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Comprehensive Debt Retirement: The Bolivian Example

IT IS USEFUL to warn, as Jeremy Bulow and Kenneth Rogoff do in another paper in this issue, that "debt reduction" is not necessarily a panacea for heavily indebted countries. Many of the new schemes for debt reduction, such as exit bonds, buybacks, and debt-equity swaps, can be a poor deal for a debtor country, even when it is thereby enabled to retire debt at a discount relative to face value. It may make little sense for a debtor country to nibble away at its debt in a series of piecemeal transactions in which a bit of debt is repurchased at a discount in each transaction. Debt-equity swap programs, and other "voluntary debt reduction" schemes in the U.S. Treasury's so-called menu of options, almost always have this piecemeal character. It is no accident that Citicorp, rather than the debtor countries, is the world's leading advocate of debt-equity swaps.

An awareness of the dangers of piecemeal debt relief, however, should not be generalized into the proposition that retiring deeply discounted debt is invariably bad for the debtor country. Buybacks can be a useful and even important device for an overly indebted country, when they are part of a comprehensive arrangement for the debtor country, as they were in the recent case in Bolivia.

In this paper, I will first explain why comprehensive debt reduction mechanisms, including buybacks, can be highly desirable. I will then suggest why these mechanisms have not so far played a significant role in the debt strategy of the United States and the multilateral lending

This paper grew out of what was originally to be a discussion of the paper by Jeremy Bulow and Kenneth Rogoff in this volume.

institutions. Finally, I will show why the Bolivian case is a successful example of a comprehensive strategy of debt reduction, one that has been to the benefit of Bolivia and its creditors as well.

The General Case for Debt Reduction Operations

The analytical framework used in the Bulow-Rogoff paper is a useful starting point. In that framework, there is no particular reason for a debtor country to pursue debt reduction, even if it is of a comprehensive nature—a buyback of *all* of the debt. Consider a country that is so hopelessly over-indebted that its debt has a secondary market value of 5 percent of face value, say \$50 million on \$1 billion of principal. In the Bulow-Rogoff framework, the \$50 million represents the present value of expected payments on the debt and therefore the full burden of the debt, in the sense that the country should never pay more than \$50 million even to buy the entire \$1 billion of debt from the creditors and thereby resolve the debt crisis.

But, in reality, there is a burden of the debt that goes beyond the expected repayments, reflecting the various costs to the country of being in default.[1] A country that owes \$1 billion on which it can pay only an expected \$50 million will face great difficulty in new borrowing, even for highly productive investments.[2] It will face high bargaining costs in handling the \$1 billion of bad debt.[3] It will face sanctions from disgruntled

1. I first presented this theory for debt reduction in the developing-country context in Jeffrey Sachs, "The Debt Overhang of Developing Countries," in Ronald Findlay, ed., *Debt, Stabilization and Development: Essays in Memory of Carlos Diaz Alejandro* (Oxford: Basil Blackwell, 1988). Further articles in this spirit include Sachs and Harry Huizinga, "U.S. Commercial Banks and the Developing-Country Debt Crisis," *BPEA, 2:1987*, pp. 555–601; Elhanan Helpman, "Voluntary Debt Reduction: Incentives and Welfare," Working Paper 2692 (National Bureau of Economic Research, August 1988); Paul R. Krugman, "Market-Based Debt-Reduction Schemes," Working Paper 2587 (NBER, May 1988); Kenneth A. Froot, "Buybacks, Exit Bonds, and the Optimality of Debt and Liquidity Relief" (MIT, 1988). All of these papers demonstrate the potential efficiency gains from debt reduction operations.

2. No bank will lend to the Argentine government, for example, even for a highly profitable public investment, for fear that the loan will simply become part of Argentina's overall bad debt. It is dangerous to lend even if the individual project has a good return.

