# II

# Revolutions in Managing International Debt

# 6

# Crisis and Strategy

A CERTAIN POINT COMES WHEN A COUNTRY SUFFERING from a prolonged deficit, and which has failed to adopt policies that can reassure its foreign creditors, runs into a financial crunch. . . . Today we are seeing a worrying number of countries stumbling in this direction. We are all conscious of the risks that this opens up: the consequences that a major default by one or more of the larger countries would have for the system as a whole.

Jacques de Larosière[1]
January 14, 1982

It was seven months before the threat of major defaults would become not only a reality but the major preoccupation of the IMF for the rest of the decade. The speaker at the lectern was the Managing Director of the IMF. Gathered around the room were the chief executive and other senior officers of many of the largest banks in the United States.

Since November 1981, the Managing Director had been planning to address the major U.S. banks on the subject of lending to developing countries, but the theme of his remarks shifted as the time for the meeting approached. Initially, de Larosière envisaged the speech as a defense of the Fund's role in promoting economic adjustment in the developing world. He had been criticized earlier for allegedly relaxing conditionality on loans to poor countries, and he wanted to set the record straight. As 1981 drew to a close, those concerns had largely dispelled and had been replaced by worries about the vast cloud of foreign debts that had already brought storms to parts of eastern and southern Europe and that was inexorably—but still almost invisibly—threatening Latin America. For years the major industrial countries and the international financial institutions had been encouraging bankers to assist the fuel-importing developing countries to cope with the rising price of oil by onlending the deposits of the oil-exporting countries. The time for this recycling was now over.

[1]"Assuring International Financial Stability: The Role of the Financial Institutions," remarks by the Managing Director to U.S. bankers at a private function in New York, January 14, 1982. Unpublished final draft as prepared for delivery (December 22, 1981), p. 5; in IMF/RD Managing Director file "Bankers—1/14/82 (Drafts)" (Accession 86/34, Box 2, Section 208).

De Larosière did not want to go public with what might be seen as an alarmist speech, but he wanted to get the message across to the main international lenders. He invited the heads of the leading money-center banks to a private dinner at the River Club in Manhattan. As it happened, getting from Washington to New York took rather more effort than expected. Both cities, and the whole megalopolis that connects them, were buried in deep snow, and all of Washington was in shock and mourning. The day before, as the storm began to cripple the city, Air Florida flight 90 to Tampa had crashed on takeoff from National Airport, killing 78 people; a half hour later, in the ensuing confusion as the Washington bureaucracy was sent home early to escape the accumulating snow, the derailment of a Metro train beneath the downtown streets had killed another three people. The tragedy could have provided an excuse for the Managing Director to cancel the speech. He was under pressure from some members of the Executive Board who felt that the Fund was becoming too cozy with the commercial banks, but he chose to go ahead. This brief trip was his first real opportunity to set out a vision and a strategy for dealing with unsustainable sovereign debts.

At the River Club, an exclusive enclave tucked into the foot of Manhattan's 52nd Street and overlooking the East River, the Managing Director made three principal points in his remarks to the assembled bankers. First, the large increase in IMF lending to developing countries in 1980–81 had been primarily through high-conditionality programs that were aimed at promoting adjustment to sustainable policies (in contrast to the lending after the first oil shock, 1973–74, when the low-conditionality oil facility had been the main lending vehicle). Second, Fund resources could make no more than a "modest contribution" to financing the deficits of developing countries, and the Fund had "no intention of seeking to supplant the traditional sources of private and governmental financing flows to deficit countries." Third, he concluded by urging commercial banks to prevent borrowing countries from using the availability of bank financing to "postpone adjustment policies," but nonetheless to "maintain, or even increase, exposure levels when a country is seeking to deal with its economic problems" through adoption of appropriate adjustment programs.[2]

Be moderate but keep lending, and depend on the IMF to insist on adequate policies as a condition for its own lending. It was a simple and persuasive message, and it became the basis for the case-by-case strategy that would prevent the debt crisis from leading to widespread defaults or a collapse of sovereign lending in the 1980s.

## Overview

### The Crisis

By conventional reckoning, the developing country debt crisis began on Friday, August 20, 1982, when the Mexican finance minister informed bankers assembled

[2]Op. cit., pp. 8 and 15–16.

