Economic Reform and Debt Relief in Eastern Europe: Lessons from the 1980s Debt Crisis[1]

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The primary thing that the creditors should learn from the debt crisis of the 1980s is that there are more important things in life than continuing to have debt serviced on the basis of the original contractual terms. That was hardly their attitude when the debt crisis broke in 1982. Walter Wriston's dictum that "sovereign countries do not go bankrupt" was the text of the time, and there were certainly banks that had acted on that dictum and that would therefore have been endangered had any large volume of sovereign debt gone unserviced. Hence enormous efforts were made to overcome the free rider problem to an extent sufficient to reschedule existing debt and provide enough "new money" (i.e. to recycle enough of the interest without formal interest capitalisation) to keep the debtors current on at least their interest obligations. These efforts succeeded in postponing the day when it was necessary to acknowledge that the debts were not worth 100 cents on the dollar, but the cost to the debtor countries ("the lost decade") was high.

In the first part of this paper I discuss three factors that helped shape the initial debt strategy and describe how those were eroded over time. The next section of the paper summarises what seems to me the best available explanation of the logic of the Brady Plan and the extent of debt relief that it provided. The final section discusses policy implications for Eastern Europe (interpreted broadly to encompass Central Europe as well as the former Soviet Union).

I. THE BASES OF THE INITIAL DEBT STRATEGY

The initial insistence that debt should be fully serviced whatever the cost to the debtor was presumably motivated principally by the perception that a number of major banks – primarily, though not exclusively, in the United

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States – would have been threatened with bankruptcy had there been any major interruption in debt service. Given fears that debt repudiation might prove contagious ("moral hazard"), this concern translated into an attempt to try and maintain service by all debtors, even those too small to have any individual systemic impact.

The concern about bank insolvency eased gradually, as the banks built up reserves and began the process of writing down the balance sheet value of their sovereign debt. In May 1987 Citibank announced that it was setting aside reserves equal to 22 per cent of the value of its loans to the problem debtors. From that time on it was clear that even substantial debt relief would not threaten the financial viability of more than the odd bank. The "debt problem" was from then on acknowledged to be a problem for the debtors rather than the banks.

The perceived imperative of supporting the banks by maintaining full debt service was reinforced by two intellectual phenomena. One was the conclusion of my colleague William Cline (1983) that the debtors' problem was one of illiquidity rather than insolvency.[2] If the debtor countries could expect to grow out of their problems within three or four years, as his projections suggested was likely, it would be foolish to jeopardise not just the financial stability of the banks but also the future creditworthiness of the debtors themselves, as debt relief would (it was argued) do.[3] Hence his prescription was for new money, to permit continued full servicing of the debt.

Cline's dichotomy has been criticised by many subsequent writers (e.g. Ahmed and Summers 1992), on the ground that a debtor that is known to be solvent ought always to be able to find a lender willing to provide it with temporary liquidity. However, that assumes a rationality in financial markets

2 Cline (1983, p. 45) noted the "classic distinction between a firm that has positive net worth but is illiquid and one that simply has negative net worth, and is therefore insolvent....To analyse whether the problem of developing-country debt is one of insolvency or illiquidity, it is necessary to examine the prospective path of [the "ex ante" balance of payments, given at least minimally acceptable growth rates] and debt...over the medium term...If the prospective external deficits are so large that there is no plausible way they can be financed...then the diagnosis must be one of insolvency. However, if instead the deficits are of a size that is consistent with reasonable magnitudes of financing, and especially if the prospective deficits relative to exports... show an improving trend, then the appropriate diagnosis is one of illiquidity." But he added that the conceptual distinction between illiquidity and insolvency was less clearcut for a country than for a firm, because of the absence of any social institution analogous to bankruptcy.

3 Debt relief means a reduction in the present value of a debtor's future debt service obligations. This is the traditional term for what the official world, seeking language to obfuscate the fact that it was doing what it had spent six years declaring to be unnecessary, decided to relabel by the hideous and unwieldy euphemism "debt reduction and debt service reduction" at the time of introduction of the Brady Plan.

that is not self-evidently confirmed by their behaviour. To my mind a more convincing criticism of the dichotomy stems from recognition that it excludes motivations for not servicing debt other than a total inability to do so, such as a belief that there are more urgent uses for such foreign exchange as is available. (Cline's own qualification, noted in footnote 2 above, about the relevant concept of the balance of payments being an ex ante one involving "at least minimally acceptable growth rates in the debtor countries", already hints at that problem.)

