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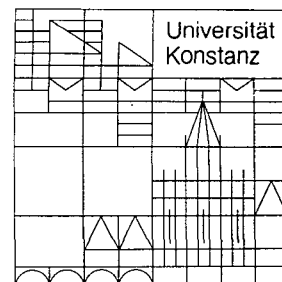
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wissenschaften und Statistik

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Jesko Hentschel

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State of the Art**

MANAGING INTERNATIONAL DEBT: STATE OF THE ART

Jesko Hentschel

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## MANAGING INTERNATIONAL DEBT: STATE OF THE ART

*by Jesko Hentschel*

*The cooperation between international organizations, private banks, and national governments as put forward in the Baker Plan has prevented major disruptions of the international financial system resulting from the debt crisis. Rescheduling agreements have been reached in large numbers. Financial innovations have provided flexibility to the banking system in dealing with their large exposure. But the disappointing response to the Mexican debt-swap initiative has also shown that financial innovations cannot be relied on solely to reduce the debt burden to levels that reestablish the credibility of major debtors. Structural adjustment efforts under the supervision of the IMF do not show the desired results either - more often proposals are put forward which demand a reexamination of some ingredients of the old debt management strategy. The conventional approach and new proposals are evaluated below.*

It seemed as if 1988 could turn out to be a promising year for the international 'debt community': Brazil made several interest payments totalling \$994 million ending a one-year moratorium, which the new Finance Minister Mr. Mailson da Nobrega now describes as "its worst mistake"<sup>1</sup>. It then reached a major rescheduling agreement of \$68 billion of interest and amortization payments due between 1988 and 1993. Final agreement is

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<sup>1</sup> Cf. Financial Times, 18.3.1988.

delayed till Brazil and the International Monetary Fund have had consultations. Thus the largest debtor was brought back to cooperative debt management. Venezuela was the first Latin American country to return to the international capital market with a \$100 million Eurobond issue. And Mexico announced in January a promising scheme to reduce its debt burden by swapping it into newly issued securities backed by US Treasury zero-coupon bonds.

But the amount of bank offers to reduce their exposure to Mexican debt was limited. It shows that financial innovations cannot be relied on exclusively to reduce the threat to the world economy stemming from the debt crisis nor to reestablish the credibility of many developing countries. And Brazil did not make interest payments because its external position improved in 1987 but because it realized that the costs of the moratorium are quite high: private credit lines have decreased, export-credit agencies have stopped financing Brazil's imports, and Brazil pays a substantially higher spread above the London Interbank Offer Rate (LIBOR) than other debtor countries.<sup>2</sup> It is argued below that while financial markets have proven innovative, the expectations placed on the ability of debtor countries to adjust to a radically different economic environment have not been fulfilled. The Baker

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<sup>2</sup> Cf. Economist, 20.2.1988, p.88.

plan has extended the time horizon in which adjustment is to take place, but it is often criticized for not going far enough.

### SECURITIZATION AND FINANCIAL INNOVATIONS

Mexico's debt deal was disappointing. It had hoped to sell \$10 billion of new bonds offered through Morgan Guaranty in exchange for \$20 billion of old debt. The issued floating rate note was to be backed by US Treasury bills. But instead of the 50% discount envisaged, the average discount achieved for the new bond was 69.8% of the face value of the old debt.<sup>3</sup> Bonds worth \$2.56 billion will be issued, settling \$3.6 billion of bank claims against Mexico.

Asset trading of bank claims in secondary markets is estimated at \$2 billion in 1986 and \$6 billion in 1987.<sup>4</sup> Although this represented only a tiny fraction of debt owed to private banks (about 1%) the emerging ability to trade debt offers a possibility for the banks to adjust their portfolios. If a bank perceives its exposure to claims against one specific country as too high, it can diversify its portfolio through secondary market trading. Specific secondary market

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<sup>3</sup> Cf. Financial Times, 5/6.3.1988.

