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POLICY BRIEF

20-13 Sovereign Debt Relief in the Global Pandemic: Lessons from the 1980s

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The coronavirus pandemic and an unprecedented global recession have triggered fears of a debt crisis requiring massive intervention by international financial institutions as well as debt restructuring by private and official creditors. In late March 2020, the International Monetary Fund (IMF) estimated the gross external financing needs of emerging-market and developing countries at $2.5 trillion. More than 100 members approached the IMF for assistance. As of early September, more than 30 members were exploring possible IMF-supported programs of financial and economic adjustment. In March, World Bank Group President David Malpass and IMF Managing Director Kristalina Georgieva called for a suspension of scheduled debt payments to official creditors by low-income countries through the end of 2020. The Group of Twenty (G20) ministers and governors endorsed their call on April 15 and proposed that private creditors grant the same treatment.

Many outside observers are calling for even more urgent action, including more quickly arranged debt relief. Bolton et al. (2020); Gelpern, Hagan, and Mazarei (2020); and Gelpern (2020a, 2020b) have called for a debt standstill of both interest and principal payments at least through the end of 2021, not only for low-income countries but also for middle-income countries. Eichengreen (2020), Stiglitz and Rashid (2020), IMF First Deputy Managing Director Geoffrey Okamoto, and World Bank President Malpass, among others, have invoked the 1980s debt crisis as a cautionary tale, contending that unnecessary delay in arranging for external debt stock reduction will worsen the economic downturn in these troubled countries.

What does the experience of the 1980s teach us about today's crisis? The answer is more complicated than some suggest. Yes, it took almost seven years from the onset of the crisis in Mexico over one weekend in August 1982 to the announcement by US Treasury Secretary Nicholas Brady in March 1989 of a plan to facilitate the reduction in stocks of debt to international banks. But the reasons for the delay are instructive. Understanding them can help policymakers appreciate the subtleties of the impending debt crisis.

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I draw two lessons for today, based on my ring-side experience throughout the earlier period:

- The initiation of debt relief will require a broad consensus among four groups: the borrowing countries, their foreign creditors, the authorities of the countries in which those creditors are located, and international institutions. Reaching consensus takes time.
- Implementation of the consensus framework will be case by case because of differences in the political and economic circumstances of each country, which will militate against simple replication for different countries and against implementation for all borrowers at the same time. Any framework will not be self-implementing. While the call for rapid action is understandable, applying a one-size-fits-all approach will not be possible.

There is no consensus today on how to address countries' pandemic-related debt problems other than the IMF–World Bank Debt Service Suspension Initiative (DSSI) for low-income countries, which currently offers only temporary liquidity relief for the balance of 2020. Based on the experience of the 1980s, a reduction in principal of foreign private debt for countries is unlikely before 2022 at the earliest.

Any viable framework will require not only that the economic situations of many borrowing countries worsen, as they will, but also that a major borrower press for substantial relief. A request for that relief will have to be supported by financial inducements, most likely backed by the IMF, other international financial institutions, and the major countries, to overcome market disincentives discouraging borrowers. Those disincentives principally involve ratings downgrades, which would reduce, or raise the price of, market access for the borrowing countries in the future. The authorities in those countries will have to conclude that the current benefits of debt reduction today outweigh the potential future costs of having done so. Once having decided to opt for debt reduction, it must be substantial enough to raise the value of the remaining debt. Against this background, implementation of a framework for debt reduction by many countries will stretch over several more years.

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CONTEXT

Table 1 presents data on the gross external debt of and international bank claims on 17 major developing-country borrowers and the year of each country's first IMF program in the 1980s.[1] Figure 1 presents trends in economic growth during the period. It shows that growth in the dozen Latin American countries in the group of 17 plunged in 1981, was negative in 1982, and even more negative in 1983. Global growth was minuscule in 1982, after two years of below-average growth. The growth outlook today is worse than it was in 1982, for both advanced and less advanced countries, as well as highly uncertain.

1 The 17 countries, 12 of which were in Latin America, were the focus of the Baker Plan. Political pressures led to the addition of Costa Rica and Jamaica to the original list of 15 countries.