3. Negotiations may break down repeatedly, at high cost (for example, with disruptions of normal trade financing), because the various parties have a continuing incentive to

creditors, such as a withdrawal of trade credits, that will hinder its future economic performance.[4] It will face a major internal disincentive to economic reforms that increase the debt service capacity of the country, since the costs of reform are borne by the country while many of the benefits of reform will be appropriated by creditors who receive higher repayments in the event of reform.[5]

For these reasons, it may well be beneficial for the country to pay much more than the $50 million (in present-value terms) to cancel the overhang of $1 billion of mostly bad debts. These payments could come in the form of a direct cash buyback, especially if the country can borrow the funds for the buyback from friendly governments, or some other arrangement where future debt payments of over $50 million are guaranteed by the debtor country. A cash-starved country would obviously prefer to find ways to make the present value of payments in the future, rather than with current cash.[6] In either case, however, by eliminating the overhang, the country would avoid the costs of default and regain the incentives for internal reform.

The Bulow and Rogoff framework is generally correct, however, for demonstrating that paying more than the $50 million makes sense only if most or all of the debt overhang is thereby solved (although Rotemberg

posture and to act tough. For theoretical analyses, see Raquel Fernandez and David Kaaret, "Bank Size, Reputation, and Debt Renegotiation," Working Paper 2704 (NBER, September 1988); and Julio Rotemberg, "Sovereign Debt Buybacks Can Lower Bargaining Costs" (MIT, October 1988).

4. Even if the banks know that the debt cannot be paid, they may still impose sanctions for nonpayment to impress other debtors with whom they are negotiating.

5. Consider a case of an economic reform that would cost $100 million of current consumption and raise the debtor's future income and debt servicing capacity by $200 million in present value. Suppose that all of this incremental debt servicing capacity would be squeezed out of the country by the foreign creditors in the course of future negotiations. The debtor has no incentive to undertake the reform, despite its high return, because the benefits accrue to the foreign creditors. However, if the country first entered into a buyback, in which it paid $60 million for the $1 billion in debt, thereby canceling the debt overhang, it would then be free to undertake the investment and to reap the large returns.

Notice that this incentive effect could work through the incentives on a given government (by leading the government officials to a rejection of specific public investments or public sector reforms), or through the electoral process, by contributing to the election of governments that oppose the reform efforts.

6. As an example, the country could negotiate with creditors to use the receipts of future export earnings as collateral for future debt service payments, in cases where it would be administratively possible to arrange for future export earnings to accumulate in an escrow account out of reach of the country.

has proved that even marginal buyback operations can be beneficial under some circumstances, if the deadweight burden of the debt is high enough).[7] It will usually make little sense, for example, for the country to pay $6 million of cash in a one-shot transaction to reduce its debt by $100 million of face value if there remains $900 million of mostly bad debt on the books.[8]

This negative assessment of most small buybacks is reinforced when we step back from a static model and view a small buyback in a more realistic multiperiod context. In a buyback, the country uses current cash to repurchase principal that has been rescheduled for many years. The current contractual burden on the debt that is repurchased is only the interest due. If the repurchase price of the debt is greater than the interest rate—for example, if the debt sells for 50 cents on the dollar, when interest rates are 10 cents per dollar of debt—then a cash repurchase reflects an acceleration of payments on the debt, even though the debt is bought at a discount. For this reason, debt-equity swaps tend to impose an enormous cash flow burden on the debtor country. Governments involved in anti-inflation programs are, for this reason as well, strongly advised to avoid debt-equity swap programs, which are usually pressed upon them by the banks.

Why Comprehensive Deals Are Hard to Make

Even mutually advantageous debt reduction schemes, in which the debtor clears the debt overhang and the creditors raise the total value of payments that they receive, are unlikely to occur under the current official debt management strategy. The reasons are not far to seek. First, heavily exposed banks have an inherent incentive to reject buyback deals, even when they are efficient from the point of view of banks as a whole—that is, when they raise the market value of overall debt repayments.[9] Second, the U.S. government, the main arbiter of

7. See Rotemberg, "Sovereign Debt Buybacks."

8. Note that the country might have to pay 6 percent on the transaction, even if the current secondary market price of the debt is 5 percent, since the repurchase would tend to drive up the price on the remaining debt.

9. The perverse incentives that I am discussing affect only four or five U.S. banks. They are, however, among the biggest. They include Citicorp, Bank of America, Chemical Bank, Chase Manhattan, and Manufacturers Hanover. Outside the United States, there are probably no banks at all in the situation under discussion.

the kind of deals that take place, has vetoed almost all comprehensive debt reduction schemes on behalf of the most heavily exposed banks. Third, negotiations over the debt of smaller countries are guided by the creditors' concerns over precedent for the large debtors, rather than for the efficiency of the outcome for the small debtor. It is generally thought best to strangle a little country, even at the expense of the country's debt servicing, if it sends a convincing signal to Brazil and Mexico to keep paying the debt.

