DEBT BURDENS AND ECONOMIC DISTRESS IN THE THIRD WORLD

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WIDER World Economy Group 1989 Report by

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INTRODUCTION

Debt discussions in the US, and to a lesser extent in Europe, focus almost exclusively on Latin America and the Philippines. They rarely touch on the problems of Africa. The reason is quite simple: most of African debt is owed to governments and to multilateral organizations. For that reason the 'international financial system' is not at stake. Nonpayment of these debts or the rolling over occurs in the Paris Club without much public attention. It is important to ask whether this division of the discussion - debt relief for Latin America, rollover of debts for Africa (excepting several bilateral moves of debt forgiveness) is at all justified. It is also appropriate to ask whether any forgiveness of Latin American debts with the active cooperation of taxpayers is not altogether misplaced; is Africa not more deserving? Are Latin America's problems not homemade as the massive capital flight would suggest?

We have a simple answer to these questions: taxpayers should urgently consider a major debt reduction for Africa, including a reduction in the claims of the IMF and the World Bank. Fortunately there is international recognition of the urgency of Africa's problem, but efforts are not going far enough.

As to Latin America, we believe that there is an important case for government intervention in the impasse between debtors and creditors: a resolution of the debt crisis is an important part of the strengthening of democratic institutions. We do not, however, recommend massive debt write-off but rather a restructuring of debt service to enhance growth and ultimately reverse capital flight. We feel that if debts ultimately are to be paid, the only way this will happen is as a result of a significant reflow of flight capital. The principal component of a successful debt strategy must therefore be to bring about a reversal of capital flight.

The Baker Plan for developing country debt recognized the need for growth, but failed to deliver it. The Brady Plan now centres on the need for debt reduction but is already in difficulty. There is a recognized and urgent need, political and economic, to get to work on reconstruction in Latin America. But the prospect for success is becoming remote.

Over the past seven years a muddling through strategy on LDC debt helped improve bank balance sheets. Whatever the wisdom of that strategy, there is little doubt that it extracted a high price in debtor countries. Banks are now in a much better position to face a situation of debt reduction. But many debtor countries have experienced an economic and social set back. The need for reconstruction is apparent from the dramatic deterioration in the Latin American standard of living. (Table 5.1)

US Secretary of the Treasury, Nicholas F.Brady, in responding to the crisis, has started a process that is difficult to reverse and, in the best of conditions, difficult to control. Under the Brady Plan banks hope to get major guarantees (at little cost) for their increasingly poor Latin loans; debtor countries see the Brady Plan as a response to their long standing demand to write debts down to the secondary market price.

The gulf can only be bridged to both parties' satisfaction if substantial resources from the IMF and World Bank are allocated for the purpose. Without public guarantees on the required scale two possibilities emerge; either banks are forced, by regulatory requirements, to pass on to debtors relief at the expense of their stockholders, or else banks are left untouched and debtors go with out much relief.

Since 1982 themuddling through strategy has led to a deterioration in the ability to service debt. Debt ratios are far higher today than they were in 1982 and that point is, of course, recognized in the secondary market. But the market also recognizes that the value of debt is impaired not only by the accrued debt overhang but also by the erosion of a political will to finance debt service.

BANK EXPOSURE

The first task is to review who are the creditors of Latin American debt.

TABLE 5.1
Debt Burdens of Heavily Indebted Countries (%)

	1980	1982	1987
Ratio of Debt to GNP:			
Africa (a)	97.5	182.7	362.3
Latin America	35.3	46.3	60.1
World Bank 17 (b)	32.8	45.0	63.1
Ratio of Debt to Exports of Goods and Services:			
Africa	72.0	[illegible]	[illegible]
Latin America	101.2	[illegible]	275.0
World Bank 17	87.6	[illegible]	272.2
Ratio of Interest to Exports of Goods and Services: (c)			
Africa	1.1	1.3	1.9
Latin America	10.0	15.2	16.1
World Bank 17	8.4	13.8	15.6

a) Africa South of the Sahara.
b) 17 highly indebted countries identified by the World Bank.
c) Interest on public and publicly guaranteed long-term debt.
Source: World Bank: World Debt Tables 1988-89.

