*Journal of Economic Perspectives—Volume 4, Number 1—Winter 1990—Pages 19–29*

# A Strategy for Efficient Debt Reduction

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For the past seven years, the U.S. government has managed the debt crisis with the preeminent goal of sustaining the flow of debt servicing payments from the debtor countries to the commercial banks. The focus on the banks, especially in the first years of the crisis (1982–85), is easily explained. Several money-center banks had exposure of nearly 200 percent of bank capital in Latin America alone upon the outbreak of the crisis in 1982. A widespread suspension of debt-service payments could well have sunk several major banks. I have discussed the U.S. government's policy focus on the debt servicing to the commercial banks in Sachs (1986b, 1989c) and Sachs and Huizinga (1987).

But today, those policies are being revised. After years of steady decline in the exposure ratios of the most heavily exposed banks, the risk of a U.S. banking crash as the result of the debt crisis is now virtually nonexistent. In addition, the burden of debt payments is contributing to profound economic crises and growing political instability in almost all of the democracies in Latin America. A wide range of analysts now concurs that the debt burden should be reduced, not only for the sake of the debtors, but also for the sake of the creditors, who have an important long-run stake in allowing the developing countries to surmount the current acute crisis. The Brady plan, unveiled by Secretary of Treasury Nicholas Brady in March 1989, is based on the need for a reduction of the debt burden.[1]

[1]As in other studies (Sachs 1986b, 1989a, Sachs and Huizinga 1987), I use the term "debt reduction" to signify a restructuring of the debt contract which leads to a reduction in the present value of payments due.

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The dire situation in Latin America in early 1989 bears stressing. Peru, for example, has suffered an economic, political, and social collapse: annualized inflation rates at the end of 1988 and early in 1989 were no less than 30,000 percent; real GNP will likely fall by 15 to 25 percent in the 12 months from September 1988 to September 1989; and radical terrorism has come in full force to the urban centers of Peru. In Venezuela in February 1989, after years of declining per capita GNP, widespread rioting with hundreds of deaths and casualties broke out upon the announcement of new austerity measures by a new government intent on following "orthodox" adjustment measures. Argentina suffered an outbreak of hyperinflation in the spring of 1989, and price inflation hit a remarkable 200 percent for the month of July. As in Venezuela, rioting and deaths accompanied the calamitous economic situation. Brazil too appeared to be headed towards a hyperinflation, with inflation exceeding 20 percent per month in the spring, and accelerating. And in Mexico, the vaunted political stability provided for decades by the ruling Partido Revolucionario Institucional could be at a point of collapse, with the country at risk of a drift into a deep political schism along class lines.

It must also be appreciated how completely the debtor-creditor relations have broken down in the past two years. There are approximately 40 countries engaged in commercial bank debt restructurings, but Brazil was the *only* country during 1988 to receive new bank lending in a so-called "new money package" that was supposed to be the centerpiece of the Baker plan.[2] The Brazilian deal, signed in September 1988, was on the verge of collapse as of early 1989. There were two other attempts to put together very modest (and very inadequate) "new money" packages, for Ecuador and Ivory Coast. Both attempts failed. Overall, while $13 billion of concerted loans were disbursed in 1983, and $10.4 billion in 1984, only $1.5 billion of concerted loans were disbursed during January–September 1988.[3] At the same time, more than a dozen countries are in long-standing open arrears, including Argentina, Bolivia, Costa Rica, Dominican Republic, Ecuador, Honduras, and Peru in Latin America.

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Cases in which payments due are merely refinanced at market interest rates (like a rescheduling of principal, or a "new money" package in which some interest is refinanced by a new loan), do not constitute debt reduction by the definition that I am using. Despite some occasional slips, this usage of the term "debt reduction" is standard in the current public policy debate.

[2]The Baker Plan was unveiled in fall of 1985 by then Secretary of Treasury James Baker III. The key idea of the plan was that countries would receive new lending from the banks and the official creditors in return for undertaking programs of economic adjustment and reform. These bank lending packages under the Baker Plan became known as "new money" packages or "concerted lending" programs. The idea of "concerted" lending is that each bank was to lend an amount in proportion to its existing exposure. The term "new money," used by the creditor community, is quite misleading. In all cases, such as Brazil in 1988, the new money (that is, the new loans) is less—and generally significantly less—than the interest due, so that the net transfer of resources is from the country to the banks, despite the so-called new money.

