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CONFRONTING THIRD WORLD DEBT: THE BAKER AND BRADLEY PLANS

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INTRODUCTION

The international debt of developing nations now exceeds $1 trillion. Simply to pay the interest on this in 1987 will cost $68 billion.[1] Understandably, failing to properly manage this situation raises serious problems that affect not only developing countries but major industrial powers as well. High inflation, high unemployment, and reduced standards of living are just some of the possible consequences. In response, Treasury Secretary James A. Baker, III unveiled an initiative to ameliorate debt burdens on October 8, 1985. The following June, Senator William Bradley, the New Jersey Democrat, introduced a counterproposal to correct failures he saw in the Baker initiative.

Historically, there have been two principal methods of dealing with the immediate problems of unserviced debt: increased lending or writing-down the debt.[2] Baker chooses the former, Bradley the latter. Both the Baker and Bradley plans have specific weaknesses and strengths. In particular, the Baker proposal has as its central feature lending new funds to indebted Third World nations, thus creating more debt. Bradley sees this as a fundamental flaw; he wants to reduce developing nations' debts. Yet the manner by which Bradley

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1. International Monetary Fund, World Economic Outlook, October 1986, p. 108.

2. Recently, a third approach, debt conversion, has become more significant. Essentially, this entails swapping bank debt for equity positions, long-term bonds, or other assets.

would forgive debt and debt service also has problems regarding its practicability, legality, and the possible perverse incentives it would create for debtors.

While neither initiative, as originally presented, is the answer for a sustainable solution, they may lead to one. Baker and Bradley, in discussions with this author, stressed that their proposals are not concrete plans but general guidelines designed to be debated and modified. Thus the real test of their merits does not rest solely on the stated specifics, but on whether they lead to a long-term solution--economic growth and a gradual, orderly reduction in debt service burdens. In fact, what is very welcome about both plans is their emphasizing that developing countries must change their economic policies and environment as the necessary condition to easing debt service problems. Translating this into actual growth-stimulating policy changes, at reasonable costs, would be a major accomplishment if achieved.

The Baker and Bradley initiatives also pose dangers. Some Third World countries, for example, hail the plans as vehicles for increased resource transfers. Others see the plans as mechanisms for relief from the responsibility of past excessive spending. What is particularly troubling is that invoking the rhetoric of economic growth has been used in the past to justify and continue unproductive wealth transfers. And after the wealth has been transferred, all the talk about strategies for economic growth has remained just talk with few policy changes. Neither the Baker nor Bradley proposals ensure against a repetition of this. The proposals also further politicize the sensitive problem of international debt. The danger, as in the past, is that short-term political solutions likely will be only band-aids for serious problems, leaving larger, more explosive difficulties, such as massive debt default, for the future.

In the four years since Mexico's debt service moratorium signaled a renewal of problems with international lending, there has been a proliferation of band-aids: multiyear rescheduling agreements, "standby," "bridge," "emergency," and "quick-disbursing" loans and credits from the International Monetary Fund, the World Bank, the Bank for International Settlements, the U.S. Treasury, and the Federal Reserve, among others. The value of completed reschedulings amounted to $52 billion in 1983, $13 billion in 1984, and a record $93 billion in 1985.[3] While the short-term stabilizing effects of such arrangements temporarily have prevented an international financial crisis, they have not addressed the root causes of the problem. This can only be done by reversing the harmful economic policies in developing countries that prevent growth and use resources inefficiently.

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3. World Bank, World Debt Tables, 1985-1986 ed., p. x.

The Baker and Bradley proposals have focused much attention on the seriousness of the debt problem. If the specific components of each plan were all that resulted, without significant Third World policy reforms, the problem would be made unambiguously worse. Since such policy changes are difficult to achieve, this unhappy result is not remote. The Baker and Bradley initiatives, however, are flexible; the specifics are being modified as the debate continues. Thus their long-term impact could be positive. They could prompt, for example, market solutions to debt service burdens based upon equity investments and the real value of loans.