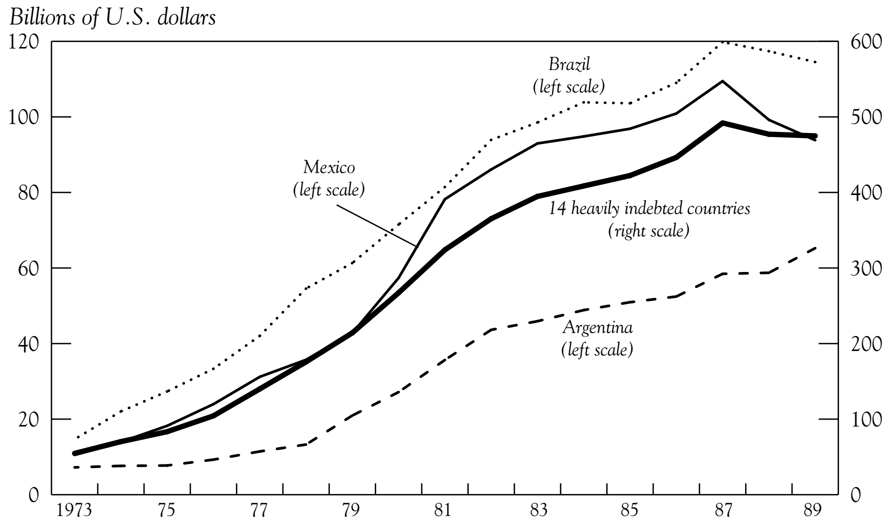
in New York that he could not repay the loan principal that was coming due on Monday. The study that follows places the eruption of the Mexican exigency a week earlier, when the Mexican authorities notified officials in Washington—including the Fund—that without an immediate rescue they would have no choice but to default. The organization of that rescue in the course of one frenetic weekend was unprecedented in its complexity and speed, but it was only the opening sprint in what would become an exhausting marathon of negotiations lasting through the end of the decade and beyond.

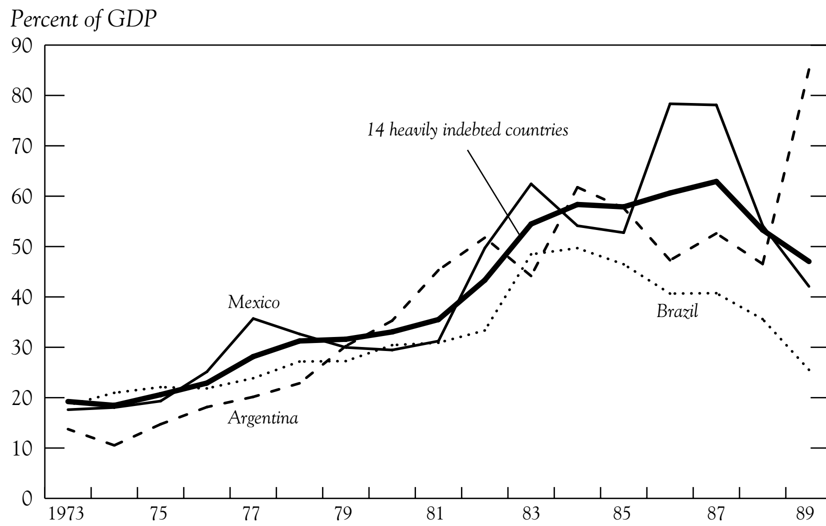
Mexico was not the beginning of the story. The first rumbles of the international debt crisis of the 1980s were heard in March 1981, when the government of Poland informed its bank creditors that it could not meet its obligations. Although that announcement generated scarcely a ripple of interest in the financial press at the time, it precipitated an international emergency: a number of western Europe's largest commercial banks were heavily exposed with loans to Poland; if they had failed to agree on rescheduling terms, European governments would have seen no choice but to rescue them. Also, Poland's problems were international because they squashed the ability of neighboring countries such as Romania, Hungary, and Yugoslavia to roll over or expand their own bank loans. Those countries had their own policy failures and shortcomings, and it is impossible to know whether they could have muddled through in the absence of the problems in Poland, but it is clear that Poland pushed them more quickly over the precipice.

But the story did not begin in Warsaw, either. The origins of the debt crisis of the 1980s may be traced back to and through the lurching efforts of the world's governments to cope with the economic instabilities of the 1970s. This story is familiar, even if arguments persist about how much space to give to each cause: the severance of the dollar-gold linkage in 1971, the shift to floating exchange rates in 1973, the first oil shock in 1973–74, the ensuing slowdown in the mid-1970s, and the inflationary binge of the late 1970s that culminated in the second oil shock of 1979–80 and that was halted by a monetary contraction in the United States (the "Volcker shock") that brought a sharp rise in world interest rates and a sustained appreciation of the dollar. By the late 1970s, developing countries were able to borrow freely in the rapidly growing international private credit markets, at low interest rates that were—for a while—negative in real terms. Money-center banks had received large deposits from oil-exporting countries, and they saw the oil-importing developing countries as a prime market for increased lending. Not surprisingly, many of those countries took advantage of the situation, and external debt continued to rise both absolutely and in relation to output (Figure 6.1). In too many cases, borrowers misapplied these loans to low-return investment projects or to current consumption. When interest rates soared in 1980–81, too many borrowers were too slow to adjust. Warning signals from the IMF and other agencies were too muted and too late and would likely have been ignored in any case.

