
Mali	2.9	3.9	4.0	5.9	7.5	15.0	11.7	9.9
Nigeria	1.8	4.6	10.8	17.5	25.5	30.7	17.9	10.0
Somalia	3.5	17.8	6.0	10.0	21.5	4.0	9.2	-
Togo	8.0	9.2	9.4	13.4	19.7	25.7	32.9	13.9

<sup>1</sup> Total external debt, including short-term external debts and IMF loans.

<sup>2</sup> Only on public and publicly guaranteed long-term debts.

Source: International Bank for Reconstruction and Development: World Debt Tables, External Debt of Developing Countries, 1988-89, Vol II (Country Tables).

(nominal interest rates less the rate of increase in the prices of tradables);

□ to engineer a surplus on current account net of interest payments by dampening import growth, but without impairing the rate of growth in the volume of exports;

□ to encourage foreign direct investment, the income from which can finance the associated interest payments and repayments of principal.

The efficiency of financial innovations from the standpoint of debt policy can now be measured by ascertaining whether they can trigger effects that meet at least one of these criteria without violating the others.

### Debt-Equity Swaps

This type of financial innovation uses the secondary market in existing debt to convert bank loans into equity capital.<sup>4</sup>

Taking a debt swap arranged with Mexico as an example, let us assume that debt instruments with a face value ( $F$ ) of US\$ 60 million are traded in the secondary market at a discount ( $d_0$ ) of 50%. A foreign investor wishing to build a factory in the debtor country purchases the paper from the foreign creditor bank via an intermediary bank and with the agreement of the central bank of the debtor country at a price ( $P_F$ ) of \$ 40 million, in other words at a discount ( $d_1$ ) of 33⅓%, which is more favourable to the creditor ( $P_F = F(1-d_1) > F(1-d)$ ). The central bank undertakes to repurchase the debt at a lower discount ( $d_2$ ) of 10% and to pay the equivalent value  $L = P_F(1-d_2)e$  in national currency converted at the official exchange rate ( $e$ ), provided that the new holder fulfils certain conditions, such as refraining from repatriating profits for a set period. So that this offer cannot be exploited for profitable arbitrage operations, the foreign investor selling the debt must undertake to channel the full proceeds into the proposed investment and not to disinvest for a stated minimum period, in the case of Mexico not before 1998.

Transactions of this kind are worthwhile for the foreign direct investor, since the interest costs of part of the capital investment are reduced – in the case in point,

with international interest rates at 10%, interest costs come down from \$5.4 to approximately 4 million, in other words to an effective rate of about 7.4% – and because the equity participation is acquired at a lower price than with a normal direct investment. On the other hand, investments associated with debt-equity swaps have the relative disadvantage that they are subject to tighter restrictions as regards the use of funds, the distribution of profits and the repatriation of capital. The immediate advantage for the debtor country is the \$60 million reduction in the debt, financed by means of central-bank money creation, and the resulting reduction of \$6 million in interest payments. Macro-economic benefits accrue if these financial incentives generate an inflow of additional foreign investment capital that can be channelled into uses that are efficient in development terms, such as export diversification or import substitution, by establishing an optimum structure of incentives, such as a sliding scale of central-bank discounts on existing debt. It should be noted, of course, that these benefits are financed by the foreign creditor bank, which must forfeit part of the value of its claims and realise losses. On the other hand, the bank also derives a relative advantage from participating in debt-equity swaps if the discount at which it sells debt in a capitalisation operation is lower than that available in the secondary market. The greater the demand for debt-equity swaps, the higher will be the purchase price of converted debt instruments and hence the smaller the loss.

Debt capitalisation therefore contributes directly and possibly also indirectly to the reduction in debt ratios if the financial incentives stimulate greater direct investment that leads to a strengthening of export growth and a net saving in expenditure on imports.

As with other investment subsidies, there is a problem in distinguishing between investment that would have occurred in any case and investment genuinely induced by the scheme. If no additional investment is generated, the creditor banks will simply be subsidising direct investment that would have been implemented even without the device of debt-equity swaps. In that case debt conversion would also fail to produce the hoped-for boost to exports and improvement in the trade balance.

