

International Debt And Economic Instability

By Rudiger Dornbusch

The debt experience of the 1920s and 1930s was one of pervasive default. Half the outstanding Latin American debt was completely in default by 1949, and nearly half was serviced on an adjusted basis, having been written down as to principal and interest. Only a tiny 1.9 percent continued to be serviced on the terms originally contracted. By comparison, today's debt performance is dramatically successful.¹ A great historical experiment is now underway in which involuntary debt service is being extracted at extraordinary costs to the debtors and to the trading interests of the creditor countries. The essential instruments are two: a return of government involvement in private debt collection that had

¹ On the history of sovereign debts, see Lipson (1985), Edelstein (1982), Rippy (1959), Landes (1979), Feis (1965), Mintz (1951), Lewis (1948), Maddison (1985), McGrane (1935), Royal Institute (1937), and Winkler (1933). A particularly important and controversial treatment is given by Eichengreen and Portes (1985).

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gone out of fashion after 19th century gunboat diplomacy and the International Monetary Fund (IMF) as the administrator of the mugging.

Even with this help, debt collection is not successful. The Baker plan turned out to be primarily a cover for commercial banks to reduce their share in debt rescheduling, leaving the bag to multi-lateral agencies with no net benefit to the debtors. Today lesser developed country (LDC) debts trade at deep discounts, suggesting that not all is well. The recommendations for action go in three directions. The Bradley-Lever approach is to recognize the problem, treat debts as a political issue, and strike a bargain that enhances growth and trade. Improved LDC growth performance would be a positive benefit and a partial offset to concessions granted under the bargain, but there would also definitely be an increase in the quality of debts outstanding.² The banks' position, advocated most skillfully by Cline (1986), is to pretend all is well. The position is to hold out for the mystical day of a return to voluntary lending or, more

² See Lever and Huhne (1986) and Bradley (1986).

TABLE 1

External debt and debt-GDP ratios: capital importing LDC's

| | 1978 | 1982 | 1985 |
|------------------------------------|------|------|------|
| Debt in current dollars (billions) | 399 | 752 | 888 |
| Debt in constant dollars* | 590 | 752 | 978 |
| Debt/GDP ratio (percent) | 25.6 | 33.2 | 38.1 |

*Deflated by the world unit import value index; 1980=100.
Source: IMF *World Economic Outlook*, April 1986

pragmatically, for a bailout by taxpayers. A third approach is to focus on a more or less unconditional reduction in interest rates applicable to reschedulings, perhaps to the level of LIBOR (London Interbank Offered Rate). Other possibilities include gearing debt service to export prices or export revenues. These are the possibilities that debtor countries tend to think of as they enter rescheduling negotiations and before disillusionment is visited upon them.

It is clear that the LDC debts can be kept going for another year, or even several years if enough rescue ingenuity and pressure is applied. But the costs of avoiding a solution are mounting for the debtor countries, the creditors' trade and employment, and the creditors' foreign policy interests. The debt problem in its trade implications is certainly one element in the growing U.S. protectionist sentiment. This is now being more widely recognized and hence a welcome debate on realistic options is finally emerging. This paper reviews where the debt problem stands, how it relates to the macroeconomics and growth problems in Latin America, and what reasonable solutions might look like.

The debt problem

We start in this section with a brief review of facts about the debt. What is its size, what part

is owed to banks and what part to other creditors, and when were the debts incurred? The next question is where the debt crisis came from. Finally, we look at the broad facts of the adjustment process over the post-1982 period. The year 1982 serves as a benchmark since in August of that year the first country, Mexico, declared that debts could not be serviced on the contracted schedule. Credit rationing set in immediately, and in short order a long list of countries had to reschedule their debts.³

Debt facts

Table 1 shows the value of external debts in current and constant dollars as well as debt-GDP ratios. The table brings out the large increase in debt in two stages. Between 1978 and 1982 debts increased due to a combination of poor domestic macroeconomic policies and an increasingly adverse world economy. In 1982-85, domestic policies were geared toward adjustment, but the world economy was insufficiently accommodating to help reduce debt burdens.

Since 1982 total debt has continued to increase, even more in constant dollars than in current dollars. Table 2 follows up with the composition of debts and new borrowing by creditor. It

³ See Simonsen (1985) and Cline (1985).

TABLE 2
LDC debts to and new borrowing from private creditors
 (percent of total)

| | <u>1978</u> | <u>1982</u> | <u>1985</u> |
|---------------------|-------------|-------------|-------------|
| Debt | | | |
| All LDC's | 34.7 | 34.9 | 41.7 |
| Major Latin debtors | 67.0 | 75.6 | 72.8 |
| New borrowing | | | |
| All LDC's | 71.2 | 51.5 | 37.6 |
| Major Latin debtors | 92.1 | 66.5 | -13.3 |

Source: IMF and Morgan Guaranty

highlights the changing role of private creditors before and after the debt crisis.

The interesting feature of this table is the difference in the participation of private creditors in the total of debt and in new borrowing. Beginning in 1982 and beyond, the share of financing from private creditors, specifically banks, drops sharply below their share in the total debt. This is, of course, particularly striking in the case of the major Latin debtors where in 1985 private creditors reduced their exposure absolutely while public money financed the small remaining borrowing requirement.