THE INTERNATIONAL DEBT PROBLEM IN PERSPECTIVE

The debt problem exists because Third World countries have not used the funds that they borrowed for endeavors productive enough to generate the income to pay the interest and principal of the debt. Instead, significant amounts of the loans were used for outright consumption, corruption, and graft, investments in creditor nations (sometimes called "capital flight"), inefficient state-owned enterprises, financing untenable government economic policies, and investment projects of low quality. In short, for decades, valuable, borrowed capital was not allocated through market-oriented forces.

Hence, the current problem was only precipitated--not caused--by a series of external factors beginning with the 1973-1974 oil shock. The recycling of petrodollars fueled high rates of growth in the non-OPEC developing countries through 1981, but the growth was engineered through expanding current-account deficits, a rapid increase in bank borrowing, and declining growth in reserves.

Throughout the 1970s, loan maturities contracted and international finance became based largely on periodic debt rollover. The 1979 oil shock sparked another recession and rising nominal interest rates. Average costs on medium- and long-term, floating-interest disbursed debt rose from 8.4 percent in 1978 to 17.4 percent in 1981, the year it peaked.[4] As a result, while income was declining, interest payments for all developing countries more than tripled from $20.7 billion in 1978 to $71.7 billion in 1982.[5]

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4. Organization for Economic Cooperation and Development, Financing and External Debt of Developing Countries, 1983 Survey (Paris: OECD, 1984), p. 11.

5. They remained high thereafter at $68.1 billion in 1983, $75.1 billion in 1984, $73.6 billion in 1985, $70.3 billion estimated in 1986, and $68 billion projected for 1987. World Economic Outlook, op. cit., p. 108.

Export growth, hindered by falling commodity prices, could not keep up with the growing debt service burden. With the 1982 Mexican debt-servicing moratorium, banks stopped lending new money to much of the Third World. As a result, many debtor countries soon became illiquid.

At the end of last year, the total liabilities of all developing countries exceeded $1 trillion. The World Bank reported in 1985 that the total external liabilities of the 107 countries under its Debtor Reporting System reached $865 billion. Long-term debt (excluding the use of IMF credit) was estimated at $708 billion.[6] This debt has been growing faster than total liabilities as reschedulings have consolidated short-term debt.

The fifteen heavily indebted countries targeted for special attention by Baker[7] have a total debt estimated by the IMF of $431 billion--almost half the debt of the developing world. Brazil, Mexico, Argentina, and Venezuela are the four heaviest borrowers with a total debt of $291 billion in 1985, of which 88 percent was owed to private creditors.[8]

Since 1982-1983, the rescheduling strategies and other palliatives have depended almost solely on huge trade surpluses, which many debtor countries were able to generate from their economies. As a condition for obtaining IMF funds, maintaining a positive trade balance was a key prerequisite. Indeed, Brazil and Mexico, the two largest debtors, even exceeded IMF targets, each achieving a $12 billion trade surplus in 1984, much higher in relation to GNP than Japan's surpluses.[9]

Ironically, this has imposed a high cost on the U.S. The American merchandise trade balance with Latin America swung from a $3.7 billion surplus in 1981 to a $15.3 billion deficit in 1985. Trade in services

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6. World Bank, World Debt Tables, 1985-86 ed., p. ix.

7. Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

8. World Debt Tables, 1985-1986 ed., p. xxv.

9. Anatole Kaletsky, The Costs of Default (New York: Twentieth Century Fund, 1985), p. 2; the author gives Japan's trade surplus in 1984 as $30 billion, or 2.3 percent of GNP; he figures that Brazil's $12 billion surplus is 5.6 percent of GNP; and Mexico's $12 billion surplus is 9.4 percent of GNP.

fell from a $17.5 billion surplus to only an $8 billion surplus during the same years.[10] U.S. farm exports to Latin America have tumbled from $6.9 billion in 1981, the year they peaked, to $4.5 billion in 1985.[11]

