

Prospect and U.S. Policy for The LDC Debt Problem

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Although the foreign debt problems of less developed countries (LDC's) are far from solution, there have been positive developments since the initial crisis of international debts in the early 1980's. First, the crisis has been defused, albeit temporarily, by the unprecedented cooperative efforts of public and private organizations in the international financial system.¹⁾ Secondly, the genesis of the initial crisis and its dynamic interplay among lenders, borrowers and regulators are better understood by bankers, public officials and other analysts of international finance and monetary systems. Thirdly, borrowers and lenders are engaged in the process of discussion in which they are trying to devise long-term developmental financial strategies under the auspices of their governments and international organizations, such as the IMF, the World Bank and regional development banks.

This paper is comprised of six sections. Section One presents a brief review of the literature on borrowing capacity of LDC's. Section Two discusses various views on the causes of the debt problems. Section Three presents a number of new approaches that have been implemented or proposed for the management of debt problems. Included in these sections are not only the innovative measures already implemented, such as multi-year rescheduling, co-financing and currency swap, but also the new approaches that have been broached, such as the Baker Plan and the Martin initiatives. Section Five discusses solutions for LDC debt problems: the maximum interest ceiling plan, the loan purchase plan and the debt-equity conversion plan. Also discussed in this section is an unconventional idea for alleviating LDC debt problems by the so-called "junk-bond fund." Concluding remarks are found in the last section.

I. Issues of Optimum Debt Capacity

The literature on debt capacity of LDC's has focused on two major questions (1) What is the optimal level of debt that can be incurred by a developing country? (2) What determines the sustainability of the

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1) The international debt crisis is essentially a problem in the Western Hemisphere. See Pyun (1985).

country's debt policies²⁾ According to McDonald (1982), these two questions have been extensively studied by researchers in one of two analytical regimes: growth-cum-debt models or indicator approaches.

In growth-cum-debt models, debt capacity is typically analyzed in the context of Harod-Domar type neoclassical growth models. The major focus of these models was initially on the use by LDC's of external funds of investment purposes. However, increasing attention has been given in recent years to the use of external borrowing by LDC's for sheltering or smoothing their consumption during periods of income fluctuations. Analytical attention has also been given to the effects of sovereign risk in determining debt capacity of individual LDC's.

In models for long-run analysis, debt problems are mainly those of sustainability and the optimal rate of borrowing. However, in general, it is impossible to define "the" optimum rate of foreign borrowing with a growth-cum-debt model. Chae (1984) showed that the optimal rate of external financing was different in each case and depended upon the objectives to be attained as well as upon the underlying assumptions of each model. In some cases, the optimum debt capacity was determined concurrently with per capita consumption and per capita debt service payments, while in other cases, the optimum borrowing was determined by the absorptive capacity of the economy. More importantly, these models are based on rigid behavioral and institutional assumptions, preventing them from relating many critical factors, such as the supply side of the international financial markets and the discretionary influence of policymakers on the fiscal parameter of the models (McDonald, 1982).

Indicator approaches to debt capacity are empirical, in that they attempt to identify those circumstances under which countries have experienced debt-servicing difficulties. Primarily, indicator approaches try to delineate liquidity and solvency elements in the debt capacity through statistical analysis of key economic and financial variables, such as export earnings, interest, and amortization. The borrower's credit-worthiness is largely determined by country-specific variables such as growth rate of its income, its export and current account earning, its reserve and debt-service ratios. Among these, the debt-service ratio was the most extensively used by researchers. Statistical techniques used for debt-service-ratio studies ranged from a simple financial ratio (Palmer and Gordon, 1985) to highly sophisticated statistical techniques such as logit analysis (Feder and Just, 1977; Chae, 1984).

2) For a survey of the literature, see McDonald (1982).