The origins of the debt crisis

The domestic policies leading up to the debt crises involved in many instances overvalued exchange rates and inappropriate liberalization of the trade or capital account. The resulting speculative flight into goods or foreign assets was of an extraordinary magnitude. The World Bank estimates that, between 1979 and 1982, capital flight from the main Latin American countries amounted to more than \$70 billion.⁴ Other estimates place the number even higher.⁵

The deterioration of the world economy certainly played a critical role. Table 3 shows the key

variables: interest rates, inflation in world trade, and the growth of industrial countries. Where 1970-73 had been a debtors' period, with negative real interest rates and strong growth, the 1980-82 period was the reverse.

A balanced view therefore attributes major importance both to domestic mismanagement and to the deterioration in the world economy. Wiesner (1984, p. 19) offers a different interpretation:

No other set of factors explains more of the debt crisis than the fiscal deficits incurred by most of the major countries in Latin America. Although there were other factors which were relevant, I have no doubt that the main problem was excessive public (and private) spending that was financed by both easy domestic credit policies and by ample resources from abroad. The world recession and high real rates of interest in international markets aggravated the crisis, but I do not believe they created it.

⁴ See World Bank (1985), p. 64.

⁵ For a case study of the sources of increased indebtedness in 1978-82, see Dornbusch (1985a,b) and Dornbusch and Fischer (1985) and the discussion in Fishlow (1985, 1986).

TABLE 3
Key macroeconomic variables of the world economy
 (average annual percentage rates)

| | <u>LIBOR</u> | <u>Inflation</u> | | <u>OECD growth</u> |
|---------|--------------|---------------------|--------------------|--------------------|
| | | <u>Manufactures</u> | <u>Commodities</u> | |
| 1970-73 | 7.6 | 12.4 | 14.4 | 4.5 |
| 1980-82 | 14.7 | -2.4 | -13.3 | 0.7 |
| 1983-85 | 9.7 | -2.0 | -0.5 | 3.4 |

Source: IMF

This is a quite extreme position that may apply to an isolated instance, but certainly not to debtors across the board. Exceptions to the assessment offered by Wiesner readily come to mind, Chile being the leading example of a country that ran into deep debt problems without a budget problem to start with.

Expectations and adjustment

The reaction to the debt crisis in late 1982 and early 1983 was to develop rescue packages and create an accompanying frame of mind. The frame of mind consisted of two essential premises. First, that debt problems were problems of liquidity, not solvency. Accordingly, the recovery of the world economy from deep recession, accompanied by falling interest rates and a declining dollar, would help bring debtor countries back into the black.

A particular point was made that much of the adjustment would come as a result of terms of trade improvements. These were expected as part of the regular pattern of business cycle recovery. The expected dollar decline also was thought to help improve the terms of trade. To the extent that creditworthiness would be reestablished by terms of trade improvements rather than cuts in absorption, the adjustment would be particularly easy.

The second premise was that a return to voluntary lending was to be expected once debt ratios had been worked down to more acceptable levels. But such a return to voluntary lending could only be expected if debtor countries faithfully stood by their commitments, making utmost efforts to reestablish and demonstrate their creditworthiness. A rescheduling without new money, in this perspective would be interpreted as a particularly good show.

The facts on the adjustment were, of course, quite different. The noninterest external balance improved sharply under the impact of budget tightening, tight money, and real depreciation. Noninterest surpluses soon earned the foreign exchange to cover the major part of interest payments. But the domestic counterpart was a sharp drop in per capita income, a significant increase in inflation, and a precipitous decline in investment.

Table 4 shows the data for Latin America to highlight just how the debt service was accomplished.

The current account surplus can be split into two components, the noninterest surplus plus interest payments. External debt increases when interest payments are not offset by a sufficiently large noninterest surplus. There was a noninterest

TABLE 4
Latin America's adjustment
to the debt crisis
(percent of GDP)

| | <u>1977-82</u> | <u>1983-85</u> |
|---------------------|----------------|----------------|
| External debt | 34.3 | 47.2 |
| Interest payments | 3.2 | 5.6 |
| Noninterest surplus | -0.8 | 4.7 |
| Net investment | 11.3 | 5.5 |

Source: IMF

deficit in 1977-82. Thus, debts increased to finance the noninterest deficit, to finance interest payments, and to finance on capital account the flight of capital. In the 1983-85 period, as a result of the adjustment programs, the noninterest deficit turned around to a large surplus, 5 percent of GDP. Moreover, the noninterest surplus was almost equal to the interest payments due. Thus, requirements for new money to finance interest payments were small. Chart 1 highlights the extraordinary size of the adjustment that has taken place.

The last row of Table 4 highlights a striking fact: interest is being paid not out of improved terms of trade but by a cut in investment. The decline in net investment matches almost exactly the increased interest payments: Net investment has fallen to half its previous level and is now extremely low. These low investment numbers must be interpreted in the light of economies where labor force growth is 3 to 4 percent. They imply a growing discrepancy between labor supply and jobs. It is also important to recognize that the areawide average conceals extreme variations. In some countries, notably in Argentina, net investment actually has been zero or even negative.

The fact that interest payments were financed by a cut in investment does not mean that output or consumption remained untouched. Against a

per capita income growth in 1968-77 of 3.6 percent, per capita growth in 1981-85 fell to -1 percent per year.

