Initiative *for* Policy Dialogue

Based at Columbia University

Working Paper Series

The 1980s Crisis in Syndicated Bank Lending to Sovereigns and the Sequence of Mechanisms to Fix It

Luis Jorge Garay Salamanca

Task Force on Debt Restructuring and Sovereign Bankruptcy

THE 1980s CRISIS IN SYNDICATED BANK LENDING TO SOVEREIGNS AND THE SEQUENCE OF MECHANISMS TO FIX IT

Luis Jorge Garay Salamanca

December 2007

The author thanks especially Barry Herman and Shari Spiegel for their valuable comments and detailed editorial suggestions.

1. INTRODUCTION

Starting from the latter 1970s, international private lending to developing country governments mushroomed and largely took the form of a new type of medium-term loan arranged by syndicates of internationally active commercial banks. This was not the classic form of general-purpose medium to long-term lending to sovereigns, which was as bond issues floated domestically or in the international financial markets. The latter had been slow to recover from the two world wars and the Great Depression, although by the 1990s, foreign and international bond issues once again became major vehicles for foreign lending to developing country governments. The syndicated loan market did not disappear in the 1990s, but turned its attention mainly to major corporate financings, especially within the United States, but also in Europe and emerging economies in Asia and elsewhere. One reason perhaps for the lower level of interest in additional syndicated bank lending to many of the developing country governments was the unhappy experience with this type of lending in much of the 1980s, when many sovereign borrowers could not service their syndicated loans as contracted.

In the final restructuring of the distressed bank debt in the early 1990s, the syndicated loans were converted into bonds. One loss in this shift was that the international mechanism that evolved to renegotiate sovereign debt to international banks – flawed, albeit operational – did not lend itself to being adapted to restructuring the bonds of debt-crisis countries. Indeed, this is one of the reasons that proposals for a new sovereign debt restructuring mechanism were seriously considered in the early years of the present decade. As those proposals were stillborn and the problem is not resolved, it may be useful to look back at how the bank restructuring mechanism evolved, how it operated, and how it brought the 1980s crisis to a close.

The first section of this chapter analyzes the development of international commercial bank financing of developing countries from the beginning of the seventies until the Mexican debt crisis erupted in 1982. The next three sections outline the commercial debt restructuring programs, along with the institutional and legal reforms and economic adjustment programs, that were introduced in three stages to address the developing countries' debt crisis (1982-1984, 1985-88, and 1989-94), under the aegis of the International Monetary Fund (IMF) and the World Bank. The final section takes stock of what was lost and gained as the era of syndicated bank lending to emerging economies was largely superseded by the return of sovereign bond financing.

2. BURGEONING INTERNATIONAL BANK FINANCING DURING THE 1970S

The story begins with an important financial innovation in the 1960s in the newly emerging Eurodollar market, an unregulated market in mainly dollar-denominated loans and deposits made by banks outside the United States. That innovation was the international syndicated bank loan, wherein a major bank would undertake to raise a specified large amount of funds for a borrower but provide only a portion of the funds itself. The arranging bank or "lead bank" (or banks, as large loans could have a small group of lead banks and agents) would act as the manager of the prospective syndicate of participating banks, which it would recruit to the deal. While there would be one loan agreement to which all participants would subscribe, each bank would have its own security note with the borrower. (Later, this would allow banks to sell their participation on a secondary market.) The syndicate would last only as long as the loan, which could be anything from several months (or longer for short-term credits in a revolving credit facility) to over 10 years, but mostly under 5 years. The banks that became involved in these loans generally participated in multiple syndicates, and the largest banks developed the activity of lead manager as a major line of their international business.

By the latter 1970s, the banks, increasingly flush with liquidity surpluses owing to the rapid growth of their deposits, established these loan syndicates for a growing number of developing and some developed country governments. From the beginning, the dominant international banks took advantage of their privileged market position in directing the sovereign credit syndications. Indeed, the first ten leading commercial banks mobilized around two thirds of the sovereign syndicated loans granted by the first fifty banks during the period 1976-1977. Such concentration reflected the high degree of asset concentration in the international banking industry at the time and the oligopolistic competition between organized groups of suppliers facing a relatively elastic demand (United Nations, 1989).

As from 1978, upon the persistence of the high liquidity situation, other international banks entered the new market. The result of the increased competition was a reduction of interest margins and an extension of the maturities of the sovereign credits. The banks also sought to diversify their activity by extending credit to relatively high-risk private entities. While the banks did not require a guarantee by the government of the borrower, they charged a high price relative to that on sovereign loans as compensation for the risk. The sovereign and private borrowings carried a variable interest rate comprised of a floating base interest rate – typically the London Inter-bank Offer Rate (LIBOR) on three or six-month loans in the currency of the loan, usually US dollars – plus a fixed "spread" reflecting the perceived risk of the borrower.

With deepening competition during the period 1978-1982, syndicated loan concentration was significantly reduced, indeed, to the point that the first ten leading banks mobilized less than half the syndicated credits extended by the first fifty banks, and the average annual value of the gross flows mobilized by commercial banks for developing countries as a whole doubled (in real terms). At the same time, the spread over LIBOR on sovereign credits charged by commercial banks was reduced to one third of the 1977 value by 1980-1981.

Gradually, the criteria for credit extension as well as the borrowers' objectives deemed eligible for financing became more flexible, and more financing was granted to the public sector. Of special significance was all-purpose financing for the central government general budget. In the Latin American case, the public sector share in the stock of medium and long-term external commercial bank debt increased from 53% to 58% between 1975 and 1981, while the share of commercial bank debt increased from 49% to 65% of the total stock of medium and long-term external government debt. Meanwhile, the share of short-term debt in the total commercial debt balance increased from 21% to 28% during this period (IDB, 1984).

Along with market extension, diversification of borrowers and more competitive pricing, the new financial arrangements embodied new rules of an institutional nature and new modes of relationships of creditors and debtors. These included the following:

i. The method for arranging the loans reflected the highly concentrated nature of the international banking industry at the time. To start, a borrowing country would select a lead bank to organize the syndication, usually supported by two or more co-leading banks for large loans. The syndicate managers would then mobilize the participation of numerous banks, each making individual contributions of a moderate size. As Rieffel (2003) has stressed, the lead managers marketed the syndicated loans as "club" deals that they sold down, rather than sell participations into an open market, as with a security issue. The loan participations nevertheless functioned like securities in that they entailed a sharing of risk among the lenders – and a diversification of risk if a bank joined different syndicates for different borrowing governments – compared to making a single very large loan to a single borrower.

ii. The syndication agreements required new jurisprudence, embodied in contract clauses that bound the individual creditors into co-responsibility for the collective pursuit, while protecting their individual creditor interests, guaranteeing loyal competition, favoring the "voluntary nature" of decisions that might be called for under the syndicate (as on restructuring terms) and providing a means for identification of the essential collective interest. The core clauses for dealing with potential repayment difficulties were the sharing, *pari-passu*, cross-default and negative pledge clauses. The sharing clause required sharing of payments by the borrower with all the syndicate members in proportion to their shares of the loan. *Pari-passu* established that the borrower should treat the members of the present syndicate and all other similarly unsecured creditors of the government with the same priority for repayment in the event of debt-servicing difficulties. Cross default allowed any bank member of a syndicated loan to declare default if the borrower defaulted on another syndicated loan and impose as a condition that any member bank of the first syndicate should share any payment received from the borrower with the rest of the members of the second syndicate. The negative pledge was a promise by the borrower not to pledge any assets to another creditor (e.g., as collateral for a new loan) if that would reduce the security of the claims of the members of the present syndicate.

iii. The basic postulates of a new theory of "restricted" sovereign immunity that became law in the United States and the United Kingdom during the period 1976-1978 were also incorporated into the loan agreements. The essential point was recognition that commercial borrowing by a government was a "non-sovereign act" and thus not protected by sovereign immunity. There had been different views on the proper scope of sovereign immunity and thus the legislative changes in the two countries under whose laws most syndicated sovereign lending would take place – and in whose courts most complaints might be brought – were a significant strengthening of the creditors' legal position.

iv. Regulatory changes were adopted by bank supervisory agencies of the major creditor countries in order to contain the new risks to which the banks were exposing themselves. The United States, in particular, already in 1978, implemented several regulations referring to permissible risk concentration (for example, the maximum commitment to a specific borrower should not exceed 10% of a bank's capital). In 1981, it set quantitative guidelines for minimum capital levels as a means to strengthen the supervision safeguards and support the competitive position of the banks. In 1983, it established "allocated transfer risk reserves" (ATRRs), which required banks to take specified reserves for each loan that was "impaired" because of transfer risk (i.e., that the borrower might not obtain the foreign exchange with which to make a payment falling due). The ATRRs were to be charged to current income and were not to be counted as part of bank capital. However, due to increasing competitive pressures coming from commercial banks of other nationalities (in particular, Japanese, German and British) and their differing regulatory constraints, the American regulatory authorities opted to apply its prudential rules with “indulgence”. It could not be otherwise explained why by the beginning of the eighties the largest American banks reached levels of exposure in Brazil and Mexico that, on average, exceeded 100% of their capital base.

