Comment on "Economic Reform and Debt Relief in Eastern Europe: Lessons from the 1980s Debt Crisis," by John Williamson

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Professor Williamson's very stimulating and thought-provoking paper on debt relief may be viewed as an attempt to rationalise the Brady Plan: the debtor country accepts policy conditionality designed to ensure that it fulfils its repayment pledge. In return, it receives funding from international financial institutions and debt relief from creditor banks and creditor governments. The international financial institutions police the conditionality.

As noted by John Williamson, the underlying idea is that all involved parties may gain from the agreement. However, one of the points that I will make in this intervention is that it is far from obvious that all parties will gain. All that can be stated with certainty is that a deal will be struck only if all parties expect to gain from it.

In this regard, bankruptcy for a country is a very different matter than bankruptcy for a company. In most western countries, a company in default can be forced by its creditors – supported by the legal system – to accept a settlement which might involve a change of company policy, a management shake-up, or a sale of assets. Creditors may have the power to decide whether the debtor company should survive as a going concern or be liquidated. The creditors are often in a position to ignore the views and interests of the debtor.

When, on the other hand, a country goes into default, nobody can force it to sell its assets, change management or adjust policies to service its debt. Apart from episodical impounding of assets located abroad and belonging to the government in default, which is often threatened, but seldom resorted to, all the creditors are able to do is to make it look appealing to the debtor to 'choose' to service at least part of the debt and to pursue economic policies that will make this possible. The carrot is lending – even if coated with the medicine of conditionality – the stick might be sanctions, like restricted access to trade finance. The debtor can be persuaded to accept the policy conditions and a renewed commitment to repay only if the required sacrifices are sweetened sufficiently by new money and, possibly, by a formal debt restructuring.

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I would like to stress, however, that there may well be cases in which there is no package of policy conditionality and debt restructuring which benefits *all* involved parties.

The benefit to the banks of rescheduling assets or providing new money is that the package may finance investment and trigger policy adjustments that might enable the debtor country to repay at least part of the outstanding claims. But there are also costs to the banks. First, there are obvious risks associated with any provision of new money. Second, formal debt reduction may force the banks to recognise the associated loss in their balance sheets. Third, any debt reduction may signal to other debtors that banks are willing to reward defaults. Fourth, once a particular "debt reduction percentage" has been agreed with one debtor country in dire straits, there is a risk that this percentage will be regarded by other, less needy debtors as a minimum acceptable "reduction percentage". Fifth, if debt renegotiation becomes widespread even in the absence of serious distress on the side of the debtor, contract sacrosanctity and banking moral basis would be undermined.

From the point of view of the debtor country, the initial default might have been the result of an unresolvable liquidity strain or an insolvency situation due to a growing disequilibrium between the foreign exchange cash-flow and the foreign debt service. It might, however, alternatively have been the result of a deliberate decision based on a simple assessment of the costs and benefits of defaulting. One cost of defaulting is loss of access to capital markets - access which most countries wish to have so as to facilitate trade and to finance temporary current account deficits. Another cost is a possible loss of moral or political standing in the international community. The potential benefit is availability of funds which the country would otherwise have to use for debt service.

Once the country has defaulted, it may wish to assess the benefits and costs of participating in a Brady-type deal. The primary benefit would be new money and a distant possibility of eventually regaining access to international capital markets – access which would, incidentally, in many cases have been very limited even before the initial default. One cost associated with a Brady deal would be the loss of funds that the deal would absorb for the resumed flow of debt service payments. Another cost would be the imposition from abroad of policy conditionality.

Given these cost/benefit considerations, it is perfectly possible that the amount of new money and debt reduction that would be needed to make the package attractive to the debtor would exceed what the private creditors would be willing to provide. There the international financial institutions – but not the EBRD that is a fully project-orientated bank – enter the play. Since they enjoy preferred creditor status, their claims on the defaulted country cannot be reduced and in principle continue to be serviced. However,

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since the risk of default vis-à-vis international financial institutions is not absent, these institutions have an interest to insist on a bigger reduction on the part of the other creditors to improve the repayment chances for their own claims, which entails a serious problem of inter-creditor equity, and a smaller participation in providing new money. Money from international financial institutions could prove, therefore, insufficient to bridge the gap. In that case, additional money from a third party, presumably a country with strategic or other interests in the debtor nation, would be needed for a deal to be struck. But I would not say it is very realistic to expect that.

Professor Williamson's paper treats the distinction between commercial and official creditors quite casually. In practice, this distinction is important. It is much easier for western governments to accept and manage administratively a write-down for their own claims on foreign countries than to justify and have Parliaments legislate to facilitate the provisioning for a write-down of claims held by commercial banks. This is why Poland and Bulgaria have found official creditors amenable to debt restructuring agreements within the confines of the Paris Club – which deals exclusively with official debt – whereas neither of the two countries has come anywhere near a parallel agreement with their commercial creditors, despite years of on-off negotiations.

Regarding the moral hazard problem, I don't believe it can be shrugged off easily. The international finance and payments system involves contractual obligations and relies on mutual trust between the signatories to the contracts. For this system to work, there must be a widespread perception that any breach of contract is associated with significant costs. This is clearly the view of most western banks, a view which goes a long way towards explaining why it has been difficult for countries like Bulgaria and Albania to reach an understanding with commercial creditors.