In the event, Cline's projections proved over-optimistic, as many writers have pointed out over the subsequent years. Two recent studies, one by Dittus and O'Brien (1991) at the OECD and the other by Cline (1993) himself, have sought to pinpoint the reasons why. The former study points to much weaker commodity prices than forecast by the model and a failure to allow for capital flight. Cline qualifies the first of these factors by pointing out that the forecast recovery in commodity prices was delayed rather than nonexistent, since they returned to near the level forecast by his model by 1989. He also adds a number of other factors: the oil price collapse of 1986 (which was on balance unfavourable to the debtors, though with very strong distribution effects); the deceleration in world inflation and rise in real interest rates; and the failure to make allowance for the "internal transfer problem", i.e. the difficulty of mobilising fiscal resources from the private sector to pay interest on the government's external debt, which contributed to the inflationary explosion in a number of countries. He endorsed the conclusions of Dittus and O'Brien on the importance of capital flight, which accounted for some 80 per cent of the debt buildup up to 1987.

Another source of powerful intellectual support for the initial debt strategy came from a profound ignorance of history. It was widely believed[4] that default on sovereign debt was a historical aberration more or less confined to the 1930s, and carrying with it penalties – in the form of a lengthy loss of access to financial markets – sufficiently severe to deter any rational country from repudiating its debt. This view was reinforced by the prevalent ideological tendency among economists to assume that markets always know what they are doing, which implied that since the banks had been making a lot of sovereign loans there must be severe consequences to a debtor that stopped debt service, because otherwise the loans would not have been made.

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4 I attempt to recall what I believed at the time. I do not recollect encountering those who were better informed, at least until the publication of Kaletsky (1985), whose striking opening paragraph read:
"For at least five hundred years, governments and nations have regularly defaulted on their foreign debts. Recent history suggests that sovereign lending debacles have followed a fifty-year cycle of monotonous predictability; today's problem borrowers were among the nations which defaulted in the 1930s, the 1870s, and, in some cases, the 1820s."

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As the decade progressed, we historically ignorant economists learned more and more about previous occasions when countries had had difficulty maintaining debt service, and had ultimately had their debt restructured in agreement with their creditors in a way that involved substantial debt relief. The earliest instance, which has been unearthed only recently (Sachs 1993), relates to an occasion in 1790 when Alexander Hamilton journeyed to Paris (then, as now, the headquarters of the creditors) to tell the mainly French holders of the bonds sold to finance the American War of Independence that they could choose from a menu of options that looks remarkably like those offered under the Brady Plan two centuries later. The creditors could accept discount bonds, involving a reduction in the face value of their claims but with the original interest rate maintained intact; or they could swap into par bonds, with the capital value intact but a lower interest rate; or they could stick with the original contractual terms, but in that case they would go to the back of the queue when the United States government did not have enough foreign exchange to service all the debt.

Soon after the outbreak of the debt crisis, a young banker reportedly assured his senior that there was no need to trouble himself about the danger that Mexican debt might be worth less than 100 cents on the dollar, since Mexico had always serviced its debt punctiliously. In a 1988 conference where the economic historians tried to educate economists about the history of debt restructuring, Vinod Aggarwal (in Eichengreen and Lindert, 1989) revealed that this was true for precisely the first six years of Mexican independence. In 1821, Mexico achieved independence; in 1824, it contracted its first loan in London; and in 1827 it stopped servicing that loan. Periodic renegotiation of that debt ensued for the following 59 years, including one innovative attempt at financial engineering where holders of Mexican debt were offered a swap into Texan land that Mexico had already lost as a consequence of the Mexico-Texas War. The matter was finally settled by the strong government of Diaz in 1886: despite a series of defaults, repudiations, conversions and forced reschedulings over the intervening years, the bondholders ultimately recovered their capital in full and got interest averaging 2.3 per cent per year on the 1824 bond issues and 1.1 per cent per year on the 1825 bond issues (as against an initial coupon of 5 per cent).

