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The Third World Debt Crisis*

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If the foreign debt problem of developing countries—especially the middle-income countries of Latin America—could be reduced to a contest of legal principles, expressed in Latin, it would pit the concept of *pacta sunt servanda* against the concept (or defense) of *rebus sic stantibus.*

Pacta sunt servanda—one of the basic legal principles underlying our social and economic systems, means that contractual commitments must be honored.

The concept of *rebus sic stantibus,* on the other hand, signifies that this principle may not apply when circumstances have substantially changed. As an argument related to the concepts of hardship and *force majeure* in domestic law, the defense of *rebus sic stantibus* was very fashionable when foreign concessions and mineral rights granted by colonial administrations were being challenged and re-negotiated by newly independent developing countries. It re-emerges now, in the mid-eighties, when the terms of loan agreements concluded in the days of easy money—especially the easy petro-money of the seventies—have become

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so onerous that major sovereign borrowers (and sovereign guarantors of private borrowing) can, or claim that they can, no longer live up to them.

Their posture is strengthened by two arguments, which may or may not be relevant in a conventional contract law model. One argument is based on the undisputed fact that some of the key circumstances which made the original commitments so onerous were within the exclusive control, that is within the discretion, of the creditor countries. This certainly applies in the case of the steep growth of interest rates attributable to unilateral decisions of the Federal Reserve and the monetary authorities of other Organization for Economic and Cooperative Development (OECD) countries. It may also be true, in a broader perspective, that creditor countries are responsible for the deterioration of the terms of international trade from which borrower countries derive the means to service their loans—that is falling prices for primary commodities, and protectionism with regard to manufactures and semi-manufactures, etc.

A second argument of many developing country debtors is that they accepted loans without knowing what they were committing themselves to. In other words, they argue that they (and their nationals) were the victims of aggressive salesmanship in the days when they were visited by hordes of foreign bankers with briefcases full of petro-dollars; some countries have used a related line of reasoning in declining responsibility for debt, including military debt, incurred by previous, authoritarian governments.

Whatever the legal relevance of these arguments, one might wonder—in retrospect—how sovereign borrowers came to accept floating interest rates as the norm in international financing, without any safeguards such as the "change of circumstances" clause customarily included in Eurodollar loans to protect the banking syndicates in the event of major market contractions. One might also wonder how a country like Costa Rica, for example, agreed to the "currency basket" formula insisted upon by the World Bank (presumably in the interest of its own treasury) so that, as a result of the drop in dollar parities, a twenty million dollar loan will now cost the country some thirty million dollars (Costa Rica's trade revenues being almost entirely tied to American currency). Quite obviously, the borrower had either negotiated blindly or, more likely, found himself in a very weak bargaining position. It would be very difficult, however, to conceive of a legal formula which would do justice to the parties in such a dilemma.

The fact is, of course, that the current debt crisis is not a contest among abstract, and overly simplistic, legal principles.

Lenders, especially commercial banks, cannot ignore, for instance,

that a rigorous application of the concept of *pacta sunt servanda* might kill a goose that laid, and may again lay, golden eggs. There is no doubt that debt servicing, under present terms, will mean the end of economic growth and thus open an era of social and political unrest in many of the developing countries. These countries are not only important banking clients (Citibank, for one, derived much of its 1988 profits from countries such as Brazil and Mexico), but are also key partners in a global economy upon which the well-being (jobs, export markets) of the lending countries continues to depend. What happened in Venezuela in February 1989, and might well happen in other Latin American countries, is clear warning.

In domestic law, creditors would protect their stake—including their stake in the future of their client-debtors, through reorganization and in extreme cases, in bankruptcy proceedings. There is no such institution—no chapter eleven—in international law when sovereign borrowers are concerned. The only avenue available is debt renegotiation and restructuring, ideally with the participation of multilateral financial institutions such as the International Monetary Fund (IMF) and the World Bank.

If insistence upon full compliance with the original terms of external lending may thus, in the present economic conjuncture, be against the long-term interests of creditors, unilateral action, for instance unilateral moratoria, based on the principle of *rebus sic stantibus* may also prove to be a double-edged sword for debtor countries which, like Brazil, Mexico, Argentina, Venezuela, Egypt, or the Philippines, depend on a continuing flow of external savings (new money) to maintain (or resume) their economic growth, ensure employment, diversify and modernize their economies, meet the basic needs of their population, and—ultimately—sustain a democratic form of government.