Some banks, such as the Bank of Montreal and First National Bank of Boston, have developed objective criteria for country risk analysis.³⁾ Typically, country risk analysis evaluates a number of relevant socioeconomic indicators of countries and ranks countries in order of credit-worthiness. However, largely because much relevant statistical information is outdated by the time it is published, and because of the difficulty in identifying effects of random shocks (e.g., oil crisis) on an ex-ante basis, it is almost impossible to devise an analytical system useful for banks at the time of loan commitment (Kharas, 1984, p. 422 and Madura, 1986, pp. 500-501). In short, the usefulness of these indicators as early warning signals has been neither theoretically validated nor empirically substantiated.

II. The Genesis of the Debt Problem

The current external debt problem of LDCs is often attributed to greedy commercial bankers, who overextended credit to LDCs and imprudent leaders of developing countries, who borrowed extravagantly. There is some truth to this characterization. However, the sheer magnitude of the external debt of non-oil developing countries, which rose by as much as \$500 billion during a ten-year period between 1973 and 1982, suggests that the problem was a culmination of a series of events that eluded hundreds of intelligent bankers and LDC government officials.

1. External Shocks

Many experts tie the emergence of the debt problem to the inflation of the late 1970's and the subsequent disinflation and world recession in 1981-82 (Weintraub, 1983 and Cline 1985). During the inflationary surge of the late 1970's, the interest rates at which LDCs were borrowing were generally below the U.S. inflation rate, making the real cost of carrying external debts negative for the borrowers. However, when interest rates rose dramatically in the 1979 to 1981 period, floating interest rates made loan rates on new and existing debts go up dramatically also.⁴⁾ It is estimated by Cline (1985) that of the \$500 billion net increase in the total debt of non-OPEC developing countries from 1973 to 1982, \$260 billion

3) For the description of the country risk analysis devised by the Bank of Montreal, see Nagy, 1978.

4) Based on 1982 indebtedness, a one percentage point increase in LIBOR meant an increase in annual net interest payments of \$594 million for Mexico, \$455 million for Brazil, and \$205 million for Argentina.

may be attributed to the quantum jump in oil prices; \$100 billion to global recession in 1981-82, the recession that both aggravated the terms of trade and reduced export volume; and \$40 billion to the high interest rates.

Putting the debt burden of LDCs in a different perspective, during the 1970's, LDCs financed their borrowing at an average rate of 10 percent, while they increased their exports at an annual average rate of 21 percent. However, in 1980-81, their interest rate rose to 16 percent while their exports grew by only 1 percent on the average. From these, Cline (1985) concluded that the debt problem was essentially due to the "shift from low or negative interest rates in the inflationary 1970's to the high real interest rates of the early 1980's, aggravated by declining real exports during the global recession."

2. The Fiscal Origin of the Debt Problem

While conceding that the global recession and high real interest rates aggravated the debt problem, Wiesner (1985) traced the origin of the debt problem to the disequilibrium created by excessive public and private spending, financed by both easy domestic credit policies of Latin American countries and by generous lending from abroad. He cited statistics that, between 1979 and 1982, the three largest Latin American nations—Argentina, Brazil and Mexico—more than doubled the size of their non-financial public sector deficits, which rose from the already high level of 6 percent of GDP to well over 15 percent. During the same period, the three countries also almost doubled their external debt. In essence, their foreign borrowings enabled them to sustain absorption levels higher than their national income allowed. It should be pointed out that they did not use all of the external financing to increase investment, but they used it to finance more consumption. Their domestic savings as a proportion of gross domestic product (GDP) did not increase, while the ratio of their gross domestic investment to GDP actually declined (Wiesner, 1985).

It should be also pointed out that when borrowings were public sectors, the importance of economic feasibility of investment projects was often deemphasized. Many projects were initiated, not because they were economically sound, but because they found external financing by multinational banks, which were eager to make loans (Wiesner, 1985).

3. The Regulatory Origin of Debt Problems

The recycling of the so-called petro-dollar was an undertaking not only mammoth in scope, but also a novel experiment in international banking. Never before in the history of international finance had such a huge amount of deposits been entrusted to commercial banks for placement, and loaned to sovereign debtors. In retrospect, in their eagerness to recycle petro-dollars, banks acquired assets that yielded rates not compensating for the riskiness of the assets. Multinational banks as a whole erred in assuming that "a sovereign risk was a small risk because public sectors normally do not default" (Wiesner, 1985, p. 193).