This perspective is appropriate because much of the discussion focuses on Latin American debt as a US bank problem. That perspective, in fact, is misleading.

The World Bank identifies 17 highly indebted countries. Their debt total in 1988 was estimated to be about $525 billion. Of that total nearly 60 per cent was owed to commercial banks, and the remainder to official institutions.

On the side of commercial bank creditors US banks predominate, but it is important to recognize that US banks account for less than 25 per cent of the bank claims. Britain and Japan combined have the same amount of claims as US banks. The predominance of US banks in the public discussion may therefore reflect primarily their vulnerability.

In the US banks' balance sheet LDC debts have clearly declined significantly since 1982. In that respect at least the muddling-through strategy has been successful. In 1982, the money centre banks could not have withstood a significant debt write-off. Today some debt write-off is clearly more digestible as Table 5.2 shows.

An interesting fact apparent from Table 5.2 is the reduction in the face value of debt that has taken place since 1985. The improvement of balance sheets has not only been achieved by raising capital and reserves. There is also a $ 15 billion reduction in claims achieved through various kinds of swaps and buy-backs.

TABLE 5.2
Highly Indebted Countries: Total Debt (Billion US$)

	1985	1988
Total	453.9	525.1
Multilaterals	54.1	85.0
Banks and Trade Credit	310.1	314.9
By Identified Creditor Banks:		
US	91.2	73.5
UK	35.8	34.5
Germany	22.4	26.2 *
France	27.8	30.3
Switzerland	7.5	8.4 *
Italy		5.8
Japan		39.3

* 1987
Source: World Bank

THE QUALITY OF DEBTS

We noted above that the debt ratios have deteriorated during the muddling-through period. In this section we briefly present the deterioration of debt.

Table 5.3 shows the debt characteristics for the main Baker 15 debtors. Not shown are various Central and South American countries, Yugoslavia, Nigeria and Cte d'Ivoire. One striking fact is that US banks own only 15 per cent of Latin America's total external debt. This small share reflects not only the presence of public debts in the total but also, importantly, the major participation of Japan and Europe as lenders. Of total private claims on problem debtors, US banks hold only 18 per cent.

TABLE 5.3
US Bank Exposure in Latin America
(Billion US$ and per cent of capital)

	1985 Exposure	1985 (b)	1988(a) Exposure	1988(a) %(b)
All Banks	80.4	78.9	63.2	46.6
9 Money Banks	60.5	148.6	45.2	81.0

a) September 1988.
b) Exposure as per cent of capital.
Source: Federal Financial Institutions Examination Council.

THE DEBT SERVICE PROBLEM AND DEBT SERVICE FATIGUE

Why is debt service such a problem? In one sense the answer is quite straightforward: countries that used to spend, borrowing the resources from official and private creditors, now no longer command these resources: they are limited to spending even less than the value of domestic production. Their adjustment is complicated by two facts. The first is the macroeconomics of earning foreign exchange, the second is the political economy problem of finding extra budget resources for debt service. These issues are familiar from the discussion of German reparation payments and hyperinflation following the First World War.

Before the debt crisis, foreign loans supplemented domestic income, enlarging the resources that could be spent. Interest payments on loans were automatically provided in the form of new money and the principal on debts was automatically rolled over. With ready access to resources beyond that required to service the debt, spending was high. After credit rationing began in 1982, spending had to be limited, and absorption fell below the level of output as interest now had to be paid out of current production. Interest payments now had to be financed by non-interest surpluses in the current account.