Table 1
Gross external debt, international bank claims, and dates of issuance of Brady bonds and first IMF programs of 17 heavily indebted countries, 1982–93

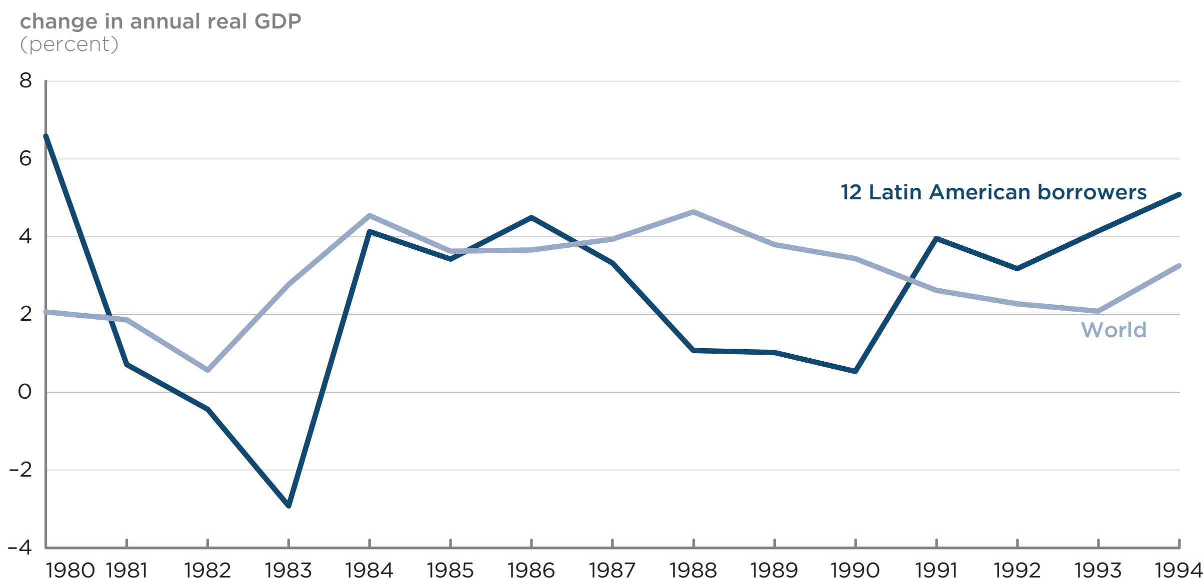
		Gross external debt (billions of dollars)				**International bank claims** (billions of dollars)				
Country	*First IMF program*	*1982*	*1985*	*1989*	*1993*	*1982*	*1985*	*1989*	*1993*	*Brady bonds issued*
Argentina	1983	43.6	50.9	65.3	74.5	22.2	29.0	32.4	30.4	1993
Bolivia	1986	3.3	4.8	4.1	4.2	0.7	0.6	0.3	0.4	[a]
Brazil	1983	93.0	106.1	111.4	132.7	56.1	76.9	70.8	69.0	1994
Chile	1983	17.3	20.4	18.0	20.6	10.4	14.3	9.1	10.0	None
Colombia	1985[b]	10.3	14.2	16.9	17.2	5.5	6.5	6.6	7.6	None
Costa Rica	1982	3.6	4.4	4.6	3.9	0.7	0.8	1.1	1.2	1990
Côte d'Ivoire	1981	8.9	9.6	14.1	19.1	2.9	2.9	3.3	2.2	1998
Ecuador	1983	7.7	8.7	11.3	14.1	4.1	5.2	4.6	3.2	1995
Jamaica	1981	2.8	4.1	4.6	4.3	0.5	0.7	0.7	0.5	None
Mexico	1983	86.1	96.9	93.8	118.0	59.03	74.5	70.1	69	1990
Morocco	1982[c]	12.5	16.5	21.6	21.4	3.6	4.8	5.2	5	None[d]
Nigeria	1987	13.0	19.6	32.0	32.5	7.0	9.1	7.4	4.1	1992
Peru	1982[c]	10.7	12.9	18.6	20.3	5.2	5.6	4.1	3.2	1997
Philippines	1983	24.4	26.6	28.7	35.3	8.3	13.4	9.6	6.6	1992
Uruguay	1985	2.6	3.9	5.2	7.3	1.2	2.0	2.0	2.7	1991
Venezuela	1989	32.2	35.3	32.4	37.5	22.7	25.8	24.1	17.4	1991
Yugoslavia	1981	19.9	22.5	19.1	11.3[e]	9.3	10.5	7.5	3.9	None
Total		**392.1**	**457.3**	**501.7**	**574.3**	**219.4**	**282.6**	**259.1**	**236.3**	