It is significant to note that the risk premiums on loans to LDCs in the 1970's were not high relative to those on loans to U.S. domestic prime rate borrowers. For instance, in 1979, more than \$40 billion in new bank loans were made to developing countries at an average rate barely 13 basis points above the U.S. prime rate. Even in 1983, after the debt crisis had blown open, interest rates on bank loans to developing countries were only about 25 basis points above the U.S. prime rate (E. Folkerts-Landau, 1984).

While commercial banks did not adequately factor the increase in lending risk into their pricing of loans, investment bankers did factor in such risk for bonds issued by developing countries. For instance Dutch Mark bonds issued by LDCs in 1982 before the debt crisis erupted, had interest rates that were 200 basis points above bonds issued by industrialized countries. This difference widened to an average of 620 basis points in September, 1982, following the Mexican moratorium on their loan payments. In an extreme case in the same year, Argentina had to pay a risk premium of more than 900 basis points for their DM bonds (E. Folkerts-Landau, 1985).

Many writers blame regulatory authorities of developed countries for distorting the market price mechanism that normally ensures risk sharing by lenders and borrowers. Wiesner and E. Folkerts-Landau, among others, maintain that the low risk premium on bank loans to LDCs was a rational response by banks to incentives that were provided by their governments. In the U.S., the Federal Reserve encouraged the recycling of the petro-dollars. Moreover, it did not discourage U.S. money center banks from assuming a loan exposure to non-OPEC countries that exceeded \$103 billion by the end of 1982.⁵⁾ Furthermore, when Continental

5) It is estimated that OPEC placed over 50 percent of their surplus cash in the world's commercial banks, which amounted to \$158 billion between 1974 and 1981.

Illinois National Bank was teetering at the brink of bankruptcy, U.S. federal regulators lifted the \$100,000 cap of deposit insurance coverage, so that deposits were fully covered by FDIC.

Two significant economic benefits accrued to large money center American banks by the change in deposit insurance coverage. First, it implied that U.S. money center banks are inviolable from default. Second, the protection of liabilities of these money center banks by the Federal Reserve and FDIC amount to a subsidy to the banks. Their loan risks were shared by the Federal government at little cost to them.

4. The Structural Origin of Debt Problems

Both international lenders and LDC borrowers practiced unsound financial principles: international banks mismatched their liabilities with their assets, while LDC borrowers mismatched their long-term investments with short-term financing. Deposits in Eurocurrency markets, where the bulk of syndicated bank loans to LDCs originated, were largely time deposits of relatively short duration. However, banks made 7- to 10-year loans. To minimize interest rate risk in lending long-term, with short-term funds in an inflationary environment, banks structured syndicated loans with floating rates of interest.

In theory, floating rates can stabilize real interest rates on long-term debt. However, the experience with the U.S. anti-inflationary monetary policies in recent years showed that both real and nominal interest rates could go up, making debtor countries very vulnerable to fluctuations in interest rates. Not only did high rates of interest exacerbate debt service load for LDC borrowers, but also the change in interest rates often made past borrowing uneconomical, as the marginal return on investment could be exceeded by the marginal cost of funds by ex-post changes in the cost of funds due to floating rates (Go, 1985). Thus, an analysis of optimum borrowing loses its validity under floating rates, as ex-post changes in cost of funds upset the economic rationale for the investment already made.

From a borrowing country's point of view, mismatching of long-term investment projects with medium-term financing is a serious structural problem confronting LDCs. In the 1920's and 1930's developing countries relied almost entirely on bond financing for their long-term credit. If petro-dollars were recycled in the form of bond financing, OPEC countries would be holding bond claims on developing countries rather than deposit claims on international banks. It is generally agreed that if LDCs had issued bonds, they would have managed their bond indebted-

ness better than they did with medium-term bank loans (E. Folkerts-Landau, p. 45). They would have borrowed less, discouraged by interest rates that compensated for default risks. More importantly, they would have been able to service their debt better, as their bond maturity would have realistically matched the economic life of the investment for which the bonds were issued.