The flipside of this argument is that the finance and payments system will also fail to function appropriately if the banks expect to be compensated for all the mistakes they have made. Much should be done to prevent the perception among western banks that they can in all cases claim financial help from their own governments to reach a debt restructuring agreement with debtor nations. Banks should never be allowed to feel they can make placements with no downside risk. That could, however, be the consequence of government-brokered restructuring of commercial creditor debt. To avoid this consequence, it will be important to intensify ex ante supervision of bank lending. Widespread and rigorous application of the Cooke ratio in international prudential banking regulation may be helpful in this regard. As you know, the Cooke ratio sets relatively high capital requirements for certain risky types of lending, including to certain country categories.

Are we sure that prudential regulation is the ex ante instrument to lower the very chance of occurrence of international debt crisis? Let us explore somewhat the subject. A debt crisis is always rooted in overlending. In turn, the latter results from a fundamental externality in the working of financial markets. Even if each lender rationally takes into account the effect of its marginal lending decision on the chance of full solvency of the borrower, it will disregard the effects on the value of other lenders' claims. Market rivalry between lenders leads to failure by anyone of them to internalise costs and benefits impinging on lenders as a group. Overlending can occur even if market participants know perfectly well what they are doing. Of course, financial fads can only make matters worse, while assessments of borrowers' creditworthiness is far from precise and inter-temporally consistent.

If the markets cannot be expected to solve the problem autonomously, prudential regulation through capital requirements and rules on risk concentration is called upon to fill the gap. However, the instrument is designed to limit the negative effects of idiosyncratic risk borne by the intermediaries lending to individual borrowers, be they national or foreign, private or public. Yet a basic feature of lending to finance a project in a developing country and a fortiori in a CEE country in transition seems to be that the country risk often dominates the idiosyncratic one. As a result, the effective returns from lending to entities located in a particular LDC or CEE country are much more highly correlated than would be the case for a developed country. Therefore, what ex ante was thought to be a lending activity driven micro-economically by market opportunities becomes ex post, in case of a severe, adverse shock, a macro problem that ties the fortunes of all creditors together. Incidentally, a way to delink the idiosyncratic risk from the country one is the setting up of escrow accounts domiciled abroad for projects with a foreign-exchange cashflow – a mixed blessing owing to the macroeconomic drawbacks engendered by massive recourse to such a technique. The recent softening of the negative pledge clause by the World Bank goes in this direction.

Since foreseeing severe country-wide shocks is extremely difficult, transboundary lending, including sovereign lending, carries an additional element of risk that is not completely embodied in the ex ante pricing of funds. Nor overlending can be avoided completely by prudential regulation. The latter can only force creditors to mark their assets to market after the outbreak of the crisis and to reconstitute their capital base, thus speeding up the resolution of the crisis. That's why, I think, in this phase of the transition of CEE countries towards the market, it is in the interest of the stability of the international financial system to have the capital flow towards those countries assured to a great extent by foreign direct investments, western public entities which can count on official support or guarantee (e.g. Export Credit Agencies) and international institutions. For the private banks to play a much bigger role – for which they do not seem to be very eager – we have to wait for a consolidation and strengthening of the economic base, which will bring about a lower correlation between individual investment outcomes in case of a strong exogenous disturbance.

Let me finish by adding a brief comment on the country-specific analysis in John Williamson's paper. I will limit myself to a few clarifying facts. First, he states in his paper that Albania's debt is modest. While some Albanians may be happy to read this, I don't believe the assessment would be shared by the country's commercial creditors. In fact, with a high of 953, Albania's debt/export ratio far exceeds that of any of the countries listed in table 2 of Williamson's paper. Another point worth noting is that the debt/export ratio may in some cases be a deceptive indicator of the risk of default. Romania is a case in point. Although Romania's debt burden is small, it is quite hard for the country to finance its amortisation payments as it enjoys virtually no access to private foreign funding. In fact, Romania has had to draw on bridging finance from the BIS this year to avoid running out of reserves. A third important factual point is that the debt restructuring issues facing countries like Poland and Russia are quite different from those facing countries like Albania, Bulgaria and Hungary. For the former two countries, the bulk of the debt is owed to official creditors; for the latter three countries most of the debt is owed to private creditors.

The last two points I would like to raise regard the suggestion Williamson makes about the structure of debt rescheduling in Russia. It seems far too generous to me to consolidate the whole of the outstanding public sector debt into 25 years maturity loans, with a 10 year grace period and a substantial proportion of interest being capitalised for the first five years. If we take into account the fact that Russia is one of the richest countries in natural resources of the world, the question that comes immediately to our mind is that if we agree with Williamson's proposal, what are we going to do in terms of debt rescheduling with all the other poorer countries which will justifiably seek similar concessions in the future? The second point concerns the fact that the mere promise of such a generous debt rescheduling might wipe out any type of incentive for the Russian government to get on with its reform programme. Even if the benefits of the debt rescheduling are not made available immediately, and even is conditionality is enforced, the simple knowledge that the West is going to be so generous in the debt restructuring might seriously damage any hope of reaching political and economic stability in Russia.

Let me finish by thanking Professor Williamson for his thoughtful paper. In addition to the points I have commented on above, I find his historical account educational. It is instructive to be reminded that the U.S. and Germany are among the countries that have had their foreign debt reduced

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by their creditors. At least in the case of sovereign borrowers, it is possible on this very earth to have proof of the evangelic promise that "the last shall be first".

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