$24.3 billion; in 1987, it fell to only $0.1 billion in the first three quarters.[5]

Various financial plans have been advanced to resolve the ongoing LDC debt repayment and economic growth problems. The proposals are divided between plans favoring an increase in lending to buy time and to finance structural reforms, and plans favoring a reduction in debt that is compatible with the debtor's ordinary servicing capacity. No matter how the current LDC debt and economic growth problems are managed, in the long run the difficulties encountered in enforcing international loan agreements seem likely to limit lenders' confidence in the likelihood of complete repayment.

The debt servicing difficulties of the past several years have increased lender's perceptions of risks to such a degree that a resumption of international lending may require basic and complicated structural changes in the framework of lending itself. Making these changes will prove to be very difficult, but if the volume of lending could be increased as a result, then both borrowers and lenders would benefit accordingly.[6]

Creditor and debtor nations will continue to struggle with their debt resolution efforts for many years. Parties on both sides will undoubtedly search for new ways to prevent overborrowing and overlending from repeating. They will also continue to calculate the costs and benefits of defaults on current obligations, and act accordingly.

■ Footnotes

1. See IMF Staff, *Recent Developments in External Debt Restructuring* (Washington D.C.: IMF, 1983, 1985), Occasional Paper, No. 25, 40.

2. Anatole Kaletsky is probably the first person to use the term "conciliatory default." Refer to the discussion of the costs of default in his book, *The Costs of Default* (New York: Priority Press Publications, 1985).

3. See Gary C. Hufbauer and Jeffrey J. Schott, *Economic Sanctions in Support of Foreign Policy Goals* (Washington D.C.: Institute for International Economics, 1983).

4. See "Brazil's Reversal of Debt Strategy," New York Times, February 22, 1988.

5. See IMF Staff, International Capital Markets (Washington D.C.:IMF, 1988), World Economic and Financial Surveys Series.

6. Various sanctions can deter defaults and enable lenders to extend credit to developing countries. See Jonathan Eaton and Mark Gersovitz, "Poor Country Borrowing in Private Financial Markets and the Repudiation Issue," Princeton Studies in International Finance, No. 47, June 1981.

Chien Nan Wang is an economist at the Federal Reserve Bank of Cleveland. The author would like to thank John Davis, William Gavin, Owen Humpage, Mark Sniderman, E.J. Stevens, and Walker Todd for helpful comments.

The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

Federal Reserve Bank of Cleveland
Research Department
P.O. Box 6387
Cleveland, OH 44101

BULK RATE
U.S. Postage Paid
Cleveland, OH
Permit No. 385

Address Correction Requested:
Please send corrected mailing label to the Federal Reserve Bank of Cleveland, Research Department, P.O. Box 6387, Cleveland, OH 44101

ISSN 0428-1276

ECONOMIC COMMENTARY
Federal Reserve Bank of Cleveland

The Costs of Default and International Lending

by Chien Nan Wang

During the past few years, a number of less developed countries (LDCs) have had difficulty repaying their foreign debt. Sometimes payments have been suspended or delayed—making it necessary for debtors and creditors to renegotiate or reschedule loan payments. These problems have raised questions about the costs and benefits of different types of debt repayment negotiations and their implications for the future of international lending. This article investigates these questions.

In August 1982, Mexico announced that it was unable to service its nearly $80 billion foreign debt. Brazil, Argentina, Venezuela and other debtor countries soon announced their own debt-servicing difficulties.

Initially, it was feared that these borrowers might flatly refuse to repay their debts, thus repudiating their loan obligations. Because debt repudiation could severely hurt both creditors and debtors, the threat became the focus of what became known as the 1982 less-developed-country (LDC) debt crisis.

Between 1983 and 1986, creditors, debtors, and the International Monetary Fund (IMF) generally were able to work together to manage the debt problems, keeping interest payments on schedule by restructuring old loans and by making new loans in what can be described as a process of "cooperative interruptions."[1]

However, in 1986, Peru limited debt-service payments to not more than 10 percent of its export revenues. More strikingly, in February 1987, despite an ongoing effort to reschedule and refinance its debt, Brazil unilaterally delayed interest payments. In addition to Brazil, seven other Latin American countries, together with several smaller African countries, delayed interest payments in 1987. However, as will be discussed later, most of these interrupted payments were renegotiated, with interest payments resuming within a year, through a set of arrangements that has been described as a "conciliatory default."[2] Earlier this year, Brazil again announced several measures designed to delay the repayment of its debts.

Conciliatory default, cooperative interruptions, and outright debt repudiation can each be regarded as a type of debt servicing failure—that is, of a borrower's failure to service and repay its debt as originally specified in the loan agreement. There are important distinctions among the types of debt-service failure. Outright repudiation is the most extreme form of noncooperative default, and occurs rarely. In contrast, both conciliatory default and cooperative interruption are characterized by important elements of mutual agreement, or at least acceptance of the need to modify the original loan agreement. Of these two, the latter procedure is the most amicable. However one describes the process, the international debt-service difficulties of recent years raise questions that are worth exploring.

