

Analytical Issues in Debt

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Issues in Debt Strategy: An Overview

W. MAX CORDEN and MICHAEL P. DOOLEY*

This paper touches on many topics relating to the debt strategy that are also discussed elsewhere in this book. Because of the market discount on debt, an inadequate share of world savings may be going to indebted countries. Various "growing out of debt" scenarios are expounded, and the roles of concerted lending and of the policies of debtor countries in affecting the availability of new funds are discussed. The paper outlines the essential features of buy-backs, of securitization, of debt-equity swaps and of the transformation of debt into contingent claims, and also the implications of debt relief for debtors and creditors and of an international debt facility.

THIS PAPER REVIEWS options for dealing with developing countries' debt problems. The paper does not attempt to make the case for or against any of the options reviewed but rather tries to clarify the issues.

The paper as a whole focuses on debtor countries' relationships with private credit markets. The first section provides an overview of four aspects of the current debt situation. The second section looks at the current strategy and qualifications to it. It outlines several "growing out of debt" scenarios. The role of policy improvements by problem debtor countries is stressed as is the need for the international system to accommodate export expansion by them. The third section reviews a number

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of supplementary approaches to the debt problem, beginning with various market-based approaches, notably buy-backs, debt-equity swaps, and securitization. It then deals with debt relief, emphasizing the long-term implications for creditors and debtors.

Most figures in this paper refer to a category of developing countries—now 65 in all—called here "problem debtors" or "problem debtor countries," these being the group described as "countries with recent debt service problems" in the IMF's *World Economic Outlook*, April 1988, p. 106. They are defined as "... those countries which incurred external payments arrears during 1985 or rescheduled their debt during the period from end-1983 to end-1986 as reported in the relevant issues of the Fund's *Annual Report on Exchange Arrangements and Exchange Restrictions*."

I. Aspects of the Debt Situation

Disruption of Financial Markets Avoided

One initial problem associated with the inability of some countries to tap private credit markets in 1982 was the threat of instability and disruption of financial markets. Avoiding this threat, and the threat that the crisis might spread to a wider range of debtor countries, was one important priority in dealing with the debt crisis. Indeed, the term "crisis" seems appropriate to a situation in which the solvency of important financial institutions was called into question. Since it is clearly in the interests of both debtor and creditor countries to maintain an open and viable international payments system, any strategy to deal with debt issues must be evaluated with this in mind.

It is in these respects that the current strategy has probably best served the interests of both debtors and creditors. The potential costs of a breakdown in international financial markets have been avoided. Private lenders are in a much stronger position to absorb potential losses on their credits than was the case in 1982 when some debtors for the first time seemed unable to service their obligations. The capital-asset ratios for banks in nine industrial countries increased, on average, by about 16 percent from 1982 to 1986, namely from 4.4 to 5.1 percent. Moreover, as a result of a decline in U.S. banks' claims on developing countries, their ratio of capital to these claims had doubled since 1982 to about 95 percent in 1986. For banks outside the United States the depreciation of the U.S. dollar has probably also generated substantial improvements in

this ratio.¹ Over the longer horizon the debt strategy seeks to restore economic growth in problem debtors and restore these countries' normal access to international credit markets.

Current and Future Consumption in Debtor Countries

The servicing of debt obligations built up over the years of high borrowing has reduced consumption levels in some problem debtor countries below where they might have been otherwise and has clearly reduced the level of investment, thus limiting future consumption. Gross capital formation as a percent of GDP averaged 25 percent during 1970–82 for this group and since 1983 has been only around 19 percent. Estimates reported in the April 1987 *World Economic Outlook* suggest that the steep decline in investment ratios for problem debtors has allowed per capita consumption expenditures to remain roughly unchanged since 1982. It is clear, however, that for a number of debtor countries consumption per head has declined over the period. By contrast, per capita consumption expenditures in developing countries without debt-servicing problems increased by about 15 percent over the 1982–86 period. The buildup of debt would not have had this effect if all the debt incurred had been utilized for investment that finally ended up yielding rates of return at least equal to the interest rates on the loans. But, in most cases output in debtor countries has not grown as rapidly as expected, the value of purchasing power over imports even less so, and interest rates have turned out much higher than expected.

Thus, borrowing was based on expectations of both debtors and private and official creditors about the terms of trade, world real interest rates, and the economic growth in developed countries that—with hindsight—were too optimistic, even though they may have appeared reasonable at the time. Furthermore, it must be remembered that during the period of high borrowing savings ratios in many of the problem debtor countries fell; in other words, borrowing allowed them to sustain or raise consumption levels so that the reduction in consumption that was compelled later by the debt crisis was to some extent a consequence of higher consumption levels earlier—levels that, at least in retrospect, were too high.

Even without increased debt service, the decline in the terms of trade would have called for reductions in present or future consumption. The debt service obligations have added to this. Clearly this situation has set up severe strains.

¹Watson and others (1988), p. 39.

Distribution of Savings Internationally

Another important aspect of the current situation is the possibility that an inadequate share of world savings is going to developing countries.