As shown in the introduction to this chapter, the Fund was not oblivious to the dangers of excessive borrowing. The type of admonition given to banks by

**Figure 6.1. External Debt of Heavily Indebted Countries, 1973–89**




Source: World Bank, *World Development Indicators*.

de Larosière in January 1982 was merely one in a long series. As early as October 1977, de Larosière's predecessor as Managing Director, H. Johannes Witteveen, warned a meeting of the heads of the agencies of the United Nations that

> a number of developing countries . . . had over-accelerated their economies and were, as a result, borrowing up to 12 percent of their national income. Such a rate of borrowing was unsustainable, and urgent adjustments were called for in order to avert

> major debt-servicing difficulties which would have serious repercussions on the entire international financial system.[3]

In January and March 1980, the Executive Board held discussions of the recycling process and concluded that while commercial borrowing by the oil-importing developing countries was essential, "borrowing will need to go hand in hand with adjustment" and therefore the Fund should play a "greatly increased" role in the recycling process.[4] A year later, the Managing Director noted at the conclusion of the Executive Board's discussion of the World Economic Outlook that the outlook for the oil-importing developing countries was "frightening," and that the projected current account deficits of those countries were "probably not financible under current assumptions about the evolution of [official development assistance]. . . . This concern struck a note of gravity, urgency, and insistence, . . . more strongly expressed than it ever had been up to now."[5]

The cautionary message, delivered occasionally by the Fund and usually in private, was offset by the more prevailing and openly expressed view that debt accumulation was, within reason, beneficial and even a key element in the solution to the problems of the 1970s. Published staff studies noted the potential problems that could arise in the most heavily indebted countries, but they argued more generally that the growing indebtedness of developing countries was essential for their growth and development, was an appropriate means of "recycling" the surpluses of the major oil-exporting countries (known at the time as "petro-dollars") to fuel-importing countries, and had the side benefit of helping governments "graduate" from dependence on official credits and gain access to loans on commercial terms.[6] No one in the Fund, of course, knew whether a crisis was coming, when it might come, or which countries would be most affected. Positive signals blurred the picture, and in any case the culture of the Fund did not encourage the sounding of alarms.

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[3]Provisional summary record of the first meeting, Administrative Committee on Coordination, United Nations (31 October, 1977), p. 11.

[4]Chairman's summing up, minutes of EBM/80/11 (January 17, 1980), p. 5. The more extended discussion of the same topic held in March 1980 drew similar conclusions; see minutes of EBM/80/50–51 (March 19, 1980).

[5]Chairman's summing up, minutes of EBM/81/74 (May 4, 1981), p. 13.

[6]See, for example, the *World Economic Outlook* for May 1980, pp. 34–38, and Nowzad and Williams (1981). The latter study (p. 11) summarized the situation as follows: "In sum, the overall debt situation during the 1970s adapted itself to the sizable strains introduced in the international payments system. . . . Though some countries experienced difficulties, a generalized debt management problem was avoided, and in the aggregate the outlook for the immediate future does not give cause for alarm." Even after the fact, the Fund resisted officially recognizing that a crisis had occurred. The 1983 *Annual Report* referred obliquely to "debt servicing difficulties" and summarized the situation of the non-oil developing countries in similarly delicate language: "Confronted with much more cautious attitudes on the part of international lenders, these countries have had to adopt policies that give their creditors grounds for confidence in their capacity to bring their external obligations and resources into better alignment" (p. 1). Also see Edwards (1995), pp. 18–21, on the general failure to foresee the 1982 debt crisis.

Commercial banks as a group found the positive message to be more appealing than the negative. Many bankers later would complain—with some justification—that they had been misled by the calls for recycling and had been blindsided by the Volcker shock. Whatever importance those factors might have had, the fundamental point is that sovereign lending to developing countries was a highly profitable activity, but the risks were inadequately assessed by lenders.[7] Walter Wriston's well-known defense of sovereign lending (as chairman of Citibank), that a "country does not go bankrupt," was only the most quotable example of the prevailing view at the beginning of the 1980s.[8] After the crisis developed, the banks established their own agencies—notably the Institute of International Finance, in Washington, and the Japan Center for Finance, in Tokyo—in part to strengthen their ability to assess country risks.