First, any type of debt servicing failure can hurt creditors and debtors alike. Creditors see their capital eroded, threatening their solvency; debtors damage their own creditworthiness, perhaps impairing their ability to borrow again. Given such significant costs, how do borrowers choose the appropriate response to their debt servicing problems?

Second, international lending to LDCs currently is declining. Declining capital inflows make it even more difficult for LDCs to service their debts and to finance their growth. Considering the huge amount of old debt and the uncertain prospects for future repayment, it is difficult to restore lenders' incentives to make new loans. Even if overall indebtedness were reduced to a more manageable level, for example, how could lenders really be confident that debtors would not default again in the future? Finally, do widespread problems with international debt service reveal a fundamental weakness in the structure of international private lending that does not exist in purely domestic lending?

The key to answering these questions centers on the benefits and costs of default in its various forms. This *Economic Commentary* investigates these aspects of default, using the current LDC debt problem to illustrate several issues that seem especially important for future international lending.

■ The Benefits and Costs of Default

International credit agreements involving the direct or indirect obligations of governments present the most difficult problems for creditors. The ultimate defenses for creditors against nonpayment —such as seizure of collateral and recourse to legal proceedings—are not fully available in international lending, so that repayment from sovereign debtors is not strictly enforceable.

A country may choose not to repay, even if it can. When unwillingness to repay motivates a sovereign debtor's debt-service decision, this decision is usually made after comparing the costs and benefits involved in a continuum of options ranging from timely debt service to extreme forms of default. One such option may be to alter the terms of repayment.

The primary benefit of altering the terms of repayment is the ability in the short run to save foreign exchange for domestic consumption and promotion of economic growth. The amount of foreign exchange saved is larger in repudiation cases than in conciliatory defaults because the former reduces the debt-servicing load for a longer period of time than the latter. While conciliatory default relieves or delays full debt-service payments for a period of time, cooperative interruption still assumes a certain amount of debt servicing for that period, thus reaping fewer benefits.

Debtors may also think that altering debt-service obligations will enhance domestic political tranquility. It is reasonable for debtors to believe that reducing debt service will permit increased domestic consumption and improve the resident population's immediate living standard. Altering the terms of debt-service agreements may help consolidate the political regime, particularly for countries with pressing demands for a higher living standard. The longer-run effect is less certain. The costs of default may make it impossible to maintain a higher growth profile that will improve the future living standard, although this will depend on the severity and the effectiveness of the creditors' sanctions.

Altering debt-service agreements, while perhaps economically and politically attractive, is not cost-free, however. The costs and benefits for the debtor depend importantly on a wide range of factors, including the ability to negotiate new terms with lenders. In extreme cases of unilateral default, the borrower often faces trade and financial sanctions that impede the ability of the debtor country to maintain its overall consumption level when its income is low and then to repay when its income is high. Profitable investment opportunities may also be lost, and trade credit may be reduced or eliminated. Trade embargoes imposed by the lender's government may cause severe damage to countries dependent on trade, which includes most major debtors.

Default may also result in seizure of a defaulter's foreign assets or exports. Sovereign immunity from foreign interference with commercial transactions once was a basic principle in international law. However, the 1976 Foreign Sovereign Immunity Act (FSIA) in the U.S. and the 1978 State Immunity Act (SIA) in the United Kingdom established the legal liability of foreign governments for their acts of a purely commercial nature.

FSIA and SIA are crucial statutes because most international loan contracts are signed under U.S. or British law. As a result, borrowing countries typically waive sovereign immunity in commercial loan contracts.

There have been several instances in which a sovereign defaulter's foreign assets were seized by creditors. In 1979, for example, Morgan Guaranty Trust Company successfully attached the Iranian government's stake in Fr. Krupp AG through the German courts. Also, in 1981, the Cuban ship I Congresso del Partido was seized by Chilean plaintiffs for a default by Cubazucar, the state sugar monopoly. In general, however, the relatively limited resort to seizure by creditors suggests that it is a useful option only in the most extreme circumstances of debt-resolution failure.

■ The Uncertain Costs of Default

Economic issues, such as debt repayments, are only one dimension of a country's overall relationship with debtors, so that it may be difficult to define the national interest of the creditor's country narrowly enough to impose sanctions. Disagreements may exist either between various interest groups within a creditor country or between creditor nations about whether or not to sanction a defaulter. For example, exporters, nonexporters, regional banks, and multinational banks within the creditor country may take different positions on proposed sanctions. Finally, economic sanctions, if imposed, may be of limited effectiveness, because trade and financial flows are multilateral. Factors such as these and others may operate to reduce the threat of default penalties from the debtor's perspective. If debtors regard efforts to alter debt-service terms as unlikely to provoke a strong response, they are likely to press forward with some initiatives.