Mexico returned to the international capital market (initially in Berlin) in 1888, refinanced in 1899, defaulted in 1913, and reached a settlement with its creditors, involving debt relief of about 90 per cent, in 1942. A new cycle of foreign borrowing did not get under way until the early 1970s, and lasted until 1982. It did not seem so at the time, but in historical perspective the latest round is notable for the speed with which Mexico restructured its debt. Most other Latin American countries have had an equally chequered involvement with the international capital market, and most of the many restructurings in the nineteenth and first half of the twentieth centuries involved an element of debt relief. Nor is debt relief a speciality of the New World, nor did it end after World War Two. Prior to the 1980s there were in fact two major debt restructurings that involved very substantial debt relief. The 1952 London Accord restructured the prewar German debts inherited by West Germany, providing debt relief that Mike Faber (1990) estimated at close to 70 per cent. And in 1966 the creditors put the German responsible for gaining those very favourable terms (Herman Abs) in charge of negotiating the restructuring of Indonesia's debt following the fall of Sukarno; the IMF is reported to have estimated the resulting debt relief at 53 per cent (Faber 1990). Neither Germany nor Indonesia has been excluded from the international capital market since they were conceded debt relief.

In short, while sovereign countries don't go bankrupt or (often) repudiate their debt, it is historically quite abnormal for debtors that have encountered difficulties in maintaining debt service to be required to stick with the terms of their original contract, or even to maintain the present value of their debts intact. Among the few cases where attempts were made to avoid debt relief were inter-allied war debts following World War One; Argentine sterling-denominated debt in the 1930s; and sovereign debt to banks in the 1980s. Of those three, only the Argentine debt was ultimately serviced in full. But it is equally unusual for debtors to get away with a total repudiation of their debts (among major debtors, the Soviet Union following the establishment of Communism came the closest: even it eventually made token payments to redeem the Czarist bonds in order to win renewed access to the London bond market). In general creditors and debtors ultimately get together and agree to restructure the debt, with some combination of debt relief and cash-flow relief, and the creditors preserving a part of the value of their claims.

II. EXPLAINING THE BRADY PLAN

To what extent can one explain the terms on which the parties agree to restructure sovereign debt? This important question was obscured by excessive moralising in the early years of the debt crisis. At that time defiant debtors would declaim the immorality of placing debt service ahead of the needs of the hungry, while earnest creditors and their friends[5] suggested that continued servicing of debts according to the original contractual terms, or at least with the present value maintained intact, was an absolute moral imperative.

5 Of whom Martin Feldstein was perhaps the most outspoken.

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It is by now widely recognised that this approach is unhelpful. It is more natural to postulate that both debtors and creditors act in their enlightened self-interest, servicing outstanding debt and extending new loans respectively when and only when they expect that to serve their interest. Of course, a debtor that earned a reputation for treating its debt service obligations casually would have to expect to find itself the target of whatever sanctions the creditors can command: the experiences of countries that have "opted out" (like the Soviet Union following the Communist takeover, and Peru and Zambia in the 1980s) have not suggested that this is a wise strategy.

It is, however, one thing to expect that debt will be serviced when the assumptions under which it was contracted are more or less satisfied, but quite another to treat the debt contract as devoid of implicit contingent clauses.[6] When expectations are disappointed, debtors think again, and creditors grumble but comprehend.

Those dissatisfied with the moralistic approach to debt restructuring were initially puzzled as to how it should be replaced. They appealed to an implicit (or sometimes explicit) model in which the debtor country had an exogenous but stochastic stream of foreign exchange receipts available for debt service, which was expected under most states of the world to provide insufficient foreign exchange to cover the full value of the debt service due. But even if the creditor was almost sure that the debt would not be serviced in full, why should it agree to a reduction in the contractual value of its claims on the debtor? There was always some tiny possibility that nature would be kind and enable the debtor to pay in full, thus giving an option value to preservation of the marginal claim.

Paul Krugman (1988) first formalised a rationale as to why the creditors might find it in their (collective) interest to agree to write down the value of the debt to something that the debtor could expect to be able to afford to pay. He argued that an unpayable debt service obligation had unfavourable incentive effects, resulting in a "debt Laffer curve". A debtor with a "debt overhang" would be obliged to pay over all (or most of) an increase in export earnings to its creditors, which would leave it with no (or minimal) incentive to undertake investments, including adjustment policies, that could be expected to increase future export earnings. Creditors collectively might thus share a common interest with the debtor in eliminating a debt overhang, although of course with many creditors it might be difficult to realise that interest because of the free rider problem.

6 It would have been better if explicit contingent clauses had been included in the original debt contract, but the failure to include them does not mean that debtors can reasonably be expected to honor the original terms irrespective of developments that erode their capacity to pay.