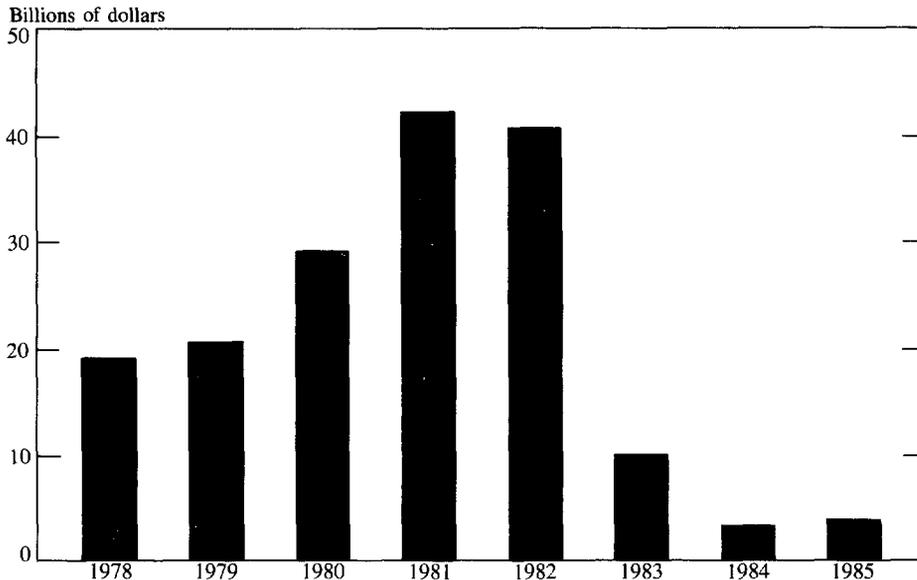
The transfer problem

We dig a bit deeper to find out why debt service now appears to be such a major problem. In one sense, the answer is quite straightforward: countries that used to spend, borrowing the resources from official and private creditors with little thought of how to service or even less repay the loans, now no longer command these resources. They are limited to spending only their income, and that proves to be very little. The adjustment is complicated by two facts: the macroeconomics of earning foreign exchange and the political economy problem of finding extra budget resources for debt service. These issues are well familiar from the discussion about German reparation payments following World War I. Exactly the same issues arise in the context of the involuntary debt service now underway.

The reduction in spending. The first issue is how a country adjusts to a reduction in its spendable resources. Before the debt crisis, foreign loans supplemented domestic income, enlarging the resources that could be spent. Interest payments on loans were automatically provided in the form of new money and the principal of debts was automatically rolled over. With so much facility in managing the debt and with ready access to resources beyond what was required to service the debt, spending ran high. After the credit rationing of 1982 set in, spending had to be limited almost to the level of income with most interest payments now earned by noninterest surpluses.

But there remained the issue of how to distribute the cut in spending between the various components: government, consumption, and investment. As we saw above, a large part of the cut took the form of reduced investment. But there was, of course, also a decline in consumption. The

CHART 1
Current account deficits
Western hemisphere LDC's



Source: World Economic Outlook (IMF)

reason that a fall in investment was not enough has to do with two special features of the adjustment process. First, cutting total demand has macroeconomic multiplier effects that translate into a reduction in output, income, and hence private spending. Second, at the same time that involuntary debt service started, there also occurred a deterioration in the world economy that required an extra adjustment in spending.

The foreign exchange problem. The second macroeconomic issue in adjusting to debt regards the fact that the country needs to earn dollars, not pesos. In other words, it needs to generate a trade surplus. The cut in spending will, of course, reduce import demand and also free exportables for sale abroad, but that will not be enough for two reasons. First, a sizable fraction of the expenditure cut will fall on domestic or nontraded goods, not tradeables. The spending cut thus

creates directly unemployment rather than potential foreign exchange earnings. Even for goods that are directly tradeable, it is not necessarily the case that increased supplies can be sold. Often a market access issue is present or, if the goods are not homogeneous commodities like cotton or copper, a cut in their price is required to realize increased sales. Even then, unless the demand is sufficiently responsive, total earnings may not increase.

To translate the spending cut into foreign exchange earnings, a gain in competitiveness is required. The gain in competitiveness in the home economy draws resources into the tradeable goods sector and in the world market makes it possible to sell the increased production of tradeable goods. Of course, the only way to gain competitiveness is by reducing the wage in dollars by a real depreciation. But the real wage cut also generates, at least in the short run, increased unemployment

as the spendable income of workers is cut.

The overwhelming difficulty in the adjustment process is that external adjustment through a gain in competitiveness takes a toll in terms of employment. The dominant effect on employment is the reduction in real wages and the resulting reduction in domestic demand. The employment response that would be expected in the tradeable goods sector is often very weak and slow. One reason for this is that expectations of a sustained change in competitiveness do not take hold immediately. The traded goods sector thus adopts a wait-and-see attitude that makes real depreciation a highly precarious policy tool. The Mexican experience in this respect is particularly instructive.