Because the origins were global or widespread, so were the effects. The problems of Eastern Europe in 1981 did not lead to those of Latin America in 1982; those were just two manifestations of the shifting tectonic plates. Similarly, although it is often said that the problem in Mexico quickly "spread" throughout Latin America—and it would later be said that the 1997 crisis in Thailand spread throughout Asia—it is difficult to separate contagion (a decrease in the willingness of banks to lend to one country because of the debt-servicing problems of another country) from synchronicity (the tendency for global forces to induce similar reactions more or less simultaneously). Argentina, Brazil, Chile, Ecuador, Peru, Uruguay, and other countries across Latin America encountered debt crises in 1982 or 1983, and they all turned to the IMF for help. Those individual cases fed on one another, and the timing of the outbreak in a number of countries was no doubt accelerated by the eruption of crises elsewhere. Nonetheless—as the case studies discussed in the following chapters will show—all of the affected countries had been pursuing policies that were unsustainable in the global economic envi-

[7]Kindleberger (1978) presaged this failure: "When riding a tiger, or holding a bear by the tail, it seems rational—but may not be—to hang on. The model is apposite today, as the world banking community contemplates its large volume of loans to developing countries and to the Socialist bloc" (p. 3). Three years later, in 1981, the Group of Thirty sponsored a survey of 52 leading international banks to assess their attitudes toward lending to developing countries. A large majority of respondents (71 percent, against a 7 percent negative response) predicted that "bad debt experience and loan write-offs" would be more favorable on international than on domestic loans "over the next four to five years," and a similar majority thought that "a generalized debt problem affecting developing countries" was not likely to emerge. Mendelsohn (1981), pp. 26–27 and 20, respectively.

[8]Wriston's point was that the debt-servicing problems of developing countries in 1982 did not necessarily constitute a crisis, and that to resolve those problems required a combination of policy adjustment and financing arrangements rather than a writing off of the debt. The quotation is from Wriston (1982); for a further explanation of his views on sovereign lending, see Wriston (1986). For a review of the difficulties that banks experienced in analyzing country risks in that period, see Rimmer de Vries (1984). Also see Guenther (1984), which attributes the heavy bank lending to Mexico in 1981 to the banks' "long-standing relationship with borrowers" there.

ronment of the 1980s, and no country's crisis could be said to have resulted in any essential way from someone else's straits.[9]

Outside of Eastern Europe and Latin America, the evidence for a global cause looked different.

Many countries in Africa faced an even greater economic catastrophe in the 1980s, in which excess debt was merely one more trauma. The debts of most sub-Saharan African countries were primarily from official rather than commercial creditors, and the underlying problems were structural more than financial. Even where the banks had lent heavily in the 1970s, such as to Sudan, the resolution of those commercial debts was a minor problem in relation to civil war, the collapse of export markets, and the inability of the government to address the pervasive rigidities and imbalances in the domestic economy.

In contrast, most developing Asian countries largely escaped the debt crisis of the 1980s; partly because they faced less daunting circumstances, partly because they implemented more effective economic policies, and partly because political corruption and capital flight were less rampant (or at least less obvious).[10] Korea was the fourth-largest debtor in the world at the beginning of the decade, but the government undertook timely and effective adjustment and reform. Korea was able to service its debt without resort to rescheduling, and by 1987 was beginning to pay it off. Indonesia had faced its own debt problems a decade earlier and would face even more serious problems in the late 1990s. On this occasion, however, when the price of its petroleum exports began to fall in 1981, the government cut back quickly enough on investment projects to avoid recourse to rescheduling or even to the use of IMF credits. Low-income countries such as India, Pakistan, and China drew on the Fund to support ambitious development and reform plans, but their bank debts were relatively small and were never a major issue for most of them. An exception was the Philippines, where the government's slide into corruption and isolation deprived the country of the means to manage its large debts to foreign banks.

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[9]For an historical perspective on the limited role of contagion in the spread of financial crises, see Bordo and Schwartz (1999). On the 1982 crisis, Stallings (1983) analyzed conditions in each country and concluded that the debt crises in Argentina and Chile resulted primarily from poor domestic policies. In contrast, although Mexico and to a lesser extent Brazil also suffered from poor policies, adverse external shocks played a larger role in these two countries. Only in the case of Brazil did she find that contagion—reluctance by banks to lend to any country in the region—was a major factor. The following chapters of the present study draw less favorable conclusions about policies in Brazil in that period.