Corollary to the mismatching of the economic life of investment with long-term financing was another structural problem called "bunching" of payment obligations faced by LDCs. As external borrowing increased, new additional loans had to be secured, and maturing loans renegotiated. Interest payments for, and amortization of, these loans tended to be packed in a relatively short time frame, so that the debt service capacity of LDCs was adversely affected. It should be pointed out that the bunching of payment obligations bore critical importance when the ability of LDCs to service their external debts was adversely affected by forces external to them, such as the second oil shock and recession in the developed countries.

III. Innovative Approaches to Debt Problems

A number of new approaches have been implemented in the past several years in the management of problems associated with LDC's external debt. There have also been a number of innovative ideas and proposals advanced to address the structural problems of debts owed by LDCs. This section discusses some of those new approaches as well as those proposals that are in their initial discussion stage.⁶⁾

1. Multi-year Rescheduling

The first multi-year rescheduling was formally agreed upon with Mexico in March, 1985. Under the conventional rescheduling, loan maturity was extended by one or two years. Under a typical multi-year rescheduling, loans maturing in three to six years are rescheduled under a single negotiation. Multi-year rescheduling allows the debtor nation to have not only an easier amortization of its loan, but also a better chance to manage its economic affairs, including necessary adjustment for debt service.

6) For a detailed discussion, see deLattre, 1985.

2. Multilateral Co-Financing

Multilateral co-financing, which involves cooperative joint lending by foreign governments (or commercial banks) and multilateral development banks (such as the World Bank and Inter-American Development Bank), is not new. What is new is a new mechanism of co-financing called the B-loan, which was devised by the World Bank in 1983. Under the B-loan format, the World Bank provides two linked loans: the A-loan and the B-loan. The A-loan is conventional multilateral co-financing under which commercial banks and the World Bank coordinate their respective loans to a single country with a cross-default clause. In the B-loan portion, the World Bank additionally participates in a syndicated loan as would a private bank. Advantages of the B-loan are that it increases the pool of funds available from private sources by linking private commercial bank loans to a limited official fund, and that it gives the borrower funds necessary for creditworthy projects with lower interest spreads and longer maturities or grace periods (deLattre, p. 32).

3. Currency Diversification and Swap

U.S. dollar-denominated debts constitute a significant proportion of debts owed by LDCs. During the early 1980's, the appreciation of the dollar, together with high interest rates, adversely affected the debt service capacity of borrowing countries. A 1983 study showed that if loans had been denominated in a mix of currencies instead of dollars for the period 1979-1982, interest payments would have been lower by \$4.5 billion, and the amount of outstanding debt in dollars would have been approximately \$11.5 billion less in terms of other currencies (deLattre, p. 34). In order to diversify the borrower's existing loan portfolio, currency swaps should be initiated by the country involved with the cooperation of lending banks and the World Bank. Rescheduling of Brazilian and Mexican debts in 1984 employed currency swap and diversification arrangements where new debts were denominated in Japanese yen and European currency units.

4. Multilateral Insurance and Guarantee

Most countries have loan or investment guarantee programs administered for the benefit of their own businesses. For instance, in the U.S., the Commodity Credit Corporation has administered insurance for financing of American exports, and the Overseas Private Investment Corporation

has offered guarantees to U.S. investors in foreign countries. In order to encourage foreign direct investment in developing countries, the World Bank has proposed the establishment of a Multilateral Investment Guarantee Agency (MIGA) under its auspices. MIGA will be primarily complementing national insurance programs by enhancing risk diversification. It will be financed and controlled jointly by home and host countries.

5. Shift From Short-Term to Long-Term Measures

The debt management by the IMF for LDCs which had payment difficulties has centered on the classical approach to disequilibria of balance of payment; that is, reduce imports and government spending and increase export through monetary and fiscal measures, including realistic exchange rate policy. This approach imposed austerity and self-sacrifice on the part of debtor nations, and it did bring forth some results. For instance, during the period between 1983 and 1985, the ten largest debtors in Latin America earned an aggregate trade surplus of over \$100 billion.