This analysis has been questioned on two grounds. One concerns its empirical importance (e.g. Cline 1990, p. 100, Diwan and Rodrik 1992). Calculations suggested that the "marginal tax rate" imposed by the banks was rather small (Diwan and Rodrik suggested as little as 2 per cent). The other argument (developed by Diwan and Rodrik) is that most investment is undertaken by individual firms rather than decided by the government, and that even a high "tax rate" on the country need not translate into a high disincentive at the level of the firm.

However, there is one context in which it is plausible to believe that the effect may have been significant, and which would not be captured by the empirical analyses mentioned above. This concerns the return of flight capital. It seems fairly clear that one reason for the reluctance of flight capital to return was the fear of measures of partial expropriation (devaluation, inflation, forced funding of liquid balances, capital levies, etc.) being resorted to in an attempt to generate the foreign exchange or meet the fiscal needs created by debt service. Hence debt write-downs that relieved such fears might induce a reversal of capital flight and thus contribute to the ability to service debt. Mexico after its Brady deal provides the classic example.

Diwan and Rodrik argue that a similar type of (collective) creditor interest in debt relief can arise in a more plausible way, from the existence of a liquidity constraint that precludes a debtor undertaking investments (including adjustment) that it regards as being in its own interest inasmuch as the ultimate benefits will outweigh the immediate costs. They argue that this problem cannot be resolved by voluntary new lending for two reasons.

The first reason involves the free rider problem again. Existence of a debt overhang means that, even though the marginal return to the creditors may exceed their opportunity cost of funds, they will not be prepared to put up money voluntarily because, as long as old claims are undiminished, the returns on new investment will be diluted by being shared with the old creditors. Resolution of the debt problem thus requires both new money and debt relief. The new money is needed to provide the liquidity that allows investment to be undertaken, and the debt relief is needed to allow the new creditors (in practice mainly the international financial institutions) to receive a competitive return rather than be exploited by the old creditors.

Second, they argue that although a government may be happy to undertake adjustment in return for new money, it may very well regard the use of additional resources to increase consumption as a more urgent priority still. Since the creditors would not get any return from the debtor's preferred use of new money, they would not lend more even if they could overcome the free rider problem, absent a way of ensuring that the debtor uses the additional funds to pursue its second-best policy in preference to its first-best choice. Conditionality provides the mechanism to ensure that the debtor uses the extra money to invest rather than increase consumption.

This analysis suggests the logic of the main features of the Brady Plan, which may be summarised as (a) the debtor country pledges to adjust and accepts conditionality designed to ensure that it fulfils its pledge; (b) the international financial institutions (IFIs) police the conditionality, lend some of their own money, and orchestrate a deal whereby (c) the banks grant debt relief (though some may put up new money instead). The debtor country gains because it is better off with the investment than without, and conditionality provides the precommitment mechanism that allows it to get the investment. The banks gain because the new lending is in the collective interest of the creditors provided it actually buys adjustment. And the IFIs (like any banks that choose to make their contribution in the form of new money rather than debt relief) gain provided that the extent of debt relief is sufficient to enable the country to pay a competitive return on the new money (where that return includes increased earnings on any old debt that may be held by the new lenders). The limits of the deal are defined by the condition that each of the three parties gains (or at least does not lose). These limits can be extended by the details of the menu options offered to the banks, which allow the heterogeneous preferences of the banks to be translated into terms that are more favourable to the other two parties. (But banks still have to be compelled to select from the menu and not allowed to freeride.)

This account seems to me to provide us with an essentially complete understanding of the logic of the Brady Plan. It does not necessarily pin down the exact terms on which debt restructuring will be agreed, but it goes a long way toward explaining why and under what circumstances banks can be expected to agree to debt relief when a debtor finds it unreasonably onerous to continue servicing its debt on the original contractual terms.

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Table 1 Eastern Europe and the Soviet Union: Gross Debt, Foreign Currency Reserves and Net Debt in Convertible Currencies (billion dollars)