A second important difficulty arises from the systemwide adjustment to forced debt service. Since most debtor countries were overspending in the early 1980s and are now under a forced debt service regime, they all had to resort to real depreciation to enhance their competitiveness. But that means they are competitively cutting their wages relative to each other and not only relative to those of the creditor countries. As a result, an isolated country, cutting the dollar wage by, say, 50 percent, will gain much less in terms of increased dollar revenues because all the competing LDC's are doing much the same.

The budget problem. The third macroeconomic problem in the adjustment process involves the budget. Much of the external debt is public or publicly guaranteed. Of the part that was not, initially much has wound up, in one way or another, in the public sector in the aftermath of the crises, as a result of bank failures. The government thus winds up having to service a debt that before was either in private hands or automatically serviced by new money. The problem, of course, is where to find the extra 3 or 4 percent of budget revenue that will pay the interest costs that suddenly have to be met.

There are basically four avenues: raising taxes

and public sector prices, reducing government outlays, printing money, or issuing domestic debt. Raising taxes is notoriously difficult since most of the taxes are already levied in the form of social security taxes on workers. The easier solution is to raise public sector prices or to eliminate subsidies. The elimination of subsidies is particularly cheered by creditors and international agencies since it means moving closer to efficient resource allocation.⁶ Of course, the imposition of extra taxes or the withdrawal of subsidies is inevitably inflationary. That in itself is undesirable but it also may feed back to the budget through indexation and the accompanying need to devalue to sustain competitiveness.

Cutting government spending is the other option. Attention here focuses on the often extreme inefficiency of the public sector. The public perceives that there must be a way to pay the bills out of increased efficiency rather than reduced private absorption. The fact is, of course, that there is very little room for public sector improvements in the short term. Large-scale firing of redundant workers would create an overwhelming political problem. Plant closings are of the same kind, and selling inefficient, overunionized firms runs into the obvious problem that the potential buyers might need to be paid to take over the liability. Perhaps the best advice comes from Milton Friedman, who argued that public sector firms should simply be given away. The problem is that the workers might oppose that, even if they were to get them for themselves.

The most common adjustment is a cut or freeze of public sector wages. This has happened in most of the debtor countries, and in some cases on a very large scale. It helps the budget, but it presents its own problems. The reduced relative wages in

⁶ The fact that it is often food subsidies that are eliminated, without the proverbial neutral lump sum tax, to compensate the losers does not seem to limit the case for the policy recommendation.

the public sector promote an exodus of the wrong kind. The efficient workers leave and the bums stay.⁷

In many of the debtor countries the answer to forced debt service has almost inevitably been to incur increased deficits and finance these by issuing debt or printing money. Money finance brings with it the inevitable problem of high and often extreme inflation. It is no accident that Argentina and Brazil experienced extraordinary inflation rates in the aftermath of the debt crisis. But when deficits are financed by debt, while the imminent inflation problem may be absent, there is still the issue of excessive debt accumulation that ultimately poses the risk of an inflationary liquidation or a repudiation in the way discussed by Sargent and Wallace (1982).

There is an interaction between the foreign exchange and the budget problem. The need to devalue to gain competitiveness implies that the debt service in home currency increases. A given payment of, say, \$1 billion now amounts to more in pesos, to a larger peso deficit, and hence to the need for increased inflationary finance. Thus, the devaluation required to earn foreign exchange is a source of inflation not only directly through the increased prices of traded goods and any accompanying indexation effects. It works also indirectly by raising the required inflation tax. In the classical hyperinflations, it is easily demonstrated that major movements in the exchange rate were the prelude to the outbreak of uncontrolled inflation, and there is some evidence that exactly the same is at work in the debtor countries today.⁸

The budget is also adversely affected by the problem of capital flight. To stem capital flight provoked by the inflationary consequences of debt service or perhaps by a tax reform, the country will have to increase real interest rates to very high

levels. These high real interest rates in turn apply to the domestic debt, causing it to grow more rapidly, and thereby raising future budget deficits and hence the prospect of instability. That, in turn, leads to more capital flight and yet higher rates. There is accordingly an extraordinary vicious circle surrounding the sudden need to service debt and the inability to do so through ordinary taxation.

It is worth recognizing an important tradeoff in the adjustment process. To earn foreign exchange, the wage must be cut in terms of tradeable goods, thus enhancing competitiveness. But to balance the budget, it is often necessary or at least recommended to cut subsidies for such items as food or transportation and that also means a cut in real wages. There is thus competition between two targets, a cut in the dollar wage or the tortilla wage. A choice must be made because there is only so much one can cut. Taking into account the lags with which the trade sector adjusts, this suggests that the competitiveness adjustment should take precedence and that budget balancing should follow once the economy's resources are reallocated. Since the real depreciation by itself is already bound to produce slack, there is no risk of an overheating in this sequencing of the adjustment.

A final point worth noting is the link between budget cutting and the extraordinary cut in Latin American investment. The reason is that, in the category of government spending, the easiest cuts are in the investment area. Postponing investment and maintenance is much easier than firing workers. The impact on aggregate investment is so large because the public sector, through public sector enterprises, accounts for a large part of total investment, and because the public sector was in the front row of adjustment. It is immediately obvious that this is a very ineffective means of adjustment that fails to recognize the distinction between the public sector's current and capital accounts.

⁷ That is, below the ministerial level.

⁸ See Dornbusch and Fischer (1986) and Fischer (1986).