3. FIRST RESPONSE TO CRISIS: ECONOMIES CONTRACT AND BANKS ORGANIZE, 1982-1984

With the outbreak of the debt crisis in Mexico in August 1982, the international financial community faced a new problem. The inability of governments to service their foreign debt obligations was not new. Indeed, the Paris Club had been helping to restructure sovereign foreign obligations since the 1950s. Governments had also defaulted many times in past periods on sovereign bonds held by foreigners. What was new here was the syndicated modality of the loans, which had made the amounts at issue very large both for the borrowers and the lenders. Indeed, a unique concern was that the lending banks that had made themselves highly vulnerable to bankruptcy through such lending were themselves central parts of the international payments system. The policy response entailed adoption of institutional, regulatory and procedural reforms, and the adjustment of the modalities, terms and conditions of the external financing of countries with debt problems.

3.1. The overall approach

Given the systemic threat of the crisis and the concern that the problems of Mexico could – and indeed did – become the problems of other countries that had borrowed heavily from the international banks, a globally concerted workout was warranted. The major multilateral organizations, the central banks and the economic authorities of the leading creditor countries and the major international commercial banks developed the initial policy response. The IMF took the lead in formulating and shepherding “rescue packages” for each crisis country, comprised of an IMF Stand-by adjustment program, a negotiated restructuring of debt repayment obligations, and the extension of new financing by the creditor banks that had exposure in the country, along with new official lending. The central banks and official authorities of the major creditor countries, in particular, the United States Treasury and Federal Reserve with respect to American banks, acted to ensure the cooperation of the commercial banks.

The problem was diagnosed as having arisen from temporary illiquidity in the crisis countries resulting from the late 1970s run up in spending by the countries and their governments, as well as owing to temporary conjunctural difficulties (weak demand for exports owing to a sharp recession in developed countries and very high nominal interest rates on outstanding commercial bank credits owing to anti-inflationary monetary tightening by the major economy countries). The result was balance-of-payments and fiscal deficits that suddenly could no longer be financed. The strategy for treating the problem aimed to re-establish as promptly as possible the external payment capacity of each crisis country. While an increase in the nominal exposure to the crisis countries of the commercial banks would result from the "new money" loans, it was acknowledged that the net amount of financing from such creditors would be reduced significantly. In fact, the net financial flow to Latin America declined from US$30.5 billion in 1981 to US$3.6 billion in 1985.

The balance-of-payments adjustment programs in the debtor countries focused on the reduction of imports to save foreign exchange, which could be effected quickly by restricting domestic demand. Meanwhile, the new financing by the commercial banks would help the debt-crisis governments make timely interest payments and thus prevent the banks from having to make impaired-loan reserves and provisions over a significant and increasing portion of their loan portfolios. At the same time, principal repayments on medium and long-term debt were postponed through rescheduling (short-term credit and inter-bank lines of credit were exempted). Both official credits from industrialized countries and bank loans were restructured, with a view to achieving a fair financial burden-sharing and avoiding that the costs of restructuring should be borne more by some creditors than others. The IMF oversaw the full process, periodically verifying that quantitative targets set in the adjustment program for each crisis country were met as a condition for the drawdown of various credit resources (the World Bank played a relatively minor role during this first phase of the crisis, which would change in the next phase when trying to address the "structural" roots of the crisis).

3.2. Initial restructuring of commercial bank debt

A specific scheme arose to carry out the restructuring of commercial bank credits, which preserved the regulations, modalities and institutional relations that had developed during the times of boom, while adding other novel ones. Central to the process was the formation by the leading banks of "bank advisory committees" (BACs) or London Clubs as an institution to legitimately represent all the creditor banks in the negotiation of rescue packages with the governments of the individual debtor countries, as well as to carry out the market validation of the financing packages provisionally agreed upon with the debtor country. Following the approach of banks with their corporate borrowers, the documents of the bank advisory committees were legally binding, unlike the informal Paris Club agreements among government creditors. A select group of law firms that had helped draft the original loan agreements played a decisive influence in designing the commercial bank workout process and in drafting the restructuring documents as well. Given the importance of the major banks to the stability of the international banking system, as well as the size of their exposure to the sovereign borrowers, there was a certain rationale to their taking a lead role in the formation of the BACs. In fact, they more than proportionately subordinated the interests of the smaller banks to their own, as the leading banks controlled the committees of the most important debtor countries through a larger representation than corresponded to their level of exposure. The major banks also limited the role of those referred to as rival banks. On the other hand, the decisive influence of the leading banks in the debt restructuring process enabled them to defend the interests and needs of their respective national banks in the syndicates. In the case of the Latin American countries, in particular, the American banks held half of the positions in the committees, a proportion that considerably exceeded the relative level of risk to which they were exposed. As an example it should be mentioned that Citibank (and specifically William Rhodes) acted as chairman of the bank advisory committees for Argentina, Brazil, Mexico, Peru and Uruguay from the early eighties to mid-nineties.

This approach embodied a notionally limited form of cartelization, in that it separately brought together the lenders for each debtor. The preponderance of this "case-by-case approach" was considered an essential aspect of the management of the sovereign debt crisis. However, "case-by-case" impacted debtors and creditors differently. While debtors would have little stake in the outcome of succeeding negotiations of other debtors with their creditors, this was not the case for the creditors. As the same creditors could participate in several BACs, they paid a great deal of attention to the possible consequences of establishing precedents. This reflected a classic negotiation principle, as stated by Schelling (1963): "The advantage goes to the party who may determine with precision a set of other negotiations where its own position will be harmed if a concession in this one is made." More precisely in the present context, as pointed out by Krugman (1985): "If creditors believe that leniency towards a debtor will generate demands from other debtors, the additional cost may make the creditors resist making concessions."

At the same time that the commercial bank creditors moved into cartelization, debtors were discouraged from forming their own organizations. Adducing the eminently financial nature of the problem, the defenders of the approach argued forcefully about the inconvenience, if not the danger for the stability of the system, if an organized group of debtors were established as official interlocutor in the negotiations.

The requirement that each debtor country have an individualized adjustment program also worked to divide the debtors. The pre-eminence of the "conditionality principle" has a basis in orthodox banking practice, wherein discipline is taken as an emblem for the good debtor, as well as a necessary precondition for new financing on market competitive terms. However, the emphasis on differences and individual national interests of each debtor – in effect, the argument that "one size does not fit all" – also impeded the recognition of a collective interest of the debtor countries. A collective consciousness among debtors was further discouraged by highlighting the adjustment behavior of certain debtors as worthy of emulation and providing them a preferential treatment, even more favorable than what a sound prescription of their credit condition would dictate, or, otherwise, punishing the conduct of other debtors, beyond what was merited according to the principle of "correspondence". All this in order to teach a lesson through penalties – even excessive if the case would be – for "bad" debtors, while favorably rewarding, sometimes excessively, other debtors that may not have necessarily been the best or the most outstanding, if this would help preserve the stability of the market regime.