IMF = International Monetary Fund

a. Had a debt buyback in 1988.
b. Did not have an IMF program. Program with World Bank was monitored in part by IMF.
c. Programs approved before the Mexican weekend, August 1982.
d. Negotiated a Brady arrangement but did not meet conditions for issuance of bonds.
e. Excludes Croatia, Macedonia, and Slovenia.

Sources: International Monetary Fund, *Transactions with the Fund*, country pages; Boughton (2012, 414-415); Cline (1995, tables 2.1 and 2.8); Das et al. (2012).

Figure 1
Annual real GDP growth, 1980–94



Note: Aggregates use purchasing power parity (PPP) weights.
Source: Author's calculations based on data from IMF, *World Economic Outlook Database*, April 2020.

US consumer price inflation was 6.1 percent in 1982 but declining. The average rate of inflation for 11 of the 12 Latin American borrowers was more than 35 percent in 1980 and 1981, more than 45 percent in 1982, and 75 percent in 1983.[2]

The borrowing countries were heavily reliant on expensive net capital inflows. The US prime rate remained in double digits until mid-1985. The average current account deficit for 10 of the 12 Latin American countries was 5.0 percent of GDP in 1980, 8.9 percent in 1981, and 7.3 percent in 1982.[3] Their gross external debt increased by 150 percent between 1977 and 1982, from $118 billion to $296 billion.[4]

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The external debt positions of many emerging-market and developing countries were problematic before the coronavirus pandemic shock. A World Bank study (Kose et al. 2020) on global waves of debt focuses on a fourth wave, which began after the global financial crisis of 2008. Domestic government debt and private international debt are larger components of the total than in the waves of the 1970s, 1990s, and first decade of the 21st century.

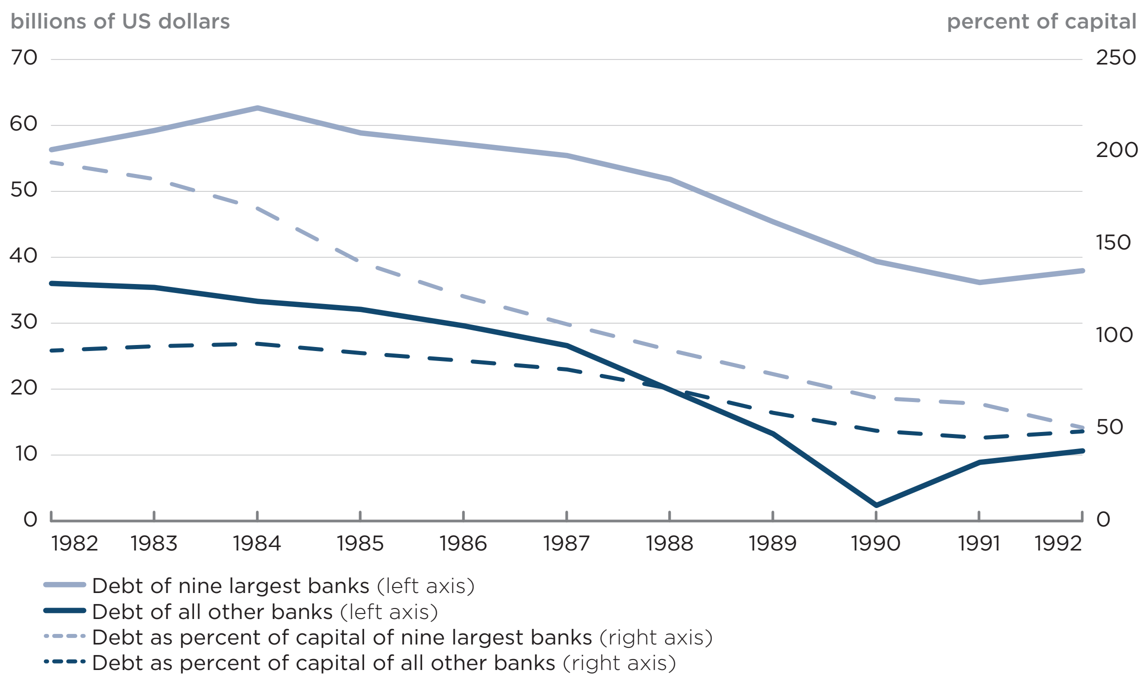
The banking systems in the advanced countries are in better shape, however. Figure 2 shows the evolution of exposures to the 17 major borrowers during the 1980s by the nine largest banks and all other US banks. At the end of 1982, the exposure of the nine was 194 percent of their capital. In contrast, in March