Table 5.4 shows the debt service process at work. In the post 1982 period

TABLE 5.4 Problem Debts (Billion US$, except as noted) (b)

	Debt Total	Private	US Banks	Debt/GDP (%)
Latin America	408.8	308.8	65.4	60.1
Argentina	59.6	47.3	8.2	73.9
Brazil	120.1	92.2	18.9	39.4
Chile	20.8	15.5	5.4	124.1
Colombia	17.2	8.3	2.2	50.2
Venezuela	35.0	34.8	14.3	94.5
Philippines	30.2	18.2	4.2	86.5
17WB Debtors (a)	528.6	377.9	69.1	63.1

a) 17 highly indebted countries identified by the World Bank.
b) April 1989.
Source: US Federal Financial Institutions Examination Coun cil, World Bank and Salomon Brothers.

of involuntary lending, debtor countries have achieved a shift in their non-interest external balance of nearly 5 per cent of GDP. This external balance improvement serves to make net transfers of interest to the creditors. It is matched by a nearly equal reduction in investment in the debtor countries.

This resource transfer, of course, comes at the expense of living standards in the developing countries. But more importantly, the transfer has as a counterpart a sharp decline in investment. Interest payments thus are really financed by a mortgage on future standards of living and on the debtors' growth potential. In countries where population growth is high and income distribution is very unequal, such a policy may turn out to be shortsighted.

THE BUDGET PROBLEM

The most immediate transfer problem arises in the budget. Much of the external debt is public or publicly guaranteed. Of the part that was not initially, much has wound up in the public sector in the aftermath of the crises, as a result of bank failures. The government thus has to service a debt which before was either in private hands or automatically serviced by the new money. The problem, of course, is where to find the extra 3 or 4 per cent of budget revenue that will pay these new interest costs.

There are basically four avenues: raising taxes and public sector prices, reducing government outlays, printing money, or issuing domestic debt. Raising taxes is difficult since most of the taxes are already levied in the form of social security taxes on workers. Tax reform is clearly a priority in the debror countries. An easier solution is to raise public sector prices or to eliminate subsidies. The elimination of subsidies is particularly welcomed by creditors and international agencies since it means moving closer to efficient resource allocation. Of course, the imposition of extra taxes or the withdrawal of subsidies is inevitably inflationary unless the tax increase or subsidy cut is offset by a reduction in other prices or wages.

Cutting government spending is another opinion. Attention here focuses on the usual extraordinary inefficiency of the public sector. The public perceives that there must be a way to pay the bills out of increased efficiency, rather than reduced private absorption.

Debt serive has increased government budget deficits, and these deficits have been financed by printing money. Money finance brings with it the problem of high and often extreme inflation. It is no accident that Argentina and Brazil experienced extraordinary inflation rates in the aftermath of the debt crisis. When deficits are financed by debt, while the imminent inflation problem may be absent, there is still the issue of excessive debt accumulation which ultimately poses the risk of an inflationary liquidation or a repudiation.

An important trade-off emerges in the adjustment process. To earn foreign exchange the real wage must be cut in terms of tradeable goods, thus enhancing competitiveness. But to balance the gudget it is often necessary to cut subsidies for such items as food or transportation and that also means a cut in real wages. Because there is a political limit to the cuts in real wages that are feasible there is a trade-off between a cut in the dollar wage or a cut in the tortilla wage. Lags in trade adjustment suggest that the competitiveness adjustment should take precedence and that budget balancing should follow once the economy's resources are reallocated. Since the real depreciation by itself is already bound to produce slack there is no risk of overheating in this sequence of adjustment.

A final point worth noting is the link between budget cuting and the extraordinary fall in Latin American Investment. The reason is that in the category of government spending the easiest cuts are in investment. Postponing investment and maintencance is much easier than firing workers. The resulting impact on aggregate investment is so large because the public sector, in the form of public sector enterprises, accounts for a large part of total investment, and because the public sector was in the forefront of adjustment. It is immediately obvious that this is a very ineffective means of adjustment, failing to recognize the distinction between the public sector's current and capital accounts.