In sub-Saharan Africa, though the gross external debt is smaller, by most measures the situation is worse. Long-term public debt outstanding at the end of 1984 was $57 billion.[12] But over the past decade, thirteen sub-Saharan African countries have rescheduled their debt more than once. Togo and Zaire rescheduled seven times each in 1975-1985; Liberia, Madagascar, Senegal, and Sudan each rescheduled six times. Niger and Sierra Leone rescheduled four times each; the Central African Republic, Ivory Coast, Malawi, and Zambia rescheduled three times; and Uganda two times. The thirteen nations face projected debt service in 1985-1987 at levels exceeding what they actually paid in 1982-1984 by an average of 169 percent. These chronic reschedulings are an indication of serious, endemic dysfunctions in many African economies.

Somewhat ameliorating the bleak picture is the fact that most debtor nations are also creditors and hold equity in developed countries. In addition debtor nations, in theory, might cause to be repatriated some of the billions of dollars in assets that their citizens have been transferring abroad. Morgan Guaranty Trust estimates that, for the ten major Latin American debtors, such capital flight totaled $30.8 billion for the 1983-1985 period.[13] Had this money stayed home, debt burdens would have been reduced considerably.

THE BAKER PLAN

At the 1985 IMF-World Bank Meeting in Seoul, Korea, Treasury Secretary Baker launched his "Program for Sustained Growth" for the largest debtor nations. The program contained three essential elements:

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10. Graciela Testa-Ortiz, "Latin American Debt: Flirting With Disaster," Economic Outlook, U.S. Chamber of Commerce, October/November 1986, p. 16.

11. U.S. Congress, Joint Economic Committee, "The Impact of the Latin American Debt Crisis on the U.S. Economy," staff study, May 10, 1986, p. 6.

12. World Bank, World Debt Tables, 1985-1986 ed., p. xxvii; data on short-term debt are scant.

13. Morgan Guaranty Trust Company of New York, World Financial Markets, February 1986, p. 6.

1) the adoption by debtor nations of comprehensive macroeconomic and structural policies to improve growth and reduce inflation;

2) a continued central role for the IMF, in conjunction with increased and more effective structural adjustment (policy-based) lending by the multilateral development banks; and

3) increased lending by the commercial banks in support of debtors' reform efforts.

Baker identified fifteen major debtors in the developing world and called for a $29 billion capital infusion over a three-year period to spark growth. Commercial banks were to provide $20 billion in new loans: $7 billion from the U.S. banks and $13 billion from non-U.S. banks. Multilateral agencies, particularly the World Bank and the Inter-American Development Bank,[14] were to provide $9 billion--doubling their present rate of lending to these countries--primarily by increasing structural adjustment lending to induce and finance domestic policy reforms, sector lending (often for agriculture), and "cofinancing" with the commercial banks. All of the new money under the Baker Plan can be considered policy-based lending, available if the recipients agree to carry out such structural reforms as trade and investment liberalization, tax reform, budget cuts, elimination of government subsidies, minimum wage cuts, large-scale privatization, and the development of domestic capital markets.

Baker summed up his plan in telling The Heritage Foundation that "increased financing not only will ease current debt servicing difficulties, but will facilitate and support domestic policy changes to increase economic growth."[15]

THE BRADLEY PLAN

In June 1986 at a conference in Zurich, Senator Bradley launched his alternative initiative based on debt service relief rather than new lending. He proposes that the commercial banks and major creditor countries convene a "trade relief summit" to be held annually for the first three years of the new round of the multilateral trade talks under the General Agreement on Tariffs and Trade (GATT). Debt and interest rate relief would be negotiated and tied to trade concessions, which the developing countries would make in the GATT talks and other structural reforms.