<sup>4</sup> Cf. Euromoney, Supplement January 1988, p.25.

transactions have had a substantial impact on the debtors external position. Chile achieved a sizable reduction of its external debt through debt-for-equity swaps which were estimated to have reached \$2 billion till mid 1987.<sup>5</sup> This represents 13.6% of Chilean debt owed to private banks. Brazil recently (March/April 1988) changed its attitude toward debt-for-equity swaps and started a relatively small scale conversion plan similar to the ones already in operation in Chile and Mexico.<sup>6</sup> Another securitization plan now being discussed is promoted by the African development bank and targeted for debt ridden African countries.<sup>7</sup> The plan, originally designed for Zaire, suggests that a country's debt should be converted into negotiable securities at face value but carrying below market interest rate. The principal repayment after 20 to 25 years will be backed by a sinking fund (managed by the World Bank, the IMF, and the African Development Bank) in which Zaire pays a certain fraction of its export proceeds.

More important have been the efforts of private banks to reduce their exposure to risky claims by building up loan-loss reserves and write-offs. US banks lag behind German banks, which have made write-offs in the

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<sup>5</sup> Cf. Morgan Guaranty Trust Company, World Financial Markets, June/July 1987, p.12.

<sup>6</sup> Cf. Financial Times, 29.3.1988.

<sup>7</sup> Cf. The Banker, March 1988, pp.21-22.

magnitude of up to 70% of nominal claims.<sup>8</sup> One can not generalize about the extent of risk reduction across banks in the US, though. Whereas big regional banks in the US have increased their reserves on Third World debt to around 50% in 1987, the New York money-centre banks (especially Manufacturing Hanover, Chase Manhattan, and Chemical Bank) have only achieved a 20 to .25% reserve buffer.<sup>9</sup> Japanese banks are still worse off. The differences originate largely from the varying importance of LDC debt to the banks' equity base (which is extremely high for the New York money-centre banks), but also from different legislative procedures regarding write-offs. In Germany, both specific charge-offs as well as a general revaluation of the total stock of claims is tax deductible. In the US, on the other hand, the Internal Revenue Service has to individually evaluate the eligibility of specific charge-offs to be tax deductible. The American Tax Reform Act of 1986 made this specific charge-off method the only means of write-offs. The 'reserve method' which previously enabled the banks to write off 0.6% of its total claims, was abolished.<sup>10</sup> Japanese banks are

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<sup>8</sup> This high amount of write-offs is reported for Deutsche Bank, whereas Dresdner Bank (50%) and the Commerzbank (35%) lag behind. Cf. Financial Times, 15.3.1988.

<sup>9</sup> Cf. Economist, 23.1.1988, p.70.

<sup>10</sup> Cf. A.I.Mendelowitz, Legislative and Administrative Obstacles to Writedowns and Swapping of Less Developed Country Debt, Statement before the Subcommittee on International Finance and Monetary Policy, unpublished manuscript, Washington D.C., 1987.



restrained domestically to charge off the desired portion of Third World debt. They have made provisions equivalent to 5% of their outstanding loans to countries in financial difficulty; the maximum at which they can claim debt relief.<sup>11</sup> They therefore started to sell their debt at a discount to own subsidiaries in the Euromarket, thereby realizing the desired reduction of book value.<sup>12</sup>

In contrast to an exchange of debt claims between banks, debt-for-equity or debt-for-bond swaps decrease the total debt owed to creditors. Although these special forms of debt relief are still in their infancy, they may become important in the future. If their financial position allows it, banks can even grant outright relief as will happen in the case of Bolivia. The International Monetary Fund set up a fiduciary fund to receive donations to allow Bolivia to buy back its own debt. Private creditor banks have now agreed to sell \$308 million of old Bolivian debt at 11% of its face value.<sup>13</sup> But up to now, these schemes have not significantly improved the external position of major debtor countries.

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11 Cf. Financial Times, 15.3.1988.