The dilemma in which both creditors and sovereign borrowers find themselves, unless the present debt crisis is resolved by negotiation rather than by confrontation (and I also mean legal confrontation) became very apparent in the course of a survey of external debt management carried out on behalf of the United Nations Development Programme, in which I participated in the latter half of last year; both the Bretton Woods institutions and the Commonwealth Secretariat assisted in this survey.

The picture we encountered—the *toile de fonds*—was a very depressing one, and remarkably consistent in spite of the differences among debtor countries.

Our survey covered both large debtors, whose debt is owed primarily to commercial banks, and other, generally smaller countries, whose

main sources of external financing had been in the form of official lending (bilateral or multilateral) and export credits subject to renegotiation in the so-called Paris Club. Needless to say, there is also a fundamental difference in the bargaining strength and posture of these different kinds of countries. On the one hand there are the large debtors (the Brazils, Mexicos, Philippines, Indonesias, or Argentinas), whose insolvency might have very serious repercussions in the financial community, and on the other hand there are the smaller countries (in Africa, or in Central America) whose default would cause only a minor ripple, but is feared mostly because it might constitute a precedent, or for other geo-political or security reasons which have little to do with economics.

As regards the debt crisis scenario itself, it came as no great surprise to find that by late 1988, all the debtor countries we visited, with the exception of Zimbabwe, Thailand, and Papua-New Guinea, were in a state of insolvency or pre-insolvency if one assumes that economic growth needs to keep pace with the increase of the population (and does not even consider the possibility of a rate of development sufficient to catch up, in the medium or long run, with the more advanced economies). The reasons for this inability to live up to external debt servicing obligations are no doubt in part endogenous: poor economic planning and fiscal management, unrealistic public investment policies, capital flight, and in some countries a hostile investment climate. It cannot be denied, however, that much of the fault lies with exogenous factors, that is with factors over which the debtor countries had no control: the dramatic rise of interest rates in international money markets, erratic exchange rate movements in the major currencies, deteriorating terms of trade, contracting export markets, and so on. And the fact remains, that for some years now more capital has flowed from the poor to the rich than from the rich to the poor, due in large part to debt amortization and interest payments.

Another common weakness resides in the debt management systems of debtor countries. More often than not, decision-making processes are slow and uncoordinated—usually involving the central banks, the ministries of finance and budgetary authorities, parliaments, as well as some of the large, autonomous public sector companies which tend to act as a state within the state. It is also striking that many debtor countries, with some exceptions such as Brazil, know very little about the structure of their external sovereign debt, and even less about the private debt which many of them have assumed or guaranteed under pressure from creditors. Debt recording and monitoring systems are gradually being computerized; however they are often fragmented, with parallel and

frequently incompatible systems being run by central banks, ministries of finance, economic or planning ministries, and budget offices. Characteristically, the data fed into them is too unreliable or too stale to allow significant analysis or projections.

The upshot is that too many debtor countries are unable to properly plan their external borrowing in the context of macro-economic, fiscal, monetary, and budget policies—that is to decide how much, where and when to borrow—and of course to manage their debt and debt portfolios. This is reflected in very substantial and avoidable penalties, commitment fees for unutilized or under-utilized special-purpose loans, as well as in exchange losses due to currency fluctuations.

Evidently, the weakness of debt management systems, and the fact that many debtors do not know the structure and composition of their liabilities, also inhibits their ability to negotiate or renegotiate with creditors. It comes as no surprise, then, that debtor countries have tended to take a reactive rather than a proactive stance in such negotiations. The absence of debtor country participation has been noticeable even for project borrowing from multilateral institutions such as the World Bank (whose loan projects—some of them not very viable—were often conceived by their own staff, and not by the borrowing country) as well as for many of the export credits now haunting some of the smaller borrowers, which are clearly attributable to the aggressive salesmanship of the exporting countries.

This reactive stance, in which the borrower responds to the proposals of the lender, often uncritically, instead of putting his own proposals on the table—is striking also in the broader context of loan or loan restructuring negotiations with the financial community at large, including the London and Paris clubs, the steering or coordinating groups of commercial banks, and the IMF. There are of course exceptions: Mexico is clearly one of them. But most other borrowers or debtors, large as well as small, tend to take a back seat in the negotiation process, especially when issues are couched in legal language. In fact, it has been their practice to rely on one of the four or five East coast law firms or London solicitor firms specializing in international financial transactions to negotiate and come up with the bulky loan documents and annexes which are then presented to the borrower or debtor for signature. There is nothing wrong, of course, in seeking the top legal and financial engineering talent where it exists. Nor can there be any doubt, however, that an active, intelligent participation of the client is of critical importance. In other words, a contractual obligation entered into with open eyes is more solid,

and more reliable, than one which is accepted blindly on the advice of one's lawyer.