	1970	1975	1980	1985	1986	1987	1988	1989	1990
					Gross Debt				
Bulgaria	0.7	2.7	4.9	4.1	5.5	7.4	9.1	10.7	11.1
Czechoslovakia	0.3	1.0	6.8	4.6	5.6	6.7	7.3	7.9	8.1
Hungary	1.0	3.9	9.1	14.0	16.9	19.6	19.6	20.4	21.3
Poland	1.2	8.4	24.1	29.3	33.5	39.2	39.2	40.8	48.5
Romania	1.0	2.9	9.6	6.6	6.4	5.7	1.9	0.7	1.2
Yugoslavia	2.1	6.0	18.5	18.4	19.2	20.5	18.9	17.3	16.5
Eastern Europe	6.0	24.9	73.0	77.0	87.1	99.0	96.0	97.8	106.7
Soviet Union	1.6	15.4	25.2	31.4	37.4	40.2	49.4	58.5	62.5
Eastern Europe and Soviet Union	7.6	40.3	98.1	108.4	124.5	139.2	145.4	156.3	169.2
					Foreign currency reserves				
Bulgaria	.	0.4	0.8	2.1	1.4	1.1	1.8	1.2	0.6
Czechoslovakia	0.3	0.3	1.8	0.9	1.1	1.4	1.6	2.2	1.1
Hungary	0.2	0.9	1.4	2.2	2.3	1.6	1.5	1.2	1.1
Poland	0.3	0.6	0.1	0.9	0.7	1.5	2.1	2.3	4.5
Romania	.	0.5	0.3	0.2	0.6	1.4	0.8	1.9	0.5
Yugoslavia	0.1	0.8	1.4	1.1	1.5	0.7	2.3	4.1	5.5
Eastern Europe	0.9	3.6	5.8	7.3	7.5	7.7	10.0	12.9	13.2
Soviet Union	1.0	3.1	8.6	13.1	14.8	14.1	15.3	14.7	8.6
Eastern Europe and Soviet Union	1.9	6.7	14.4	20.3	22.4	21.8	25.3	27.6	21.8
					Net debt (deducting foreign currency reserves)				
Bulgaria	0.7	2.3	4.1	2.0	4.1	6.3	7.3	9.5	10.5
Czechoslovakia	.	0.7	5.0	3.8	4.5	5.3	5.7	5.8	7.0
Hungary	0.8	3.0	7.7	11.8	14.6	18.0	18.2	19.1	20.2
Poland	0.9	7.8	24.0	28.4	32.8	37.7	37.1	38.5	44.0
Romania	1.0	2.3	9.2	6.4	5.8	4.3	1.1	-1.2	0.7
Yugoslavia	2.0	5.2	17.1	17.3	17.7	19.8	16.6	13.2	11.1
Eastern Europe	5.2	21.4	67.1	69.8	79.5	91.3	86.1	84.9	93.5
Soviet Union	0.6	12.3	16.6	18.3	22.5	26.1	34.1	43.8	53.9
Eastern Europe and Soviet Union	5.8	33.7	83.7	88.1	102.1	117.4	120.1	128.7	147.4

Source: Economic Survey of Europe in 1991-1992, UN Economic Commission for Europe, New York, 1992. 332 p.

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Table 2 Eastern Europe: Estimated Net Foreign Debt and Debt/Export Ratio, 1992

	Debt (billions dollars)	Debt/Export (percentage)
Bulgaria	11.5	345
Czechoslovakia	7.4	65
Hungary	18.0	169
Poland	50.0	357
Romania	3.0	73
Russia	77.7	204

Sources: Eastern Europe: Debt, EBRD 1992 Annual Economic Review; Exports, Exchange rates, OECD; Polish export figure from Polish embassy and is based on payments, not customs information.
Russia: Debt, Treasury, International Affairs (hard currency debt of the former Soviet Union); Exports, State Statistical Committee of Russia.

III. IMPLICATIONS FOR EASTERN EUROPE

A number of countries in the region have only modest levels of debt: Albania, the Baltic states, the CIS states other than Russia and perhaps Ukraine, the Czech Republic, Georgia, Romania, and Slovakia. The heavily indebted countries are Bulgaria, Hungary, Poland, Russia, perhaps Ukraine (if it succeeds in fending off the "zero option" offer from Russia to take over the whole of the external debt of the former Soviet Union[7], and the successor states of Yugoslavia. (See Table 1 for the evolution of the external debt of the main countries of the region, and Table 2 for estimates of current debt levels and debt/export ratios as a measure of the debt burden.)

Hungary has so far preserved its creditworthiness, and did not allow Poland's success in gaining substantial debt relief to seduce it into seeking similar treatment. This is one of those instances (like Indonesia versus

7 One might wonder why Ukraine has been so anxious to take over a portion of the debt of the former Soviet Union. There appear to be two reasons. One is the hope that inheriting a part of the debt will serve to consolidate its sovereignty, as has occurred with other successor states (like Ecuador, New Granada, and Venezuela after the breakup of Great Colombia in 1829, or Czechoslovakia after the dismantling of the Austro-Hungarian Empire in 1918). The other is scepticism as to whether the assets of the former Soviet Union (which have to be renounced as the counterpart to escaping an obligation to service the debt) are as negligible as the Russians have claimed, especially relative to the likely present value of servicing ex-Soviet debt. See Armendariz and Williamson (1993).