12 Cf. Die Bank, January 1988, p.33.

13 Cf. Financial Times, 17.3.1988.

## DEBT INDICATOR DEVELOPMENTS

Four years ago a study of the Institute of International Economics projected that the major debtors would be able to regain credibility, especially by improving their debt to export ratio by 1986.<sup>14</sup> Once more the crisis was characterized as being one of illiquidity rather than insolvency. But threshold levels like 200% for the debt-to-export ratio<sup>15</sup> are far from being realized. This indicator increased dramatically for the three largest Latin American debtors between 1982 and 1986: from 390% to 438% for Brazil, from 311% to 428% for Mexico, and from 447% to 534% for Argentina.<sup>16</sup> Closely related to this is the comparison between the growth rate of exports and the interest rate. If the debtor country runs a balanced trade account and thus reschedules the interest due on its debt, total debt will grow by the rate of interest. If the ratio of debt to exports is not to grow under these circumstances, the rate of growth of exports must be at least as high as the interest rate. While Brazil's interest rate averaged 10.9% from 1982 to 1986, its export value grew only by an average 1.6%

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14 W.R.Cline, *International Debt: Systematic Risk And Policy Response*, Institute of International Economics, Washington D.C., 1984.

15 A two-to-one ratio of the debt-to-export level is often cited as a critical value. Cf. Morgan Guaranty Trust, *World Financial Markets*, June 1983. See also A.Krueger, *Origins of the Developing Countries Debt Crisis*, *Journal of Development Economics* 27, 1987, pp.165-187.

16 Data from World Bank, *World Debt Tables 1987-1988*, Washington D.C., 1988.

during this time span (it grew 24.3% from 1983 to 1984 but dropped again sharply thereafter).<sup>17</sup> The same is true for Mexico and Argentina: 11.2% and 10.4% average interest rates and -2.8% and -1.2% export value growth, respectively. An improvement of the situation did not occur as projected and a further deterioration is more likely than a relaxation of the situation.

#### EXTERNAL CONDITIONS

External conditions have to be favorable in order to enable the debtor countries to run trade account surpluses to pay interest and current account surpluses to reduce the debt burden<sup>18</sup>: growth in industrial countries would give impetus to developing country exports<sup>19</sup>. Also, low interest rates would decrease the debt service burden and new voluntary credit flows could alleviate the high costs of rescheduling. Finally, free access to the industrial countries' markets is a necessary condition for higher exports of

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17 Ibid.

18 See for a discussion of links between creditor and debtor countries R.Dornbusch, Policy and Performance Links between LDC Debtors and Industrial Nations, Brookings Papers on Economic Activity, 1985 (2), pp. 303-356, and W.R.Cline (1984), op. cit.

19 It is most often assumed that developing country exports are demand determined and that there is a stable relationship between industrial country growth and developing country exports. This builds on the role of industrial countries as the 'engine of growth' of developing countries' exports. Compare A.Lewis, The Slowing Down of the Engine of Growth, American Economic Review 70, 1980, pp. 555-564.

the developing countries. It is obvious that the external conditions have been unfavorable: the high US budget deficit has produced high real interest rates world wide, hitting those countries with a large part of commercial debt since the latter is largely on a floating rate basis. Industrial country growth has slackened, protectionistic pressures are mounting, especially in the US. The IMF conditionality attached to stand-by-agreements, drawings in higher credit tranches, and use of specific funds like the new Enhanced Structural Adjustment Facility, addresses policy adjustments to reduce balance of payments imbalances in the deficit countries - surplus countries remain unpunished. When the International Monetary Fund was founded, Keynes proposed that countries showing balance of payment surpluses should also be pressed to reduce these surpluses. This proposal would be well suited today to induce Japan and West Germany to reduce their balance of payments surpluses.