[3]See World Bank, *World Debt Tables*, Vol. 1, Analysis and Summary Tables, 1988–89 Edition, Table III-2, p. xliv, for the sharp decline in the aggregate amounts of concerted loans. See also Table III-5 for a country-by-country account of the debt renegotiations concluded between debtor countries and commercial banks.

By early 1989, the process of rebuilding the banks' capital base relative to Latin American exposure was far along. This point was made recently by Mr. William Seidman (1989), Chairman of the FDIC:

> Moreover, even in what surely could be considered a worst-case scenario, each of the nine money-center banks could write-off 100 percent of their outstanding loans to these six [largest debtor] countries and, on an after-tax basis, each of these banks would remain solvent.

This basic fact is underscored further by the all-time record profits of the U.S. money-center banks in the fourth quarter of 1988.

Debt reduction would now seem to be warranted for Latin America. Significant debt reduction is likely to be in the long-term interests of the banks themselves, since debt reduction can improve the economic performance of the debtor countries and thereby the ultimate value of repayments that the banks will receive. In short, as Sachs (1986a) first argued, debt reduction can be a Pareto improvement. But even though extensive debt reduction is in the collective interests of the banks, *it will not occur by itself*, for the same reasons that the discharge of debt obligations under bankruptcy can't generally occur without bankruptcy law and bankruptcy courts.

Debt reduction, like bankruptcy, needs an institutional setting to bring it about, to overcome an inherent free-rider problem. Even when it is in the collective interests of the banks to reduce the debt, each individual bank is still tempted to insist on full repayment of its own claims, while free riding on concessions made to the debtor by the other banks. The banks have recently come to endorse the idea of "voluntary" debt reduction, in which each individual bank can choose whether to participate in a given debt reduction scheme. The Brady plan similarly has endorsed the concept of voluntary debt reduction. But because of the free rider problem, such voluntary schemes are doomed to failure, as would be the notion of "voluntary" bankruptcy in a setting with a large number of creditors. (For a specific critique of the Brady plan, see Sachs, 1989d). A more fruitful course would be the establishment of an International Debt Facility (IDF) to provide the necessary institutional framework for debt reduction.

The remainder of this paper focuses on two central themes. First, I will discuss the profound shortcomings of so-called "voluntary debt reduction" schemes, as now supported by the commercial banks. Second, I will outline the case for an IDF, and try to clear away much of the underbrush of misunderstanding that has slowed the adoption of the proposal.

## The Illusion of Voluntary Debt Reduction

It is now widely recognized that the overhang of sovereign debt is seriously disrupting the debtor economies, thus imposing major costs on both debtors and

creditors. The costs of the debt overhang, combined with the recovery of the commercial banks, have led to a widespread acceptance of the need for a process of debt reduction. The major commercial banks have, in rhetoric at least, started to advocate debt reduction as one step out of the current crisis.

Debt reduction schemes should be measured against the standard of restored creditworthiness of the debtor country, for it is with restored creditworthiness that the efficiency gains from debt reduction may be achieved. Sachs (1989b) discusses various debt reduction mechanisms at length. But any adequate debt reduction should be extensive enough to accomplish the following goals: (1) to allow the debtor country to service the external debt on the revised contractual basis without the need to refinance interest payments in new concerted lending packages; (2) to allow the private sector in the debtor country to attract suppliers' credits, trade credits and project finance on a decentralized basis.

By this standard, "voluntary" schemes will not come close to solving the current problems. Under the current incentives, voluntary debt relief is bound to mean no more than a continuing nibbling away at the edges of the debt overhang, without real relief for the debtor or real benefits for the creditors. We need instead a much more ambitious program of "concerted" debt reduction, in which all of the creditor banks participate in debt reduction on an equal basis.

There are several barriers to adequate debt reduction through "voluntary" means, like buybacks, exit bonds, and debt-equity swaps.[4] These barriers include the inherent free rider problem in voluntary debt reduction, the problem of setting possible bad precedents, the problem of public sector bailouts, and the distorted incentives of the large banks.

Consider first the free rider problem. "Voluntary" schemes contain a fundamental paradox. If the scheme is effective enough to restore creditworthiness, then each bank should hold on to its original claims, which will rise in market value (back to par) as the other banks give the relief. Thus, each bank has the strong incentive to hold back from such schemes, letting the other banks give up their claims.