THE FOREIGN EXCHANGE PROBLEM

Debts must be serviced in dollars, not pesos. In the 1970s, debtors were borrowing abroad, supplementing domestic incomes with foreign resources. Since 1982, they have been forced to make large outward transfers (Figure 5.2). These transfers require a trade surplus. The cut in spending will, of course, reduce import demand and also free exportables for sale abroad, but for two reasons that will not be enough. First,sizeable fraction of the expenditure cut will fall on domestic (non-traded) goods, not tradeables. The spending cut thus creates unemployment rather than potential foreign exchange earnings. Even for those goods that are directly tradeable it is not necessarily the case that increased supplies can be sold. Often there is the problem of obtaining market access and, if the goods are not homogeneous commodities like cotton or copper, a cut in their price is required to achieve increased sales. Even then, unless demand is sufficiently responsive, total earnings may not increase.

To translate the spending cut into foreign exchange earnings, a gain in competitiveness is required. The gain in competitiveness draws resources into the tradeable goods sector and in the world market makes it possible to sell the increased production of tradeable goods. Of course, the only way to gain competitiveness is by a real depreciation. But the real wage cut also generates, at least in the short run, increased unemployment as the spendable income of workers is cut. The size of the required cut in real wages deserves further comment. It is larger the larger the share of trade goods in income and the smaller the share of wages in GDP.

The overwhelming difficulty in the adjustment process is that external adjustment via a gain in competitiveness reduces employment in the short run. The dominant effect on employment is from the reduction in real wages and the resulting reduction in domestic demand. The positive employment response that would be expected in the tradeable goods sector from the gain in competitiveness is often very weak and slow. One of the reasons for this is that expectations of a sustained change in competitiveness do not take hold immediately. The traded goods sector thus adopts a wait-and-see attitude, which makes real depreciation a highly precarious policy tool. The Mexican experience in this respect is particularly instructive.

A second important difficulty arises from the world-wide adjustment to forced debt service. Since most debtor countries were overspending in the early 1980s, and are now under a forced debt service regime, they all had to resort to real depreciation to enhance their competitiveness. But that means they are competitively cutting their wages relative to each other, and not only relative to those of the creditor countries. As a result, an isolated country, cutting its dollar wage, say, by 50 per cent, will gain much less in terms of increased dollar revenues because all the competing LDCs are doing much the same.

THE CAPITAL FLIGHT PROBLEM

A special complication of debt service arises via private capital flight. Uncertainty about the exchange rate, or near-certainty about a forthcoming devaluation required to generate a trade surplus, will bring about an exodus of private capital. Thus, in addition to debt service, countries need resources to finance the private flight of capital. Even with stringent capital controls, the net is not tight, and under or over invoicing of trade flows provides a ready escape. But in many countries capital controls are not even feasible or advisable. The scope for effective restraints on capital movements is very small..

Investors have an option to postphone the return of flight capital and they will wait until the frontloading of returns is sufficient to compensate for the risk of relinquishing the liquidity option of a wait-and-see position. This is the case even when interest rates are high and rewarding. Moreover, when capital does return it chooses a highly liquid form. There is definitely little commitment to a rapid resumption of real investment. The reason for this is residual uncertainty as to whether stabilization can in fact be sustained.

How can investors be reassured? The common answer is that 'credible' stabilization needs to take place. In practice, that comes down to high interest rates and a real exchange rate so competitive that expected further real depreciation is unlikely. But high interest rates are counterproductive from apoint of view of growth because they lead to holding of paper assets rather than real-investment. A low real exchange rate cuts the standard of living and thus reduces domestic demand and profitability for all investments except in the traded goods sector.

But if real depreciation is not sufficient to bring about investment the government faces a very awkward position: income is being redistributed from labour to capital, but because the real depreciation is not sufficient, the increased profits are taken out as capital flight. Labour will obviously insist then that the policy be reversed. This uncertainty is an important features in understanding the real relationship between real exchange rates and capital flight and the post-stabilization difficulties in developing countries.