The coalescing of debtor governments into a bloc was also impeded by the separate negotiations needed for restructuring different forms of debt, falling into at least four sub-categories: the international commercial banks, the multilateral creditors (concerning multilateral banks and IMF), the bilateral or official creditors (i.e., governments and official agencies of the creditor countries), and the private credit market (referring to non-financial entities having claims on the government, such as suppliers). The basic premise throughout the 1980s was that each and every one of the agreements with the multilateral entities (in particular, the IMF and the multilateral banks) had to be fully upheld and their financial terms excluded from any debt restructuring. That is, multilateral debt was treated as senior to commercial debt, with no possibility of rescheduling even if the limited external payment capacity of the debtor country would otherwise warrant it.

The outcome of this process in the initial years 1983-1984 was that 53 debt restructuring packages with commercial banks were negotiated (not necessarily signed in the same period) by developing debtor countries, which rescheduled repayments over 7-8 years at an interest rate that carried an average spread over LIBOR of close to 1.9%, plus an average net commission of 1.1% of the value of the restructured debt (World Bank, 1988). During that same biennium, outlays of US$23.4 billion were provided to the debtor countries on account of new financing as a component of the debt rescheduling packages. While buying time, the rescheduling agreements and new loans turned out to be costly for the debtor countries, as the profile of their foreign debt further deteriorated over the period.

The leading banks, meanwhile, succeeded in improving their risk position thanks in part to an *ex-post facto* concession that gave some form of debtor government guarantee or special treatment to the high-risk non-guaranteed loans that a number of these banks had made to the private sector, as noted above. Moreover, the American banks as a whole benefited from a reduction of their exposure relative to other banks, as they did not contribute to the "new" financing in the same proportion as their share in the stock of commercial bank debt.

This latter point warrants some explanation. Under the premise that the new financing requested would help the debtor to reestablish its payment capacity, every creditor would evidently desire that it take place, although it would benefit from the new financing even if it did not itself contribute new resources. Banks assuming such behavior are referred to as “free riders” (and banks that did not abstain from providing new money but provided less than their proportional share could be called “cheap riders”). The most likely candidates to actually become free riders were the banks that were the least exposed in terms of their share in the debt of the country with insufficient payment capacity, as well as in terms of the share of their own capital at risk. These would have been, in general, the smaller and less active banks in the international market, which included a number of regional US banks. As every bank would have an incentive to be a free rider, intervention “from the outside” would be required to impose the collective interest, although the smaller banks would be less susceptible to the pressure, which could (and did) take various forms.

The clauses in the syndication agreements noted earlier did not describe how to bring about an adequate collective decision on “new money”. Instead, there was extra-contractual pressure to cooperate on this matter, as on the package as a whole. First, the creditor countries’ governments, multilateral organizations and leading banks served as persuasive voices – as “rationalizing entities” – for the collective interest. In this sense, the IMF stood out as the most suitable institution to exercise a “catalytic” function, a position conferred on it as the central entity “responsible” for the adequate functioning of the international financial system. Similarly, the leadership role of the large banks seemed natural in light of their privileged position in the global financial market and their business and financial relationships with the smaller banks. At a second rung of influence, the taxation and regulatory regimes of the creditor countries could be brought to bear or modified to encourage the banks to participate.

The strictly involuntary or “forced” – albeit informal – character of the treatment of the commercial bank debt of the sovereigns with payment capacity problems was apparently essential. As Rieffel (2003) argues,

> “Senior finance officials also exerted pressure at key points in the negotiating process. The IMF managing director would contact a BAC chairman on occasion to stress the implications of specific terms for the debtor country’s recovery prospects. [Group of 7] finance ministers and their deputies would more often engage in arm-twisting with BAC chairmen or members. The views of certain governors and senior staff members of the Federal Reserve Board were conveyed occasionally and were given great weight by banks generally.”

Finally, it may be noted that while this discussion has focused on the need and approach to minimize self-interested actions by individual banks that were members of syndicates, other creditor banks had also granted individual loans. However, owing to *pari passu* and other clauses in the loan agreements, there was no point in trying to settle their claims independently, as they would have had to share the proceeds with the others.

Indeed, they would be “isolated” from the rest of the banking community unless, as counterpart to their proper cooperation in the success of the package, obligations to them were included with those of the rest of bank creditors under equitable conditions under the clauses and in the contractual terms established in the rescheduling agreements.

In sum, the initial international treatment of the debt crisis saw international bank finance transit from a market-oriented regime to one characterized by the cartelization of the creditor banks under official oversight and the treatment of each crisis country’s sovereign debt on a separate (case-by-case) basis, albeit under a market-based approach. It would have been preferable to avoid outright crises and pursue a mutually agreed voluntary restructuring between creditor banks and the debtor country when the alternative for the banks was not to be paid under the initial conditions. When that could not be achieved due to the persistence of disagreement between banks and the debtor country, involuntary restructuring had to be imposed by third parties. The need arose for invoking various modalities of “persuasion” and exercise of “majority power” so as to ensure the primacy of the systemic interest over the diverging particular interests. In this way, international cooperation among the major actors became a central axis of the strategy for managing the debt problem in its first stage.

4. THE SECOND STAGE: THE BAKER PLAN AND STRUCTURAL ADJUSTMENT, 1985-1988

Proponents of the initial strategy did not expect continued unsatisfactory growth of the world economy, the persistence of high real rates of interest on international debt, the recurrence of external shocks in the debtor economies, the modest amount of new financing by the commercial banks, the flaws in the economic policies adopted by indebted countries, and thus the inability of debtor countries under difficulty to recover adequate rates of growth and strengthen their payment capacity. With the aim of preventing the failed first stage from turning into a widespread debtor moratorium, some modifications of the strategy for managing the debt crisis had to be introduced. The "Baker Plan" was thus announced in October 1985.

4.1. The approach of the Baker Plan and its limitations

Developed by the US Secretary of the Treasury, James A. Baker III, the plan began with the acknowledgement that the debt-servicing difficulties of the major crisis countries – 15 of which were identified – were of a more "structural" character than had been accepted in the first stage, when temporary austerity and debt relief were the policy focus. Accordingly, the plan called for a triad of requirements in order to restore the capacity of the highly indebted countries to service their outstanding debt and return to creditworthiness, namely, the recovery of adequate rates of growth that are sustained, the adoption of "structural" reforms, and access to enough financing to carry out the other parts of the program.

The plan built on the basic dimensions of the international strategy for managing the crisis that had developed in the first stage:

i. The multilateral character of crisis management would be retained, albeit with strengthened coordination between the IMF and the World Bank in order to:
   (a) guarantee the proper reconciling and sound balance between the short-term adjustment policies promoted by the former and the structural reforms supported by the latter, and to avoid harmful contradictions and inconsistencies between the policies embodied in the loan agreements negotiated with these two institutions;
   (b) formulate the details of the "financial support and economic growth promotion packages;" and
   (c) reinforce the institutional authority of the multilateral entities to conduct the new strategy, so as to reverse the loss of confidence and

growing hostility toward the IMF resulting from the unsatisfactory outcomes of the short-term adjustment programs it had promoted in the first phase.

ii. The "conditionality principle" would continue to be applied in the sense that progress in the application of policies and carrying out of reforms negotiated with IMF and the Bank would be monitored and pre-agreed benchmarks would have to be achieved for release of promised financial support. The institutional and regulatory scheme in the Baker Plan thus maintained the type of relationship that arose in the first stage between the creditor bloc, the Bretton Woods institutions and creditor governments on one side and each of the debtor developing countries individually on the other.

iii. The case-by-case approach was confirmed as a key element of the debt management strategy. Coupled with the coordinated position of the community of private creditors, industrialized country governments and the multilateral entities, as noted above, this amounted to the determined opposition to the formation of an organized group (or cartel) of debtors. This, in turn, ruled out the formalization of a political dialogue between creditors and debtors around the debt issue.

iv. The bank advisory committees were fully accepted as the legitimate institutional mechanism to represent the bank creditors of a sovereign debtor in crisis. They would remain throughout the crisis as the key actors on the commercial bank side in the formulation, negotiation and management of the financial packages.

v. The involuntary or "forced" character of the commercial bank "new-money" financing of debt-crisis countries continued as before, upon the unwillingness of the international banks to return to new sovereign lending on a voluntary basis. The return to normal international private financing for the crisis countries was implicitly acknowledged to be remote, as the countries were said to face structural difficulties that made completion of adjustment more complex than initially foreseen.