2 The source (IMF *World Economic Outlook Database*, April 2020) does not provide data for Argentina.

3 The source (IMF *World Economic Outlook Database*, April 2020) does not provide data for Uruguay. Venezuela was in current account surplus.

4 These data are from the World Bank's international debt statistics, https://databank.worldbank.org/reports.aspx?source=international-debt-statistics.

Figure 2
Exposure of US banks to 17 heavily indebted countries, 1982–92



Source: Author's calculations based on Cline (1995, tables 2.10 and 2.11).

2020, the seven largest US banks had exposures to all nonadvanced countries, excluding banking centers, equal to 83 percent of capital; the exposure of all other US banks was 23 percent (FFIEC 2020).

The IMF is also better equipped financially in 2020 than it was in 1982. Today it has about $1.4 trillion in gross financial resources. In 1982 its resources were about $80 billion. They were raised to $130 billion in 1983.

International trade is now 10 times higher than it was in 1982. World GDP (on a purchasing power parity basis) is now about eight times higher (IMF 2020). Before the August 1982 Mexican weekend, the IMF was already actively lending (table 1). In March 2020, the IMF had $155 billion in current commitments to 21 members, including 5 (Argentina, Colombia, Ecuador, Mexico, and Morocco) that were among the 17 major borrowers in the 1980s.

DEBT RELIEF IN THE 1980S

The 1980s Latin American crisis unfolded in three phases:

- The concerted lending phase (August 1982–October 1985).
- The Baker Plan phase (from its unveiling at the IMF/World Bank Annual Meetings in Seoul in 1985 until March 1989).
- The Brady Plan phase (starting with US Treasury Secretary Brady's announcement of his debt reduction plan in March 1989 and continuing until the mid-1990s).

Debt relief broadly defined was central to each phase. In the first phase, debts to international banks were rescheduled, which provided immediate cash

flow relief. However, the present value of this debt increased, because interest margins were raised. In addition, in the concerted lending phase, banks were required to make new loans to major borrowers proportional to their existing exposures as a condition for IMF approval of country programs. In the later part of the first phase and the second phase of the crisis, multiyear rescheduling agreements were negotiated. The first, by Mexico in September 1984, involved a stretching out of maturities, a lower interest rate, and a resulting modest reduction in the present value of its debt.[5]

In the second phase, borrowing countries employed a range of techniques, such as buybacks at below par and debt-equity swaps at discounts, that reduced the stock of debt.

In the third phase, two items were added to the menu of options for bank creditors: (a) securitization of the written-down principal of the debt while maintaining something close to a market interest rate (par bonds) and (b) the present-value-equivalent of option (a), in which the securitized principal remained intact but the interest rate was substantially below the market rate (discount bonds). These "Brady bonds" were normally backed by 30-year US treasury zero-coupon bonds, and a portion of the interest payments were guaranteed by funds held in escrow. In this phase, banks also had a third option of continuing to supply new money.

Although several commentators, most prominently Peter Kenen (1983), called for collective action to reduce the stock of debt early in the crisis, there was no appetite for such an approach among the principal parties.