First of all, one must distinguish the so-called resource transfer from the transfer of savings. The resource transfer *out* of a debtor country is usually defined as the current account surplus plus all interest payments to nonresidents. The transfer of savings from a debtor, however, is measured by the current account balance plus the inflation premium in interest payments. The inflation premium can be measured by considering the portion of interest payments required to keep the real value of debt unchanged. For problem debtors the transfer of real savings is estimated to have been about \$4 billion in 1987, assuming the relevant inflation rate to be 3.3 percent a year.²

It is reasonable to expect that a country will make interest payments to nonresidents for a period when it has in a previous period been absorbing large capital inflows. If the funds have been efficiently utilized they would have raised the real value of the country's output by more than the subsequent payments needed to service interest on the debt. This is, after all, the logic behind placing interest payments to nonresidents among other service payments to nonresidents. Interest payments are payments for the use of nonresidents' savings. Thus, the resource transfer is simply the cost that goes with the benefit of higher output. The problem with funds that were borrowed in the 1970s and early 1980s is that they did not always lead to the necessary rise in output. They were used either to sustain consumption levels or invested on the basis of expectations about interest rates and terms of trade that were widely held but unfortunately turned out to be quite wrong.

Problem debtor countries had a cumulated current account deficit of \$82 billion from 1983 to 1987, but this does not imply that they were net borrowers in real terms from the rest of the world. While their nominal debt did rise as a counterpart of the current account deficit, the real value of that debt was eroded by inflation. Thus, about \$100 billion in the interest payments recorded over this period represented amortization of debt rather than service payments for the use of nonresident savings. In other words, if account is taken of the inflation premium implicit in interest payments, problem debtors transferred real savings to the rest of the world that cumulated to about \$18 billion from 1983 to 1987.

In effect, there has therefore been some net repayment of borrowing

²The appropriate choice of a deflator will vary according to the question investigated. For expositional purposes, the U.S. GNP deflator is used here.

by the group as a whole. Over 1983–87 the decline in real debt came entirely from private sources as the real value of official credits to problem debtors rose while the real value of private credits fell by about 7 percent.³

From the point of view of world efficiency, funds should move internationally in response to prospective relative returns on investment opportunities whether in the public, the parastatal, or the private sector. Put very broadly, countries should be able to borrow if the expected risk-adjusted rate of return in terms of extra national output resulting from the new investment measured at expected and undistorted prices exceeds the world rate of interest. But the existence of market discounts suggests that the incentive structure discourages the flow of new funds to problem debtors.

The problem is that, in evaluating new investment opportunities in an indebted country, a resident or nonresident investor would consider his standing relative to existing creditors. When existing debt sells at a discount in secondary markets, potential investors might assume that new claims would also trade at a discount. This could be offset by relatively high expected earnings, but there are probably a limited number of investment opportunities that would be expected to yield this relatively high rate of return. In these circumstances, expectations that bring about the market discount will affect the distribution of new savings around the world, reducing the flow of new funds on a voluntary basis to problem debtor countries. This helps to explain the decline or even cessation of new lending.

Many developing countries have been able to maintain a normal relationship with their creditors, and it is not assumed here that it is beyond the grasp of those that have experienced difficulties to regain that status, as already shown by some countries. Moreover, it cannot be automatically assumed that the inflow of net new funds has been inadequate in all cases (i.e., that expected risk-adjusted rates of return at the margin generally exceed the world rate of interest). If countries have borrowed so much in the past that there has been an undue rise in their debt ratios, it may well be prudent to cease borrowing or even to reduce their indebtedness. Projects that yield the necessary rate of return may not exist. There is no presumption that all developing countries must be consistently net borrowers, and, for some, any addition to their indebt-

³In fact, nominal debt is estimated to have risen by more than the cumulated current account deficits for problem debtors over this period. This discrepancy may reflect valuation changes that do not appear in balance of payments data or errors in one or both sources of data. Both sources of data suggest that the real value of private claims on these countries declined over the period although debt statistics suggest that the real value of total debt rose somewhat.

edness at market interest rates may currently be quite unwise. This is not to say that they may not be in desperate need of extra current resources to maintain present levels of per capita consumption or even to prevent a decline. But this really represents a need for concessional finance, for a change in domestic policies, or for both. Thus the decline of new lending may have some justification, especially if new funds would be used for the maintenance of consumption or if domestic policies or economic prospects are poor.

When interpreting the causes and implications of market discounts, some attention needs to be given to the characteristics of the instruments being traded and the structure of the market. For example, observed discounts on existing syndicated credits might reflect not only the market valuation of alternative new claims on the debtor country but also the characteristics and status of these particular financial instruments. Existing syndicated credits are illiquid instruments and prices quoted in these markets are in some cases not transactions prices but only prices that the intermediaries believe are representative of market conditions. They are not structured as “trading” assets—indeed the legal structure may create impediments, thus raising the cost of trading and thus resulting in a higher discount than tradable securities. For these reasons the secondary market for existing commercial bank syndicated credits may understate the value of claims on debtor countries. But the secondary market is likely to provide at least an indication of how investors at the margin view the relative returns required for general balance of payments lending to different countries. They may not reflect, however, the return that investors require from other forms of lending to the debtor countries, such as negotiable securities. Indeed, an underlying premise of market-based approaches to the debt problem is that alternative methods of financing could be more attractive to creditors.