Even though the institutional basics of the strategy followed during the first stage were preserved in the Baker Plan, innovations were needed to deal with consequences of the structural character, and not merely short-term nature, of the prescribed reforms and the desire to recover adequate and sustained economic growth rates. In addition to the coordination problem among the key players that had to be addressed, including making room for a larger role for the World Bank, there was a question of who would provide the necessary financing. In fact, new commercial bank financing was becoming progressively scarce. Thus, for example, while outlays of US$ 23.4 billion of "new" credit were made during the 1983-1984 biennium (as part of 53 re-scheduling packages negotiated during the period), only US$ 8.4 billion was provided in the 1986-1987 biennium (World Bank, 1988).

As the "new money" problem was intimately tied to the rescheduling negotiations, one answer was to seek to lock the banks into longer-term agreements. A multi-year rescheduling modality was thus introduced and the repayments terms were eased. From rescheduling loan payments over 8 years with 3 years' grace, paying an interest rate of 1.9% over LIBOR on the rescheduled amounts, which had been agreed, on average, for the debt re-scheduled during 1983-1984, the terms grew to rescheduling over 10.5 years with 4 years' grace and a 1.4% margin, on average, for the multiyear agreements negotiated during the 1985-1986 biennium. Additionally, the average annual amount of rescheduled debt increased from US$55 billion during the period 1983-1985 to US$80 billion in the period 1986-1988.

However, the commercial bank debt renegotiations were becoming increasingly difficult, as different competitive strategies and regulatory and tax pressures affected the banks in the creditor blocs differently. The competitive environments, as well as regulatory ones, in some of the industrialized countries also differed, particularly between Western Europe and the United States. There is no other explanation for the fact that by the end of 1986 medium-sized and small US banks had built reserves of less than 20% of their exposure to the highly indebted countries and the 15 major American banks had taken reserves in proportions ranging between 20 and 35%, while the reserves of the continental European banks were between 35 and 70%.

A key question, then, was how to mobilize additional financial resources for the debt-crisis countries. One answer was increased financing by the World Bank itself. The average annual amount of the loans committed increased from US$ 3.5 billion during the period 1982-1984 to US$ 6.0 billion during the period 1985-1988. However, the effort was insufficient and the Bank became a net recipient of funds from the 15 countries included in the Plan (World Bank, 1989). Similarly the 15 countries turned into "net capital exporters" to IMF during each of the years 1986 to 1988, for a total net payment to the Fund of around US$5 billion.

What then about private sources of financing? At least three kinds of incentives could be conceived to stimulate such financing by private actors, namely:

(a) The (partial) displacement of the risk of non-payment to an economic agent different from the one providing the financial resources (traditionally, this would mean a creditor government guarantee, but by the 1980s it could also mean derivative contracts to transfer specified risks to specialized market players);
(b) The debt-for-equity swap, through which the credit nature of the liabilities is changed into an ownership share in an investment, such as a privatized state enterprise (see below); and
(c) The issuing of notes, securities with floating interest, or any other security of such type, either for sale to investors or for swapping with bank creditors, these being clearly different financial mechanisms than the traditional banking credit in terms of status, nature and economic and legal character of the creditor (which no longer are bank entities, as non-financial legal entities and even natural persons could be included). Of these modalities, the debt-for-equity swap was frequently used in this period. An estimate of the transactions volume traded until 1987 was around US$7.5 billion, which was nearly 3% of the stock of the commercial bank debt of the highly indebted developing countries (Morgan Guaranty Trust, 1988).

Taking the different sources of finance together, however, the outcome was contrary to one of the basic requirements of the Baker Plan: an adequate financing of the adjustment programs of the highly indebted countries. On the other hand, the commercial banks did not fair badly. As a consequence of a marked reduction of their new financing, debt swaps and other transformations of liabilities, the commercial banks as a whole noticeably reduced their nominal exposure to the 15 countries included in the Baker Plan. More precisely, during the first three years of the plan, such reduction reached about US$ 12.4 billion, equivalent to 4.8% of the debt owed to the commercial banks at the end of 1985 when the plan started.

Meanwhile, attitudes towards cooperation in some of the highly indebted countries had begun to change. In the case of Latin America, in June 1984 the most heavily indebted countries established a regional consultation organ, known as the “Cartagena Consensus” (*Consenso de Cartagena*). Its purpose was to exchange experiences and reach concrete collective positions regarding the debt problem, without intending to become a “club of debtors” that would carry out joint negotiations with the international creditors.

Notwithstanding its potential as a collective organ for most of the highly indebted middle-income countries (i.e., excluding Nigeria and the Philippines), the Consensus lacked influence at a formal political level in the international arena, providing a lot to reflect upon. It was in response to this point that in November 1987, the presidents of eight of the member countries of the Cartagena Consensus decided to formalize a new consultation mechanism, referred to as the Group of the Eight, which became a substitute for the Consensus in practice.

In reality, however, no effective bloc of debtor countries arose, despite the deepening of the debt crisis. The international strategy continued to give differential and discriminatory treatment to individual debtor countries. The financial packages continued to be conditional on policy formulated with the World Bank and with the usual involvement of IMF and the bank advisory committees in their specification and with financial flows conditional on performance in implementing reforms. Moreover, a sequential pattern for the treatment of debtor countries on a separate, case-by-case approach was adopted. First, a country was selected that, aside from being highly indebted, would be distinguished as strategic at the economic and geopolitical level and also "eligible" due to its commitment to observe the conditionality on its economic policy reform and adjustment. This role had been played by Mexico until this stage, then by other countries, in particular, Argentina and Chile. Brazil also played this role during the first stage but not in this second one. Finally, with a precedent established, it would be extended to the remaining countries that would require it.

In all, it is outstanding that during the period 1985-1987, not only were the basic goals stipulated in the Baker Plan not realized, but, on the contrary, conflicts at the interior of the bloc of creditors sharpened due to differences in national regulatory, taxation and accounting regimes and to divergences in lending patterns among creditor banks of different countries (World Bank, 1988), as well as in reaction to worsening debtor-creditors relations. Debtor countries' financing difficulties intensified and arrears accumulated as "opposition in debtor countries to debt service rose since the costs of debt service were high and the benefits seemed remote" (World Bank, 1989). The "institutional power" of the creditor governments and the multilateral institutions to safeguard the solidarity among the commercial banks weakened and, as a consequence of all this, the outlook for the debt problem became even more uncertain. Despite this, certain principles and basics of the market practice still prevailed, as well as the negotiation structure with the debtor countries and the basic strategy for sovereign debt management that had been supported since the beginning of the debt crisis.

4.2. Loss of confidence and the beginning of debt reduction

As the World Bank (1989) pointed out, "Towards the end of 1987, after two years of mediocre progress in the highly indebted countries and of defensive actions on the part of the commercial banks, it is evident that the expectations generated by the strategy launched in 1985 [had] not been satisfied." The commercial banks, whose claims on the highly indebted countries were looking less and less viable, proposed improving the financial terms of the multiyear restructurings in successive rounds of renegotiation of the debt. Of course, the "softening" of terms offered did not extend to the small debtor countries (for example, Honduras, Malawi); neither were they uniformly available to the larger highly indebted countries. Indeed, while in August 1988 Brazil obtained a 20-year restructuring, Chile had obtained only 15 years in April 1988. Nor were the restructurings sufficient to cover the external financing requirements of the indebted countries.