14. Ten of the fifteen major debtors are Latin American countries.

15. Interview, December 5, 1986.

Bradley wants the relief packages tailored to the needs and commitments of each country, claiming that, while the reforms should "come from within," they should generally liberalize trade, reverse capital flight, increase internal investment, promote economic growth, and enjoy broad internal political support.[16] This plan also aims at the Baker Plan's fifteen major debtors. As "only targets" for the total value of yearly relief packages that the summit would offer, Bradley suggests:

- o 3 percentage points of interest rate relief for one year on all outstanding commercial and bilateral loans to eligible countries;
- o 3 percentage points write-down and forgiveness of principal on all outstanding commercial and bilateral loans to eligible countries; and
- o $3 billion of new multilateral project and structural adjustment loans for eligible countries.[17]

Each year, the value of a country's relief package would depend on its performance vis-a-vis its promised reforms over the previous year. Bradley told The Heritage Foundation that "these relief packages must be on a multilateral basis--with all creditor countries and banks signing on--so that no bank or country would obtain benefits while not participating." He also calls for a regulatory review board to consider the necessary changes in bank regulation and interpretations of accounting rules.

According to Bradley, his plan "would make economic growth more probable in an environment with stringent political constraints." He feels that Third World growth will lag until new incentives are created for government officials to promote necessary policy reforms. Bradley believes that his plan does this by "giving inducements, such as debt write-downs, that could prompt the leaders of debtor nations to take the political risks necessary to restore growth." He also states that "the debt problem provides the U.S. with an unusual opportunity to forge a new relationship with Latin America."[18]

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16. "A Proposal for Third World Debt Management," address given by Senator Bradley in Zurich, Switzerland, June 29, 1986, p. 4.

17. This would total $9 billion over the three years and be identical to the level of MDB lending called for in the Baker Plan.

18. Interview, November 1986.

THE POLITICS OF INTERNATIONAL DEBT

The Baker and Bradley initiatives suggest that international debt service problems are as political as they are economic. First, U.S. officials could pay a political price for seeming to have created an international economic situation in which U.S. exports decline and the U.S. banking system is weakened. U.S. officials also risk being blamed if debt burdens destabilize friendly regimes. On the other hand, there are political dividends for U.S. officials who "solve" these problems.

Leaders of debtor nations, of course, also face political pressures. There is little insolvency among debtor nations but primarily a political unwillingness to service debts. Most debtor nations own assets whose values far exceed their debts. These assets could be sold outright or used to raise equity capital. Additionally, altering domestic policies that are economically harmful but popular among voters also would help. But Third World leaders believe, sometimes correctly, that such solutions to the debt problem would be very difficult politically.

An overall resolution requires that developing nations' leaders must be able to accept and execute the changes that will lighten debt service burdens. While economically viable answers may not be difficult to construct, they may be difficult to sell to those constituencies whose unsustainably high living standards may be lowered. Indeed, one reason for the debt service burden is that borrowed funds have been used to placate powerful domestic constituencies.

The Baker Plan continues the lending, which prevents the problems from coming to a head for now, and it increases the dialogue on policy reforms for economic growth. This is a politically safe, short-term strategy, which does not fundamentally alter past prescriptions. It was initially greeted favorably as a bold, pragmatic approach, in contrast to the Treasury's inclination under Donald Regan to reduce the role of the international financial institutions in favor of market-oriented solutions.

The applause for the Baker Plan from bankers, the press, Congress, Third World leaders, international bureaucrats, and fellow Administration officials creates a danger: now something known as the "Baker Plan" must be perceived to work and be successful; otherwise the political capital it has created vanishes. The one clearly objective measure of "success" is the amount of new money that the multilateral development banks (MDBs) and commercial banks will lend the fifteen targeted debtor nations. Baker has many levers to assure such lending: through multilateral bank replenishment negotiations, enforcement of U.S. bank regulations, Administration positions on

proposed legislation, appointments, and other actions under the Treasury's purview.

More difficult to measure and to achieve, of course, will be how sincerely and energetically the debtor nations embrace growth-oriented policies. While dialogue on proper policy reforms has increased and some debtor nations have announced growth-oriented plans based upon privatization, controlling government spending, and other sensible policies, this has occurred in the past with little result. Thus the politics of the Baker Plan imply that increased lending is much more likely to result than the rest of the initiative.