Philippines and Colombia versus Mexico) which have cast doubt on the "moral hazard" argument that was so popular in the early days of the debt crisis. It seems that the disadvantages of losing creditworthiness are perceived to be so pronounced that there is little need to reinforce them by deliberate punishment of a debtor that encounters legitimate difficulty in maintaining debt service. Indeed, one sometimes hears suggestions that the Hungarians may have been exaggerating the rewards of virtuously maintaining full debt service, although Table 2 suggests that the burden of the Hungarian debt is quite moderate compared to the levels that were reached in many Latin American countries in the 1980s (where debt/export ratios were mostly well over the traditional prudent ceiling of 200 per cent). An important question would seem to be whether Hungary's success in attracting direct investment is due in any significant measure to its willingness to avoid a confrontation with its creditors.

Poland has already (with help from the Polish ethnic lobby in the United States) received a reduction of approximately 50 per cent in the present value of the servicing obligations due on its official debt. (This does not show up as a big fall in the stock of debt outstanding, presumably because most of the creditors chose the option of par bonds with a lower interest rate rather than discount bonds.) Poland's remaining aim is to persuade the banks to settle their (relatively modest) portion of the debt on comparable terms. Given the combination of vigorous export growth in recent years, the low interest rates that have resulted from the substantial debt reduction already achieved, and the absence of capital flight, its debt burden now looks manageable despite the high debt/export ratio shown in table 2.

It will be a cause for celebration when it becomes possible to start worrying about the need to restructure the debt of the *Yugoslav* successor states.

Bulgaria and *Russia* constitute the core of the present problem.[8] As asserted in the introduction to this paper and substantiated above, the primary moral that the 1980s' debt crisis suggests for the treatment of their debt by the creditors is the need to renegotiate its terms promptly, if necessary by the provision of substantial debt relief as well as the extension of maturities, when it transpires that servicing of the debt on the original contractual terms is not practical. With one crucial proviso, this is better done with goodwill and sooner rather than grudgingly and later, in particular because Mexican experience suggests that a debt settlement can be a potent instrument in combating one of the most debilitating problems from which at least Russia is currently suffering, namely massive capital flight.

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8 If Ukraine were to succeed in taking over its share of the former Soviet debt, it would face similar problems.

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The proviso is that the debt reconstruction be done in support of an adequate set of policy reforms. Conventional wisdom holds that aid, of which debt relief is a particular form, is a double-edged sword: useful and perhaps even necessary to permit rapid economic recovery when a country finds itself in a difficult situation but has introduced the policy reforms needed to turn the economy round, but also potentially dangerous inasmuch as it can enable a country to postpone the policy reforms needed to initiate recovery. The debt crisis reinforced this view, since the easy access to bank finance[9] in the 1970s permitted the perpetuation of policies that would have been better changed, while the Brady Plan provided the financial relief that finally allowed countries like Mexico to start benefiting from their brave reforms.

The conclusion is that conditionality has a vital role to play. However much it may be resented by populists, the Diwan-Rodrik analysis summarised in the previous section explains why conditionality is not just in the interest of creditors-who otherwise may have no interest in the provision of aid-but also why it is in the interest of debtors-who otherwise must expect that there will not be much aid.

But suppose that the creditors decided to give massive aid without conditionality because of what they perceived to be an overwhelming political need to support the incumbents. Would this necessarily be in the interests of the debtors? That depends on the balance of political forces in the beneficiaries: if they have sufficient political cohesion to be able to implement the set of policies that are in their own best long-run interest even without the spur of conditionality, then creditor generosity would be pure gain. But the most persuasive justification for conditionality argues that this is an atypical situation, and that normally the reformers need bolstering against conservatives and/or nationalists who are attempting to obstruct the reforms that will benefit the country in the long run. To the extent that this is judged likely to occur in Eastern Europe (about 99 per cent likely in my view), debt relief should be made conditional on the implementation of economic reforms. One would certainly want to see any major consolidation of Russian debt conditional on Russia's real interest rate rising to at least zero (from its recent rate of about -80 per cent per year), since otherwise there is no hope of stemming capital flight.