It may also be a misconception to believe that all foreign economic interests would unite to cut off future loans to a defaulting country. A permanent interruption of debt service on medium-term bank debts, for example, would cut a country off from new medium-term bank loans for a substantial period. However, if the debt service interruption is either temporary or occurs within a framework of ongoing negotiation and of acceptance by the borrower of the need to resume debt service, then eventual renegotiation of the loan contract is likely to restore access to credit. In such a setting, the reactions of nonbank foreign traders, multinational direct investors, and providers of short-term, direct-trade finance to a defaulting country might not be as serious. Foreign equity investors could very well retain their equity intact, and trade credits might still be serviced.

Trade retaliation against a defaulting nation is another option available to creditors, although such restrictions are most effective when applied by the creditors' governments. Moreover, the impact of trade embargoes is often diluted by trade with other countries and triangular-trade arrangements through third-country firms.[3]

The effectiveness of legal sanctions against sovereign defaulters is also limited. Although the legal position of creditors against the sovereign immunity defense has been improved substantially since 1976, the practical remedies for creditors still are limited.

For example, the Act of State principle, an established tenet of U.S. law, prevents U.S. courts from passing judgment on foreign countries' actions in cases involving our national interest. Execution of judgment under the legal process also usually does not apply to foreign diplomatic, military, and central bank properties in the U.S. Private property of individual foreign nationals located in the creditor country also is usually protected. Finally, legal actions may be avoided simply because they diminish the debtor's incentive to renegotiate the debt.

The argument that sovereign nations can avoid or reduce the cost of altering the terms of debt sevice implies that the benefits of such efforts may often be greater than the costs. While outright permanent and unilateral abrogations of lending agreements are uncommon, cooperative interruptions and conciliatory default, as part of an ongoing effort to reduce debt-service obligations, have occurred often since 1982. However, the infrequency of outright debt repudiation suggests that both debtors and creditors saw benefits in renegotiation and new repayment terms.

There are two other factors that seem to be important explanations of the willingness of debtor countries to renegotiate new repayment terms. National pride and a sense of fairness often require making the necessary payments. However, a borrowing country may simply be unable to generate enough foreign exchange through export expansion, import reduction, or acquisition of new capital to repay its debts, thus becoming unable to make the capital transfer.

Both the reputation factor and the transfer problem have been important underlying factors in the default and repayment experiences following the onset of the LDC debt crisis. During this period, most LDC debtors tightened their belts in order to generate sufficient trade surpluses to service their debts, both for preventing sanctions and for maintaining their reputations.

After the 1982 debt crisis, extensive debt restructuring was negotiated, usually requiring debtors to adopt International Monetary Fund (IMF) adjustment programs. These restructuring packages included lowering interest terms and stretching out interest or principal payment schedules, which increased the benefits of interrupting the debt servicing in a cooperative way. The restructuring packages also included refinancing arrangements that lowered the costs of cooperative interruptions. Therefore, debtors, after examining the costs and benefits, did not choose repudiation.

■ Changing Situation

Recently, lending to LDCs has been shrinking. In 1983, new bank lending to developing countries was $34.3 billion; in the first half of 1987, new lending fell to $3.4 billion. Reduced lending reduces the benefits to debtors of debt service because not much new financing is likely to be forthcoming whether they repaid or not. Also, the longer that debt stalemates continue, the longer would the benefits of withholding debt service accrue to debtor countries for enhanced economic growth, living standards, and political stability. A probable result of these changes in the cost-benefit effect was the 1987 Brazilian interest moratorium. More than 10 other LDCs also delayed interest payments in the same year.

Brazil's interest moratorium did not last, however; Brazil and its creditors were able to negotiate lower fees and interest on restructured loans, and assemble new-money financing packages. The possibility that creditors would seek more extreme measures in order to maintain their reputation for debt-repayment enforcement also may have contributed to the reluctance of Brazil to remain in arrears.

For some countries in arrears, private medium-term financing virtually ceased, and short-term trade credits also declined. Peru, for example, has received few new agreements on short-term trade credits since its default. As for Brazil, it reportedly experienced difficulties in obtaining trade financing. (According to Brazil's Finance Minister, Mailson Ferreira da Nobrega, Brazil's 1987 interest moratorium was a mistake because it created new economic uncertainty and affected credit flows from abroad.)[4]

The bank trade credit loss for Brazil was estimated to be a moderate 20 percent. Once Brazil publicly expressed its intention to renew debt servicing, a record-high $82 billion restructuring package was assembled by Brazil's bank creditors. This event illustrates that, overall, the costs of debt service interruptions can be low as long as debtors show evidence of a cooperative attitude.

■ Conclusion

After the 1982 debt crisis, difficulties in securing debt repayment in the terms as originally agreed upon has emphasized the risks in international lending, and has contributed to a decline in lending. In 1983, involuntary bank lending to Latin America was $13.3 billion; it dropped to $2.0 billion in the first three quarters of 1987. In 1981, voluntary bank lending to Latin America was