The Bradley Plan's politics are quite different. Because Bradley is not a Treasury Secretary, he can take greater risks than Baker in challenging, in a fundamental way, the charades of international lending.

Bradley has very limited power to execute his plan other than by persuasion. Bankers and Third World government officials know that their day-to-day activities will not be affected by ignoring Bradley's proposal. Thus, the expectations and standards by which his initiative is being judged are much different than those for Baker. Even if none of Bradley's specific measures are adopted, his proposal will be viewed as successful if the debate moves in the direction of increased debt write-downs.

Neither proposal is a concrete plan but rather a dynamic approach. As such, each should be evaluated not only on its specifics but also on the general outline of solutions it offers. On the specific items, in fact, both Baker and Bradley show flexibility, a point they stressed to The Heritage Foundation. When Baker's proposal, for example, was criticized for concentrating on new debt flows over equity investments, he modified his stance by moving away from the original numerical lending targets and is now emphasizing more equity arrangements--particularly debt/equity swaps. Baker also has recently acknowledged that some debt write downs may be necessary. Alternatively, Bradley was criticized for apparently advocating broad brush debt forgiveness. He now more strongly emphasizes that his approach would proceed case-by-case and that not all countries would receive the same amount of debt forgiveness. If the end result is an easing of the debt problem through mechanisms flowing from the debate, their initiatives can be judged as successful. This is true even if the particulars of each contain serious flaws, which they do.

ASSESSING THE BAKER PLAN

Foremost among its attributes is its recognition that pro-growth conditions must be created in developing nations. The Baker plan provides debtor countries and their lending institutions with some

incentives to change past policies that have retarded growth and unproductively increased debt. These incentives are based on increased financial support from the major industrial powers. Additionally, Baker sends a strong signal to the developing world that the U.S. government recognizes their debt difficulties and is serious about solutions. This helps keep the problem manageable by defusing such notions as debtor cartels.

There are, however, serious problems with the Baker Plan. Among them:

1) It creates more debt and hence more debt service burdens. Example: The recent Mexican rescue package, hailed as the first test of the Baker Plan, provides for $12 billion in new lending. There is no guarantee that these funds will all be used productively to spur growth and reduce debt burdens.

2) There is no enforcement mechanism to ensure that policy reforms are actually carried out. New lending is forthcoming based upon policy dialogues and the presentation of reform plans. Once the lending begins, it could be several years before policy reforms would be completed. At that point, multilateral development bank and Treasury officials would be very reluctant to interrupt loan disbursements, even if little progress had been made.[19]

3) The rapid increase in lending required by the Baker Plan can retard developing nation policy reform. Because these nations know that they have been targeted as recipients of increased lending and because officials at international lending institutions have incentives to ensure that the loans are made, Third World officials can adopt a tougher attitude in loan negotiations to resist needed policy reforms that are politically unpopular with their constituencies.

4) The U.S. taxpayer will be getting a larger bill for international finance activities. There has been concern that, to gain converts for the Baker Plan, Treasury officials have obligated the U.S. government to contribute more funds to a number of international organizations.[20] The Baker Treasury now views the international financial institutions as playing a key role in debt management and wants to increase their resources. Recently the

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19. The Secretary believes that "the MDBs will be sufficiently motivated to enforce reforms by their desire to receive future capital replenishments from major donors such as the U.S." (interview, December 5, 1986).

20. This is evidenced, for example, by a recent Wall Street Journal article, which noted that "Secretary Baker has made bolstering the World Bank a central part of his initiative to solve the Third World debt problem, The Wall Street Journal, December 10, 1986, p. 4.

Treasury has acquiesced to: a new special International Development Association (IDA) facility for Sub-Saharan Africa; a new joint IMF-World Bank Structural Adjustment Facility; a surprisingly large "IDA 8" replenishment;[21] negotiations for a larger than expected Asian Development Fund replenishment; and even hints of a large capital increase for the World Bank and quota increase for the IMF. These positions represent a significant reversal of prior Reagan Administration policies.