Unfortunately, the trade surplus was not the result of improved performance in their exports, but it was the upshot of drastic cuts in their imports. In fact, IMF's austerity programs were often not implemented as they were intended, and few of the debtors have made much improvement in stabilizing their internal economies. Instead of reducing budget deficits by reducing government workers and closing unprofitable state enterprises, these governments cut capital spending for development projects. Moreover, Latin American debtors as a group have not brought budget deficits under control. Neither have they been very successful in curbing rampant inflation. Consequently, their per capita income has declined since 1982.

Under the IMF imposed measures, these countries have ended up sacrificing domestic growth and investment in order to meet their debt service obligations. It is estimated that approximately a third to one-half of domestic savings in the Latin American countries is used to service the estimated total debt of \$437 billion. Figures from the Inter-American Development Bank revealed that public and private investment in the Latin American countries last year fell by approximately \$45 billion, or more than 25 percent, from 1980 levels (*Wall Street Journal*, June 11, 1986).

Corrective measures should be aimed at LDCs to help promote efficiency and long-term development of their economies. In Paul Volcker's view

(1985, p. 703), which is shared by other high ranking officials of the Reagan administration, heavy reliance on the short-term tools used by the IMF in debt rescheduling should be phased out and replaced by a long-term, policy-based program that can best be administered by the World Bank. The proposed role of the World Bank in debt management reflects several views widely shared by officials of both lending and borrowing countries for some time, namely: (1) stabilization program that IMF has imposed on debtor nations, as a condition of its rescheduling of their debt, were too austere and have not produced the desired results, (2) IMF programs have often conflicted with the World Bank's long-term growth-oriented policies, and (3) the thrust of the debt rescheduling should be directed at the promotion of general economic efficiency and growth through increased flow of additional foreign capital.

IV .The Baker Plan

At the annual meeting of the IMF-World Bank in Seoul last fall, U.S. Treasury Secretary James Baker proposed a multilateral approach to the debt problem. The plan, focused on a total of 15 major debtors—10 major debtor countries in Latin America and five elsewhere⁷⁾—calls for making a new loan of \$40 billion of these 15 countries over the next three years in exchange for their promise to take corrective policy actions to reinvigorate their economies. The 15 countries owe a total of \$437 billion, carrying an average interest of 10 percent.

The plan proposes a \$30 billion increase in net commercial lending in the next three years, equal to a 2½ to 3 percent annual increase in exposure. It is estimated that the commercial banks will receive approximately 140 billion annually in interest from the 15 countries. The plan also proposes a 50 percent increase in disbursement by the multilateral development banks to their major debtors, up from \$18 to \$27 billion. The World Bank will provide 65 to 70 percent of the total. Under the plan, it is envisioned that if the multilateral development banks contribute an additional \$9 billion in the next three years, commercial banks around the world would make greater loan commitments, possibly as much as \$20 billion. Some commercial bank lending will be formally tied to the World Bank's lending through co-financing (see co-financing in this paper). Lending will continue on a case-by-case basis, with loans of

7) The 15 countries and Brzil, Mexico, Argentina, Venezuela, Chile, Columbia, Peru, Uruguay, Bolivia, Ecuador, Yugoslavia, Nigeria, Morocco, Ivory Coast and Philippines.

individual countries negotiated separately. Thus, the centerpiece is the World Bank and other multilateral development banks, whose initial loan commitment will encourage a new form of leveraged loan from commercial banks (*Euromoney*, Dec., 1985). It is important to note that the plan shifts emphasis in commercial loans to policy-based lending.⁸⁾

Reception of the Baker plan by government officials and bankers has not been enthusiastic. Some see it as a fresh approach worth trying, while many others criticize it as being ill-conceived and unworkable. However, it is generally agreed that if the new strategy for growth works as it is conceived in the Plan, a positive environment could be created in the major debtor countries for a sustained economic growth and an increased flow of foreign capital.