It is not my intention to over-do this point: after all, I am also an attorney, and I am talking to an audience of distinguished lawyers. Concrete experience has shown, however, that sovereign borrowers have often given too little autonomous thought to some of the key provisions of loan or loan restructuring agreements. These key provisions include clauses relating to default; conditionalities and covenants, especially the *pari passu* clauses and negative pledges customary in loan agreements, and commitments on counterpart funding or in-kind counterpart contributions in project loans; "change of circumstances" clauses benefitting the lender or the banking syndicates; clauses relating to disbursement and amortization schemes and schedules, including their currencies or currency mixes; onerous provisions under which the borrower assumes the responsibility for handling and legal fees of both parties, and so on. There are also the clauses relating to the settlement of disputes, choice of laws and choice of forum, and questions of sovereign immunity. In general, however, these are well understood by borrowers, at least Latin American borrowers highly sensitive to anything that might touch on their formal sovereignty.

So much, then, for the position of the debtor countries. It is not, obviously, a position of great strength and this by itself should be seen as a danger signal indicating that under the pressure of public opinion debtor countries may be tempted to take unilateral action rather than to sit at a negotiating table in what they perceive to be a weak bargaining posture.

This brings us, then, to the stance taken by the creditor community. Six months ago, it was still a stance marked by a considerable degree of righteousness and inflexibility. There were some exceptions: the Japanese proposals submitted but not fully discussed at the Bank and Fund meeting in Berlin; the Mitterand offer of debt forgiveness to some of the least developed countries, an offer reflected in the "*a la carte*" approach adopted at the Western presidential Summit meeting in Montreal in the summer of 1988. This latter proposal was intended above all for the benefit of African client-states of the European Economic Community (EEC), while the Japanese plan was primarily targeted at the large debtor countries of Latin America. Among commercial banks, there was the liberal line taken by the Deutsche Bank in favor of debt relief.

A new perspective may now have been opened by the recent Brady plan, unveiled in early March, 1989. While its operational implications and scope are not known in detail, it seems to go in the direction of

negotiated debt relief. Except for this, however, the creditor community, official as well as commercial, appears to have maintained its position, in what seems to be a dangerous exercise in collective brinkmanship.

A few facts illustrate the rigidities—but also possible new openings—in the creditor community:

— It is very difficult, for constitutional reasons, to restructure the debt owed to multilateral financial institutions such as the World Bank, the IMF and the regional banks, and, as matters stand at present, to expect any debt forgiveness or relief from them.

— Something should be said here about the role of the much-maligned IMF. In my years in Latin America, I have at times had to complain about the arrogant, highly visible stance taken by some of the Fund's negotiating or supervisory missions. This, however, is now changing and the Fund, under its new managing director, seems to be more open to a real dialogue with debtor countries. If the Fund, and the letters of intention on which its lending is based, is used—often quite demagogically—as the scapegoat for all evil pressures from the creditor community (including pressures derived from the 1988 Omnibus Trade Act, or conditionalities attached to World Bank loans), it must be recognized that the fund, as presently mandated, cannot but play a disciplinarian and watch-dog role in connection with the short-term support which its very limited financial basis allows it to provide.

— There is increasing talk of new functions that might be assumed by multilateral financial institutions in the sense of debt relief or to facilitate new money flows (e.g., by absorbing some of the Libor or interest charges, or by playing a leading role in debt conversion or securitization schemes).

— As regards the Paris Club, its approach has been, and remains, to rephase or roll over the debt, on a country by country and generally short term basis, thus postponing the day of reckoning rather than providing debt relief.

— As regards the commercial banks, particularly those exposed in the major debtor countries—Brazil, Mexico, Argentina, Venezuela, Indonesia, and the Philippines—they maintain a tough line against debt relief, but are now, in fact, in a position to absorb the book losses which would be caused by such relief. Many of them have already played the secondary markets, and overall, few if any of the large banks have lost money on their

developing country sovereign borrowers, who remain important clients for future lending.

At this point, we should ask ourselves what this complex scenario means for the future and what it means for the law and for a legal profession capable of playing a creative role and solving conflicts of interest without unnecessary confrontations.