The borrowing countries were wary of jeopardizing their access to bank financing, which they expected would resume quickly. In December 1982, Brazil's interim minister of the economy, Carlos Viacava, told the US authorities that Brazil expected to be back in the market within a year.

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The international commercial banks were opposed to reducing the principal amounts of the claims on the major borrowers, fearing contagion to other borrowing countries that would substantially erode their limited capital (see figure 2). Their authorities and the IMF shared these concerns.[6] They did not consider an immediate write-down of bank claims, in part because of concerns about the stability of the global banking system. Avoiding this risk was implicit in the approach taken. These shared concerns about financial stability were instrumental in persuading the major central banks, supported by their governments, to establish short-term bridge loans for several of the major borrowing countries.

The initial debt strategy was predicated on the view that the borrowing countries faced a liquidity crisis compounded by macroeconomic imbalances. With appropriate adjustment policies, the borrowing countries would resume growth and regain access to international financial markets. Analysts, including

5 Frequently, the interest rate was repegged to the London Interbank Offered Rate (Libor), which was 100 basis points lower than the US prime rate previously used, and the margin was reduced to 13/16ths, compared with 150 basis points and higher.

6 De Larosière (2018) reports that during the Mexican weekend, he convinced Finance Minister Silva Herzog that Mexico should not default on its debt to commercial banks. However, this option was not discussed with US officials.

some who were later critical of the debt strategy, supported this approach and also pointed to the revival of global growth (see figure 1) as helping borrowers grow out of their crises (Cline 1983, Cooper and Sachs 1985, Dooley et al. 1983).

However, voluntary financing did not return to the affected countries. Concerted bank lending to Latin America was $13.3 billion in 1983 and $15.5 billion in 1984, but voluntary financing, so-called spontaneous lending, declined from $1.9 billion in 1983 to $0.6 billion in 1984 (IMF 1990).

These developments motivated the Baker Plan. It emphasized structural change (for example, liberalization of foreign investment regimes and privatization) rather than fiscal adjustment; set a target for banks to lend $20 billion over the next three years to the 17 countries identified with the initiative; and called for increased lending of $10 billion by the World Bank and the Inter-American Development Bank to these countries over the same period.

In late 1985, none of the four principal parties to the strategy supported debt stock reduction. In June 1986, Jeffrey Sachs (1986), who had supported the concerted lending approach, argued that the earlier optimism had been unjustified. He advocated a new approach, including a substantial debt stock reduction for some countries.

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In January 1987, Michel Camdessus replaced Jacques de Larosire as managing director of the IMF. On his departure, de Larosire suggested that a change in the strategy toward bank claims was needed.

Thinking at the IMF began to change, although staff views were divided (Boughton 2001). Michael Dooley (1986), who also had supported the initial debt strategy, wrote that an overhang of external debts with face values that were more than their current secondary market values was a disincentive to foreign and domestic investment and, therefore, growth (see also Dooley 1989). Although the empirical foundation of his argument was weak (Cline 1995), his paper was very influential.

By 1987, as it became clear that the Baker Plan was not going to achieve its objectives and the capital positions of the major banks had improved (see figure 2), analysts within the official sector began to think about debt stock reduction. At the Federal Reserve Board we analyzed Plan B involving such relief. We also actively considered a Plan C, which would have drawn on Article VIII(2)b of the IMF charter as a mechanism by which the IMF could permit the imposition of controls on debt payments in support of a member that needed leverage over its bank creditors, including debt relief.

Debt sales in the secondary market increased as banks added to their reserves and unilaterally wrote down the value of their claims on their books and on reports to their regulators. Several small-scale initiatives effectively reduced the principal amount of some countries' debts. In 1987, Mexico, without objection from the official sector, offered to exchange up to $20 billion in face value of its debt for marketable bonds backed by 20-year US dollar zero-coupon bonds. The bank response to the offer was disappointing with a take up of only $3.7 billion in claims, at a discount of 30 percent, compared with an expected 50 percent discount (Boughton 2001). In early 1988, Bolivia retired about a third of its bank debt at 11 cents on the dollar in a buyback.