Obviously, external conditions alone cannot help highly indebted countries to improve their credibility. But favorable external conditions can induce domestic policy adjustments. Right now, it seems like protectionistic pressures hinder the export growth of developing countries. This discourages the country to choose an outward-oriented development strategy, which in turn further hinders export-growth. Due to the bad

export performance, external credit is further restrained, which makes adjustment efforts even more difficult and painful. A good example is the Multi-Fibre-Agreement (MFA). Since the export quota system of the MFA is very unflexible, newcomers in the clothing and textile market (like Mauretania, Sri Lanka, or Bangladesh) can not grasp a sufficient share of the market to fully exploit their export potential. Their effort to develop labor-intensive manufacturing industries has shown little success. With industrial markets protected it will be impossible for the large part of the developing countries to follow the South-East Asian development strategy.

#### IMF CONDITIONALITY REVISITED

The major Latin American debtor countries all undertook the IMF austerity measures for quite some time and the result was impressive: all countries improved their external balance substantially. Brazil's current account, for example, was balanced in 1984 and 1985 as was Peru's in 1985, thus interest payments could be generated from a trade account surplus. But this was not achieved through a growth in export receipts but much more through a reduction of imports. The major debtors sharply reduced absorption at home - not without costs: since major sectors are dependent on

imports as inputs, national income dropped between 1984 and 1985 in Peru, Argentina, Chile, and Venezuela and between 1985 and 1986 in Mexico (due to the oil price decrease). Accordingly, it became much harder for the governments to pursue austerity measures. Brazil and Peru overtly broke with the IMF; president Alan Garcia of Peru declared that only 10% of Peru's export proceeds would be used to service the debt; Brazil declared a moratorium. Although one might attribute this to a 'lack of willingness' to adjust, the major Latin American debtor countries were caught in a double conditionality<sup>20</sup>: On the one hand, private banks determined the amount of fresh money available which in turn determined the speed of adjustment, on the other hand, the IMF set targets for macroeconomic variables and demanded liberalization moves. Additionally, with falling per capita income (which naturally hit the poorest people most) domestic political pressure grew. The Baker plan recognized these strains on the debtor countries and their limited ability to produce the desired balance of payment results in a short time period and in an unfavorable international environment. Additional credit was mobilized and the World Bank with its Structural Adjustment Facility gained more importance in designing country adjustment policies. In

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<sup>20</sup> Cf. A.Foxley, Latin American Development after the Debt Crisis, *Journal of Development Economics* 27, 1987, p.201-225.

addition to this shift to a longer term view, two arguments that question the IMF conditionality policy have recently attracted attention.

One argument challenges the view that immediate liberalization policies are necessary under highly unstable domestic circumstances.<sup>21</sup> Debt servicing involves two steps: the first is to raise resources at home, the second is to transfer the domestic resources abroad by earning enough foreign exchange. A large part of the current debt is public or publically guaranteed debt. Thus the government has to raise resources domestically in the form of a budget surplus. A current account or trade account surplus then enables resources to be transferred abroad. But import liberalization and exchange rate devaluation (in order to raise the relative price of tradables versus nontradable goods) put additional strain on the government budget in the short run: the reduction of tariff receipts, additional social welfare spending to ease the reallocation of the work force, and the need to generate a higher amount of domestic currency for a dollar to be transferred abroad. In the past, fiscal imbalances have in quite a few countries been financed through an expansion of the money supply. In order to meet debt service obligations, domestic currency was often converted into

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<sup>21</sup> See, for example, J.Sachs, Trade and Exchange Rate Policies in Growth Oriented Adjustment Programs, National Bureau of Economic Research Working Paper 2226, 1987.

hard currencies on the free exchange market. This has led to enormous inflation rates and devaluation, which in turn put further pressure on the domestic price level and stimulated capital flight. It is therefore argued that domestic fiscal stabilization has to precede liberalization moves.