The second problem is that of precedent. The leading commercial banks fear that any concessions that they make to a particular country will set a floor on the demands made by the other debtor countries in subsequent negotiations.[5] For this reason, when the bank committees negotiate with any particular country, they are really weighing the effects of any concessions not just with regard to that country but also with regard to the other 40 countries or so that might press for similar terms. Obviously, this interdependence of negotiations harms the most highly indebted countries that need

[4]In a debt buyback, the debtor country repurchases the debt at a discount, using cash. In an exit bond swap, the debtor country exchanges the current debt for a new bond, usually carrying a lower interest rate or a lower principal repayment. In a debt-equity swap, the debtor country repurchases the debt using local currency, which is to be earmarked for an investment within the debtor country.

[5]As a concrete example, when Mexico succeeded in reducing the interest rate charged on its debt in its 1986 negotiations (to a spread of 13/16 over the London Interbank Offered Rate), each of the major debtors that followed in negotiations in 1987 and 1988 also demanded that their interest rate be cut on *exactly* the same terms.

the deepest relief. It also cripples the negotiations of the smaller debtor countries. The banks have such little exposure in the small countries that it makes far more sense for the largest banks to play tough with these countries as a demonstration effect to other debtors, rather than to make concessions that might spill over into the negotiations with the large debtors.

In fact, among the banks and the U.S. Treasury, the debt problem is effectively conceived of in terms of no more than five countries: Argentina, Brazil, Mexico, the Philippines, and Venezuela. While there are at least 42 countries that have rescheduled their commercial bank debts in recent years, the five main debtors account for about 75 percent of the exposure of the nine money-center U.S. banks to all 42 countries![6]

The third major reason why comprehensive debt reduction has not occurred is the continuing signal from the official community that public money will come to the rescue of the faltering renegotiation process, even if the banks do not agree to much debt reduction. To the extent that the banks limit new lending or debt reduction, they know that the official community will make up at least part of the difference in official lending to the debtor countries. *This infusion of public money acts as a tax on debt reduction schemes*, because it reduces the incentives of the banks to agree to debt reduction schemes. The process of public sector bailouts is increasingly evident, as I have shown elsewhere (Sachs, 1989c).

The fourth major problem is the incentive problem of the largest banks, which are also the most heavily exposed. These banks have had several reasons for avoiding comprehensive debt reduction, none of which can be justified on efficiency grounds. Most importantly, the large banks, which have the highest ratios of LDC exposure to capital, have resisted any solution which would require writing down the value of loans extensively, and putting losses on their books, even if the solution would raise the market value of the LDC claims.[7]

The key here is that under standard accounting procedures for the U.S. banks, the LDC debt has a book value of par (that is, 100 percent of face value), even though the market value of the debt is greatly depressed. Thus, a process of debt reduction generally requires book losses, even if it produces gains in the market value of the LDC claim. In Sachs (1988, 1989b), I point out that a heavily exposed bank might have the incentive to reject a deal that raises the market value of the LDC claim, but at the expense of book losses. Large banks have also resisted comprehensive solutions because they have better access than small banks to debt-equity swaps, and have pushed for these swaps. Unfortunately, from the point of view of the debtor country,

[6]The nine money-center banks are: Citicorp, BankAmerica, Chase Manhattan, Manufacturers Hanover, J.P. Morgan, Chemical Bank, Security Pacific, First Interstate, and Bankers Trust.

[7]Note that large banks have added to reserves for loan losses, but such reserving is different from debt writedowns and from debt reduction. The reserves for bad LDC debt have not been allocated to particular countries (with a few small exceptions). Under U.S. banking regulation, unallocated reserves do not result in a writedown of debt or in a writedown of the bank's capital. Moreover, neither loan loss reserves nor a writedown of specific claims by a bank directly reduces the debt owed by a debtor. Rather, the bank unilaterally announces in its books that it is unlikely to collect fully on the loan, while at the same time maintaining the legal right to full collection from the debtor.

debt-equity swaps tend to be highly deleterious, because they amount to a prepayment of the debt in local currency.[8]

## The International Debt Facility

The voluntary approach, at least as now conceived, is unlikely to succeed in its central purpose: to restore the creditworthiness of the debtor countries in order that they may achieve renewed growth and political stability. A real debt settlement requires the concerted participation of the banks. To the extent that there remains a "menu of options" for the banks, this menu should only include alternative ways of accomplishing debt reduction. In other words, banks should not have the luxury of opting out of the debt reduction process entirely, for that frustrates the whole process. Of course, a "voluntary" approach in rhetoric could be a comprehensive approach in fact, if the official creditors (like the International Monetary Fund and the U.S. Treasury) put pressure on the major banks to participate in a "voluntary" scheme. Such pressures have been repeatedly applied in the past seven years to get individual banks to participate in the concerted lending programs.