A perspective on the generally deteriorating confidence in the prospects for the crisis countries and their external debt can be gotten from the secondary market that arose as a way for the banks to swap or sell their shares in the syndicated loans owed by debt-crisis countries. This market increasingly provided a way for banks (usually with small holdings) to exit the crisis-country debt market by selling their participations to other financial institutions, but it also introduced a mechanism by which governments could buy back their loans. The latter required the approval of the lending banks in each affected syndicate, which over time was increasingly given. Indeed, debt reduction raised the probability of repayment to the remaining creditors. From the debtor government's perspective, the discount on their debt in the secondary market made repurchase attractive, although even more so was introduction of debt-for-equity swaps in which direct investors would buy the debt claims on the secondary market and share the discount with the government in exchange for local currency for a desired capital investment (charitable organizations also began to capitalize on this opportunity with "debt for nature", "debt for children" and other debt-reduction swaps, wherein the debtor government promised to redirect a portion of the local currency equivalent of the foreign payments saved into specified social and environmental programs).

The secondary market acquired progressively more significance after 1985, both as a way for banks to adjust their loan portfolios and for debtor governments to reduce their obligations. Transactions reached around US$ 40 billion during the period 1985-1988. The average discount on the debt of the 15 countries in the Baker Plan was 30% in mid 1986 and 35% in mid 1987, but by the end of 1988 it was edging toward 60% (Morgan Guaranty Trust, 1988). Of course, the discount varied among countries. Furthermore, the "contamination" effect was said to reduce the value of the debt of a country if it were located in a "neighborhood" with crisis countries (in Latin America in particular).

Using the secondary market to reduce their outstanding obligations, the value of debt conversions of developing countries increased from US$ 1.3 billion in 1985 to US$ 4.7 billion in 1987 and reached approximately US$ 15.0 billion in 1988. In addition, in 1988 four Latin American countries negotiated important packages of debt reduction with their bank creditors, with an eye on the prices for their debt in the secondary market. Bolivia repurchased US$ 335 million of its debt with the commercial banks (40% of its balance) at an average discount of 89%. Mexico was able to "drawdown" US$ 3.67 billion from its commercial sovereign debt, at an average discount of 30.25%, using a technique that would become central to the Brady Plan, the final stage of the 1980s debt crisis (see below); i.e., Mexico swapped the bank debt for US$ 2.56 billion in newly issued tradable securities backed by United States treasury bonds it had purchased. Chile repurchased US$ 300 million of its long-term commercial bank debt at an average discount of 44%, using US$168 million of its international reserves. In addition, Brazil agreed a package of $62 billion in rescheduled debt and $5.2 billion in new funds, which included several important debt reduction mechanisms. Among them were "debt-equity conversions at 100 percent face value (that) would further result in a reduction of debt stock by $1.8 billion over a three year period" (World Bank, 1988). As was to be expected, the discounts at which some countries could negotiate to reduce their debt were significantly inferior to those that were registered at the time in the secondary market itself. To illustrate, the discount obtained by Mexico for the reduction of part of its debt, 30.25% as noted above, could be compared to the secondary market discount at that time (second quarter, 1988), which amounted to 53.3%.

There is no doubt that the incorporation into the menu of debt restructuring options of such innovative mechanisms and modalities as noted above for the voluntary reduction of the debt helped debtor countries, in particular as from the end of 1986. However, the scope for debt reduction through such processes was restricted by the limited willingness of many creditors to make their claims eligible for swaps and purchase and the limited discount they would accept. More precisely, by the end of 1988 the 15 countries of the Baker Plan had foreign debts of US$ 500 billion, of which US$ 240 billion corresponded to medium and long-term commercial bank debt. Assuming that the commercial banks would "voluntarily" reduce the value of this type of debt by 30%, on average, and assuming an annual LIBOR rate of 9% and a 1% margin over the LIBOR rate as an average interest rate on the outstanding debt, the 15 countries of the Baker Plan could see their interest payments reduced by US$7 billion per year. This was not enough. As stated by Morgan Guaranty Trust (1988),

> "This savings may hardly be the answer to any of the debt or growth problems. It represents less than 1% of the GDP for the 15 countries as a whole and not even the annual amount of financing which the Baker Plan had budgeted for the commercial banks. The average load of the interest in their exports would descend from 26% to 22% and the foreign debt to exports ratio would be reduced from 315% to 270%."

Therefore, to progress on the treatment of the debt problem and, at the same time, ensure appropriate economic growth in the debtor countries in the medium and long term, more was needed than the Baker Plan had offered. The Baker Plan had bought time for debtor countries to adjust their economies, for the commercial banks to build up reserves against their exposure to debtor developing countries (Rieffel, 2003), and for the creditor bloc to organize a favorable burden-sharing arrangement, at least from their perspective. Still needed was deeper debt-reduction, strengthened financial support from multilateral entities, creditor governments and their official export agencies, and, not least, reform of the institutional, regulatory and procedural arrangements in the international financial system. The Brady Initiative stepped precisely into this space.

5. THE THIRD STAGE: THE BRADY INITIATIVE FOR DEBT REDUCTION

Nicholas Brady, who succeeded Baker as US Treasury Secretary in 1988 and who came from a long career in private banking on Wall Street, introduced the initiative that carries his name on March 10, 1989. The new plan, building on the principles of the Baker Plan, continued to aim to spur economic growth and return the debt crisis countries to financial solvency. It added, however, a mechanism for bringing about significant reductions of bank debt, which was increasingly acknowledged as essential if countries were to move out from under their debt crises.

5.1. Why a new initiative was needed

Banks had been reluctant to acknowledge that their developing country borrowers would unlikely ever be able to fully service their debt, despite several years of rescheduling and "new money" loans. But that was the case. Also, the magnitude of developing country commercial bank debt was still large enough to threaten the international financial system. In particular, at the beginning of 1988, the 10 largest banks of the United States had loans outstanding to developing countries that amounted on average to more than 85% of their primary capital and close to 8% of their total assets. Furthermore, their average exposure to these countries net of loan reserves as a ratio to shareholders' equity exceeded 2.15 (Huizinga, 1989).

By the late 1980s, moreover, it had become obvious to shareholders in the banks, to bank supervisors and regulators, and to the international policy community that outright reduction in debt and debt servicing was required. And yet, certain factors impeded the direct negotiation of agreements between countries and their banks to actually reduce those obligations.

Consider first what one might assume to be the simplest case, an individual credit granted by only one commercial bank. It might be expected that nothing would interfere with a unilateral decision by one of the parties to alter the contractual terms in favor of its counterparty, as long as the change would not contravene overall sovereignty principles or the voluntary nature of such actions. In this sense, a debt or debt-service reduction jointly agreed between the individual creditor bank and the debtor country could be expected to fall into the same legal, institutional and financial status as the original credit arrangement.

However, if the country also had syndicated loans and if their documentation contained the specific standard clauses mentioned in the beginning of this chapter (i.e., cross default, sharing, *pari passu*, and negative pledge), then the banks in the syndicates would have had a voice in the transaction, even though they were not directly party to it. The overriding concern of the syndicate members would be that nothing in the bilateral deal put them at a disadvantage. If, as part of the bilateral deal, the bank creditor were granted a privileged status with respect to collecting on the remaining debt (as through some type of guarantee or if there were some preferential regulatory treatment of the bank), then the other creditors could assert their interest in the arrangement. Moreover, any benefits or advantages derived by the individual bank creditor from its bilateral deal would have had to be shared with all the banks in proportion to their loan exposures in each of the syndicated loan deals. In addition, owing to this type of concern, the bilateral deal would have had to be approved unanimously or with the majority provided for in the original syndication agreements.

The same impediments would arise for comparable arrangements between the debtor government and participants in any of the syndicated loans themselves. Under these circumstances, governments could be stopped from repurchasing their own debt. Indeed, until it was agreed to suspend these clauses under the Brady Initiative, only two commercial debt repurchase agreements had been negotiated in the Latin American countries and for very modest amounts (US$335 million in the case of Bolivia and US$300 million in the case of Chile).