The capital flight problem is similar to a bank run: If the public is concerned about the value of their assests they stage a run on the (central bank) and force depreciation. The belief that everybody will do the same reinforces each individual investor's belief that he must move out of domestic assets because the general exodus will, inevitably, force depreciation. The income distribution problems associated with the capital flight problem, whether through slow growth, high real interest rates or real wage cutting exacerbates the debt problem.

DEBT REDUCTION STRATEGIES

There are two central questions about debt reduction: all things considered, which is the best way to go about debt reduction and how much debt reduction is necessary? These questions will not receive a unanimous answer.

THE DEBT OVERHANG

The issue of the debt overhang is perhaps hardest to settle. The idea of an overhang suggests that current debt levels are an obstacle to economic performance and a return to creditworthiness. A country's public debt service

TABLE 5.5
The Transfer Problem in Latin America
(Per cent per year or share in GNP)

	1970-80	1980-88
Growth	3.1	-0.8
Inflation	36.7	123.0
Investment/GDP	23.5	18.7
Transfer/GDP (a)	-2.6	3.5
Terms of Trade	3.8	-2.7

a) 1973-81 and 1982-88 respectively.
Source: IMF and UN Economic Commission for Latin America.

TABLE 5.6
Estimates of Capital Flight
(Cumulative without imputed interest, US$ Billion)

	1976-82	1983-87	1976-87 Total	Per Capita (US$)
Argentina	22.4	6.7	29.1	924
Brazil	5.8	14.6	20.4	144
Mexico	25.3	35.3	60.6	745
Peru	n.a.	3.3	n.a.	n.a.
Phillipines	4.5	1.1	5.6	98
Venezuela	20.7	19.4	40.1	2,195

Source: Son Lessard and John Williamson: Capital Flight andThird World Debt, Institute for International Economics, Washington DC, 1987, updated by the authors.

ability depends critically on the quality of its fiscal system. If the tax base is narrow and taxation is inefficient the scope for debt service is exceptionally limited. High external debt may imply growing and ultimately unsustainable internal debt, as countries finance interest payments abroad by borrowing at home. Alternatively, it can lead to unstable inflationary finance, reaching potentially hyperinflation. An unjustifiable postponement of infrastructure investment in physical capita, education and health is almost surely the outcome of excessive debt.

In the short run, a debtor country can easily face up to an excessive debt because these alternate options of budget adjustment or financing provide some leeway. But, already within a few years it becomes clear that these are not realistic options. Moreover, if they are pursued too long or too vigourously they add their own difficulties via capital flight or political deterioration.

By historical and international standards, the debts even of Mexico or Brazil are not record highs: British debt in the 19th century exceeded 200 per cent of GDP and the debt ratio of Ireland or Israel today exceeds those in Latin America. But even these countries, although they have access to the world capital market, have extreme and possibly unsustainable fiscal difficulties. Rapid growth of internal debt in Brazil, Mexico or Chile today is not encouraging. In Mexico, it is especially clear that budget balancing has come at the price of an unsustainable reduction of public sector investment. If growth is to resume, public sector infrastructure investment will be necessary, and that in combination with debt service is incompatible with budget balancing.

In the past seven years the debt/GDP ratio of highly indebted countries has increased dramatically. On the current course of the world economy a further deterioration is likely. Therefore some immediate adjustment of debt service is appropriate. Unfortunately, there is no clearly defined threshold of unsustainability: in large measure the threshold will depend on growth rates of real income, real interest rates and expectations about the terms of trade. In an optimistic scenario for the world economy a debt ratio (internal plus external) of 80 per cent might be sustainable. But with slow growth and high real interest rates in world markets even that is incompatible with financial stability.

At this point, there is no way of predicting which scenario will prevail. It therefore seems appropriate to make conditional debt reduction or, better yet, to link debt service requirements directly to the external environment and growth pereformance of the debtors.