The simplest way to achieve a comprehensive reduction of debt is through a reduction of interest rates to sub-market levels on the existing debt. This mechanism is nearly ideal: it is administratively straightforward (the contracts merely have to be rewritten to include interest rates of, say, a fixed 4 percent, rather than a spread over market interest rates); it is comprehensive; it is equitable in its impact across banks; it avoids the adverse consequences of debt-equity swaps; it is a standard mechanism for debt workouts in the domestic context; and it may even obviate the need for large, immediate writedowns of capital under U.S. banking regulations. Under the accounting convention known as FASB 15, a debt restructuring which preserves principal, but which reduces interest rates, does not in general require a capital writedown. Furthermore, it is easy to combine interest rate relief with credit enhancement, since the reduced interest rates can be guaranteed by the official creditors—like the World Bank—as part of the restructuring process.

These steps could best be accomplished in the context of an international debt facility, which would be in charge of organizing the comprehensive package, linking the debt reduction package to policy reforms in the debtor country, and providing

[8]In a debt-equity swap, the central bank repurchases the debt in local currency, which must then be used for a domestic investment. The repurchase price (when expressed in dollars at the prevailing exchange rate), is typically less than par, but significantly above the secondary market price of the debt. The issuance of local currency is itself highly inflationary. If the central bank tries to sterilize the monetary effects, by selling a domestic bond to soak up the money supply increase, the result—from the government's point of view—is a conversion of the external debt into internal debt. However, the internal interest rates tend to be *far higher* than the interest rates that are locked into the existing bank debt. In effect, the government is issuing a new domestic "junk bond" at very high interest rates (that reflect the government's current insolvency), to refinance a prepayment of debt that has a much lower interest rate that was set several years before. In the end, debt-equity swaps tend to raise inflation, or raise the overall debt-servicing burden, and thus are not an effective means of debt relief.

official guarantees on the reduced interest payments that are due after the debt reduction package is put into operation. In essence, the IDF would act as a kind of bankruptcy court, in charge of guiding a comprehensive settlement.

The Facility would be lodged in the IMF and the World Bank. The IDF would make estimates of the extent of necessary debt reduction for each country based on market indicators (like the secondary market price of the debt at a given historical date) and medium-term economic scenarios prepared by the IMF and the World Bank. The Facility would press for a comprehensive settlement between each country and its bank creditors according to the extent of debt reduction deemed to be necessary.

The IDF would not have the full legal authority of a bankruptcy judge to impose a settlement, and there is no prospect for obtaining the necessary legislative changes in the major creditor countries to establish such complete legal authority. Thus, the IDF would probably have to steer the negotiations using existing legal authority residing in the IMF and the World Bank, together with the credit enhancements that the IDF would provide for banks that agree to a given program of debt reduction.

In particular, I would envision the following kind of operations. The IDF would indicate a range of acceptable debt reduction, to be achieved mainly through a permanent cut in interest rates to sub-market levels. It would call for universal participation of all banks in the agreement. Pending the completion of the debt reduction negotiations, the debtor country would pay only a fraction of the interest due on the existing debt, in line with IMF estimates of ability to pay. The IDF would give *de facto* protection to the debtor for the partial nonpayment of interest, since the IMF and the World Bank would continue to lend to the debtor country despite the presence of growing arrears to the banks. The IDF could probably also give *de jure* protection to the debtor, under an arrangement in which the IMF would formally approve the nonpayment of interest as an "exchange control" that is necessary to protect the economy of the debtor country.[9]

Once a critical mass of banks (perhaps 80 percent of banks, by amount of loans) agrees to necessary debt reduction, the interest rate would be cut to those banks, and the IDF would then provide full guarantees on the reduced flow of interest payments. Thus, the banks would give up their claim to full repayments, but would instead get a guaranteed but smaller stream of interest repayments. Principal would be rescheduled (say, for 30 years), and would be fully repayable without a discount. For banks that do not agree to the debt reduction, the country would remain in arrears under the protection of the IDF.