Trading in the secondary market up to this point had focused almost exclusively on transactions between different international commercial banks or between creditor banks and other types of financial entities (for example, intermediaries, financial groups, brokers). These transactions transferred the debtor's obligations among different creditors and did not modify the condition of the credit per se. It allowed banks to rebuild their portfolio, reduce their exposure in countries with payment problems, redirect their financial specialization and redefine the geographic pattern of their functioning. Moreover, as the new owners of the debt would usually have purchased their claims at a discount and for speculative purposes, they would be less inclined to extend new financing as part of subsequent rescheduling negotiations. In other words, the secondary market was endogenously developing in a way that made continuation of the previous debt strategy increasingly problematical.

5.2. Elements of the debt reduction strategy

The Brady Plan acted on the possibility that effective debt restructuring agreements could result from voluntary market-based negotiations between each debtor and its creditors, once freed from contractual and policy impediments. The Initiative sought to take account of both the sovereignty of the debtors and the private interests of the creditors, under what it saw to be equitable and market-driven conditions for the various agents.

But it also recognized that the problem was too big for the market to absorb by itself without a certain intervention from outside of the market. This would take the form of stronger official international support in a context of more effective domestic economic adjustment and growth programs. Brady thus proposed that the following four sets of priority actions be undertaken as part of an enhanced international cooperation program:

i. Debtor countries would apply sound economic policies, deepen their structural economic reforms and promote growth, including through the adoption of policies to raise investment, strengthen domestic savings and encourage the return of flight capital;

ii. The creditor commercial banks would agree to temporary exemptions (for three years) of the "sharing" (or "prorating") and "negative pledge" clauses in loan contracts, so as to make it easier for a debtor government and its banks to negotiate a menu of restructuring terms from which different banks could choose comparable debt or debt-service reduction;

iii. The governments of creditor countries would remove obstacles of an accounting, actuarial, tax, regulatory and procedural nature to their banks being able to participate in the new debt or debt-service reduction agreements; and

iv. The international community would offer financial support to debt-crisis countries, either directly (as in the rescheduling of government and official export agency loans through the Paris Club and providing additional official financing) or indirectly (as in guaranteeing interest payments on restructured bank debt).

The first set of actions pertained to burden sharing with the creditors, as well as concerns for structural adjustment. While the Brady Initiative accepted the need for debt and debt-service reduction, it was sympathetic to the views of the creditor bloc that the economic burden be placed to the extent possible on the debtor countries. To this end, debtor countries had to satisfy a set of economic policy conditions and imperatives in order to be eligible for the initiative. On the other hand, the promise of additional international support (the fourth set of actions) would recognize the need for a more equitable distribution of the costs of adjustment than in the past.

The second set of actions addressed the impediments caused by the contractual clauses noted above. By removing them, it was expected that negotiations would follow on a case-by-case basis without any agent interfering that was alien to the parties that were contractually linked. Bank advisory committees, representing all the international creditor commercial banks of each country, were once again deemed the institutionally legitimate body to negotiate the exemptions, and to be the counterparty of the debtor country's government in negotiating the voluntary operations of debt and debt-service reduction. In this way, it was said, the debt agreement could be tailored to the individual country situation. Also, the voluntary nature of the negotiations was considered important, in particular to win the cooperation of the banks in participating in the final debt agreement.

The third set of actions was meant to change the regulatory environment so as to legitimate the reduction of the face value of the debt in light of the general perception of the low-probability of the full repayment of the loans. Priority was also accorded to policy modifications by different regulatory authorities, so as to facilitate comparable debt or debt-service reduction by banks from different countries. An important step toward systemic improvement in this regard was the adoption by the Basel Committee in 1988 of the first set of common capital adequacy standards for internationally active banks, which were recommended for adoption by the authorities in the major financial centers.

The final set of actions reiterated the international and multilateral character of the treatment of the sovereign debt crisis. Besides quantitatively adding financial support, emphasis was put on financial innovation (in particular, conversion of bank debt to bonds with partial guarantees of repayment), as well as making more flexible and speeding up the process for determining debtor country financial gaps (and thus required debt relief). An additional concern was to strengthen the financial position of the multilateral entities. As with the Baker Plan, the importance of close coordination between the IMF and the World Bank was also emphasized.

In sum, the fundamental contribution of the Brady Initiative consisted in: (a) giving sufficient legitimacy to the voluntary reduction of commercial bank debt or debt service, (b) organizing the debt reduction as a voluntary market practice through the establishment of regulatory, institutional and procedural schemes propitious for the free decision of the agents participating in the market, and (c) making the program operational as a financial mechanism and providing support to the programs of structural adjustment.

5.3. How much debt reduction?

By December 1990, the first four operations of commercial bank debt reduction under the framework of the Brady Plan had been arranged: Philippines (January, 1990), Mexico (February, 1990), Costa Rica (May, 1990) and Venezuela (August, 1990). In February 1991 an additional agreement on Uruguayan debt was adopted. Subsequently, the packages for

Argentina and Brazil, two of the most important debtors in the Third World, would be detailed. In each of the agreements, the bank advisory committees effectively negotiated with the government a "menu" of alternative but comparable options, from which the participating banks selected and thereby made concrete their contributions to the financial package. The understanding was that all banks would participate to the same degree, if in different ways.

Some of the main characteristics of the agreements are worth mentioning, namely: (a) the full amount of the eligible bank debt that was not extinguished was converted into freely tradable bonds, losing their status as traditional sovereign bank debt; (b) the bonds, which reflected a discount on the nominal value of the bank debt or a reduced interest rate, benefited from special collateral on the principal (i.e., they were backed by thirty-year zero coupon bonds of the United States Treasury), purchased by the debtor governments with a combination of their official reserves, IMF credit, and loans of the World Bank and Inter-American Development Bank; (c) the banks were given the possibility to recapture some of the discount off face value if certain positive developments ensued, up to an annual limit of 3% of the amount of the debt reduction and as from a specified date; (d) as calculated by the World Bank (1989, 1990, 2002), the net discount of the commercial bank debt was 35% for the Mexican arrangement (on US$48 billion debt treated), 50% for the Philippines (on US$5.7 billion debt treated), 30% for Venezuela (on US$20.6 billion) and, given their particular conditions, 80% for Costa Rica (on US$1.6 billion), which compares with discounts prevailing in the secondary market of 60%, 52%, 65% and 87%, respectively.

As Cline (1995) has argued, by the end of 1995 the Brady Plan write-downs amounted to about one third of the US$190 billion of bank claims treated in thirteen countries, albeit equivalent to only 15% of the total external debt of these countries. In this regard, it appears that the psychological impact of this forgiveness was bigger than its financial impact, as new private flows returned and in some cases surged into the countries. Including four more deals that were completed during 1996 and 1997 (on US$20 billion of debt treated), the overall approximate discount was less than 40% on US$211 billion of commercial bank debt treated in seventeen deals under the Brady Plan during the period 1990-1997.

In light of the sharp difference between the realized commercial bank and overall debt reduction, serious questioning arose over how the scheme was working in practice, the cost distribution, and the resulting risks among the various creditors as well as between them and the debtor countries. Among these concerns, the following are worth highlighting (Garay, 1991a):

i. The financial participation of the multi- and bilateral entities was deemed not large enough to resolve the debt problem. This criticism was made by influential actors in the international financial community, including the presidents of Midland Bank and Lloyds Bank, (Latin Finance, 1990), as well as by more frequently heard critics.

ii. More generally, the overall need for external financial resources to finance growth and investment in the highly indebted economies was underestimated. One sign that countries would be under funded was that debt and debt-service reductions were barely one third of the discount prevailing in the secondary market, meaning that the cash flow savings would be less than the market was implicitly projecting as needed.

iii. The multilateral entities put themselves at increased risk in how they lent to the highly indebted countries, i.e., by lending to help the countries purchase partial guarantees of repayment in the form of zero-coupon US Treasury bonds, rather than for domestic capital formation and growth in the debt-crisis countries.

iv. The massive conversion of bank debt into marketable debt securities was seen to have restricted the flexibility of policy makers in handling future debt crises, as it was thought that "Brady bonds" would not be subject to restructuring (However, Ecuador's subsequent default on and restructuring of Brady bonds showed this not to be necessarily the case, although bond restructuring had been quite rare in the 1980s and in most of the 1990s). It had seemed as though the new bonds would be treated as senior to commercial bank debt in any future debt renegotiation, degrading the traditional standing of bank loans as *pari passu* with all other non-collateralized private lending to the sovereign.