[10]Although the measurement of capital flight is difficult and controversial, the Fund viewed it as an important component of the debt-management problem facing many developing countries in the 1980s. A 1987 internal staff paper defined capital flight as "the acquisition or retention of a claim on nonresidents that is motivated by the owner's concern that the value of his asset would be subject to discrete losses if his claim continued to be held domestically." Discussing the paper, Executive Directors noted that motivation could not be tested directly and that assessment of capital flight was therefore inherently ambiguous; nonetheless, they agreed that the Fund should collect information on capital flight, advise member countries on how to cope with it, and take it into account in designing Fund-supported adjustment programs. "Capital Flight—Concepts, Measurement, and Issues," SM/87/24 (January 23, 1987), p. 4; and the Secretary's précis (March 4, 1987) of Executive Board Seminar 87/1 (February 20, 1987).

**Table 6.1. Commercial Debt Crises, 1981–89**

| Stage | Country and Year | Fund Involvement |
|---|---|---|
| I. Onset, 1981–82 | Poland, 1981 | None (nonmember) |
| | Yugoslavia, 1981 | Stand-by arrangement (SBA) |
| | Costa Rica, 1981 | Extended arrangement (EFF) |
| | Hungary, 1982 | SBA |
| | Morocco, 1982 | SBA |
| | Romania, 1982 | SBA |
| II. Concerted Lending, 1982–86 | Mexico, 1982 | EFF, concerted lending (CL) |
| | Argentina, 1982 | SBA, CL |
| | Brazil, 1982 | EFF, CL |
| | Chile, 1983 | SBA, CL |
| | Uruguay, 1983 | SBA, CL |
| | Ecuador, 1983 | SBA, CL |
| | Philippines, 1983–84 | SBA |
| | Côte d'Ivoire, 1984 | SBA, CL |
| | Peru, 1984 | SBA |
| III. MYRAs and Enhanced Surveillance, 1984–85 | Mexico, 1984 | Support for multiyear rescheduling agreement (MYRA) |
| | Jamaica, 1984 | SBA |
| | Venezuela, 1984 | MYRA, enhanced surveillance (ES) |
| | Ecuador, 1984 | SBA, MYRA |
| | Argentina, 1984–85 | SBA, CL |
| IV. Experimentation, 1985–88 | Chile, 1985 | EFF, CL, support for debt-equity swaps |
| | Colombia, 1985 | Seal of approval |
| | Bolivia, 1985 | SBA, allowance of commercial arrears, support for debt buybacks |
| | Yugoslavia, 1985–86 | MYRA, ES |
| | Uruguay, 1986 | ES |
| | Mexico, 1986 | SBA, CL |
| | Argentina, 1986 | SBA, CL |
| | Costa Rica, 1986–87 | SBA, allowance of commercial arrears |
| | Brazil, 1987–88 | SBA |
| V. Debt Relief, 1989 | Costa Rica, 1989 | Brady-plan SBA |
| | Philippines, 1989 | Brady-plan EFF |
| | Mexico, 1989 | Brady-plan EFF |
| | Venezuela, 1989 | Brady-plan EFF |
| | Argentina, 1989 | SBA |

The international debt crisis lasted from 1981 until 1989. It encompassed at least 30 distinct episodes involving nearly 20 countries around the world (Table 6.1). That it could not be quickly resolved was a product of two forces. First, for a number of countries, servicing the debt was only a symptom of a deeper problem of economic mismanagement; to bring about the needed reforms took a "silent revolution" in attitudes that did not gain strength until late in the decade. Second, for the most heavily indebted countries, no feasible reform program could suffice to break the country out of the maelstrom, restore normal economic growth, and restore the government's access to credit markets; some direct relief from the debt burden was also needed. Both elements of the solution were understood and were in place by 1989. A full resolution of the debt problems of developing countries would take years more, but the international crisis had become part of history.

## Strategy

The strategy of the IMF and of the major creditor countries for managing the debt crisis evolved in stages, as illustrated in Table 6.1 and summarized below. The one constant throughout was that the central role for the Fund was to negotiate adjustment programs for countries and to support those programs with financing to cover a (usually small) portion of the external deficit. As the initial strains moved across Eastern Europe in 1981 and the first half of 1982, the Fund became increasingly involved in that manner, though without any noticeable shift in its role or its methods. From that perspective, at least, Mexico was a watershed. In working with Mexico in 1982, the management of the Fund realized that the situation called for major changes in relations between the institution and other creditors, notably commercial banks.