The second argument questions whether liberalization policies will indeed lead to successful structural adjustment. It has been stressed for a long time that countries following an outward-orientated development strategy performed far better in terms of economic growth<sup>22</sup>, flexibility to adjust to external shocks<sup>23</sup>, and availability of capital than countries pursuing an inward-looking strategy targeted primarily at import substitution. Outward orientation is then equated with liberalization policies. But this link does not seem self-evident. The successful countries in South-East Asia, especially South Korea, Taiwan, Hong Kong, and Singapore did not pursue liberal trade policies with a low degree of state intervention, but these policies are demanded from the Latin American countries right now. In South Korea, the government played the leading

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<sup>22</sup> See, e.g., B.Heitger, Import Protection and Export Performance - Their Impact on Economic Growth, *Weltwirtschaftliches Archiv* 123, 1987, pp. 249-261.

<sup>23</sup> See, for example, B.Balassa, Adjustment to External Shocks in Developing Countries, *World Bank Staff Paper* 472, 1981.



role in structural adjustment.<sup>24</sup> Exports were subsidized and supported by a favorable real exchange rate. Credit rationing discriminated in favor of export industries. As Dornbusch and Park put it:

*"Economists and policymakers seeking to apply the lessons of Korea's success to poorly performing countries in Latin America should note that the recipe is definitely not simply 'hands off, give free reign to market forces'. Government intervention has been intense, and restrictions on trade and capital flows are the rule. Thus if any general description is appropriate, it is that the government has for the most part run a tight ship, sailing very close to the wind."*<sup>25</sup>

Anne Krueger's definition of 'outward orientation' as policies characterized by the fact "that there is at least as much incentive to earn as to save foreign exchange and that incentives to export are fairly uniform and not discriminating across commodity groups"<sup>26</sup> seems much more appropriate than the one which simply hails liberal trade policies.

Another aspect which has become important when the successful development stories of South-East Asia are compared to the Latin American growth strategy and experience is the importance of an equitable income

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<sup>24</sup> Cf. R.Dornbusch and Y.C.Park, Korean Growth Policy, Brooking Papers on Economic Activity, 1987 (2), pp. 389-454.

<sup>25</sup> Cf. R.Dornbusch and Y.C.Park (1987), op. cit., p.394.

<sup>26</sup> Cf. A.Krueger, Import Substitution Versus Export Promotion, Finance and Development 22, 1985, p.20.

distribution.<sup>27</sup> In Korea and Taiwan, very effective land reforms in the 1940's and 1950's created small scale rural family farmers not only producing with a labor-intensive technology in agriculture realizing the 'full production potential',<sup>28</sup> but also supplying labor to the development of labor-intensive industries. A more equitable income distribution might have also reduced political tension between the urban and rural sectors in these countries.<sup>29</sup>

#### FOREIGN DIRECT INVESTMENTS

Foreign direct investments, as the major part of non-debt creating flows, might help to alleviate the debt-service problems of major debtors. Although small in relation to total external debt, they financed around 22% of total debt service of Brazil, 26% of Argentina, and 5% of Mexico in 1985.<sup>30</sup> The instability due to the debt crisis has reduced the volume of private direct investments substantially; the establishment of the

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<sup>27</sup> Cf. G.Ranis, Latin American Debt and Adjustment, *Journal of Development Economics* 27, 1987, pp.189-199. Also J.Sachs (1987), op. cit., R.Dornbusch and Y.C.Park (1987), op. cit.

<sup>28</sup> Cf. A.De Janvry, The Role of Land Reform in Economic Development: Policies and Politics, *American Journal of Agricultural Economics* 63, 1981, pp. 384-392.

<sup>29</sup> Cf. J.Sachs (1987) op. cit.

<sup>30</sup> Data from IMF, Balance of Payments Statistics, 1987(2), and World Bank (1988), op. cit.

