

Sachs, Jeffrey; Kneer, Josef

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Jeffrey Sachs* and Josef Kneer**

Debt Reduction: the Basis and Shape of a New Strategy

The burden of past restructuring of the external debt of developing countries has been distributed asymmetrically among creditors owing to the lack of incentives for voluntary debt reduction. "New creditors" have been deterred from lending voluntarily because their claims would inevitably be added to a mountain of bad debt. Therefore new ways of reducing debt and debt servicing must be found. Our authors suggest a process of concerted debt reduction designed to ensure that all the creditor banks involved play an equal part.

After the onset of the debt crisis in August 1982, efforts to find the causes of the crisis were intensified so that strategies for dealing with it could be developed. External and internal factors were identified as having triggered the crisis. In the concurrent debate about the nature of the crisis it was diagnosed as being largely a problem of liquidity rather than one of solvency. At the same time, the debt crisis was frequently portrayed also as a reflection of the increased sovereign risk.

The causes of the crisis were not correlated to the nature of the problem as strictly as one might have expected. Whereas in the early years the majority opinion was that the crisis was one of liquidity, it was the domestic factors that dominated the debate about its true origins. The external causes could obviously not be denied, but the content of the adjustment and stabilisation programmes shows that they were thought to play a secondary role. This analysis served as the basis for the initial short-term rescheduling agreements between creditors and debtors, which were subsequently complemented or replaced by longer-term agreements. Financial packages involving "fresh money" were intended to meet the debtors' short-term financing needs.

It emerged very early, however, that this crisis management strategy would not lead to a permanent reduction in the debt burden of the developing countries,

which in some cases was extremely high. This was realised at the latest when unexpected developments in the world economy (the fall in raw material and oil prices, etc.) increased the borrowing needs of many debtor countries. Since voluntary lending, particularly by international commercial banks, was drastically curtailed after 1982 and was accompanied by negative capital transfers, the costs of the debt overhang increased sharply – for debtors and creditors alike. For debtors, the reduced but still relatively high debt servicing burden jeopardised long-term adjustment. For creditors, the generally inadequate "new financing" did not make the banks' overall claims any more secure.

Once it was acknowledged that the inadequacy of voluntary financial resources was hampering long-term adjustment, the idea of global framework agreements for reducing the debts of heavily indebted developing countries gained ground. Most of the central ideas of this new strategy have now been embraced by international organisations and are being endorsed by international banks, which had previously merely paid them lip-service.

Definition of Debt Reduction

The terms "debt relief" or "debt reduction" are inadequate to describe the true nature of the easing of the debt servicing burden. It is not just a question of reducing contractual redemptions, but of restructuring external debt in such a way that the expected discounted current value of all contractual debt service obligations is reduced. From this definition it will also be clear that the conversion of debt into domestic currency does not necessarily constitute a debt reduction, as in

* Harvard University and the National Bureau of Economic Research, USA.

** Chief Economist of F.A.Z. GmbH-Informationsdienste and Research Director at the Institute for International Economic and Political Research, Frankfurt, West Germany.

the case where the discounted current value of debt servicing commitments is not reduced for the debtor, despite conversion. The definition demonstrates as well that debt reduction does not mean solely cutting redemption payments or the repayable credit; it also includes other forms of reduction in debt or debt servicing, such as reducing the interest rate below the market level (interest rate variant), debt repurchase at a discount to the nominal value, and so forth. In our view, the interest rate variant is the simplest and most effective form of debt reduction defined in this manner.

If one looks at some of the procedures now being regarded as debt-reduction instruments, it becomes clear that debt-equity swaps cannot be classed unreservedly as a means of reducing the debt servicing burden; indeed, they should be regarded as a relatively expensive instrument for debtors, particularly as the indebtedness of developing countries is first and foremost a problem of public debt, whereas debt-equity swaps are intended primarily for private-sector debt conversions. The additional costs engendered for the public sector of the debtor country (increased burden on the budget, additional stabilisation costs, etc.) show clearly why countries such as Brazil and Mexico suspended their debt-equity programmes in 1987 and 1988.

Against this background, to advocate debt reduction as defined above obviously does not mean that we refute the critical objections that have been voiced against general debt forgiveness. Indeed, these criticisms and the largely negative experiences with past restructuring should be explicitly taken into account in the formulation of a debt reduction scheme by laying down formal preconditions for such an arrangement.

Experience with Past Restructuring

It should be realised that past restructuring was largely voluntary as far as creditors were concerned. In other words, they had the choice whether to participate in each programme or not. However, voluntary debt reduction and voluntary new lending depend to a large extent on the composition of a country's creditors, which can differ markedly. Oligopolistic structures on the creditor side have led to an uneven distribution of the burden of voluntary debt reduction plans. Whereas smaller banks have more frequently opted for debt reduction for reasons specific to themselves, large banks have participated on a less than proportional basis. Since the debtor country's total outstanding debt was smaller after the debt reduction by the smaller banks, the risk of it defaulting on the claims held by the large banks was diminished. The distribution of the

burden between public creditors and international commercial banks shows similar asymmetry.