Why would a heavily exposed bank reject a comprehensive deal? Suppose that a bank holds $100 million of debt at face value, with $90 million in liabilities to depositors, and $10 million of book value of shareholders' equity. If the debt is worth only 5 percent of face value, then the bank cannot meet its liabilities in present value, and should be liquidated by the regulators.

In practice, however, the regulators would allow the bank to keep the debt on the books at face value ($100 million) rather than market value ($5 million), and the depositors would be fully insured by the Federal Deposit Insurance Corporation. The bank managers, acting on behalf of the shareholders, would try to continue to run the bank, on the chance that some highly profitable investments will come along and put the bank into the black.[10] The bank would have a positive market value despite having assets worth less than liabilities, reflecting the option value on future investment opportunities, combined with the FDIC guarantees.

How would the bank regard a cash buyback in which the debtor pays $100 million for the $1 billion of debt? Obviously it should reject the deal, even though the market value of the debt would go up, since it would be forced to write down the face value of the debt.[11] The bank would immediately be liquidated after the buyback, since the regulators would have to act on a bank with negative *book* value. The FDIC should be delighted with the buyback since it would reduce the FDIC's likely long-term cost of paying off the depositors, but the bank managers and shareholders would reject the buyback proposal.

Even if the buyback did not force a liquidation, it could well force a change of bank management, by reducing the book value of capital

10. As with the savings and loans in the mid-1980s, the banks would also have the incentive to go after highly profitable, highly risky ventures (as perhaps with money-center financing of leveraged buyouts in the mid-1980s).

11. The buyback constitutes an "accounting event" that forces the bank to mark to market value all of the assets involved.

enough to force the intervention of the bank regulators. Thus, even for heavily exposed banks not at risk of insolvency, bank managers might oppose buybacks for fear of losing their jobs.

Few, if any, banks in the United States would now be placed at fundamental risk by a widespread write-down on claims on the LDCs, but U.S. policymakers have not wanted to test that proposition. They have acted with one goal in mind: prevent a process that could escalate into widespread write-downs, which in turn might threaten the survival of current management of even one or two of the most heavily exposed banks. And it is the U.S. government, even more than the banks themselves, that determines the parameters of the debt negotiating process. So far, the U.S. government, working in tandem with the most heavily exposed money-center banks, has rejected virtually all attempts at a comprehensive settlement of the debt.[12] The U.S. government has made interest servicing of bank debt a litmus test of foreign policy relations between most debtor countries and the United States. Most debtor governments pay their debts not out of fear of the banks, but out of fear of a foreign policy rupture with the United States.[13]

The Bolivian Buyback

In only one case to date has the U.S. government supported a policy of debt relief. After long and difficult negotiations with the government of Bolivia, it endorsed a strategy that has been highly beneficial for all parties, in accordance with the theory of the debt overhang outlined

12. As an example, when the Brazilian government announced its intention in the summer of 1987 to negotiate a comprehensive package of debt reduction (by a conversion of debt to bonds with below-market interest rates), it was Secretary of Treasury James Baker III, and not the banks, who first determined that the proposal was a "nonstarter." In that case, as in almost all others, the U.S. government set the parameters of negotiation, by determining what is and what is not in the so-called menu of options available to the developing countries and the banks.

13. This fear comes from several sources. Bad relations with the United States would make it hard for the debtor to secure an International Monetary Fund program and World Bank financing, which in turn would frustrate relations with other bilateral creditors (for example, by preventing a Paris Club rescheduling of government-to-government debt). Moreover, powerful conservative elites within the debtor countries, especially in Argentina, Brazil, and Mexico, view good relations with the United States as crucial in avoiding a dangerous *internal* political turn to populism or to the far left. Thus these elites vigorously oppose a hard-line position on the debt. Third, the debtor country might have important

earlier.[14] Bolivia, alone of the high-inflation countries in the Southern Cone, has been able to stabilize and to resume growth, because it has not been trapped by excessive debt repayments. Political stability has also been restored, after the chaos and virtual anarchy of hyperinflation during 1984–85.