TABLE 5
Mexican macroeconomic indicators

| | <u>1980-82</u> | <u>1983</u> | <u>1984</u> | <u>1985</u> | <u>1986*</u> |
|---------------------------------------|----------------|-------------|-------------|-------------|--------------|
| Budget deficit (percent of GNP) | — | 9.0 | 8.0 | 8.3 | 13.0 |
| Interest payments | 7.4 | 14.0 | 12.8 | 12.3 | 16.9 |
| Noninterest deficit | 3.6 | -4.9 | -4.8 | -3.9 | -3.9 |
| Current account (billions of dollars) | -9.4 | 5.3 | 4.0 | 0.5* | -3.9* |
| Real wage† | 100 | 77 | 71 | 71 | 63 |
| Real exchange rate† | 100 | 78 | 92 | 90 | 69 |
| Oil price (dollar per barrel) | 34 | 29 | 27 | 26 | 15 |
| Investment (percent of GDP) | 25.1 | 16.0 | 16.3 | 17.0 | — |
| Public sector | 8.8 | 5.7 | 5.3 | 4.9 | — |

*Estimate, May 1986
†1980-82=100

A case study: Mexico

Mexico illustrates in a very striking way many of these issues. The least noted fact, apparent in Table 5, is the dramatic shift in the budget over the past three years. The noninterest budget has improved by more than 7 percent of GNP. (That improvement amounts to more than a full Gramm-Rudman in less than three years. Perhaps we should enlist Mexican policymakers to help control U.S. budget deficits.) Note that the whole improvement in the noninterest budget went to finance increased interest payments on the domestic and foreign debt.

The increase in interest payments is to a large extent a reflection of inflation. Inflation and the accompanying exchange depreciation raise the nominal interest rates required to make Mexicans hold the depreciating asset. These interest rates in turn translate into a large interest bill in the

budget. If by some miracle, meaning an Austral-type program, inflation were to disappear, the budget would be nearly balanced. There is a budget deficit because there is inflation, not the other way around.

But what happened to the budget after the oil price fall in 1986? The direct impact of lower oil prices meant a deterioration in the budget of 6 to 7 percent of GNP. Where at 1985 oil prices, the non-inflationary budget would have shown a surplus, it now is in deficit by about 2 percent of GNP. If zero is the magic number, then clearly some extra budget work is necessary.

Consider next the current account. There is a striking turnaround from the deficits before the crisis to surpluses afterward. In 1983-84 the surpluses were enough to help finance capital flight and also meet the interest payments. In 1985 all of interest was paid out of surpluses and by attracting a reflow of private capital through very

TABLE 6
U.S. bank claims on non-OPEC LDC's
 (billions of dollars)

| | <u>All U.S. banks</u> | <u>9 major banks</u> | <u>15 major banks</u> | <u>All other</u> |
|-----------------------------------|-----------------------|----------------------|-----------------------|------------------|
| Total claims of U.S. banks | | | | |
| 1978 | 52.5 | 33.4 | 9.9 | 8.9 |
| 1982 | 103.2 | 64.2 | 20.2 | 18.9 |
| 1985 | 98.2 | 62.8 | 18.3 | 17.1 |
| Percent of capital | | | | |
| 1978 | 110 | 163 | 107 | 57 |
| 1982 | 154 | 227 | 162 | 75 |
| 1985: | | | | |
| All claims | 99 | 156 | 99 | 41 |
| Latin America | 69 | 109 | 66 | 30 |

Source: Federal Reserve

high interest rates. But after the oil price decline the external financing problem is back, forcing a decision to have further real depreciation or an alteration of the terms of debt service.

The real exchange rate and the real wage show a dramatic drop in the past few years. Real wages today are 40 percent below their 1980 levels and the external competitiveness has improved by 40 percent. These are extraordinary adjustments to make for any country. The decline in investment is apparent from the table. Finally, not shown, there is the employment story. The labor force is growing at 3.5 percent per year, but employment after an initial decline has been entirely stagnant over the past four years. Thus unemployment is widening, and with it social conflict. The lack of employment growth, even after so extreme a real depreciation, is an issue of major concern. It suggests that depreciation works primarily through the income effect and very little through substitution.

Bank exposure and the quality of debts

In this section, we sketch what bank exposure looks like and what can be said about the quality of the debts.

Bank exposure

Table 6 shows the claims by U.S. banks on the non-oil LDC's, both in dollar terms and as a fraction of capital. The table makes a distinction between various groups of banks to highlight the concentration of exposure in the large banks.

The first point to notice from these data is the absolute decline in bank exposure over the past three years. This is the result of loan run-offs, writedowns, and asset sales. It applies particularly to Asia and Africa. The data highlight that banks are not moving in the direction of voluntary lending, but rather in the opposite direction.