Critics of the plan often point to three impondables in the Baker plan. First, structural changes in the major debtor countries proposed in the plan are difficult to put into effect without inviting serious political unrest in the debtor countries. Secondly, money center banks will have difficulties in lining up some 700 banks in 50 nations to commit to lend \$20 billion. This is particularly difficult because many second-tier banks, which participated in past loans to the 15 countries, have already written down their losses and most of them are not likely to participate in the new loans. Yet their participation is essential for the success of the plan.

Thirdly, the \$20 billion contributions from the multilateral development banks are not enough. Even if the amount is assumed to be adequate, the World Bank cannot borrow \$2 billion or more annually needed under the plan without jeopardizing its credit standing in the international capital markets. The World Bank's leverage of 123 percent now is already high as compared to a mere 44 percent debt-to-capital ratio for the Inter-American Development Bank, which has the second highest debt ratio. In addition to these impondables, it should be noted that European bankers are not happy with the plan, because their participation in the Baker scheme is unilaterally assumed by the U.S. Treasury (*Euromoney*, Dec., 1985).

There has been a continuing capital flight from the 10 Latin American debtor countries. In fact, as Table I shows, most of the new debt-rescheduling loans made to the Latin American countries in the past three years by commercial banks can be regarded as having facilitated more capital flight. The capital flight not only aggravates the balance of payments of

8) Policy-based lending can be structural adjustment and sector loans, both of which attempt to maintain growth while supporting institutional reforms and policy changes aimed at efficient resource allocation and improving balance of payments.

these countries, but, more importantly, undermines entire global efforts to restore creditworthiness of, and confidence in, the Latin American countries.⁹⁾

This is part of the phenomenon that Lever and Huhne (1986) called "the central aberration of the debt crisis." The phenomenon refers to flow of capital in a direction opposite from what is theoretically and intuitively correct; that is, capital flows into LDCs from industrialized countries. According to Lever and Huhne, funds are flowing the wrong way in the world capital markets because of soaring volume of debts and attendant interest payments that LDC countries have to make. It is

[Table 1] Capital Flight and Net New Borrowing, 1983-85
(in billions of dollars)

Country	Capital Flight	Net New Borrowing
Argentina	0.1	6.5
Bolivia	0.3	1.0
Brazil	6.6	20.2
Chile	-0.6	3.9
Columbia	0.7	3.2
Ecuador	0.6	1.3
Mexico	16.2	9.0
Peru	1.1	2.9
Uruguay	0.2	0.5
Venezuela	5.5	-4.2
Total	30.8	44.2

Source: *World Financial Markets*, Morgan Guaranty Trust Company in New York, February, 1986.

estimated that net outflow of funds from the seven largest debtors exceeded the inflow of funds by \$32 billion last year. When capital flight from the Latin American countries is added to funds flow out of the developing countries in the form of debt service, the total amount of money flowing into industrialized nations from the South American countries is quite enormous. This process must be reversed if they are expected to ever pay off their external debts.

9) See Khan and Haqua (1982) for a theoretical discussion of capital flight from LDCs.

V. The Martin Initiatives: Aborted Ideas

Shortly before the annual meetings of IMF—World Bank in Seoul, former Federal Reserve Vice Chairman Preston Martin publicly broached his ideas on the international debt problem. It is very significant that Chairman Paul Volcker reacted disdainfully to Martin's ideas and that shortly after the public clash between the two, Martin abruptly resigned from the Federal Reserve. For the time being, at least, it appears that Volcker favors a slow and gradual change in the management of the debt problem which is consistent with the approach of the Reagan administration. It should be pointed out that some conservatives in the U.S. are critical of the IMF's austerity measures that forced debtors in Latin America to impose import restrictions and currency blockages.