During 1982–84, Bolivia was treated like any other small debtor country. It was in deep financial crisis, paying nearly 6 percent of GNP each year during 1982–84 in net resource transfer to the foreign creditors. In April of 1984 hyperinflation set in; by August 1985, inflation had reached 24,000 percent—the world's worst in 40 years. Real GNP declined about 30 percent in per capita terms during 1980–85. In mid-1984, during the hyperinflation, Bolivia ceased most foreign debt payments after the Bolivian Treasury ran out of foreign reserves.

A new government came to power in mid-1985 and undertook remarkable stabilization efforts to halt the hyperinflation.[15] Despite the economic catastrophe facing the country, official U.S. and IMF policy in the spring of 1986 was that Bolivia should resume interest payments on its foreign bank debt. Indeed, in March 1986, only two months after price stability had been restored to the country, the IMF was urging a large devaluation in Bolivia to facilitate increased interest payments to the commercial banks.[16] The Bolivian government was convinced that such a move, in addition to destroying the economic and political basis of the stabilization program itself, would cause a collapse of the government.

In the spring of 1986, the Bolivian government urged a different approach in discussions with the U.S. government and the IMF.[17] Ultimately, the official creditor community and the IMF agreed to

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strategic concerns (for example, Argentina, following the Falklands War) that cause the government to toe the U.S. line. Fourth, the government might fear retaliation in the form of hostile trade policies from the United States in the event that it opposes the U.S. foreign policy line.

14. I have been closely involved in the Bolivian debt negotiations, as the government's main outside economic advisor.

15. Overall tax revenues were raised by almost 10 percent of GNP during the first year and a half. The politically and socially important mining sector was virtually closed down after the collapse of world tin prices in October 1985.

16. The IMF was pressing for net interest payments to the banks in 1986 of about $40 million.

17. Bolivia during this crucial period did not make progress in negotiations with banks. The official negotiations with the IMF, and discussions with the U.S. government, were of most importance.

treat the Bolivian case on the merits of the Bolivian situation, and acknowledge that Bolivia's foreign bank debt could not be paid, at least under conditions consistent with economic and political stability in the country.[18] The IMF agreed to grant Bolivia a program based on its successful stabilization efforts and despite the fact that the Bolivian government had not reached any understanding with the commercial bank creditors. The IMF agreement was the first in which the debtor country was not obliged to pay interest to the banks and to clear interest arrears.

In late 1986, once the banks saw that the U.S. government and the IMF were not going to defend their position vis-à-vis Bolivia, the banks began to discuss with Bolivia a longer-term solution to its debt overhang. Because U.S. regulators had begun to force write-downs of Bolivian debt in the banks' books, the banks no longer had any important incentive to hold on to Bolivia's debt in their books.[19] After two years of complicated discussions and legal work, the buyback was arranged. During the entire period of discussions, Bolivia did not pay any interest to the commercial banks. At the same time, Bolivia received large net resource transfers, on the order of about 5 percent of GNP per year, from the official creditors.

With the buyback, Bolivia repurchased about one-half of its debt at 11 cents per dollar of face value. The money used for this purpose was donated from foreign governments. While some of the money might otherwise have come to Bolivia as foreign aid in other forms, much of it would not. I would guess that of the $34 million spent on the buyback, Bolivia might have been able to get $15–20 million of the money in other forms of aid.

Although its remaining debt is still deeply discounted, Bolivia's

18. Among the complex reasons for this change of position, the most important was the ferocity of the economic crisis in Bolivia, combined with the strength of Bolivia's adjustment program, which eliminated tens of thousands of jobs in state enterprises and closed the budget deficit by more than 10 percent of GNP almost overnight. Also the United States had important foreign policy interests in stabilizing democracy in Bolivia, which borders most of the large countries of South America and has often been feared as a center of unrest (Che Guevara's death in the Bolivian jungles in 1967 being a case in point). Moreover, the United States was interested in pursuing an anti-cocaine policy in the region, and could accomplish it only with a friendly, stable government.