Under the theory of Pareto-improving debt reduction, there is really no reason for the IDF guarantees on interest payments. The debt reduction itself should suffice

[9] Under Article VIII, Section II(b) of the IMF Articles of Agreement, the IMF Executive Board may approve exchange controls of a member country, and thereby give legal protection to the country if it withholds contractual payments to a creditor as a result of the exchange controls. It is currently debated in legal circles whether the IMF can thereby protect a debtor country from lawsuits that might arise from a partial suspension of interest payments. While there is some ambiguity in the IMF's legal authority, there are important legal arguments in support of the IMF's power to protect debtor countries in arrears.

to raise the value of the debt and thereby encourage the banks to participate. But there are three pragmatic reasons for including interest guarantees as part of the IDF strategy. First, given the IDF's weak legal basis for imposing a settlement, the presence of credit enhancements will significantly smooth the process of getting banks to agree to a debt reduction package. The enhancements will also lessen the risk to the IDF of legal challenges from the banks that the IDF is forcing a reduction of the banks' claims without just compensation.

Second, the banks need protection from the risk that the creditor governments will in the future put pressure on them for still greater concessions. The banks fear that the creditor governments will again press them to make cuts in the debt, but perhaps for foreign policy reasons rather than for reasons of economic efficiency. Thus, the interest guarantees act as a kind of protection to prevent the creditor governments from putting on undue future pressure to make greater concessions.

Third, the guarantees are appropriate in order that the public sector share some of the financial losses associated with the debt reduction. The banks are not the only creditors of the heavily indebted countries; much of the debt is owed to foreign governments and international institutions. Ideally (as in the setting of domestic bankruptcy), *all* creditors should be called in to make concessions in a single comprehensive agreement. In practice, that would be practically impossible in the current setting. For myriad reasons, the official debt will not be cut along side of the bank debt.[10] The interest guarantees are a pragmatic way to allow for some (modest) assumption of costs by the public sector.

The IDF would provide a practical and efficient solution to the debt overhang. It has nonetheless been vigorously opposed (by the largest banks and by some creditor governments), often on misleading grounds. Let me conclude by touching briefly on several of the "myths" surrounding an international debt facility.

**Myth 1: A Debt Facility is a Taxpayer-Financed Bank Bailout.**

This is a real whopper. A debt facility is the most effective and orderly way for insuring that the banks accept losses on their bad loans. Under current arrangements, the banks try to foist part of their losses onto the taxpayer, via an arrangement in which new lending from the IMF, World Bank, and creditor governments is used by the debtor country to help pay for interest payments to the commercial banks (see Sachs, 1989c, for evidence of such a transfer to the banks). A debt facility would require a concerted acceptance of bank losses for the first time in this crisis. Note that the facility would not impose *new* losses on the banks, but would force them to

[10] In fact, the official community has made far greater concessions than the banks in recent years, amounting to an implicit bank bailout. This differential behavior would have to be taken into account in properly sharing the losses among public and private creditors. Official loans to debtor countries have helped to finance interest payments to the banks, and the official creditors in the Paris Club setting have rescheduled debt payments far more generously than have the banks. (The main difference is that the Paris Club routinely reschedules interest as well as principal, while the banks reschedule only principal, while occasionally refinancing interest via a "new money" package.)

recognize existing losses that have already been capitalized into their stock market valuations (see Sachs and Huizinga, 1987).[11]

**Myth 2: A Debt Facility is Too Costly for the Taxpayer.**

This, no doubt, is the preeminent myth that has forestalled any action on the proposal. With the popular press fond of quoting a developing country indebtedness of more than $1 trillion, opponents of the debt facility are able to instill the notion that real relief would require hundreds of billions of dollars of taxpayer funds.

This is wrong from several points of view. The target of the facility is *medium-and-long-term debt of the public sector of troubled debtor countries*. This amounts to about $240 billion, with a secondary market value of the debt of about $90 billion. Other kinds of debt (like debt owed to the IMF, World Bank; short-term debt; debt owed by the private sector; and so on) would not be part of the plan. Moreover, it is the banks, not the taxpayer that would assume the bulk of the losses under the debt facility. Roughly speaking, the debt would be cut from approximately $240 billion to $90 billion (in steps, and assuming that all countries eventually qualify for debt reduction, by undertaking adequate adjustment programs). The facility would guarantee the payments of part or all of the $90 billion due. The taxpayers would be liable only if the debtor countries could not manage to carry the burden of the $90 billion, and would be liable only for that part which remains unpaid by the debtor countries.