Meanwhile, proposals for systematic debt stock reduction surfaced in the United States. Plans by Senator Bill Bradley (1986) and Congressman John LaFalce (1987) were motivated in part by the fact that the slow growth of the borrowing countries was hurting US exports.

Japanese Finance Minister Kiichi Miyazawa proposed to the Group of Seven in June 1987 that an exit bond be included in the menu of options, with the principal amount of the debt secured by a zero-coupon bond purchased by the borrower, with the financial assistance of the official international financial institutions and carrying a reduced interest rate. At the IMF Annual Meeting, in Berlin in September 1988, US Treasury Secretary Brady, who had replaced Baker, expressed "skepticism [about] proposals that may appear to conform to the basic principles of the debt strategy, but which in practice produce only an illusion of progress. . . [and build] political opposition among taxpayers in creditor countries" (IMF 1988, 46). He was particularly critical of any use of funds from international institutions or governments to finance debt reduction and bank bailouts. As 1988 was a US presidential election year, the US administration wanted to distance itself from potential calls to use official funds to finance debt forgiveness for domestic borrowers, such as farmers and local governments.

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After the US election, the stage was set for a systematic approach to reducing the face value of bank claims on borrowing countries. Secretary Brady's plan, announced March 10, 1989, contained four key elements:

- A portion of IMF and World Bank loans would be used to help collateralize the principal amounts of new instruments with US Treasury zero-coupon bonds and partial interest guarantees.
- IMF and World Bank lending would also be used to help countries buy back their debts at a discount.
- The commercial banks should waive the sharing and negative pledge clauses in their agreements to permit individual debt reduction operations.
- The IMF should modify its policy of not lending to members while they are in arrears to their bank creditors to reduce the leverage of banks in their negotiations with borrowers.

The Brady Plan was not immediately implemented. Country negotiations with bank creditors often dragged on for months. In 1989, agreements in principle were announced with Costa Rica, the Philippines, Mexico, and Venezuela. However, the first Brady bonds were not issued until January 1990, by Mexico. Only 9 of the 17 beneficiaries of the Baker Plan completed Brady packages over the next five years—two each in 1990 (Costa Rica and Mexico), 1991 (Uruguay and Venezuela), and 1992 (Nigeria and the Philippines) and one each in 1993 (Argentina), 1994 (Brazil), and 1995 (Ecuador) (see table 1).

Reduction of the principal value of international bank claims on borrowing countries became an accepted component of the debt strategy only when the four principal relevant parties achieved a consensus on its desirability. Borrowing countries began to press to reduce the stock of their debts, with Mexico once again leading the pack. The balance sheets of international bank creditors had strengthened, and many creditors were anxious to put their exposure to the borrowing countries behind them. The key international institution, the IMF, had revised its thinking. In the end, the United States embraced debt stock reduction.

How consequential was the delay in incorporating debt stock reduction in the debt strategy? It could have occurred earlier—possibly in 1986, probably in 1987—if the shifts in the IMF's views and the position of Japan and, most important, the United States had come earlier. However, I am skeptical that rolling out the Brady Plan or its equivalent two years earlier would have had a significant effect on growth in the borrowing countries in 1988 and 1989, given the lags in implementing Brady packages, which in part were linked to not meeting associated policy commitments to the IMF.

LESSONS FROM THE 1980S

Substantial sovereign debt relief requires a consensus among four groups: the borrowing countries, their foreign creditors, the countries in which those creditors are located, and the international financial institutions, principally the IMF. In the absence of a bankruptcy mechanism, the four parties must solve a coordination problem. Their consensus need not be complete, but it must start with the key borrowing countries and receive political support from important creditor countries and institutions.

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The Debt Service Suspension Initiative (DSSI) response to the coronavirus pandemic illustrates the relevance of this lesson. To date, no borrowing country has stepped forward to ask for the suspension of debt payments from private creditors. One reason why is the reputational disincentive for the country's leaders. But the major disincentive is that the rating agencies are likely to downgrade the country's bonds, accelerating and prolonging the country's loss of market access. To seek a temporary suspension of debt payments to private foreign creditors, a borrowing country must conclude that such a restructuring would be in its medium-term interest. If instead it decides to tough it out, and the tsunami hits, the economic and financial damage will be greater than it would have been had the country restructured earlier. These choices are not easy.