Multilateral Investment Guarantee Agency<sup>31</sup> (MIGA) might help to create a regulatory framework stimulating more direct investment projects. In the balance of payments accounting framework, direct investment flows appear in the capital account and therefore seem to finance a current account deficit or amortization payments. But the impact of foreign direct investments should be examined carefully. The total amount of foreign exchange is only available for debt-service payments, if all investment goods are purchased in the host market. In later periods, foreign exchange outflows may occur stemming from the investment projects. High import requirements for production and the repatriation of profits and dividends may erode the initial positive impact on the balance of payments. Although most studies find a positive impact of foreign direct investments on the growth rate of the host country, the net effect on the balance of payments is quite ambiguous<sup>32</sup>. But the underlying assumption of these cash-flow studies is that the investment projects would

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31 See for an evaluation of the MIGA S.Sinn, Der Vorschlag der Weltbank zur Gründung der Multilateralen Investitions-Garantie-Agentur: Analyse und Kritik, Die Weltwirtschaft, 1987 (2), pp.126-138.

32 Studies examining the balance of payments impact of foreign direct investments are surveyed in K.Glaubitt and W.Lütkenhorst, Private Direktinvestitionen und das Verschuldungsproblem der Entwicklungsländer - Empirische Studien and wirtschaftspolitische Optionen, in: H.-B.Schäfer (ed.), Gefährdete Weltfinanzen, Bonn, 1980, pp. 199-223. See for an evaluation of the impact of foreign direct investments on the growth performance J.P.Agrarwal, Ausländische Direktinvestitionen und industrielle Entwicklung in der Dritten Welt, Die Weltwirtschaft, 1987 (2), pp. 146-157.

have been carried out by local instead of foreign entrepreneurs had the latter not undertaken the investment. Thus changes in the import/export structure, technological improvements, and employment effects of foreign direct investments are not assessed. One should therefore draw a sharp distinction between the role of foreign direct investments as a mean to ease the debt-service burden, where they are unlikely to have a substantial positive impact, and a longer term perspective in which foreign direct investments could play a crucial role in supplementing the capital stock in developing countries. It should be mentioned here that the 'outward-oriented' success countries of South-East Asia did not rely on foreign direct investments to help generate their spectacular growth record. South Korea, for example, had hardly any foreign investments till the beginning of the 80's<sup>33</sup>.

#### DEBT RELIEF

Arguments against a debt relief scheme are twofold: The first addresses the financial inability of banks to grant substantial debt relief and stresses that governments can and should not 'bail out the banks'. But banks have made substantial write-offs of Third

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<sup>33</sup> Compare International Monetary Fund, Balance of Payments Statistics, various issues.

World debt and debt relief does not imply that the total debt of developing countries has to be forgiven. Advocators of a debt relief scheme<sup>34</sup> point to the heavy debt-service burden which depresses investments and led to decreasing per capita income levels in quite a few debtor countries in the past couple of years. Countries can get caught in what Anne Krueger calls a 'high-debt-service trap': with decreasing capital inflows and high debt-service outflows, investments are depressed although rates of return on them might be quite high. Because of high-debt service ratios and slow growth, foreign finance further decreases. Exports might then not grow because of a lack of capacity expansion and countries will not regain creditworthiness, since the debt-service ratio remains high.<sup>35</sup> A lower debt service burden (achievable through lower total debt or lower interest rates on the existing stock of debt) would enable debtors to use some of the foreign exchange now transferred abroad to import necessary investment goods and to revitalize growth.

The second argument against debt relief is concerned with the moral hazard problem associated with forgiveness of debt: if relief is for example tied to

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<sup>34</sup> See, e.g., J.Sachs, *Managing the LDC Debt Crisis*, *Brooking Papers on Economic Activity*, 1986 (2), pp. 397-440. S.Fisher, *Sharing the Burden of the International Debt Crisis*, *American Economic Review Papers and Proceedings*, 1987, pp. 165-170.