The content of the needed reforms in many respects parallels those that were introduced in Latin America during the 1980s, although Eastern European countries have an even more ambitious agenda in the institutional dimension. In an earlier paper (Williamson 1990), I described the list of reforms that were being urged on Latin America and increasingly

9 Admittedly their lending was not intended by the banks to be aid, but it had the same effect in this dimension.

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implemented within the region as the "Washington Consensus" (a term that was not intended to imply that Washington institutions could claim any particular intellectual priority in having developed that reform agenda). These reforms can be summarised as follows:[10]

* *Fiscal Discipline.* Budget deficits, properly measured to include provincial governments, state enterprises, and the central bank, should be small enough to be financed without recourse to the inflation tax. This typically implies a primary surplus (i.e., before adding debt service to expenditure) of several per cent of GDP, and an operational deficit (i.e., the deficit disregarding that part of the interest bill that simply compensates for inflation) of no more than about 2 per cent of GDP.
* *Public Expenditure Priorities.* Policy reform consists in redirecting expenditure from politically sensitive areas which typically receive more resources than their economic return can justify, like administration, defense, indiscriminate subsidies, and white elephants, toward neglected fields with high economic returns and the potential to improve income distribution, like primary health and education, and infrastructure.
* *Tax Reform* involves broadening the tax base and cutting marginal tax rates. The aim is to sharpen incentives and improve horizontal equity without lowering realised progressivity. Improved tax administration is an important aspect of broadening the base in the Latin context. Taxing interest earned on assets held abroad ("flight capital") should be another high priority for broadening the tax base in the coming decade.
* *Financial Liberalisation.* The ultimate objective is market-determined interest rates, but experience has shown that, under conditions of a chronic lack of confidence, market-determined rates can be so high as to threaten the financial solvency of productive enterprises and government. Under that circumstance a sensible interim objective is the abolition of preferential interest rates for privileged borrowers and achievement of a moderately positive real interest rate.
* *Exchange Rates.* Countries need a unified (at least for trade transactions) exchange rate set at a level sufficiently competitive to induce a rapid growth in non-traditional exports, and managed so as to assure exporters that this competitiveness will be maintained in the future.
* *Trade Liberalisation.* Quantitative trade restrictions should be rapidly replaced by tariffs, and these should be progressively reduced until a uniform low tariff in the range of 10 per cent (or at most around 20 per cent) is achieved. There is, however, some disagreement about the speed with which tariffs should be phased out (with recommendations falling in

10 This summary is drawn from Williamson (1991).

a band between 3 and 10 years), and about whether it is advisable to slow down the process of liberalisation when macroeconomic conditions are adverse (recession and payments deficit).

* *Foreign Direct Investment.* Barriers impeding the entry of foreign firms should be abolished; foreign and domestic firms should be allowed to compete on equal terms.
* *Privatisation.* State enterprises should be privatised.
* *Deregulation.* Governments should abolish regulations that impede the entry of new firms or restrict competition, and ensure that all regulations are justified by such criteria as safety, environmental protection, or prudential supervision of financial institutions.
* *Property Rights.* The legal system should provide secure property rights without excessive costs, and make these available to the informal sector.

All those reforms are as desirable in Eastern Europe as in Latin America. The same could be said about the social agenda that I reluctantly omitted from the "Washington Consensus" because social issues did not command much priority in Washington in the 1980s, but which could now be legitimately included.

In a number of these areas, certainly those listed below, the changes needed in Eastern Europe are far more profound than was the case in Latin America.

* *Tax reform.* Most socialist countries had relied heavily on siphoning off the profits of public enterprises and were therefore lacking a modern system of taxes on income and value-added.
* *Financial liberalisation* had to start by breaking up monolithic public-sector banks and creating from scratch non-cash payments mechanisms for the personal sector.
* *Privatisation.* In round figures the task was to privatise more than 80 per cent of the economy rather than the 20 per cent or so that was at stake in Latin America, including agriculture and shops rather than just public utilities and bits and pieces of manufacturing.
* *Property rights* were almost non-existent at the outset of reform.

In addition, it was necessary to create institutions and social norms appropriate to the functioning of a market economy – things that were a part of the cultural heritage of Latin America as much as of the developed countries, and that economists had not previously focused on. Bankruptcy laws and laws on corporate governance are the tip of the iceberg, which covers also all those other social constraints, many of them still poorly understood, that serve to produce rough harmony between the pursuit of personal gain and furtherance of the social good.