A very significant difficulty in deciding on immediate, large debt reduction arises from the fact that the debt service problem reflects not a physical inability to service debts, but rather a combination of mismanagement, unwillingness and political difficulty. A major fiscal reform leading to a broad and comprehensive tax base is an essential counterpart of debt reduction. There is little or no excuse for the low yields from taxation in debtor countries. Debt reduction should therefore be conditioned on far-reaching fiscal reform.

A further difficulty arises in deciding how much of the debt reduction should fall on internal versus external debt. To a large extent these debt reductions are substitutable: Domestic debt reduction should certinly be contemplated as part of a major restructuring of debt and public finance.

Another point concerns external debt owed to official creditors. In the discussion on debt reduction (except in Africa) the attention focuses on private debt and rarely on public debt. There is very little justification to single out private creditors alone for debt reduction.

A final consideration is how to treat the sizeable flight capital abroad. Under favourable conditions this clearly represents a partial, and in some countries major offset against debt. The difficulty is that flight capital would only return under favourable conditions and that means under conditions of major debt relief. Thus, together command over flight capital debt relief is necessary, but if flight capital does return less debt reduction is requried.

In summary, there is no answer to the debt overhang problem. When the debt ratios are rapidly rising without a clear prospect of reversal, there is clearly an overhang. Solutions involve two adjustments: a broader-based and more efficient tax system, and a reduction in debt service. Both will contain the buildup of debt and the resulting excess dent that stems from capital flight. The distribution between the two adjustments is largely a political decision and a bargaining issue.

We next turn to the chief vehicles for debt reduction. There are two basic issues: one is how to reduce the present outward transfer of resources; the other is how to avoid an unnecessarily large reduction in creditors' ultimate ability to recover at least part of their claims.

SWAPS

Debt equity swaps and debt-debt swaps need little comment. An extensive discussions has highlighted several shortcomings of swaps and conversions:

Conversions rarely present additional resources; conversions apply frequently to projects that would have taken place even without a discount. As a result the central bank loses foreign exchange that could have been used for debt reduction or other priority assignments.

Conversions have to be financed. A country in debt difficulties typically faces for higher borrowing costs on new debt than on captive debt. As a result, the implied refinancing raised dramatically the debt service cost.

Conversions, because they convey the right to remit earnings and principal within a few years, liquefy the external debt. With a conversion, a debtor loses the ability to control the outflow of foreign exchange and thus, becomes more vulnerable.

These arguments against debt swaps have been accepted in the aftermath of recent experience. The Brazilian excesses in swapping almost everything that moved have proved telling evidence. Other countries recognized earlier that their interests were poorly served by swaps.

The Chilean case remains the exception. Chile has reduced significantly its external debt, using mostly repatriation of foreign assets of Chilean nationals to finance the debt reduction. The main reason for the success of this

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policy is that domestic interest rates were little higher than in New York. As a result the Chilean debt was refinanced at a lower cost by taking advantage of the world market discount on the debt.

It is worth emphasizing in conclusion that whatever the merits of debt conversions, and we believe they are limited, these mechanisms have received entirely unjustified public support. Creditor governments and the multilateral organizations have been in the forefront advocating these schemes with an enthusiasm that is altogether out of line with their effectivenes.

BUY-BACKS

The development of the secondary market, just as in the 1940s, has created an active interest in debt buy-backs as a means of debt reduction. In the 1940s, debt repatriation was an important part of the reduction of external debt. Specifically, Chile reduced its external debt in the mid-1930s by one third, using $ 13 million to repurchase $ 88 million, thus paying on average 15 cents on the dollar.

The first major initiative on buy-backs occurred in the Mexico Morgan deal. The disappointing results of this deal arose from the fact that the cash component in the form of a zero coupon bond represented only a small fraction of the new instrument, leaving the chief portion in interest payments without well-established seniority. Bolivia achieved significant debt reduction in its buyback operation. But even that experience has been questioned. The issue, hotly debated, is whether debt-reduction is a good idea for a debtor country. The question involves the alternative use of the resources committed to the buy back. It is not enough to argue that a buyback is interesting because there is a discount. Ther is a discount because some creditors believe that the competing uses of resources will take priority over debt service.