Owing to political pressure and for foreign policy reasons, the governments of creditor countries have agreed to bear credit risks as part of rescheduling or refinancing packages; this constitutes nothing more or less than a special tax that the state shoulders in the place of international banks, particularly if rescheduling agreements and "new money" have short maturities and are put in place primarily to safeguard contractual interest payments. Both the rescheduling programmes and the financing strategy must be considered ultimately to have failed. For one thing, very few countries have been able to agree financing packages with the banks, and these have come about only as a result of political pressure from creditor governments and international organisations. Only four of the more than 50 rescheduling agreements concluded between 1986 and 1988 actually involved fresh money. Leaving aside the Congo, these concerned the three major debtors of Brazil, Mexico and Argentina. If one assumes that the latest framework agreement between the Mexico Advisory Committee and the Mexican Government was also due to Mexico's acute liquidity problems, it must be concluded that all the financing programmes have failed for lack of adequate resources. This applies to Argentina and Brazil just as much as to Mexico. Moreover, financing packages have the disadvantage – by comparison with reductions in debt and debt servicing – that they increase the future debt servicing burden of the debtor country; given the short maturity of the new credits, they have the effect of taxing new investment in the debtor country. If one realises that investment in Latin America in 1988 was around one-fifth lower than at the beginning of the decade, it becomes clear how difficult it will be to pay this tax.

Analogy with National Law on Composition

If the burden of past restructuring of the external debt of developing countries has been distributed asymmetrically among creditors owing to the inadequacy or lack of incentives for voluntary debt reduction, if "new creditors" have been deterred from lending voluntarily because their claims would inevitably be added to a mountain of bad debt, then other ways of reducing debt and debt servicing must be found.

The alternative to voluntary debt reduction is not compulsory debt reduction, however. In any case, that is not the true problem. We refer instead to a process of concerted debt reduction designed to ensure that all the creditor banks involved play an equal part. In this way, it

should be possible to avoid an asymmetrical distribution of the burden among creditors and hence inadequate incentives for voluntary debt reduction. The manner in which each creditor participates in the scheme should ultimately be left to the creditor himself. What matters is that all creditors participate equally in the process.

This process of debt reduction has an analogy in national law on composition, which is also based on the fact that decentralised voluntary debt relief is less efficient if all creditors insist on their claims being met in full. In such circumstances a reorganised enterprise would have no chance of survival. It is the equal treatment of creditors that induces them to participate in a longer-term restructuring plan (namely composition) and gives them the prospect of recovering a larger proportion of their claims in the future than if the company were liquidated. Successful composition usually leads also to an improvement in the company's position in the capital market. Transposed to the international capital market, this would mean that the country would receive both short-term trade finance and long-term project finance on a voluntary basis. Potential new creditors would be prepared to lend in improved capital market conditions.

When would the creditworthiness of the debtor country be reestablished if debt reduction did take place? As with other parallel markets that already exist, a country's creditworthiness would be fully restored when its debt was once again being traded at 100% in the secondary market after the reduction operation. The extent of the reduction in debt or debt servicing is therefore based on the secondary market discount.

Formal Preconditions

There are formal preconditions attached to a reduction in developing country debt and debt servicing of this kind. On the one hand, the justified criticisms of general debt forgiveness (such as the reduced willingness of the debtor country to adjust, the problem of creating precedents, the propriety of bailouts by the public sector, etc.) must be taken into account and on the other debt reduction must be organised efficiently by laying down formal preconditions. The following measures, *inter alia*, are necessary:

- ☐ Explicit support from the IMF and the World Bank with the aim of permanently reducing the debt burden. Their support is conditional on the undertaking of the debtor country to adopt appropriate policies.
- ☐ An official policy that ensures that all creditor banks bear an equal burden in the process of debt reduction. Legal differences between the countries of creditor

banks can be taken into account by offering alternatives in the concrete framing of the plan without discriminating between banks from an economic point of view.

- ☐ An official policy against the assumption of additional budgetary and stabilisation burdens by the debtors. Capitalisation should be confined to the external debts of the private sector and to cases of privatisation of public enterprises.
- ☐ The formulation of official lending programmes (stand-by credits and structural adjustment loans) incorporating the debt reduction and the debt service payments that are to be made.
- ☐ The permitting of payment arrears to international commercial banks in the event that the IMF and World Bank programmes are ready to begin before the banks have agreed on a system of debt reduction.
- ☐ The introduction of legal requirements to write down the market value of the debts of those countries for whom no debt reduction programme has yet been instituted.
- ☐ The provision of official funds to guarantee interest payments, especially in cases where creditors and debtors have agreed on the interest rate variant (reduction of interest rates below the market rate by the equivalent of the secondary market discount) as part of the debt reduction programme.
- ☐ The observance of strict conditionality for official credit linked to debt reduction. Stabilisation and structural adjustment under international supervision is essential, particularly in cases where official lenders guarantee interest payments; here conditionality acquires a legitimate role in the protection of the use of public funds.

- ☐ "Cross default" with other IMF and World Bank loans if interest payments continue to be in arrears after debt reduction has taken place.

- ☐ Official support for the simplest, most just and administratively most efficient form of debt reduction.

When should debt reduction begin? It makes sense if the debtor country has already introduced adjustment measures that are proving effective. The possibility of redemption arrears occurring in the meanwhile should therefore not be excluded. What is important is not so much the actual timing of debt reduction as the prior undertaking of international organisations to support the debt reduction in conjunction with an effective adjustment programme whatever the government in power in a debtor country, on condition that full debt servicing demonstrably exceeds the country's capability, both politically and economically.