My own guess, but I am of course not a licensed fortune-teller, is less pessimistic than what the comments made in this brief account of the debt crisis would seem to warrant. Venezuela notwithstanding, there is some hope that both the financial community (perhaps even led by the commercial banks) and the sovereign borrowers from developing countries will give some ground and agree on a negotiated way out of the present debt and development dilemma. This is possible as long as it is made clear that debt forgiveness (as opposed to more reasonable, and more secure terms for future lending) is an exceptional measure of crisis management, and will not become a chronic feature in sovereign borrowing. This last proviso is essential. If debt forgiveness were to become a permanent feature of Third World lending, financial flows would quickly dry up, or Libor rates would skyrocket in anticipation of future discounts.

One of the reasons for optimism is that even in the United Nations there seems to be a new mood, quite different from the confrontational and simplistic rhetoric of the seventies. Developing country governments, even socialist governments, have become quite pragmatic, especially in economic matters. East-West tensions no longer polarize the Third World by aggregating client groups along geo-political or ideological lines. Middle powers, both in the OECD camp and among developing countries, play an important mediating or buffer-role between the super-powers. And all in all, the international community has become much less manichean than it was only a decade ago.

In terms of the debt crisis (and I would stress again that it should be seen not only in narrow financial terms, but also in the perspective of global development processes—social, political, as well as economic), I would suggest the following elements of an optimistic, but still credible future scenario.

In the first place, it is evident that there exist a number of palliatives which can reduce—even if not eliminate—the current debt burden. They include a variety of securitization and other conversion schemes (debt-equity swaps, debt-for-nature swaps, etc.) which may alleviate the debt crisis, especially for smaller countries: Bolivia, Costa Rica, and of course Chile are cases in point. Other palliatives, and they are no more than

that, are the rescheduling and refinancing packages offered under the Paris Club or by bilateral lenders.

A more definitive approach—the only one which can presumably solve the debt crisis to the satisfaction of lenders and borrowers, and of the societies they represent—resides in negotiated debt restructuring that would involve debt relief, assurance of new money flows and, to that end, a new supporting role for the multilateral financial institutions. This seems in fact to be the line the Brady plan takes. There are, of course, many questions that remain open. Will the commercial banks be prepared to take a long-term rather than an orthodox short-term view? Will their governments support them by appropriate regulatory and tax policies and by trade policies giving developing countries the means to service their future debt? Will debtor countries under pressure from public opinion in highly volatile political settings be prepared to adopt and implement—without undue and admittedly counterproductive external pressures—the economic policies needed to attract new money, whether in the form of loans or of investment? Will they be able to keep the social cost of adjustment measures needed to that end within bearable proportions, and will external assistance (financial and technical) be available to them? Finally, will debtor countries set up recording, monitoring, and management systems capable of ensuring effective servicing of their debt?

As regards strategy, should debt restructuring negotiations with commercial and official lenders be global or, as might seem more realistic and as creditors would no doubt prefer, should they be undertaken on a debtor-country by debtor-country basis? Will debtor countries themselves be prepared to negotiate as a group? Or will they at least agree to exchange experiences and views, even informally, in order to achieve better concertation and provide mutual support in facing a tightly knit and very well organized creditor community—real creditor cartels—in the so-called Paris and London Clubs?

Whatever the answers to these questions, it is evident that it is in the area of debt restructuring and in the negotiation of new money flows that the most important legal issues will arise, and the legal profession will find the greatest opportunities to play a constructive role. Long-range, it is to be hoped that this role will not remain the exclusive prerogative of the highly experienced and qualified East Coast and London firms who have traditionally advised sovereign borrowers. Their expertise with international capital markets is important, but it is essential—and I cannot stress this point enough—that the field should be broadened, if for no other reason so as to avoid potential conflicts of interest, and that the legal profession in the debtor countries themselves (including the lawyers

and financial engineers on the staff of debtor governments) play a more active part than in the past in representing the borrowers' position in debt negotiations. A number of schemes are being developed to that end: courses in negotiation strategy and tactics offered in law schools; upgrading and debriefing of negotiating teams; internships with specialized law firms and the legal departments of lending institutions, and so on. It would go beyond my present purpose, however, to dwell on these operational perspectives, interesting though they may be.

In conclusion, I am afraid that I may have said both too much and too little in what was intended to be a brief keynote address. It will thus be for your seminar to fill in gaps, deepen some enquiries and formulate conclusions which I would not, on my own, have the capacity and courage to place before you. If I were nevertheless to try to close with a lapidary statement, it would say that the law and lawyers were needed not to solve the debt crisis of the nineteen-eighties, but rather to avoid its recurrence by giving better advice to sovereign borrowers and, perhaps, to lenders as well.