The essential question in deciding on the merits of a buyback concern the alternative use of the resources applied. There are two extremes: in one case resources are made available, earmarked specifically for this purpose. At the other extreme, a country uses scarce foreign exchange reserves or even borrows to use the proceeds in a buy-back operation. The discount is attractive,but the question is whether the foreign exchange could not be used even more effectively in alleviating the domestic macroeconomic problems of a siege economy.

It has been argued that there are large efficiency gains to be derived from debt reduction, possibly including gains in macroeconomic stability, and this extends to the prospect of sharply reduced capital flight. Of course, it is also possible that the cost of making resources available for debt buy-backs is very large. This is certainly the case when, as in Brazil until recently inflationary finance is used for informal debt conversions. In that case buy-backs may be a source of increased rather than reduced financial instability and capital flight.

Buy-backs are a one-way street when a country is credit constrained. Using reserves, as Mexico did to retire debt seemed a good idea at the time because reserves were plentiful. But less than six months later the country is on the verge of a major devaluation because it does not have the reserves to support the exchange rate and yet does not want to face the confrontation of a halt in debt service. Bankers are pleased that they took the money then: they certainly will not give it back. Mexico would have done better to hold on to its reserves, a point many observers made at the time. But the situation is not always as obvious as it was in Mexico's case. Unfortunately, there is not simple and robust test of the importance of these efficiency gains. Hence the argument must remain open.

Beyond the efficiency gains noted above we must also note the implications of buy-backs for creditor-debtor relations. Buy-backs may be a means of conflict avoidance. It is not apparent what creditors could and would be willing to do to enforce therir claims. Perhaps they could do very little and hence (morality aside) it is surprizing that debtors do service at least part of their debt. But it is also possible that, particularly in the event of frivolous non-service, creditors receive political support to inflict major damage on unwilling debtors. This uncertainty about the consequences of partial or full default are a burden on debtor economies' prospects. Cooperation in debt reduction schemes may be the price to pay for reduced debt service without penalty. If outright nonpayment is a taboo, buy-backs may be a relatively cheap rescheduling strategy. Of course, when countries pay all the interest as Mexico did and Brazil expects to do, this argument does not hold.

A successful opportunity for buy-backs seems almost a contradiction in terms: if debtors do have the money the discount will be small. If they do not have the money the discount will be large, but beyond reach. But there remains an important opportunity that arises from the contamination factor: Today, all of Latin American debt trades at a discount, even the debt of Colombia, not with standing the fact that it has continuously serviced its debt in respect to interest and principal. If capital markets do not discriminate between debtors, there is an opening for relatively well-performing debtors to buy out particularly ill-informed (or constrained) creditors. There is an overriding temptation for Colombia whose debt trades at a 50 per cent discount to use its resources for buy-backs rather than amortization.

By historical standards it may be too early to buy out the cerditors. Ten years from now they may be eager to settle at 10 or 20 cents on the dollar. But for debtor countries holding out is also costly; the unresolved debt overhang can be a source of capital flight and macroeconomic instability. An early, though less drastic debt reduction may therefore be preferred.

INTEREST REDUCTION OR BUY-BACKS?

In the context of the Brady Plan it is useful to ask whether resources should be concentrated on reduction of principal or of interest. Both lower the level of debt service, but they operate quite differently. Because the total amount of official resources that are available is limited, it is essential that maximum leverage be sought. The use of zero-coupon, 30-year instruments to collateralize principal payments goes precisely in this direction since it costs only 10 cents today to by a dollar 30 years from now. Accordingly even a very small amount of official resources can be effectively used to collateralize distant principal repayments. But the principal payments are very distant and for that reason they are relatively unimportant in creditors' calculations; near-term interest earnings count for more than very remote principal. Creditors therefore would prefer, on the whole, to see resources applied to collateralize a few years' interest payments and, for such guarantees, would, in principle, be willing to suffer some reduction in the face value or in the interest rate on outstanding claims. While creditors might consider reductions in the face value of debt, their preference is clearly for granting a limited period of interest relief. The reason is that a debtor country might recover ability and willingness to pay and, in such a case, it would have been unwise for creditors to discard claims to full debt service.