Traditional relations between the IMF and commercial banks may be characterized as an arm's-length mutual dependency. The Fund typically relied on the banks to provide an appropriate level of financing for the country, while the banks relied on the Fund to negotiate an appropriate set of supporting economic policies, but it was rare for either one to pressure the other. Starting with Zaïre in 1976, Fund staff members occasionally participated in meetings between a country's authorities and commercial banks. In 1978, in preparation for an extended arrangement with Jamaica, the Fund sought and obtained informal financing commitments from bank creditors.[11] The next year, when bank creditors reacted to deteriorating conditions in Sudan by trying to withdraw as rapidly as possible, the staff intervened to persuade them that the country's adjustment program deserved continuing support. Although the banks gave no firm assurances that they would maintain exposure, the staff felt confident that they would do so if the government could get current in servicing its debts. Accordingly, the Fund made the elimination of some $1 billion in arrears to commercial banks a precondition for the continuation of the arrangement beyond the first year.[12] These cases, however, remained exceptional. More typical was the case of Turkey, in which the Fund approved an unusually large stand-by arrangement in 1980 in the hope that the combination of a strong adjustment program and substantial commitments from official creditors as well as the Fund would persuade the banks to increase their own lending.[13]

[11]Minutes of EBM/78/86 (June 9, 1978), pp. 5–6. Drawings by Jamaica in the first year of the extended arrangement were phased to coincide with a schedule of anticipated bank loans that had been agreed upon through informal contacts between bank representatives and Fund staff; the bank loans were conditional on the provision of Fund financing, and in effect the Fund financing depended on the continued participation by the banks.

[12]"Sudan—Use of Fund Resources—Extended Fund Facility," EBS/79/250 (April 26, 1979); and minutes of EBM/79/71 (May 4, 1979), pp. 15–16.

[13]Jacques de Groote, the Executive Director representing Turkey at the Executive Board meeting on June 18, put it this way: "The influence of the Fund should not be limited to those cases where the Fund's decision to delay or suspend its financial assistance elicits from the banks a corresponding reaction. Banks should respond in a positive way when the Fund expresses its confidence in a country's recovery program and gives them a clear signal." When the Board met five

A central feature of the debt strategy that was developed in 1982 was an intensification of relationships between the Fund and the commercial banks. Because banks were now unwilling to lend to the most heavily indebted countries unless forced to do so, either out of self-preservation or in response to outside pressure, the Fund began requiring firm commitments as a precondition for Fund financing. Although the official policy was that this practice would be limited to exceptional cases, for a while it became almost routine for Latin America, starting in 1983.[14]

Three key assumptions underlay this strategy. First, the Fund staff and management viewed the problem as a threat to both debtors and creditors. They viewed the economic prospects of most of the indebted countries, especially the major economies in Latin America, to be strong enough that once the adverse shocks of the 1970s and early 1980s had been absorbed and adjustment policies had begun to work, those countries would be able to restore sustainable growth and service their debts. The Fund also viewed the international financial system as sound; if the initial threat could be averted, the money-center banks would be able to restore their balance sheets and would resume lending to developing countries voluntarily.

Second, the Fund judged that the problem could be solved only by cooperation between debtors and creditors. A unilateral default on payments would inevitably follow from a breakdown of negotiations and would have far worse consequences for both parties than would a negotiated settlement. That view was a strongly held article of faith at the Fund, and it was believed almost as strongly by many officials in the indebted countries.[15] It was challenged, not only by developing country advocates for unilateral action but also by some historians of earlier debt crises who noted that defaults had only temporarily stopped the inflow of capital.[16]

What persuaded the Fund in 1982 that the risk of default was a serious threat to the financial system was that the situation was fundamentally different from all ear-

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months later to review the program, de Groote acknowledged with disappointment that the banks were continuing to withdraw support from Turkey. Minutes of EBM/80/92 (June 18, 1980), p. 8; and EBM/80/163 (November 7, 1980), p. 3. For a detailed survey of relations between the IMF and commercial banks through 1982, see "Payments Difficulties Involving Debt to Commercial Banks," SM/83/47 (March 9, 1983). For the background to the debt crisis in Turkey, see the papers in Aricanli and Rodrik (1990), especially Chapters 2 and 10.

[14]Remarking on the value of this practice in its first application, to Mexico, the Managing Director noted that "the Fund would have been happy to act in the same way a few years previously in a case like that of Turkey" (see footnote 13, above); minutes of EBM/82/168 (December 23, 1982).

[15]Jesús Silva Herzog, the Mexican finance minister from 1982 to 1986, wrestled with the idea of default throughout his term but always rejected it. Whether as warning or inspiration, a dominant feature of his office decor was an oil portrait of Benito Juárez, the great Mexican president whose moratorium on servicing foreign debts in 1861 led to invasion by France and the installation of the Emperor Maximilian in 1863.