Advocates of debt stock reduction must also recognize that borrowing countries today have more diverse crisis strategies than they did in the 1980s. Bolton et al. (2020) cite Mexico as a potential beneficiary of the DSSI. However, restructuring its debt to private creditors would not fit Mexico's strategy. In the global financial crisis, Mexico sought and received a flexible credit line commitment from the IMF; that commitment has been renewed. After the Asian financial crises in the late 1990s, the strategies of several of the principal emerging-market and developing countries have been to build cushions of international reserves.

Also relevant is the fact that a larger number of countries have substantial liabilities today. Once a framework is agreed to, it will therefore take time to fully implement it.

In the 1980s, each major borrowing country had a bank advisory committee, often with overlapping bank representatives. Over time, the overlapping membership on many such committees facilitated consensus among the creditors. The representatives had to balance the financial interests of their own institutions against the need to manage the crisis in the interests of all parties. After seven years, they became more efficient in reaching consensus. Today, with more lenders, leadership is more complex. The Institute of International Finance played a coordinating role in the restructuring of Greek debt in 2012. It has been

tapped to do so on including private creditors in the DSSI . In the Greek case, success was achieved on the second try. The jury is still out on the DSSI.

One challenge today is that international banks are no longer the dominant players in the external debt arena that they were in the 1980s, making up only 4 percent of emerging-market commercial debt in 2018. However, banks are important lenders to low-income countries and mechanisms for coordinating bank lenders are out of date (Liu, Savastano, and Zettelmeyer 2020). Sovereigns are also no longer the only entities in countries that issue external financial obligations.

The IMF and other international financial institutions played an important role in the 1980s and will do so in future crises, but their role is limited to prodding their member countries to act and responding to initiatives from members if they propose them.

Once consensus is achieved, the IMF and the multilateral development banks need adequate financial resources to support initiatives. In 1982 and 2007, at the outbreak of the global financial crisis, the IMF's resources were initially insufficient. Its resources were built up in both cases. The IMF is now much better positioned financially, at least as of today, to provide financial incentives for countries to seek debt stock reduction. This will help them overcome the disincentive from rating agencies' downgrades. Alternatively, the major countries will need to strong arm the rating agencies to refrain from downgrades.

The IMF is now much better positioned financially, at least as of today, to provide financial incentives for countries to seek debt stock reduction. This will help them overcome the disincentive from rating agencies' downgrades.

The second lesson from the 1980s follows from the first: Implementation of any debt stock reduction will be gradual and made on a case-by-case basis. Small borrowing countries will not be pathbreakers. Every borrowing country's economic and financial circumstances differ, along with their political circumstances. Countries going through political transformations, as Argentina and Brazil did in the 1980s, will have less time and political space to devote to debt renegotiation.

Two features of the global economic and financial environment in 2020 favor the facilitation of a systemic approach to debt stock reduction. First, borrowing countries face a common external shock. The external financial impacts differ across countries, but the pandemic affected every country at roughly the same time, even though some countries were more and others less prepared. This simultaneity should help the four parties reach consensus about how best to respond to the potential need to restructure sovereign debt. The process will take time, however.

Second, considerations of the financial stability of creditors and the financial systems of the host countries' lenders are a less prominent concern than they were in 1982.

In October 2020, achieving debt relief that results in a substantial reduction in the present value of claims on a broad swath of emerging-market and developing countries, middle-income as well as low-income, is a lower priority than it was in March and April. In the context of low global interest rates and ample global liquidity, several major borrowing countries have maintained or regained access to international credit markets. The global persistence of COVID-19 and the likelihood that the global recession will extend well into 2021 may shift priorities again, however.

Many observers are optimistic about growth prospects in the advanced countries and expect positive spillovers to emerging-market and developing countries. I am less optimistic. If my pessimism turns out to have been well founded, debt relief will again rise to the top of the global policy agenda. When it does, policymakers, their advisers, and analysts should remember the lessons of the 1980s. Debt stock reduction, if it occurs, will not be achieved quickly by many countries at the same time and will have to be subsidized.

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