Finally, there is some evidence that the market values of commercial banks' stocks reflect the banks' exposures to those debtor countries whose debts are heavily discounted in secondary markets. Thus, the very well developed market for bank equity seems to reflect the same valuations of the external debt as observed in secondary markets for syndicated credits.

Fiscal Problems of Debtor Countries

Another feature of the current situation is that external debt obligations represent a present and future expected fiscal commitment in the debtor countries. Interest payments accounted for about 16½ percent of fiscal expenditures of problem debtors in 1987, and for several of these

countries interest payments accounted for more than 40 percent of total expenditures. These ratios reflect the fact that in most cases the external debt of developing countries was originally—or subsequently became—an obligation of the government. This fiscal obligation is likely to reduce domestically financed investment both directly through restricting capital formation by the government, and indirectly, since private investment may be a relatively attractive tax base. Higher taxes may also distort resource allocation. There are a number of different effects here.

First, expenditures on public investment have declined and, indeed, with inadequate gross investment the public capital stock may well have depreciated in some countries. Against this, it has to be borne in mind that some public investment in the recent past has been highly uneconomic, and the reduction of such investment could even be a blessing.

Second, there is an internal transfer problem—that is, a need to raise taxes now and in the future to finance service on the public external debt. Raising taxes involves familiar collection costs and distortions in relative prices and incentives. Particularly important is the effect of future tax liabilities on the extent and form of domestic investment.

Productive investment in domestic real capital is a relatively visible activity and hence liable to be taxed heavily in direct and indirect ways, and this could lead to a sub-optimal share of domestic savings going into such investment. This prospect produces incentives both for capital flight—the investment of domestic savings abroad—and for excessive investment in nonproductive assets. Furthermore, savings may be discouraged. Prospects of high taxation also discourage the inflow of new foreign capital into the private sector. Finally, the fiscal problem generates uncertainty as to the extent to which the government will resort to inflation in order to generate internal transfers to the government.

A fiscal problem is nothing new for governments, whether developed or developing, and as the debt service obligation may be just one out of many causes of such a problem, one needs to put the role of debt service in perspective. But for many countries the increased debt service obligations have been combined with a severe deterioration in the terms of trade that has eroded the tax base. Tax liabilities are likely to reduce investment unless the burden of earlier mistakes or misfortunes is to be borne wholly by cuts in consumption. The burden must be borne somewhere, unless it is possible to increase output sufficiently by supply side measures.

II. Debt Strategy

The present strategy is that debtor countries should grow out of their debt situation with the help of (i) improved policies that are expected to raise their rates of growth, (ii) official support from governments and

multilateral agencies, (iii) new money from private lenders, and (iv) growing and open markets in the industrial countries for debtor countries' exports. We discuss the role of domestic policy changes below. With regard to official funds, problem debtors have received about \$124 billion in net new credits from 1982 to 1987. Increased efforts by official creditors (e.g., the Fund's enhanced structural adjustment facility) hold substantial promise for the low income countries whose debt is small in absolute terms though not relative to their capacity to pay, but official credits are not likely to provide a significant offset to the reduced availability of private credit to the middle income debtors.

Given the availability of official finance, the key issue is whether it is possible for debtor countries to meet their current debt service obligations and yet gradually grow out of debt.

Growing Out of Debt: Possibilities

To start with, one particular scenario might be considered. This is perhaps closest to the scenario implicit in the current strategy. Suppose that a debtor country gets sufficient net new funds annually so that its nominal external debt grows at the rate of inflation in the country in whose currency the debt is denominated (e.g., the United States) or—which is the same thing—its real external debt remains constant. If the country's debt/GDP ratio is 50 percent (roughly the average, net of official reserves, for the problem debtors) and if the real rate of interest on its debt is 4 percent, then the debtor country would have to make payments equal to 2 percent of its GDP annually to its foreign creditors. For the "average" problem debtor this would equal about 16 percent of exports.

One view is that this is not a great burden and is feasible. With real growth of, say, 3 percent a year, the debt/GDP ratio would steadily fall and after ten years it would be only about 37 percent. Given the same 4 percent real interest rate, only about 1½ percent of GDP would be paid to nonresident creditors. The country would be well on the way toward having grown out of debt. Both consumption and investment as a proportion of GDP could increase over time, and the rise in investment might further increase the growth rate.

Another view, however, is that this scenario would entail serious difficulties for many debtor countries. A payment of even 2 percent of GDP for an extended period would be quite large by historical standards. Moreover, these figures are based on averages for problem debtors. In fact about one quarter of all problem debtors have debt/GDP ratios that exceed 100 percent so that the ratios look twice as serious. Furthermore, it cannot be assumed that the real interest rate would stay at 4 percent