[16]In a 1986 paper, Jeffrey Sachs (an occasional advisor to Latin American governments) argued that indebted countries would have been better off repudiating their debts in the early 1980s, as they had in the 1930s, except for the intervention of creditor governments and the IMF: "Countries that might happily break with the commercial banks are loath to break with the rest of the international system" (Sachs, 1986, p. 411). Eichengreen and Portes (1989) documented the relatively benign effects of defaults on bonds in the 1930s, but they warned against inferring that defaults would have led smoothly back to normal market access in the 1980s. For a thorough discussion, see the papers in Eichengreen and Lindert (1989).

lier debt crises. Those of the nineteenth and early twentieth centuries had been characterized predominantly by defaults on bonds held by individual investors, rather than by threats of default on syndicated bank loans. Losses—possibly exceeding the value of a bank's capital—to the leading international banks could have generated cascading losses and failures throughout the financial system. This new situation thus carried a systemic risk that had not previously been a central issue.

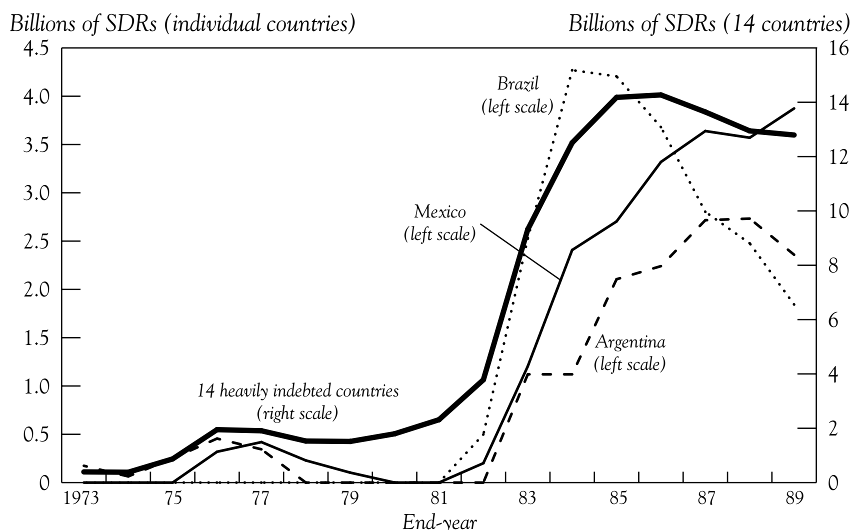
The third main assumption was that resolving the problem required coordinated and centralized action. In the words of one banker, it required a "conductor, in the electrical sense of the word, to bring the parties to agreement" (Leslie, 1983). The banks had a collective interest in negotiating a solution, but they could not be relied upon to coordinate their own response because of diverging interests: between banks in different countries, between competing banks within a country, and between large banks and small. Even though it would have been easier for creditors to organize themselves than in the days of bond financing, the difficulties still dominated.[17] The creditor countries also had a collective interest, but it was more efficient for a multilateral agency to assume responsibility than to coordinate on an ad hoc basis. While there was no specific mandate that made it more natural for the IMF to play that role than, say, the World Bank, the Fund demonstrated an ability to step in quickly and forcefully when the indebted countries requested its assistance.

Although the systemic crisis gradually subsided after 1983, the debt-servicing difficulties of many developing countries continued to mount. By 1985, IMF credit outstanding to many of the most heavily indebted countries was reaching its peak (Figure 6.2), reflecting the normal cycle of Fund lending. At the same time, more and more attention was being paid to the longer-term requirements for normalcy. Fund-supported adjustment programs began to include more structural elements and were aimed more at generating real economic growth, the multilateral development banks began to play a more active role in the indebted countries, and the banks became more willing to reschedule debts on longer terms. The period from 1985 to 1987 is appropriately characterized as one when the restoration of sustainable growth became viewed as the primary means by which developing countries could reduce the burden of servicing external debt.

The "growing out of debt" strategy failed. By 1987, most of the creditor banks had reduced their exposure to problem countries to a point where cohesive coordinated agreements among hundreds of banks could no longer be achieved. Banks then became more willing to wait for a better outcome, and approval of a program by the Fund became merely the starting point rather than the catalyst for an agreement with bank creditors. The restoration of economic growth remained an elusive goal, while the overhanging stock of debt continued to grow. The resulting stalemate between debtors and creditors forced the Fund to reexamine its opposi-

[17]See Dawson (1990) for an account of efforts by bondholders to organize themselves in the wake of the Latin American debt crisis of the 1820s. Jorgensen and Sachs (1989) examine the role of bondholders in the crises of the 1930s. Piñón-Farah (1996) discusses the limited experience with restructuring sovereign bonds in the 1980s: only three countries—Costa Rica in 1985, Nigeria in 1988, and Guatemala in 1989—succeeded in exchanging old for new bonds.