The participation of the central bank of the debtor country in debt capitalisation is the main problem of the proposal. Since the central bank purchases the foreign claims in exchange for domestic currency, it is treading the dangerous path of financing debt redemption by means of money creation. If the money creation effects are to be contained in relation to monetary base, the volume of debt-equity swaps and hence the scale of direct debt relief must also be strictly limited. If the

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<sup>4</sup> See H. Braun: „Schulden-Swap“ und „GRIP“ – Instrumente zur Entschärfung der internationalen Verschuldungskrise?, in: IFO-Schnelldienst, No. 1-2, 1987, pp. 3-5; M. P. Dooley: Buy-Backs and Market Valuation of External Debt, in: IMF Staff Papers, No. 35, 1988, pp. 215-229; G. Franke: Economic Analysis of Debt-Equity Swaps, in: Diskussionsbeiträge des SFB 178 „Internationalisierung der Wirtschaft“, No. 41, Constance 1987; W. Ollard: The Debt Swappers, in: Euromoney, August 1986, pp. 67-75; Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Jahresgutachten 1987/88, paragraphs 14-17.

monetary financing of conversion of part of the external debt led to an appreciable acceleration in money supply growth because of a lack of macro-economic backing, the acceleration in inflation would cause debt ratios to rise; if the country failed to devalue in order to compensate for the rising inflation rate – and as a rule they have not done so – the real appreciation of the currency would dampen export growth, stimulate imports and increase the current account deficit net of interest payments. If debt-equity swaps are to have a neutral inflationary effect, the budget deficit – often the primary source of money supply growth – would have to be reduced in relation to the volume of debt capitalisation by replacing unproductive state expenditure with productive foreign investment.

It also follows from this that debt-equity swaps cannot make a lasting effective contribution to reducing the burden of debt and regaining international credit-worthiness unless the domestic causes of the debt problems are resolved at the same time. The unresolved fiscal problems of highly indebted countries thus also impair the effectiveness of this financial innovation from the point of view of debt reduction.

### Debt-Bond Swaps

Another form of debt management, the conversion of foreign debts into negotiable fixed-interest securities, entails the debtor country financing the repurchase of loans by issuing securities.<sup>5</sup> If this also enables the creditor banks to divest themselves of the loan commitment by selling the paper, the securities are also termed “exit bonds”. A variant of this rescheduling technique was used in the agreement between the governments of Mexico and the United States at the end of 1987.

In exchange for a payment of US\$ 1,866 million, the Mexican government acquired a zero-coupon bond issued by the US Treasury, which will repurchase it for \$10 billion after 20 years. The bond has been deposited with the US Federal Reserve as a guarantee for a Mexican state loan for \$10 billion with the same maturity and bearing interest at 9 5/8% (\$962 million per annum). Including the purchase price of the zero-coupon bond, Mexico’s effective interest costs work out at 11.2%, or \$1.12 billion per annum. After negotiations on the purchase price, creditor banks then took over this package of secured fixed-interest government bonds in

exchange for claims on Mexico totalling \$14.3 billion that give rise to interest costs of 8 3/8% (\$1.26 billion per annum).

This transaction reduces Mexico’s interest payments by \$ 114 million a year and its foreign debt by a total of \$ 4.3 billion. The lowering of the debt ratios is again financed by realised losses on the part of the creditor banks, but here again the losses can be expected to be less than if the existing debt were valued at secondary market prices. In the example given above, Mexican debt was trading at around 52% of face value in the secondary market, whereas prices quoted for the new financing instrument can be expected to be around 70% of the face value of the old debt. Moreover, in exchange for doubtful external claims the creditor banks have received marketable securities with a higher interest rate than the old claims and less risk of default, since the collateral security guarantees repayment of the principal but not the interest on the loan.

The replacement of existing external debt with newly issued securities leads to a direct reduction in the debt ratios without having repercussions on export growth, the current account net of interest payments or direct investment. Debt-bond swaps have a macro-economic advantage over debt-equity swaps in that they do not have any money creation effects and hence do not unleash inflationary forces. So far, only a very small portion of commercial lending to developing countries has been securitised, mostly long-term loans. This situation does not accord with creditor preferences, since creditor banks will prefer tradable credit instruments with a higher degree of liquidity. Debt-bond swaps are therefore an appropriate means of improving the debt structure of the debtor countries and the claims portfolio of the creditor institutions. Capital market innovations that provide securitised and secured loans suit creditor preferences better than conventional forms of loan and hence might stimulate a growing volume of such debt conversions or even generate flows of new funds on more favourable interest rate terms.<sup>6</sup>

Flexible maturity loans, shared equity loans and transferable loan instruments are new forms of credit discussed in this connection. In particular, the introduction of flexible maturity loans offers a free-

<sup>5</sup> Cf. K. P. Regling: *New Financing Approaches in the Debt Strategy*, in: *Finance & Development*, March 1988; J. Sachs and H. Huizinga: *U.S. Commercial Banks and the Developing-Country Debt Crisis*, in: *Brookings Papers on Economic Activity*, Washington 1987, pp.555-601.