<sup>35</sup> Cf. A.Krueger, *Debt, Capital Flows, and LDC Growth*, *American Economic Review, Papers and Proceedings*, 1987, pp. 159-164.

the per capita income-level growth, it might pay for a country to accept slow or even negative growth of per capita income in order to achieve relief. But selective and partial debt relief could be administered in a way that will minimize this moral hazard. Stanley Fischer proposed that relief should be available in the context of structural adjustment programs in cooperation with the IMF.<sup>36</sup> Instead of a general forgiveness of debt, interest and principal payments to commercial lenders would be renegotiated and reduced to 65% of the contractual value. Additionally, the major debtors might be hesitant to seek relief since they might fear to jeopardize short-term credit flows.<sup>37</sup>

Up to now, the international financial system has not been seriously harmed by the debt crisis. The current 'muddle-through' approach (renegotiation, rescheduling, fresh money to meet debt service obligations) could probably go on for a while. But it does not offer a perspective to reduce the burden on the highly indebted developing countries. Partial, conditional, and selective debt relief will probably be necessary to revitalize growth in these countries.

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<sup>36</sup> S.Fischer (1987), op. cit., p.169.

<sup>37</sup> Cf. J.Sachs (1987), op. cit, p.404, and W.R.Cline (1984), op.cit., chapter 4.

## A PERSPECTIVE

It is generally acknowledged that the developing and also the Newly Industrializing Countries (NICs) are not at a stage in their development process where they should be exporting capital - right now Latin America is transferring net resources abroad. To regain credibility and to induce voluntary capital flows from private creditors necessitates a non-orthodox approach by all participants. The Baker plan has reduced the emphasis placed on short term adjustment programs. By increasing the importance of the World Bank in designing adjustment programs, it acknowledged that debt-servicing cannot take place through an 'adjustment through austerity' policy alone. The Baker plan has been criticized for not putting enough pressure on the creditor countries themselves to adjust.<sup>38</sup> The transfer problem can not be solved without a reduction of the balance of payments surpluses of major industrial countries.

The international financial system has proven very innovative and has successfully prevented major disruptions. The Mexican debt swap, although relatively narrow in scope, and the Bolivian buy-back scheme have for the first time granted some debt relief of what has

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<sup>38</sup> Cf. P.Nunnenkamp, Das internationale Schuldenproblem: Ein Fall für die Regierungen der Gläubigerländer? Eine kritische Analyse des Baker Planes, Kieler Diskussionspapiere 117, 1986.

been already put aside for this purpose on the banks' balance sheet. Selective debt relief has been advocated by both leading economists and bankers as an appropriate tool to revitalize growth in countries that have been hard hit<sup>39</sup>. The moral hazard problem stemming from selective debt relief - other countries might act in a way that will enable them to achieve relief, too - will have to be taken into account; it could probably be dealt with by tying the relief to structural adjustment programs administered by the IMF and the World Bank. An interest capitalization scheme<sup>40</sup>, which would automatically capitalize interest payments above some certain threshold level, could stabilize debt-service payments and income in debtor countries. The establishment of regional Development Funds<sup>41</sup> could offer favorable credit conditions to hard hit countries and could tailor adjustment programs to specific circumstances. An enlarged Structural Adjustment Facility of the World Bank could emphasize the

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<sup>39</sup> See fn.34 and Frankfurter Allgemeine Zeitung, 30.9.1987, 'Herrhausen denkt über Schuldenerlass nach'.

<sup>40</sup> Different versions of such a scheme exist. They have in common that they cap interest payments, which is very important for countries with a large share of floating-rate debt. One proposal, for example, focuses on the establishment of an Interest Rate Compensation Facility within the IMF, which would operate like the Compensatory Financing Facility. It has been endorsed by W.R.Cline, *International Debt: From Crisis to Recovery?*, American Economic Review Papers and Proceedings 75, May 1985, pp. 185-190. See for a critical evaluation: G.Bird, *Interest Rate Compensation and Debt: Would a Cap Fit?*, World Development 15, 1987, pp. 1237-1242.

<sup>41</sup> The Latin American Development Fund was recently proposed by A.Foxley (1987), op. cit.



importance to support fiscal stabilization in countries first and help them later to abandon inefficient inward-looking policies in favor of an outward orientation. One should be careful, though, not to mistake outward orientation as pure liberalization, as the South-East Asian success stories have taught.

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