5) The Baker Plan pressures commercial banks to use noneconomic criteria when making decisions to lend Third World countries money.[22] If economic reasons alone were considered, for example, a U.S. banker surely would hesitate to lend more money to a country like Mexico whose debt is selling in the secondary market for 62 cents on the dollar.[23] Baker remarked in June that: "We do not intend to twist the arms of U.S. banks or to support special government or World Bank guarantees in order to secure new lending."[24] Yet tales of government arm twisting abound, particularly with those regional banks that already have absorbed losses to dubious Latin loans.[25] Since the U.S. government is championing this new lending, bankers could believe that Washington or the multinational banks implicitly guarantee the loans; indeed as part of the Mexican package, explicit World Bank guarantees of commercial bank debt were given, contrary to Secretary Baker's statement.

6) It encourages and subsidizes exports which compete with U.S. products, particularly in agriculture, mining, and steel.

7) It encourages Structural Adjustment Loans (SALs). Though these attempt to finance and induce positive policy reforms, they also can prompt massive new lending of questionable value because SALs remove the necessity to find concrete projects to justify the loans.

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21. Indeed at a time of severe domestic budgetary problems, Secretary Baker has negotiated an approximately 40 percent increase in the controversial IDA.

22. Secretary Baker feels that "it is not uncommon or noneconomic for lenders to provide new lending with the purpose of turning poor credit risks into better credit risks" (interview, December 5, 1986).

23. It is widely presumed that the package will become the model for all the major Latin debtors. Already the Philippines and other debtors have indicated they expect packages similar to Mexico's--new money at 3/16 of a percentage point over Libor, the cost of obtaining the capital.

24. Remarks to the New York Financial Writers' Association, New York, June 17, 1986.

25. See, for example, "How Uncle Sam is Selling Banks on the Mexican Bailout," Fed Fortnightly, October 28, 1986, p. 13.

8) It emphasizes loans rather than other forms of capital, such as equity and bond financing.[26]

ASSESSING THE BRADLEY PLAN

Chief among Bradley's positive suggestions is that his plan squarely addresses the fundamental problem of excessive debt and seeks solutions that reduce debt and debt service burdens. It attempts to recognize the market value of the debt by adjusting face values downward to what the loans can actually be sold for.[27] This ends the charade that the loans are worth their face value and gets on with the business of allowing markets to explicitly deal with real numbers.

Most important, it recognizes, as does the Baker Plan, that increased economic growth is the only long-term answer to debt problems and seeks ways to stimulate growth and trade among all nations.

But the Bradley Plan also has its shortcomings. Among them:

1) It sets the bad precedent of loan forgiveness. This could harm financial markets in the long run, for it allows debtors capable of paying, but who do not wish to, off the hook. It thus reinforces incentives for the poor debtor nations not to repay loans.

2) Bradley's banker-debtor summits are not likely to yield pro-growth policy reforms. Commercial banks have little incentive to enforce conditionality on debtor nations. These banks' prime interest is ensuring that past loans are kept current, even at the expense of long-term economic stagnation in debtor nations.

3) If writing-down the loans forces the banks to accept large losses, this may be equivalent to a confiscation of the U.S. banks' assets. There are serious legal and constitutional problems involving infringement of the banks' property rights. Bradley implicitly recognizes this problem and indicates that he would seek to have the banks accept such losses voluntarily. "One possibility," he told The

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26. As noted earlier, Secretary Baker now indicates that "equity solutions are preferred over creating more debt. However because developing countries do not have in place the policy reforms which would attract equity investment, debt solutions are the initial focus of my initiative" (interview, December 5, 1986).

27. Argentina's debt is now priced at 67 cents on the dollar; Bolivia, $.08; Brazil, $.76; Chile, $.69; Ecuador, $.66; Mexico, $.62; Peru, $.24; and Venezuela, $.77. The Wall Street Journal, October 17, 1986.

Heritage Foundation, "is that shareholders will pressure management to write-down debt as this may increase their stock prices." This, however, is problematic, and there remains no convincing rationale as to how the write-downs would be achieved.