The experience of the international institutions with conditionality in Latin America and elsewhere has focused on a fairly narrow segment of this

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broad agenda, primarily fiscal (and monetary) discipline, exchange-rate policy, and financial and trade liberalisation. These topics, plus privatisation, have also provided the core of the conditionality operated by the IFIs in the East European countries. I am not sure that I would have wanted to see conditionality tied to (for example) the establishment or enforcement of bankruptcy laws (though the West does seem to have been rather feeble in the limited technical assistance provided in these areas where the terrain is novel). It is probably better that conditionality has stuck to the areas with which the institutions were already familiar, which have provided ample challenges. While we have all surely had our detailed criticisms of the advice provided on one occasion or another, I would rate it as having been broadly appropriate. In particular, the charge that the output decline could have been avoided or substantially mitigated by less strict macro policies looks increasingly unpersuasive.

One of the surest lessons of experience with conditionality is that the Bretton Woods institutions cannot force policy changes on a government that is united in opposing them. The leverage for conditionality arises when the reformers control some of the key levers of power and can have their internal political clout strengthened by access to external finance. The ideal time to come in with strong international support is when the reformers have succeeded in implementing their programme and the key question is whether the programme will be politically sustainable for long enough to give it a chance of working. January 1990 in Poland provides a classic example of how it should be done.

In several respects Poland seems by far the most relevant precedent when considering the possibility of support to Russia. It too had a big foreign debt, a thoroughly socialised economy[11], and had allowed a hyperinflation to develop during a chaotic first phase of liberalisation. If the reformers get a second chance in Russia, the West should aim to let them use it as productively as Balcerowicz did by stabilising at the beginning of 1990.

One element of support should be a consolidation of the debt as sweeping as that in Poland was, although the much smaller debt burden in Russia (relative to the size of GDP or exports) suggests that it would be appropriate to focus on cash-flow relief rather than debt relief. My own suggestion would be to provide for the whole of the outstanding public-sector debt to be consolidated into long-term loans, with a maturity of (say) 25 years, a lengthy grace period (say 10 years), and a substantial (but possibly decreasing) proportion of the interest being capitalised at the beginning, say for the first five years. One advantage of avoiding debt relief is that this would minimise

11 Although the agricultural sector had never been collectivised in Poland.

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the burden-sharing problem among the Western countries which arises from the enormous disproportion between the extent of past lending by Germany at one extreme and Japan and the United States at the other.[12]

As in the case of the Polish debt restructuring, it would make a lot of sense to avoid making all of the benefits of the restructuring unconditionally available immediately. In the Polish case the debt relief comes only after Poland has remained current on an IMF programme for three years. The leverage this provides to the IMF may have been crucial in preventing Poland reverting to populist policies that would have wrecked the prospects for the recovery it has since started to experience (Sachs 1993).

Another lesson of the debt crisis is the advantage of combining an obligation on each creditor to participate in a debt restructuring with an element of choice in allowing each creditor to select the particular way in which it would contribute. Concerted action is necessary to overcome the free rider problem, but none of the grand schemes to create a new institution to take over sovereign debt ever got off the drawing board, mainly because they all tried to force all the creditors to do the same thing. The Brady plan let each bank choose from a menu the option that best suited its particular circumstances and expectations, thereby making the obligation to contribute less onerous. This is a lesson that will certainly be relevant to the restructuring of Bulgaria's debt, much of which is owned by the commercial banks, as well as in the consolidation of the residual (bank) component of the debt of Poland and Russia.

IV. CONCLUSION

Debt restructuring is an effective way of helping finance a programme of economic reform, thus increasing the probability that it will be sustained long enough to start producing results. The experience of the debt crisis has set to rest exaggerated fears that debt relief would produce excessive moral hazard, and has indeed demonstrated that even the creditors have an interest in a prompt reconstruction of debt whose continued service on the original terms would be unreasonably onerous to the debtor. The main constraint on a speedy debt restructuring should not be such fears, but rather a concern that debt concessions only be made when there is reasonable assurance that they will be used to support the reform process rather than to delay its

12 If subsequent "aid" were all to take the form of loans on commercial terms, Russia could indeed end up as over-indebted. But burden-sharing considerations suggest that in that event it would be better to give new money, which will presumably be contributed according to the customary proportions, on concessional terms, rather than to grant debt relief on old debt.

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introduction. This criterion suggests that it is high time that a definitive Bulgarian restructuring was initiated, although it is not equally clear that the time is yet ripe in Russia. Until that time arrives, the traditional Paris Club process of annual debt renegotiations dealing with the debt falling due each year may be more appropriate.

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