TABLE 7

Price of Latin American loans in the New York secondhand market and debt

| | Loan price (cents per dollar) | Total debt (billions of dollars) | U.S. bank debt |
|-----------|----------------------------------|-------------------------------------|----------------|
| Argentina | 63 | 49.6 | 8.5 |
| Bolivia | 7 | 4.2 | 0.14 |
| Brazil | 76 | 104.5 | 23.9 |
| Chile | 68 | 21.5 | 5.9 |
| Colombia | 85 | 13.6 | 2.6 |
| Ecuador | 64 | 7.7 | 2.1 |
| Mexico | 60 | 97.3 | 24.8 |
| Peru | 20 | 14.2 | 1.65 |
| Uruguay | 64 | 4.7 | 0.89 |
| Venezuela | 77 | 36.5 | 20.4 |

Attention focuses on the exposure measures since these highlight the vulnerability of banks to possible defaults. We show separately the data for exposure to Latin America, which is of particular interest because Latin debt accounts for the major part of debts and, for cultural reasons, is judged the most vulnerable.

The table brings out that exposure has declined significantly since 1982. In part this is cosmetic, in part it reflects a strategy of bank capital (including notes) and a sharp curtailment in new money commitments. Part of the increase in capital takes the form of equity commitment notes rather than actual equity.⁹ The strategy of raising capital through these notes reflects the double advantage of favorable tax treatment and a potentially more favorable timing of actual equity issue. It leaves open the question of where the financial effects of an actual call on the commitment would fall. It is clear that there is a sharp difference in exposure between the large money market banks on one side and all other banks. A complete

Latin writeoff of debts would wipe out the large banks but would keep the smaller ones intact. This is one of the senses in which LDC debts are a "big bank" problem.

The quality of debts

Latin debts do not fail to make the headlines. IMF agreements and reschedulings are hailed and welcomed with relief, breakdowns of negotiations are a source of anxiety until everybody gets accustomed to the fact that in the end an agreement always seems to be reached, even if the going is rocky. But even against a background of four years of highly successful reschedulings and not a single outright default, there remain doubts.

One measure of the quality of these bank loans is provided by the discount at which they trade in the secondhand market. There is now a well functioning market in which banks can sell or swap loans in their portfolio. Business is done between banks but also with corporations and even private investors. Table 7 shows the discounts in mid-May for Latin American loans.

⁹ See the *American Banker*, August 9, 1985.

The evidence is, of course, quite striking. Discounts of 30 or 40 percent suggest that the market must assign a very significant probability to partial or complete default. These valuations might be affected by the market continuing to be quite narrow, without a massive spreading of the risks to widows, orphans, and insurance companies that might ordinarily be expected to hold some share of these claims. But even with allowance for the narrowness of the market, the discounts are very large. It must certainly be clear that these deep discounts suggest that an imminent return to voluntary lending is entirely inconceivable.

A separate source of information is provided by the yield differential between medium-term bonds (issued by deutschemarks) by various debtor countries and the yield bonds of industrialized countries of comparable maturity.¹⁰ Table 8 shows this differential in the yield to maturity. Charts 2 through 5 show the same information.

The risk premiums are strikingly concentrated in the early period of the debt crisis, in the fall of 1982. There are variations between countries, but in all cases there is a very sharp decline over the subsequent period. Individual country variations include quite obvious effects: the Malvinas war and the risk of a Peronist victory in Argentina in the fall of 1983, the effect of declining oil prices in Mexico, and the problems associated with Brazil's rescheduling in 1983. Perhaps the most striking fact of these series is the relatively small premium showing here compared with the data for discounts on bank debts. The difference in evidence raises the question whether assets are not really traded, whether the markets are unconnected, or whether bank debt is particularly vulnerable, which might appear at first sight surprising.

¹⁰ The data are described in Folkerts-Landau (1985) and an update was kindly made available by the German Bundesbank. The Mexican, Argentinian, and Brazilian bonds are to mature in 1988, the Venezuelan bond in 1990.

Another direction to look for evidence on the quality of LDC debts is in the stock market. The stock market value of banks with LDC exposure should be affected by variations in the prospects for loan recovery. Kyle and Sachs (1984) have indeed brought evidence pointing in that direction.

Possible solutions

The basic fact in assessing the debt problem is that it will not go away. Every year, or every other year, will look good from the debtor's point of view, and soon an adverse shock or mismanagement will bring them back into a precarious situation. The world economy is unlikely to provide enough growth at low interest rates and booming commodity prices to make the debt problem go away. And even if it did, there is no assurance that in the debtor countries pent-up demands for expansion of demand and social programs would not simply squander quickly any available room and more. There is also no doubt that the debt problem is a first-rate political liability. We review here some of the more interesting or controversial solutions.¹¹

Reversal of capital flight

The wishful thinking turns to the \$100 billion or more of Latin assets that have fled from financial instability and taxation to the industrial countries, especially the United States. Reversing these capital flights, especially in the case of Mexico or Argentina, would make it almost possible to pay off the external debt. The reason is that much of the debt was incurred in the first place to finance the exodus of private capital.

The idea that private capital could be the main solution or an important one is naive. There is little or indeed no historical precedent for a major

¹¹ See Lessard and Williamson (1985) for a thoughtful assessment of a large range of solutions.