4) The summits would be difficult to organize with the 700 banks in 50 countries that represent the private creditors. Would the small, regional banks, for instance, settle for representation by the big, money center banks they may distrust?

5) Few of the countries on Bradley's list are in such an insolvent position that debt forgiveness should be considered appropriate.

6) Will current banking regulations allow orderly write-downs as Bradley seeks? Moreover, will the write-downs increase expenses for other organizations, such as the FDIC?

CONCLUSION AND RECOMMENDATIONS

The Baker and Bradley initiatives have attracted considerable attention to the debt problem. A welcome new emphasis on Third World economic policy reform has begun. Yet there are flaws in their specific proposals that would exacerbate the situation. Baker would allow, for instance, overall levels of debt to continue to increase with active prompting of the Treasury Department. And Bradley would seem to encourage some debtors to doubt that they ever will have to repay.

The exact details of the two plans, however, have not been cast in stone. Discussion and modifications have occurred. In their discussions with The Heritage Foundation, both men indicated that their approaches are flexible. Thus, the process that they have started may move toward a reasonable solution. Indeed, this has already occurred. Innovative market mechanisms are arising which are turning debt problems into market opportunities. What Baker, Bradley, and other politicians focusing on this issue need to do is to build on these initiatives by encouraging more market solutions.

One innovation, which both Baker and Bradley seem willing to consider incorporating into their plans, is what is generically called debt conversion. It promotes private sector investment in developing nations while lowering their aggregate debt. A market for debt conversion began to emerge about three years ago out of the "secondary market" in developing country debts. This involved commercial banks trading--or swapping--their Third World loans at a discount. In a sense, this is no different than any other secondary market for loans. Soon some debtor countries recognized that they could benefit

from this. By allowing either their own citizens (through agents) or foreign investors (usually multinationals) to buy the discounted debt[28] and present it to the central bank for par or near-par value in local currency, Third World countries could attract foreign private investment and the return of flight capital. When the foreign investor buys the debt, the local currency he eventually receives is used to finance plant expansion or invest in government bonds or for other agreed upon investments.[29] There are many forms the exact transactions can take and the process is becoming well known as debt swaps.

Chile and Mexico have made the most conversions to date. Other debtor nations are looking into the swaps.[30] Both an open, market-oriented investment climate and a revision of foreign exchange and foreign investment regulations are necessary to attract the funds. Chile made major modifications in its foreign exchange code in 1985, and this has become a model that others have been examining. Chile converted about $600 million through June 1986, and if the current trend continues, could have $2 billion--about 10 percent of its foreign debt--converted within two to three years, according to a recent World Bank study.

There are, however, many legal, accounting, and public policy problems to be addressed before this market can flourish. In the debate over the Baker and Bradley initiatives, some of these issues are being clarified and resolved.

Both the Baker and Bradley initiatives have strengths and weaknesses. They make a valuable contribution to the Third World debt problem by linking the debt burden with the debtor nations' reform of their economic policies. The goal of both Baker and Bradley is to stimulate the economic growth that will produce the revenues to service and reduce the debts. Baker and Bradley also are giving impetus to financial markets to seek their own solutions.

It is troubling, however, that Baker encourages more debt and that Bradley too easily grants debt forgiveness. By doing this they weaken the leverage they need to force the policy reforms that they seek. Serious concerns also exist about the costs and efficiencies of

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28. Selling at, for example, 70 cents to the dollar for Chile.

29. To stem inflationary pressures, the new assets cannot be highly liquid short-term investments. In addition, some restrictions are usually placed on the pace of repatriation of this capital.

30. According to Secretary Baker, however, only six of the fifteen countries on his list even allow for debt swaps.

Baker's desire to increase the resources of the multilateral development banks.

The challenge to Secretary Baker and Senator Bradley--and to U.S. policy makers--will be to ensure that their plans actually spur overdue policy changes in the Third World. Baker and Bradley will have failed if all they accomplish is to apply one more bandaid to the deep wound of Third World indebtedness.

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