Creditors face two issues, immediate illiquidity, and hence inability to service debts, and second, growing debt burdens. Politically, debt reduction is the most visible option, but a strategy of interest relief combined with a restructuring of the principal is preferable. Interest relief helps solve the liquidity problem. Beyond that, the principal should be restructured so that the debtor undertakes to resume specified degrees of debt service based on specific objective indicators, including growth and export prices. Until their economy reaches these trigger points, interest relief remains. The interest relief in turn is guaranteed by official resources.

Alternative uses of official resources are less desirable. This is especially the case with buy-backs because they absorb a large amount of very scarce resources; applying them to the flow of interest rather than the principal makes them go further. There is the additional argument that buy-back operation on a majour scale could not fail to raise the secondary market price and thus dilute the potential of debt reduction that the limited resources now available might offer.

INTEREST RECYCLING

Debt reduction implies a fall in current debt service obligations and that is welcome. It also involves, however, an unconditional reduction in future debt service, whatever a country's ability to pay ultimately. This seems a poor economic approach to resolving debtor-creditor relations. We favour an approach that is radically more supportive of growth requirements in the debtor countries, and at the same time, emphasize the debtors' responsibility to pursue fiscal and growth policies which ultimately service a significant portion of their debts.

Much of the discussion on debt reduction does not distinguish sufficiently between the two sources of debt difficulties: one is the budget problem, the other is the dollar or trade problem. It is not necessarily the case that countries experience equally or at all the two problems. It is perfectly conceivable that one country has a trade problem but no budget problem, and another country has a trade surplus and thus from a foreign exchange point of view is in a position to service debt while its fiscal situation is not sufficiently solid to entertain debt service.

When external transfer problems predominate the problem can be addressed not only by debt service reduction but also by a fundamental restructuring of debt service in a manner which takes care of the major part of interest payments due. Actual payments in dollars would be reduced to that needed to service trade credit and the loans of multilateral organizations. A large share of the remaining interest payments would in part be capitalized, thus freeing resources for much needed public sector investment, and in part they would be made in local currency. Creditors who receive the local currency payments could use them for unrestricted investment in the debtor countries' economies. The only limitation on the use of funds would be that they cannot be transferred abroad. The claims to these payments could, however, be sold.

The advantages of interest recycling are threefold. The transfer abroad of resources is suspended. Rather than running trade surpluses, debtor countries have resources freed that can be devoted to investment. Of course, serious budget action is required to assure that in fact the resources go into investment rather than consumption. The shift of resources toward investment has two effects. It implies an expansion in capacity and thus sustains job creation. This issue is central in an economy where labour force growth rates in excess of 3 per cent have created major imbalances between labour supply and demand. The expansion in capacity removes the bottle necks which today stand in the way of growth. Growth in turn translates into more stable public finance via a broadened tax base.

The scheme creates a more stable and prosperous business environment. With the current strategey a foreign exchange bottle neck is always around the corner and the reaction is invariably contraction of demand and exchange depreciation. This reality has led to a lack of interest in productive investment and extensive capital flight. The centre of gravity has shifted to financial markets, far away from productive activity. By removing the need for immediate debt service the debtor economy can resume a more balanced position with an emphasis on long-term investment and growth. As a lever for returning capital there is no better way than a restoration of business confidence and an end to exchange rate pressure.

Recycling also offers two further advantages to creditor countries: it avoids outright debt relief (or debt default) and hence avoids involvement of creditor country taxpayers on a large scale. Furthermore, by providing debtors with room for growth there is every expectation of increased exports to debtor countries and a reduction in the currently high levels of imports. Interest recycling, by reducing exchange rate uncertainty, creates an essential precondition for a return of flight capital.