<sup>6</sup> J. M. Guttentag and R. Herring: *Commercial Bank Lending to Developing Countries: From Overlending to Underlending to Structural Reforms*, in: G. Smith and J. T. Cuddington (eds.): *International Debt and the Developing Countries*, Washington 1985; H. R. Heller: *The Debt Crisis and the Future of International Bank Lending*, in: *American Economic Review*, No. 77, 1987, pp. 171-175; K. G. Saini: *Capital Market Innovations and Financial Flows to Developing Countries*, in: *World Bank Staff Working Papers*, No. 784, Washington 1986.

market alternative to the earlier proposal for an IMF interest equalisation scheme.<sup>7</sup> This scheme, modelled on the IMF system of compensatory financing, provides for automatic IMF equalisation loans if the country's interest burden increases as a result of variable borrowing rates, with the trigger point being expressed in terms of LIBOR. Debt instruments providing for constant annual debt service payments can perform the same function in private capital markets. If interest rates rose (fell), the capital repayment element would decrease (increase) and the maturity would be lengthened (shortened) accordingly. The new instrument might need to have a larger margin over LIBOR to win the necessary creditor acceptance for introduction to the capital market. Similarly shared equity loans could improve a country's debt structure by inviting lenders to accept low interest rates on the loan in exchange for a share in the profits of the project being

financed; since the potential creditor would therefore also have to accept the risk of losses, he would presumably have to be offered a say in project management as well in order to make the new instrument acceptable to the financial market.

#### Counterpart Fund

This recent proposal<sup>8</sup> aims at a form of debt management that should reduce the debt ratios of less developed countries whose debts are mainly with official creditors – primarily debtor countries in Sub-Saharan Africa – by giving them the opportunity to redeem part of their external debt in their own currency. Creditor countries receiving redemption payments in the debtor's currency then pay the amounts into a fund to finance investment projects in the developing country in question. The money can then be lent on favourable terms to domestic or foreign investors who undertake to meet the domestic cost of investment projects subsidised in this way.

In essence this is a form of debt repurchase that the government of the debtor country can finance by creating money. This debt reduction concept is the intergovernmental equivalent of the financial innovation embodied in debt-equity swaps in the private capital markets, and is thus subject to the same reservations and the same requirements for success, which are

<sup>7</sup> Cf. B. Balassa: The Problem of Debt in Developing Countries, in: B. Balassa (ed.): Change and Challenge in the World Economy, London 1985, pp. 102-127; B. Balassa: Developing Country Debt: Policies and Prospects, in: H. Giersch (ed.), op. cit., pp. 103-122; C. F. Bergsten, W. R. Cline and J. Williamson: Bank Lending to Developing Countries: The Policy Alternatives, Institute for International Economics, Policy Analysis in International Economics, No. 10, Washington 1985; W. R. Cline: International Debt and the Stability of the World Economy, Institute for International Economics, Policy Analysis in International Economics, No. 4, Washington 1983.

<sup>8</sup> Cf. T. Kampffmeyer: Die Verschuldungskrise der Entwicklungsländer. Probleme und Ansatzpunkte für eine Lösung auf dem Vergleichswege, DIE-Schriften, Berlin 1987.

PUBLICATIONS OF THE HWWA-INSTITUT FÜR WIRTSCHAFTSFORSCHUNG-HAMBURG

Klaus Bolz  
(Ed.)

### DIE WIRTSCHAFTLICHE ENTWICKLUNG IN DEN SOZIALISTISCHEN LÄNDERN OSTEUROPAS ZUR JAHRESWENDE 1988/89

For 17 years now, the Eastern European Department at the HWWA-Institute has examined the economic situation in the individual countries of Eastern Europe at the beginning of the year, especially with regard to the results of the previous year and to current trends. Economic results are compared in particular to those foreseen by the current five-year plan. The multiplicity of changes to the system in most of the Eastern European countries means that particular attention must again this year be paid to the economic reforms. In addition, important questions for the CMEA such as the new cooperation mechanism, the convertibility of national currencies, the single European market, relationship to international organisations etc. are discussed.