Preston Martin proposed the following three measures that are designed to help reduce the crushing debt burden of debtor countries (Martin, 1985):

1. Place a cap on the amount of interest that debtor countries have to pay on their debts.
2. Have multilateral agencies, such as the World Bank, buy up developing countries' debts from commercial banks in exchange for the agency's own bonds. The idea, initially proposed by Lazard's Felix Rohatyn, is for commercial banks to be able to strengthen their balance sheets by writing down part of their non-performing loans and by acquiring loan notes issued by multilateral agencies.
3. Convert part of a country's external debt into equity in a state-owned or privately-held company in the debtor country.

1. Maximum interest Ceiling Plan

Under the typical rescheduling, principal payments falling due over the next year are postponed, while new loans are made to help pay interest on the old one. However, rescheduling makes the debt burden of borrowers even worse, because new loans are made at an interest rate substantially higher than the rate on the old one. As Table II shows, debt-service payments in the form of interest spreads for Argentina almost doubled. If she had problems of repayment for a loan with a low interest rate, can she reasonably be expected to repay the new loan that has a higher interest rate?

There is a growing school of thought that some debts of developing countries, particularly those of low-income countries, may have to be written off, as their debts are not realistically sustainable under the best

possible conditions. Unless banks forgive these debts soon, many experts argue convincingly for putting ceilings on debt repayment. U.S. Senator John F. Kerry, a member of the Senate Foreign Relations Committee, favors not only limiting the amount of interest that can be charged to developing countries with payment difficulties, but also linking the level of interest ceilings to the amount of American goods a country buys (*Korea Herald*, May 22, 1986)

[Table 2] Debt Rescheduling in Latin America

Country	Amount	Terms of Original Loan	Rescheduling Terms
Argentina	\$5.5 billion	8 years at 1.125-1.28% + LIBOR	Either 2.125% + LIBOR or 2% + US prime in 17 quarterly installments from June 30, 1986
Bolivia	\$1.4 billion	7 years at 2.25% + LIBOR	Three-year delay on payments
Ecuador	\$1.2 billion	1 year at 0.25% + LIBOR	6 year maturity from December 1983 at 2.25% + LIBOR or 2.15% of US Prime
Mexico	\$19.5 billion	7 years at 1.5% + LIBOR	1.875% + LIBOR or 1.75% + US Prime in 16 quarterly installments beginning 1987

Source: *Euromoney*, March 1983, p. 55.

2. Loan Purchase by the World Bank

At present, it is unlikely that the U.S. Congress will support the idea of World Bank purchase of LDC debts. Many see it as an easy bailout for large money center banks, while others oppose the idea on the grounds that the World Bank's credit rating will be lowered by the measure, which will thereby raise the cost of capital for the World Bank and its client countries.

3. Loan-Equity Conversion Plan

The Baker Plan does include a measure to induce foreign direct investment with guarantees provided by the Multilateral Investment Guarantee Agency. However, it does not include conversion of a country's existing foreign debt into equity in a company in the debtor country. Many

bankers believe that the conversion scheme has merit in some countries, and that the conversion will complement well the overall management of LDC debts. The conversion will enable the debtor country to defer both interest and repayments on principal, so that the debtor country may recover and ultimately pay other debts. To implement this scheme, the debtor country will have to liberalize its foreign exchange controls as well as its foreign investment rules (Sycib, 1985).

There is another argument for the conversion of debt to equity. In general, business saving in relation to investment needs is inadequate, and the reliance on bank loans as primary sources of business capital has been substantial in most developing countries.¹⁰ If conversion of debt to equity is possible, the measure will not only relive the external debt problem of the country involved, but also alleviate the detrimental effects of high corporate debt-equity ratios upon macroeconomic stability in general and on government monetary policy options in particular (Sundararajan, 1985).

4. Junk Bond Plan

A new addition to the growing list of ideas for the solution to the LDC debt problem is a report that investment banking firms are interested in buying a large portion of LDC debts from money center banks at a deep discount, say 25 cents on the dollar. They could then resell the loans as high-yield bonds to investors. If some of the loans are repaid by shaky countries such as Peru, the "junk bond" can give investors as much as 40 percent annual yields (*Fortune*, February, 1983).