In other words, while removing the "bad debtor" image of the debt crisis countries, the Brady Plan provided an exit opportunity for the creditor banks and that seemed to presage a long-term loss of flexibility in foreign private financing for developing countries, as more selective international securities investors increasingly substituted for international bank creditors, some of which had ongoing relationships with the borrowing countries and thus were more familiar with them. It was thus feared this would make the countries more dependent on other sources of external financing, including multilateral entities, governments and official agencies. Moreover, it was expected that the overall the degree of segmentation of financial access of developing countries would intensify, with the bond market, for one, differentiating between countries according to whether they had previously needed debt forgiveness or not and other criteria. In fact, the financial markets in the 1990s turned out to have a large appetite for developing country securities, including those of formerly insolvent sovereigns.

Even critics of the Brady Initiative, however, acknowledged that its approach to debt reduction should have been promoted in the early 1980's, when it might have helped restore economic growth in the major borrowing countries at an earlier point in time. Brady had made the reduction of sovereign debt practical, offering a menu of options to banks under a market approach, and strengthening international cooperation among banks, multilateral agencies and government authorities of creditor countries. The plan enabled the international system to avoid a systemic crisis that could have arisen from how different national legal systems might have reacted had it been necessary to force the banks to write down their claims on debtor countries. The creditor bloc favored the initiative for protecting its interests, not to mention for continuing to emphasize debtor responsibility by conditioning relief on domestic policy reforms and economic adjustment.

6. AN ERA COMES TO A CLOSE

While the Brady Plan removed one barrier to renewed private capital inflows into the debt-crisis countries, the liberalization of the controls on capital flows that spread across the developing world in the early 1990s removed another. Financial flows – in particular, short-term and speculative finance – then surged into a number of developing countries. Also, international bonds, including placements by sovereign borrowers from developing countries, once again came to be a central form of medium-term financing. The global demand for international securities – equities as well as bonds – burgeoned, with mutual funds and even households joining traditional and new forms of institutional investors by the end of the decade. In other words, financial globalization was rapidly advancing in the world as a whole in the 1990s, carried by a progressively sophisticated and complex set of financial instruments and actors. This challenged the world's governments to adequately strengthen regulatory institutions to supervise the flows and institutions in an opportune, strict and effective way. The world was also challenged to organize the capacity to mobilize sufficient and timely financial support to combat massive financial outflows when investors panicked in the newly open financial markets of emerging economies. International policy makers were further challenged to develop a more adequate mechanism for coordination of the world's main central banks. The suggestion that the IMF could become a kind of global central bank did not take root, and by the end of the decade policy makers foreswore any more massive bailouts. And if the 1990s brought the commercial banks' involvement in debt crises to a close, it also left the world without a mechanism or a process to deal with the next wave of sovereign insolvencies, which would no longer involve commercial banks in a central way.

6.1. Renewed confidence in emerging markets

The capital surges into developing countries first helped strengthen them and then highlighted their weaknesses. The experience of many developing countries during the early nineties is illustrative. It began with a period of financial *bonanza*, based not on new loans to governments, as had been the tradition in the past, but the massive entrance of strictly private capital (i.e. portfolio capital and foreign direct investment, short-term and speculative finance). Indeed, the net private capital inflow into developing countries amounted near $540 billion over the period 1990-1994 (World Bank, 1994).

This massive capital inflow to developing countries had multiple causes. As Goldstein (1995) has argued, "the fall in industrial-country interest rates was probably the most important driving force but also a policy performance in host countries along with certain changes in the operating environment also figured prominently in the outcome." Another potential contributory factor is contagion as a "process by which changes in market assessments for some borrowers lead to sequential changes in assessments (in the same direction) for other borrowers, above that implied by the latter's true creditworthiness. Positive contagion is often mentioned as a factor enlarging net private flows to developing countries in 1992-1993."

The financial inflow was managed with an orthodox "sterilizing" monetary policy, absorbing the domestic liquidity surpluses through the increased sale of government securities in the financial market, in order not to disrupt tight anti-inflationary stances. This led to further increases in domestic interest rates and raised the profitability of domestic financial investment relative to abroad, promoting a larger capital inflow. The attraction of funds to the region was abetted by a sharp fall in international interest rates, which stimulated a further financial outflow, in particular, from the US economy and an insufficient reactivation of economic activity there. A vicious circle was set in motion in the emerging economies favoring the entrance of speculative capital, reserve accumulation, national currency revaluation, commercial deficit aggravation and further rise of domestic interest rates. In presence of high capital mobility internationally, sterilization policy becomes less effective the longer it is applied. This was an important reason why "a group of developing countries [were] wrestling over 1990-1994 with how to conduct macroeconomic, exchange rate, and supervisory policy in the face of a cumulative capital inflow" (Goldstein, 1995).

One consequence of this foreign exchange *bonanza* fell on sovereign external debt management, as there was a rapid and extended rise in the price of the remaining "distressed" sovereign bank debt in the secondary market. This reflected in part the serious progress in economic recovery and the structural reforms that many countries had undertaken. It also embodied recognition that a good number of economies had experienced an abrupt increase in international reserves, and, therefore, in their external payment capacity. The down side of this good news was it reduced the space for conducting exchange and repurchase operations of outstanding bank debt at a discount. In many countries, such as Chile, Venezuela and Colombia, the level of transactions in the secondary market for sovereign bank debt fell or practically disappeared, as creditors increasingly considered themselves sufficiently safe under a medium term perspective in terms of the timely fulfillment of the contractual obligations of these debtor countries.

At the same time, there were increasing reasons to worry about the vulnerability of all these economies to a sudden flight of speculative capital. As it turned out, the reserve levels in most of the countries were wholly inadequate in the face of financial panics in open financial markets, and risky fiscal and exchange-rate policies in several countries would give investors reasons for concern. Precisely such situations came to pass towards the end of 1994 in Mexico, in 1997 in some East Asian countries, in 1998 in Russia and

Brazil, and at the beginning of the current decade in Argentina, only to mention the most widely known examples.

6.2. Sovereign insolvency with bonds instead of bank loans

The Brady Plan and the secondary market in syndicated bank debt had brought the 1980s debt crisis to a close, essentially by creating an "exit strategy" for the commercial banks to take their losses and move on. The subsequent surge in capital inflows and the increasing access of emerging market borrowers to the international bond market masked a concern that became apparent to the investing community by the end of the 1990s: there was no mechanism to deal with defaults on bonds comparable to what had evolved for commercial bank debt. Even in the case of the commercial banks, it's important to stress, the international financial institutions needed to intervene to ensure the debt restructuring. Creditors and debtors had been unable to come to an agreement on their own. The problem was seen by the Deputy Managing-Director of IMF, Anne O. Krueger (2002), as follows,

> "I am very satisfied with the widespread consensus about the nature of the problem which we are facing: that is, the lack of adequate incentives for an orderly and timely restructuring of the unsustainable sovereign debts. Under the current arrangement, the international community is facing a choice between accepting a potentially contagious situation of individual default or conducting the rescue of the private creditors and contributing to the reproduction of the moral hazard…."

One problem caused by the shift to bond financing was the loss of a suitable jurisprudence to handle situations of default of debtor country governments. While bond contracts had some clauses that were similar to the ones in syndicated bank loans that had brought individual creditor banks together to jointly seek a workout (such as cross-default, *pari-passus* and negative pledge), other clauses made a cooperative solution more difficult. One such is the "acceleration" clause, in which a specified minority of bondholders could make the outstanding balance on the bond fully and immediately repayable after some event such as a missed interest payment. Once a bond was "accelerated", a bondholder could run to a court and ask it to enforce the immediate repayment on the complaining investor's holdings. The incentive to do so was the knowledge that the borrower had some funds, if not enough to cover all its obligations, and so the first to seek collection would be the most likely to be successful. Also, unlike in bank loans, there was no "sharing" clause in sovereign bond contracts. Any successful bondholder would be able to keep whatever he or she received.