TABLE 8
Yields on deutschemark bonds

| <u>Date</u> | <u>Industrial</u> | <u>Argentina</u> | <u>Brazil</u> | <u>Mexico</u> | <u>Venezuela</u> |
|-------------|-------------------|------------------|---------------|---------------|------------------|
| 1982:1 | 10.0 | 13.8 | 11.2 | 10.7 | 10.5 |
| 1982:2 | 10.1 | 13.6 | 11.4 | 10.8 | 10.7 |
| 1982:3 | 9.8 | 13.3 | 11.0 | 10.8 | 10.8 |
| 1982:4 | 9.2 | 14.0 | 10.9 | 10.7 | 10.8 |
| 1982:5 | 8.9 | 15.3 | 11.1 | 10.5 | 10.8 |
| 1982:6 | 9.2 | 16.9 | 11.3 | 10.9 | 10.9 |
| 1982:7 | 9.1 | 15.5 | 10.9 | 10.5 | 10.9 |
| 1982:8 | 9.1 | 17.8 | 13.4 | 13.1 | 11.5 |
| 1982:9 | 9.0 | 19.5 | 14.8 | 13.3 | 12.1 |
| 1982:10 | 8.8 | 19.1 | 13.6 | 13.0 | 12.2 |
| 1982:11 | 8.5 | 17.5 | 13.8 | 12.9 | 12.2 |
| 1982:12 | 8.1 | 16.8 | 13.0 | 12.1 | 11.7 |
| 1983:1 | 7.8 | 17.6 | 14.1 | 12.0 | 12.0 |
| 1983:2 | 7.9 | 17.5 | 14.6 | 13.2 | 14.0 |
| 1983:3 | 7.7 | 17.0 | 13.1 | 13.2 | 12.7 |
| 1983:4 | 7.5 | 17.0 | 12.6 | 12.2 | 11.9 |
| 1983:5 | 7.5 | 17.3 | 12.5 | 12.1 | 11.4 |
| 1983:6 | 7.7 | 17.5 | 12.5 | 11.6 | 11.5 |
| 1983:7 | 7.9 | 16.4 | 12.6 | 10.7 | 11.6 |
| 1983:8 | 7.9 | 15.5 | 14.3 | 10.3 | 11.6 |
| 1983:9 | 7.9 | 16.8 | 14.4 | 10.3 | 11.7 |
| 1983:10 | 7.8 | 19.3 | 14.5 | 10.7 | 11.7 |
| 1983:11 | 7.7 | 16.9 | 14.9 | 10.7 | 11.6 |
| 1983:12 | 7.8 | 15.8 | 13.1 | 10.4 | 11.1 |
| 1984:1 | 7.8 | 12.7 | 11.3 | 10.0 | 9.9 |
| 1984:2 | 7.6 | 11.2 | 10.2 | 9.6 | 10.0 |
| 1984:3 | 7.5 | 12.9 | 10.6 | 9.5 | 9.9 |
| 1984:4 | 7.6 | 12.3 | 10.8 | 9.1 | 9.9 |
| 1984:5 | 7.7 | 12.7 | 10.7 | 9.8 | 9.8 |
| 1984:6 | 7.8 | 14.7 | 11.2 | 9.9 | 10.5 |
| 1984:7 | 7.9 | 15.6 | 11.7 | 9.8 | 11.1 |
| 1984:8 | 7.8 | 13.4 | 11.1 | 9.6 | 10.1 |
| 1984:9 | 7.6 | 10.7 | 9.9 | 9.0 | 9.4 |
| 1984:10 | 7.5 | 9.8 | 9.1 | 8.7 | 9.3 |
| 1984:11 | 7.3 | 9.1 | 8.8 | 8.7 | 9.3 |
| 1984:12 | 7.2 | 9.3 | 8.5 | 8.7 | 8.7 |
| 1985:1 | 7.3 | 8.7 | 8.3 | 8.1 | 8.7 |
| 1985:2 | 7.7 | 8.2 | 8.2 | 8.5 | 8.9 |
| 1985:3 | 7.7 | 8.3 | 8.6 | 8.4 | 8.7 |
| 1985:4 | 7.4 | 8.6 | 8.6 | 8.1 | 8.8 |
| 1985:5 | 7.3 | 8.5 | 8.3 | 8.0 | 8.6 |
| 1985:6 | 7.2 | 8.9 | 8.2 | 8.2 | 8.7 |
| 1985:7 | 7.1 | 9.0 | 8.3 | 8.3 | 8.8 |
| 1985:8 | 6.8 | 8.6 | 8.5 | 8.3 | 8.8 |
| 1985:9 | 6.8 | 8.1 | 8.5 | 8.3 | 8.9 |
| 1985:10 | 7.0 | 8.4 | 8.5 | 9.0 | 8.8 |
| 1985:11 | 7.0 | 7.7 | 8.2 | 8.8 | 8.5 |
| 1985:12 | 6.9 | 7.9 | 8.4 | 9.0 | 8.6 |
| 1986:1 | 6.8 | 7.9 | 7.9 | 8.4 | 8.7 |
| 1986:2 | 6.7 | 8.4 | 8.2 | 8.8 | 8.8 |
| 1986:3 | 6.5 | 6.9 | 7.3 | 8.3 | 8.7 |
| 1986:4 | 6.5 | 7.1 | 7.2 | 7.8 | 8.5 |
| 1986:5 | 6.6 | 6.8 | 7.2 | 7.3 | 8.4 |