19. Bolivia was one of the few countries subject to an ATRR (allocated transfer risk reserve), in which the U.S. regulators force a write-down in book value of the debt. Intentionally, the regulators have avoided any forced write-downs for the largest debtor countries.

position is much improved from what it was before the buyback. Under current U.S. and IMF policy, Bolivia is not being pressed on the remaining part of the debt, except to settle that remainder on a basis similar to the buyback.[20] In effect, the official community is supporting a gradual process in which Bolivia will clear *all* of its commercial bank debts at a price of about 11 percent of face value. Meanwhile, as this process goes forward, the official community will not impose sanctions on Bolivia for nonpayments on the remaining bank debt.

Was the debt strategy of the IMF and U.S. government successful in the case of Bolivia? The answer is a resounding yes, for all of the parties concerned. In effect, the official community recognized in 1986 the futility of trying to press Bolivia to pay unpayable debt. As a result, the Bolivian government got the time and international support to put in place a remarkably strong and effective stabilization program that has ended a hyperinflation and restored economic growth to the country for the first time in almost a decade. Bolivia's political stability has been enhanced, as have its democratic institutions. The creditors as a whole benefited as well, as shown by the fact that Bolivia's debt rose in value from 5 cents per dollar to 11 cents per dollar. This increase in the price of debt was not a giveaway by Bolivia.[21] It reflects, instead, the creditors' share of the remarkable turnaround of the Bolivian economy, from the worst in the world during the early 1980s to one of stability and incipient recovery in 1988.

Bolivia's success story depended strongly on the supportive actions of the U.S. government and the IMF, in providing a framework in which Bolivia could successfully negotiate with its bank creditors. Effective progress for other debtor countries will require similar official forbearance. As the Bolivian case has demonstrated, the debtor as well as the creditors, at least taken as a group, can benefit importantly from a realistic approach to comprehensive debt reduction.

20. Bolivia has just signed a three-year Enhanced Structural Adjustment Facility with the IMF, based on a program of balance of payments that presumes that Bolivia's remaining debt will be settled on terms similar to the buyback.

21. The financial costs to Bolivia of the debt strategy have been minimal. If we judge the net cash costs of the buyback to Bolivia at $20 million, the country has paid in total over three years less than 1 percent of one year's GNP ($20 million/$3 billion) to its commercial bank creditors. At the same time Bolivia has received large net resource inflows from the official creditor community—in contrast to all of the other countries in the region, who have been making large net resource transfers to the foreign creditors, as Bolivia itself did during 1982–84.

Comments and Discussion

Jeremy Bulow and Kenneth Rogoff: We are pleased that Jeffrey Sachs's interesting paper, originally written as a discussion of our report, agrees with our central point: that voluntary participation buybacks and debt-equity swaps can be a bad deal even when they allow a country to retire debt at substantial discount from face value. In turn, we agree with Sachs that if a country can negotiate for a large repurchase of its debt in which all creditors are forced to participate, the country may benefit.

Our main disagreement concerns whether the overhang of foreign debt significantly hinders growth in the debtor countries, and if so, whether debtors should employ voluntary participation buyback schemes to alleviate the problem. It is hard to believe that foreign debt is the main impediment to growth in Latin America, as advocates of the debt overhang view seem to imply. A country such as Bolivia would have had to forgo only a week's GNP to meet the *full* annual interest payments on its predefault private bank debt. For most highly indebted countries, the recent debt crisis is best viewed as a symptom of poor growth and not a cause of it. In 1961, Japan's per capita GNP was 15 percent lower than Argentina's. In 1986, Argentina's per capita GNP was 15 percent of Japan's.

However, even if debt overhang is important empirically, its presence would only *strengthen* our basic conclusion that debtors should engage in buybacks (of any size) only if they are compensated by their creditors for doing so.[1]

1. We in fact discuss efficiency issues in our report, but deal with them more thoroughly in the companion paper we cite, Bulow and Rogoff, "Sovereign Debt Repurchases: No Cure for Overhang" (Stanford University, October 1988).

Sachs argues that efficiency-enhancing buybacks have been blocked by a U.S. government whose Latin American foreign policy has been deeply concerned with protecting current bank management. Our view is that the banks and countries have not negotiated comprehensive debt restructurings primarily because the feasible efficiency gains are not very large.

Finally, it is important to emphasize that our analysis is not sensitive to whether the funds for a buyback come from the debtor country's own cash reserves or from third-party donors. Our message is that a well-intentioned donor government can help the debtor country more by giving it aid directly than by earmarking the same funds for a buyback.