The Costs of Default and International Lending

by Chien Nan Wang

In August 1982, Mexico announced that it was unable to service its nearly $50 billion foreign debt. Brazil, Argentina, Venezuela and other debtor countries soon announced their own debt servicing difficulties.

Initially, it was feared that these borrowers might flatly refuse to repay their debts, thus repudiating their loan obligations. Because debt repudiation could severely hurt both creditors and debtors, the threat became the focus of what became known as the 1982 less-developed-country (LDC) debt crisis. Between 1983 and 1986, creditors, debtors, and the International Monetary Fund (IMF) generally were able to work together to manage the debt problems, keeping interest payments on schedule by restructuring old loans and by making new loans in what can be described as a process of "cooperative interruptions." However, in 1986, Peru limited debt-service payments to not more than 10 percent of its export revenues. More seriously, in February 1987, despite an ongoing effort to reschedule and refinance its debt, Brazil unilaterally delayed interest payments. In addition to Brazil, seven other Latin American countries, together with several smaller African countries, delayed interest payments in 1987. However, as will be discussed later, most of these interrupted payments were renegotiated, with interest payments resuming within a year, through a set of arrangements that has been described as a "conciliatory default." Earlier this year, Brazil again announced several measures designed to delay the repayment of its debts.

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

First, any type of debt servicing failure can hurt creditors and debtors alike. Creditors see their capital eroded, threatening their solvency; debtors damage their own creditworthiness, perhaps impeding their ability to borrow again. Given such significant costs, how do borrowers choose the appropriate response to their debt servicing problems?
The key to answering these questions centers on the benefits and costs of default in its various forms. This Economic Commentary investigates these first and half of the reasons why the current LCD debt problem to illustrate several issues that seem especially important for future international lending.

- The Benefits and Costs of Default

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

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

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

Debtors may also think altering debt-service obligations will enhance domestic political tranquility. It is reasonable for debtors to believe that reducing debt service will permit increased domestic consumption and improve the resident population’s immediate living standard. Altering the terms of debt-service agreements may help consolidate the political regime, particularly for countries with pressing demands for a higher living standard. Also, in 1981, the Cuban ship Cristi Congresso del Partido was seized by Chilean plaintiffs for a default by Cubans in sugar imports. In general, however, the relatively limited resort to seizers by creditors suggests that it is a useful option only in the most extreme circumstances of debt-resolution failure.

- The Uncertain Costs of Default

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

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

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

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

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

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

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

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

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

- Changing Situation

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

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

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

The bank trade credit lost for Brazil was estimated to be a moderate 20 percent. Once Brazil publicly expressed its intention to renew debt servicing, a record-high $2 billion restructuring package was assembled by Brazil’s bank creditors. This event illustrates that, overall, the costs of debt service interruptions can be low as long as debtors show evidence of cooperative attitude.

- Conclusion

After the 1982 debt crisis, difficulties in securing debt repayment in the terms as originally agreed upon has emphasized the risks in international lending, and has contributed to a decline in lending. In 1983, involuntary bank lending to Latin America was $13.3 billion; it dropped to $3.5 billion in the first three quarters of 1987. In 1984, voluntary bank lending to Latin America was...
The key to answering these questions centers on the benefits and costs of default in its various forms. This Economic Commentary investigates these first of all, by analyzing the current LDC debt problem to illustrate several issues that seem especially important for future international lending.

- **The Benefits and Costs of Default**

  International credit agreements involving the direct or indirect obligations of governments are likely to be restructured, with the most extreme cases involving a default threat or actual default.

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