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difficult to meet. Here too, mobilisation of the resources tied up in the fund creates inflationary dangers that must be neutralised by pursuing a restrictive budgetary policy. Ultimately this means that the debt repayment must be financed by government saving, which can be achieved only by curbing state expenditure on consumption or increasing taxes.

### Debt Buy-back Fund

The aim of a "buy-back fund" is to reduce commercial external debt by switching to multilateral official credit. It is intended to give debtor countries the opportunity to finance the repurchase of debt in the secondary market by taking up IMF credits created specially for this purpose. For example, with an IMF loan of \$6 billion debtor countries would be able to repurchase old debt totalling \$10 billion that was being traded in the secondary market at a discount of 40%. In this way their total debt could be reduced by \$4 billion and their interest burden, assuming borrowing rates of 10%, cut by \$0.4 billion. If the debt buy-back loan were granted at a subsidised interest rate, the decrease in the interest burden would be correspondingly larger.

There are parallels between this scheme and the earlier proposal for a supranational rescheduling agency that would purchase problem loans at a discount from commercial banks and convert them into longer-term credits at lower rates of interest. The buy-back fund differs from this in that it would be integrated into the IMF system of loans and conditionality. Despite these institutional differences, both schemes boil down to the replacement of commercial or bilateral loans by subsidised multilateral lending. Hence an IMF buy-back fund would not solve the problems associated with an international debt conversion agency.<sup>9</sup>

Since such a fund needs financial resources, it can be assumed that either the debt repurchase will be financed by the IMF member countries regarded as wealthy, in other words primarily the creditor countries themselves, or additional Special Drawing Rights will be created and passed to debtor countries in the form of SDR credits from the buy-back fund. Whereas the latter method of financing revives the old call for an SDR link, the first variant could be put into effect if the central banks mobilised hidden reserves by selling gold and transferred the proceeds to the fund in exchange for claims to future SDR repurchases.

The adverse repercussions that debt-equity swaps or counterpart funds can have in debtor countries if they are financed by national money creation now emerge at the level of the world economy, for the repurchase of

debt is ultimately financed by international money creation. This generates an international inflationary potential, since the international liquidity mobilised in this way turns into demand for goods in world markets.

A buy-back fund made possible through multilateral monetary financing does have a relative advantage over bilateral debt-equity swaps and counterpart funds in that it would be tied to conditional IMF financing programmes. In principle this could help ensure that the debt reduction strategy had no inflationary effect in the aided debtor country if lending from the buy-back fund were made conditional on the agreement and implementation of a macro-economic and structural adjustment programme. However, the problem with this proposal emerges if lower real interest rates for the debtor countries are to be achieved by allowing world inflation to rise.

### Conclusions

Debt capitalisation, counterpart funds and buy-back funds can have undesirable side effects if certain macro-economic requirements of a predominantly fiscal and monetary nature are not met. Debt restructuring by means of new financial instruments should therefore be promoted only in conjunction with the acceptance and progressive implementation of macro-economic and structural adjustment programmes, which would themselves have to be adapted to suit the new financing techniques. Priority should be given to capital market innovations in the style of debt-bond swaps, since here the danger of adverse repercussions should be relatively small and the international capital market should have little difficulty absorbing the new paper.

Both of these aspects – the integration of financial innovations into stabilisation and structural adjustment programmes for debtor countries and the effects of capital market innovations – still need thorough theoretical and empirical examination before projections of their effect on debt reduction can be made. The same applies not only to the problem of capital flight, which has been disregarded in this article but which has exacerbated the debt situation of some Latin American countries,<sup>10</sup> but also to the question whether new capital market instruments that create incentives to repatriate flight capital can be introduced and made acceptable to the markets.

<sup>9</sup> See also W. Nölling: Internationale Verschuldung – Wege aus der Krise, in: Kredit und Kapital, No. 16, 1983, pp. 441-458; P. Nunnenkamp: Bank Lending and Government Intervention in Capital Markets: Has Recycling Gone Too Far?, in: H. Giersch (ed.), op. cit., pp. 42-65.

<sup>10</sup> See the study by M. Khan and N. Ul-Haq: Foreign Borrowing and Capital Flight: A Formal Analysis, in: IMF Staff Papers, No. 32, 1985, pp. 606-628.