At present, the idea is not appealing to American money center banks. If and when these banks sell part of the LDC loan at a deep discount, they may have to write down the remaining loans to that country. With certain changes in accounting rules, the junk bond scheme can be made into an attractive alternative to a partial solution of the LDC debt problem.

VI. Concluding Remarks

In the mid 1970's, international banking markets successfully absorbed huge amounts of petro-dollars and recycled them through institutional and financial innovations. A network of multinational banks has emerged

10) For instance, the average leverage ratio of firms in the industrial sector in Korea was reportedly as high as 500 percent in recent years. (See Sundararajan, 1985)

as a dominant source for both short- and long-term credits, replacing the markets for international bonds. International banks have developed efficient mechanisms to deal with sovereign borrowers. In particular, the risks of individual loans to different borrowers in one country were linked through public guarantees and cross-default clauses, while at the same time the lending side of the market was also concentrated through the syndication of loans (D. Folkerts-Landau, p. 352). Thus, a country cannot default on some of its international bank loans without risking loss of access to the international banking market. This largely explains why in recent years there have been few defaults, as well as why national and international agencies, along with international banks, assisted countries with payment difficulties by rescheduling external debts. This also explains the low risk premia that international banks tacked on their syndicated loans to LDCs: they perceived little likelihood of outright default and therefore included in their rates only risk premia for the expected cost of rescheduling, which was a fraction of the expected cost associated with default.

A valuable lesson that we have learned from the IMF experience is that adding new debt to existing LDC debts to keep up interest payments, and forcing austere economic measures on weak LDCs, was not only politically unacceptable to most LDCs, but also inherently unworkable for lenders in the long run.

The solution to the LDCs debt problem must be formulated with a long term perspective. Their loans must be rehabilitated by reducing their debt servicing burdens and by allowing their economies to grow. In order for LDCs to grow, they must have growing markets for their exports. Additionally, the current floating exchange rate system is in need of a major overhaul, and developing countries need a mechanism that allows them to float long-term bonds.

Lastly, it must be recognized that the external debt problem of LDCs is not simply a financial one. It involves major social and political problems in developing countries and may very well jeopardize their political and social stability. Debtor nations need time to implement realistic adjustment programs. This also means that all parties involved—the IMF, the Bank for International Settlements, governments and central and commercial banks of creditor countries and debtor countries—must make cooperative efforts to prevent the breakdown of economies of debtor countries and minimized the overall impact on the international financial system.

Appendix

External Debts and Debt Service Ratios of Selected Countries, 1985

	Long-term Debt (\$ Billion)	As % of GNP*	Debt Service Ratio**	Total Debt Service Ratio***	Per Capita Income	Per Capita External Debt
Argentina	\$ 49.5	82.6%	60.6	234.5	\$ 1,962	\$1,618
Brazil	104.5	49.9	74.0	112.4	1,546	771
Chile	21.5	133.3	51.9	105.6	1,333	1,777
Mexico	97.3	48.3	78.6	125.8	2,931	1,238
Venezuela	36.5	71.8	36.4	155.3	2,931	2,110
Hong Kong	9.5	27.8	6.4	13.0	6,306	1,759
Indonesia	37.0	45.5	24.5	58.0	497	226
Korea	48.0	57.7	19.7	60.4	2,017	1,165
Malaysia	20.3	63.1	12.2	27.8	2,068	1,310
Philippines	26.3	86.6	38.5	155.5	554	481
Taiwan	7.8	13.0	6.7	14.7	3,138	408
Japan	148.0	11.2	9.7	21.9	10,973	1,763
USA	410.0	10.3	16.6	45.7	16,699	1,225

* Long-term debt as percent of GNP or GDP.

** Interest plus paid amortization on long-term debt as percent of exports of goods, services and net private transfer.

*** Total debt service including short-term debt as percent of exports of goods, services and net private transfer.

(Notes: Two general rules of thumb are that a country's debt service ratio should not exceed 20 and that a country's external debt per capita should not exceed half of her per capita income.)

Source: *Morgan International Data*, 1986, Morgan Guaranty Trust Company, New York.

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