The Costs of Default and International Lending
by Chien Nann 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 simply refuse to repay their debts, thus repudiating their loan obligations. Because debt repudiations 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 strikingly, in February 1987, despite an ongoing effort to reschedule and refinance its debt, Brazil unilaterally delayed interest payments. In addition to Brazil, seven other Latin American countries, together with several smaller African countries, delayed interest payments in 1987.

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

Second, international lending to LDCs currently is declining. Declining capital inflows make it even more difficult for LDCs to service their debts and to finance their growth. Considering the huge amount of old debt and the uncertain prospects for future repayment, it is difficult to reassure 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?


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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, whether the current LDC debt problem is likely to resolve 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 extraordinarily complex, and the ultimate defenses for creditors against nonpayment—such as seizure of collateral and recourse to legal procedures—are not fully available in international lending, so that repayment from sovereign debtors is not strictly enforceable.

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

The primary benefit of altering the terms of repayment is the ability in the short run to save foreign exchange for domestic consumption and promotion of economic growth. The amount of foreign exchange saved is larger in repayment cases than in conciliatory defaults because the former reduces the debt-service burden on a longer period of time than the latter. While conciliatory default relieves or delays full debt-service obligations, it greatly reduces the debtor country's own market in its overall consumption level when its income is low and then to repay when its income is high. Profitable investment opportunities may also be lost, and trade credit may be reduced or eliminated.

Trade embargoes imposed by the lender's government may cause severe damage to countries dependent on trade, which includes most major debtors. Default may also result in seizure of a defaulter's foreign assets or exports. Sovereign immunity from foreign interference with commercial transactions once was a basic principle in international law. However, the 1976 Foreign Sovereign Immunity Act (FSIA) in the U.S. and the 1978 State Immunity Act (SIA) in the United Kingdom established the legal liability of foreign governments for their acts of a purely commercial nature. FSIA and SIA are crucial statutes because most international loan contracts are signed under U.S. or British law.

A result, borrowing countries typically waive sovereign immunity in commercial loan contracts.

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

- **The Uncertain Costs of Default**

Economic issues, such as debt repayments, are only one dimension of a country's overall relationship with creditors, so that it may be difficult to define the implications of the creditor's country narrowly enough to impose sanctions. Disagreements may exist either between various interest groups within a creditor country or between creditor nations about whether or not to sanction a defaulter. For example, exporters, importers, regional banks, and multinational banks within the creditor country may take different positions on proposed sanctions. Finally, the process 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 nations located in the creditor country also is usually protected. Finally, legal actions may be avoided simply because they diminish the debtor's incentive to renegotiate the debt.

The argument that sovereign nations can avoid or reduce the cost of altering the terms of debt service implies that the benefits of such efforts may be greater than the costs. While outright permanent and unilateral abortions of lending agreements are uncommon, cooperative interpolations and concilia-

- **Changing Situation**

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

Brazil's interest moratorium did not last, however. Brazil and its creditors were able to negotiate a moratorium on interest and increased restructured loans, and assemble new-money financing packages. The possibility that creditors would seek more or less lenient terms 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 creditors have seized the opportunity to seize collateral assets expanded, and short-term trade credits also declined. Peru, for example, has received 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, Manuel Ferreira da Nobrega, Brazil's 1987 interest moratorium was a mistake because it created new economic uncertainty and affected credit flows from abroad.