The absence of other clauses was also said to make a negotiation between the debtor and its numerous, anonymous bondholders to exchange, swap or restructure its bonds extremely difficult. In particular, absence of “collective action clauses” (CACs) in bonds issued under New York law was said to make it seriously difficult to bring together and persuade the bondholders to participate in new financing, be it “voluntary” or “semi-voluntary”. However, CACs already existed in bonds issued under British law, defining how holders of an individual bond issue were to arrange to change the financial terms of their bond if needed and what specific “super-majority” would be required to reach a decision. New York law bonds had required unanimous consent, although “exit consents” (discussed elsewhere in this book) developed as a way to work around that difficulty.

Nevertheless, by the middle of the present decade CACs became a standard part of new bond contracts. Some of them also contained “aggregation” clauses, which provided a way for holders of one bond to participate with holders of other bonds in a joint renegotiation with the sovereign debtor. The idea was that as existing bond issues were rolled over into new bonds with CACs as they matured, the process would generalize into a means to renegotiate a growing share of any country’s outstanding bonds. The question remains, however, whether or how they would work in a sovereign financing crisis. The key point is that bonds are not bank loans, their contractual terms are still more centrifugal than centripetal; and bondholders are not bankers, their relationship with the borrower is different, and leadership on the creditor side by banks with a continuing interest in the country cannot be assumed.

A final element that is potentially different between current bond-based and 1980s bank-based debt in crisis situations is the relationship of the creditors and sovereign debtor with the rest of the international community. General proclamations aside, it is not clear today what the relationship would be, especially following the recent Argentine workout. A strong relationship could be attractive if it embodied the prior committed support of IMF, the multilateral banks and the governments of the key developed countries, especially the United States, to provide financing (or guarantees) to debtor countries should they face liquidity problems (the commitments might be included in multi-year adjustment programs). Another device could be to add an automatic renewal clause to official loans, to be available over a specific period to use in situations of lack of liquidity (not insolvency), carrying a penalty rate of interest to avoid “moral hazard”. IMF approval could be required to invoke such a clause, which would put it in the context of an adjustment program already supported by the international financial institutions.

7. CONCLUSION

As this chapter has described, the international financial architecture underwent major changes in the 1980s to handle the debt that developing country governments owed and could not pay to commercial banks, and it is undergoing further reform to adjust to primarily bond financing. Possibilities exist to increase the margin for maneuver of debtor countries and reduce the systemic risks and ensuing costs of crises in the payments capacities of debtor countries, as well as bring greater fluidity and less instability and unpredictability to their sovereign financing. Reform, however, is not easy. It should be remembered, in this regard, that it took most of a decade to reach the eventual workout process for commercial bank debt:

> "Five years and more than five workout cases were required for the commercial bank process to metamorphose from a series of experiments to a recognizable process. This process was refined over another eight years and more than one hundred rescheduling deals before debt reduction was introduced under the Brady Plan at the end of the 1980s debt crisis… [The] ease of restructuring bank debt is more myth than reality. The process … diverted the attention of policymakers from implementing essential reforms, it resulted in deals that never seemed generous enough to voters, and it was more expensive than the Paris Club process. Nor was it easy from the creditor perspective of the [Group of 7]. Considerable arm-twisting and cajoling was required to bridge the gap between offers from the banks and requests from the debtor countries" (Rieffel, 2003).

One reason the process was difficult is that it embodied major reallocations of financial resources. Some creditors, including many banks, suffered losses (if not initially), but there were also many in the international private sector who profited handsomely. These included the financial intermediaries who bought impaired bank debt at a steeper discount than was contained in the final settlement. Significant resource transfers also took place within the debtor countries, as when private sector foreign debt was taken over by the government. Similarly, resources were reallocated when decentralized public sector (e.g., state enterprise) debt was shifted to the central government, followed by privatization under unfavorable arrangements in terms of the social costs then incurred by the population and the potential profitability of the enterprises foregone. It would be hard to make a full accounting of who benefited and who lost in the debt crisis years, or to measure if there was any correspondence with the degree of joint responsibility for the crisis. What is evident is that the net benefit in the outcome was inferior to what was expected.

The international reform process had been shaped by the political, economic and financial power relations between the international creditors – governments of developed countries, multilateral entities, bilateral agencies, commercial banks and other financial entities – and the debtor developing nations on one hand, and the conflicts of interests, the differences in socio-economic situations and the political and institutional discrepancies among major debtor countries on the other. The outcome was the “individualist” (case-by-case) approach to handling the 1980s debt crisis. Not only did this privilege short-term financial relations between each separate debtor nation and its international creditors, but it also prevented the configuration of a cartel of Third World debtor countries, even among a set of neighbor countries with relatively common traditions and interests as in Latin America. In this sense, the creditor bloc succeeded very well in managing the debt problem so as to prevent the emergence of political and economic conditions that might have challenged the established systemic order.

8. REFERENCES

Calvo, G. *et al.* (1993). 'Capital inflows and real exchange rate appreciation in Latin America: The role of external factors'. *IMF Staff Papers*, 40/1.

Cline, W. (1995). *International Debt Reexamined*. Washington, DC: Institute for International Economics.

Cuddington, J. and Smith, G. (1985). *International Debt and the Developing Countries*. Washington, DC.

Garay, L. (1991). *Colombia y la Crisis de la Deuda*. Bogotá: Cinep-Unversidad Nacional de Colombia.

———. (1991a). *El Manejo de la Deuda Externa de Colombia*. Bogotá: Fescol-Cerec.

Goldstein, M. (1995). 'Coping with too much of a good thing. Policy responses for large capital inflows in developing countries'. International Economics Department, World Bank Working Paper 1507.

Huizinga, H. (1989). 'How has the debt crisis affected commercial banks?' International Economics Department, World Bank Working Paper 195.

Inter-American Development Bank. (1984). *La Deuda Externa y el Desarrollo Económico de América Latina*. Washington, DC.

Krueger, A. (2002). 'Preventing and resolving financial crises: the role of sovereign debt restructuring'. Presented at the Latin American Meeting on Econometrics, Sao Paolo, July.

Krugman, P. (1985). 'International Debt Strategies in an Uncertain World', in J. Cuddington and G. Smith (eds.), *International Debt and the Developing Countries*. Washington, DC.

Latin Finance. (1990). No. 15, April.

Morgan Guaranty Trust Co. (1988). 'World Financial Markets'.

Rieffel, L. (2003). *Restructuring Sovereign Debt: The case for Ad Hoc machinery*. Washington, DC: Brookings Institution Press.

Schelling, T. (1963). *The Strategy of Conflict*, Oxford University Press.

Shepherson, I. (1990). ‘Cold Comfort’. *Risk*, 3/8.

The World Bank. (1988). *World Debt Tables 1988-1989,* vol. I. Washington, DC.

———. (1989). *Annual Report 1988*. Washington, DC.

———. (1989a). ‘Report of the President to the Executive Directors of a Loan to the Republic of Philippines for a Debt Management Program’. Washington, DC.

———. (1990). ‘Report of the President to the Executive Directors of a Loan to Banco Nacional de Comercio Exterior and on related measures to support the debt reduction program of the United Mexican States’. Washington, DC.

———. (1990a). *World Debt Tables 1990-1991*, vol. I. Washington, DC.

———. (1994). *World Debt Tables 1994-1995,* vol. I. Washington, DC.

———. (2002). *Global Development Finance 2002,* Washington, DC.

United Nations. (1989). ‘El Comportamiento de los Bancos Transnacionales y la Crisis Internacional de Endeudamiento’. CEPAL/CET, mimeo.