The U.S. share of the guarantees could be quite modest. In another study (Sachs, 1989c), I have illustrated the very small amounts at stake by assuming that the Japanese would cover one-third of the guarantees, and the U.S. would cover one-fourth. The result is that the U.S. ends up guaranteeing about $22.5 billion in liabilities of the facility.[12] Assuming that the debt reduction reduces the debt in accordance with ability to pay (and produces the efficiency gains that can be expected), then the guarantees on the interest will not be needed. The debtor countries will be able to meet the reduced interest bill without needing to call on IDF funds. The taxpayers will not pay at all. In practice, a modest fraction of the guarantees might become necessary; perhaps the U.S. taxpayer cost would be one-third of the $22.5 billion, or $7.5 billion, distributed over many years.

**Myth 3: A Debt Facility is Contrary to the Case-by-Case Approach.**

This myth reflects a simple misunderstanding. Advocates of a debt facility do not advocate an across-the-board writedown of debt. Rather, comprehensive debt reduction would be available on a case-by-case basis, depending on the willingness of the

[11]It may seem odd that the banks, the taxpayers, and the debtor countries could all benefit by the IDF relative to the status quo. This is possible because the existing debt overhang creates a pure deadweight loss, as noted earlier in the paper.

[12]The actual budgetary expenditures needed for the U.S. contribution would be considerably smaller. If paid-in capital is about 10 percent of the amount of the guarantees, the U.S. budgetary contribution would come to approximately $2.3 billion. This could be distributed over five years, with an annual budgetary burden of about $470 million.

country to undertake economic reforms. In each case, the extent of reform would be tailored to the economic needs of the country in question.

**Myth 4: The Debt Facility is Inimical to Economic Reform.**

This notion is simply backward. The debt overhang itself is the greatest barrier to economic reform, because it destabilizes governments in Latin America, and thereby deprives governments of the political base to pursue sustained programs of reform. Moreover, it is virtually impossible to sell a program of economic reform in Latin America today, because the political opposition is only too quick to point out that under current arrangements, the benefits of reform accrue to the international banks, rather than to the domestic citizenry. (For a discussion of the types of fiscal and trade reforms that are most essential, see Sachs, 1989a).

Two countries, Bolivia and Costa Rica have already achieved a measure of *de facto* debt relief. These two governments have, indeed, among the most successful programs of reform now underway in the region in large part because of the breathing space offered by the easier terms on debt servicing. See Sachs (1988) for a discussion of the Bolivian case.

**Myth 5: Debt Reduction Would be Harmful to New Lending.**

The banks have long argued that Latin America should be drained of approximately 5 percent of GNP per year in net interest payments, since to give relief would somehow restrict the access of the countries to "new lending." Since no real net lending is in fact available, the point seems to be unreal in the extreme.

But more fundamentally, there is an enormous confusion about the linkage of debt reduction and new lending. In domestic bankruptcy cases, for example, the reduction of debt is seen as vital to restoring creditworthiness. It is common in a bankruptcy action that once the existing debts are reduced, the bankrupt firm may immediately return to the credit markets for new financing based on a cleaned-up balance sheet. Similarly with sovereign debt, it is the debt overhang itself that prevents the return of the sovereign to the loan market, and the most effective way to *revive* lending for trade financing and fixed capital formation is to reduce the debt burden to a level that can be serviced by the debtor.

Those who argue against debt reduction because of an alleged adverse effect on future lending confuse the effects of two kinds of actions on the debt. A unilateral and hostile suspension of payments by a debtor may indeed delay the debtor's return to the capital markets. (As a last resort, though, such a suspension of payments may make sense for the debtor country anyway.) Contrariwise, an agreed and negotiated reduction of debt can speed the return of the sovereign to the capital market.

In summary, voluntary debt reduction is unlikely to produce the extent of debt reduction necessary to reestablish creditworthiness, and necessary to overcome the inefficiencies of the debt overhang. An international debt facility, which organizes debt reduction on a country-by-country basis, with comprehensive (as opposed to "voluntary") participation of the creditor banks, offers the best prospects for adequate debt reduction. Because there does not exist a bankruptcy code to support the IDF,

the design of IDF operations must be guided by certain pragmatic considerations. For example, the IDF and the rest of the official community (especially the IMF) should recognize that some interest arrearages will be inevitable during the process of negotiations. Also, the IDF should provide interest guarantees to banks to accept debt reduction, in order to strengthen the IDF's hand and to encourage the near-universal participation of banks in the debt reduction process.

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