**Figure 6.2. Fund Credit Outstanding to Heavily Indebted Countries, 1973–89**




tion to lending to countries that had not settled their arrears to commercial creditors, forced major creditor countries to reexamine their opposition to debt relief, and opened the way to the final phase of the debt strategy.

In May 1989, the IMF adopted new policies that allowed countries to use Fund resources to finance operations such as repurchases of their own debt at discounted prices (buybacks) and the establishment of escrow accounts to guarantee future interest payments in exchange for cuts in interest rates. That strengthening of the strategy, which fortuitously coincided with a marked improvement in the external economic environment facing many of the indebted countries, brought an end to the international crisis.

## Managing the Debt Crisis: A Summary of Part II

Chapter 7 examines the central event of the initial period: Mexico in 1982. It begins by recounting the web of earlier policy mistakes and adverse shocks that prevented Mexico from avoiding a crisis in 1982, and the limited ability of the Fund to monitor, predict, or forestall the calamity as it unfolded. It then examines how the initial rescue package was assembled in August, analyzes the difficult and lengthy negotiations on the adjustment program that were successfully concluded in November, and reviews the initiatives that ensured that the banks would help finance the program. The Fund's approval of an extended arrangement in December and the banks' approval of a complex package of rescheduling and new lending three months later marked the end of an extraordinary effort to avert a possibly systemic collapse.

Chapters 8 through 11 examine the four broad stages in which the debt strategy evolved. Starting in 1982, the Fund organized "concerted lending" arrange-

ments for several countries while they implemented adjustment programs grounded primarily in traditional macroeconomic policy corrections. The first two years of that strategy are reviewed in Chapter 8. The next two years, when creditors began searching for ways to extend the strategy beyond the short-term financial involvement of the IMF, are the subject of Chapter 9. By 1985, it was becoming clear that a resumption of longer-term growth in the most heavily indebted countries would require further innovations and a broader strategy. Chapter 10 examines the shift toward growth-oriented adjustment. The final stage came when creditors devised a strategy for debt reduction, as described in Chapter 11. Readers whose main interest is in one or more of the three largest affected countries will find a continuous history in the pertinent sections of each successive chapter. For Mexico, the story begins in Chapter 7 and continues in Chapters 9–11; for Argentina and Brazil, it is found in Chapters 8–11.

Chapter 8 looks at several related cases. First, it steps back in time to examine how three Eastern European countries—Poland, Romania, and Hungary—got into trouble in 1981–82 and how each case was handled. Each successive case involved the Fund a little more closely. The chapter then looks closely at the Fund's crisis management in Argentina, Brazil, and Chile. Each one faced a serious debt problem, but each had unique elements in both its origins and its implications. By the time programs were arranged for these countries in 1983, the Fund's case-by-case approach, as it came to be known, was firmly established.

Chapter 9 carries the story forward through to 1985 by examining how the programs with the three largest Latin American countries were handled. Sooner or later, the adjustment programs of Mexico, Brazil, and Argentina all ran aground. The chapter concludes by taking a broader look at how the overall strategy evolved during this period and why it could no longer be sustained without a major overhaul.

Chapter 10 takes up the second main phase of the strategy, which was dominated by the Baker plan to strengthen the growth prospects of indebted countries. After reviewing the development of that plan and other strategic innovations, this chapter picks up the stories of the major Latin American countries where they had been left off in Chapter 9. Each of the three, at some point in 1986 or 1987, showed promise of escaping the overhanging burden of debt, only to relapse into even deeper economic difficulties.

The effort to resolve the crisis through debt relief is the subject of Chapter 11. The keystone of the strengthened strategy was the Brady Plan of 1989, but the strategy gradually shifted from 1987 on. Chapter 11 summarizes the intellectual and bureaucratic battles on debt relief and then describes two cases—Bolivia and Mexico—where the Fund showed flexibility in supporting the efforts of the countries to negotiate reductions in their debts. After reviewing the development of the Brady Plan, the chapter examines the four Fund-supported debt-relief cases implemented in 1989: Costa Rica, the Philippines, Mexico, and Venezuela. The final section of Chapter 11 picks up once again the stories of Argentina and Brazil, both of which implemented Fund-supported programs in this period, though they were still a long way from qualifying for debt relief under the Brady Plan.

Part II concludes with an analytical retrospective on the role of the Fund in managing the debt crisis of the 1980s. Chapter 12 poses a series of questions about the assumptions and choices made by the institution from 1982 through 1989 and attempts to draw a few lessons for the future.

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