Source: Deutsche Bundesbank

CHART 2
Yield on deutschemark bonds: Argentina

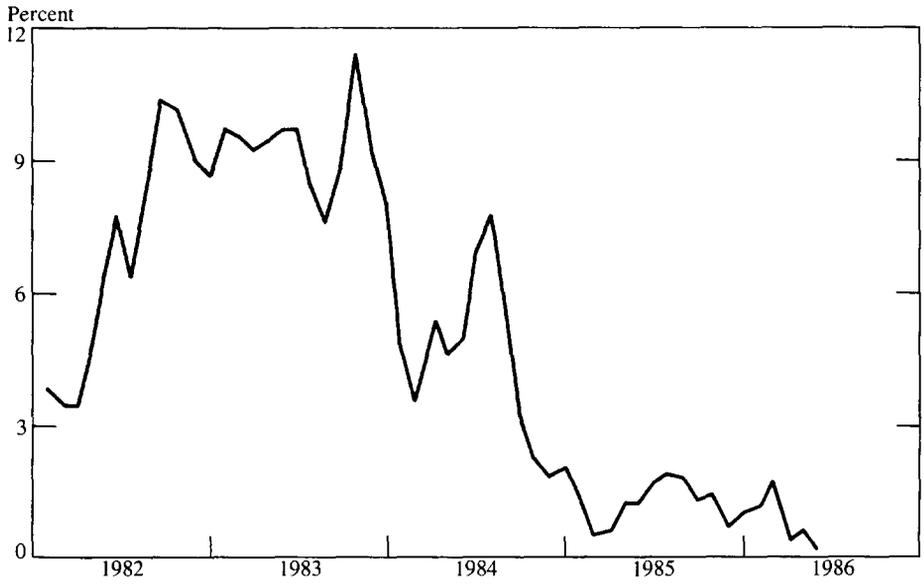


CHART 3
Yield on deutschemark bonds: Brazil

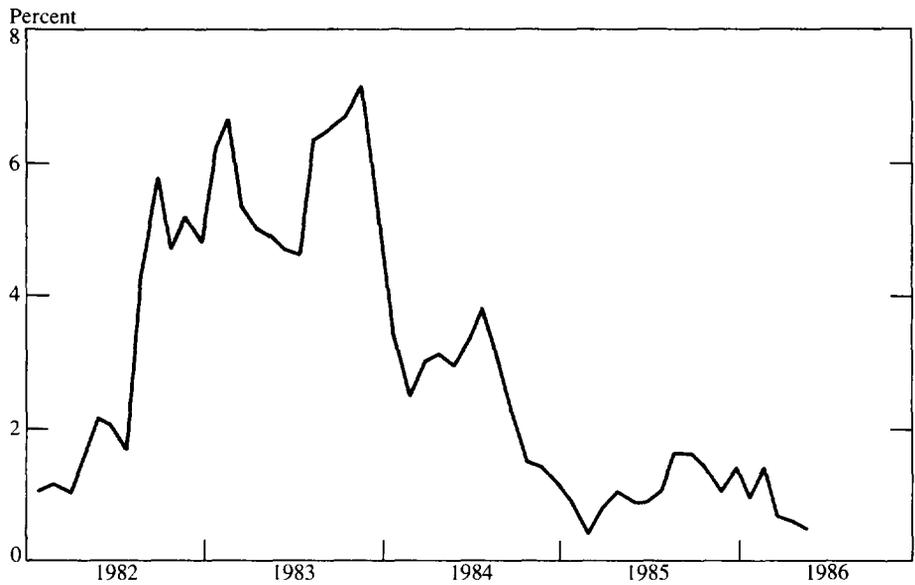


CHART 4
Yield on deutschemark bonds: Mexico

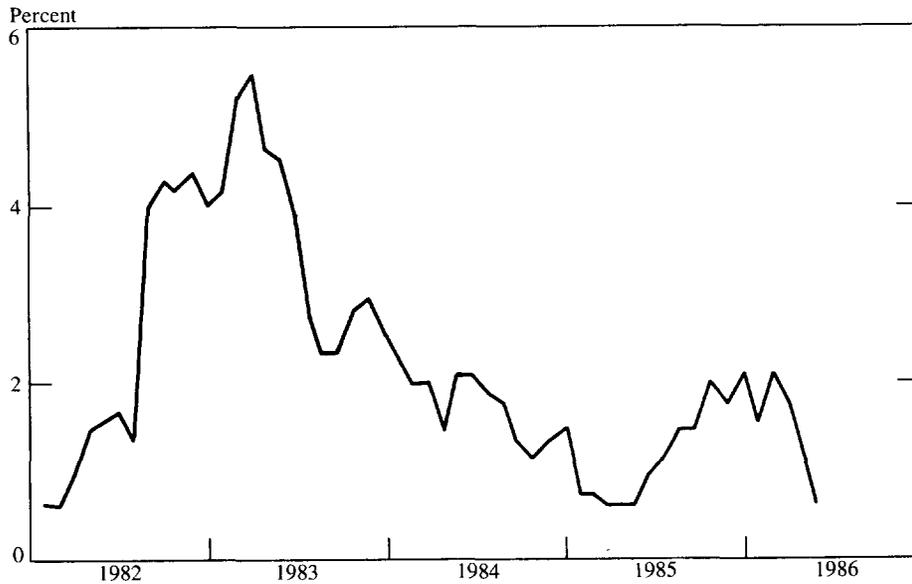
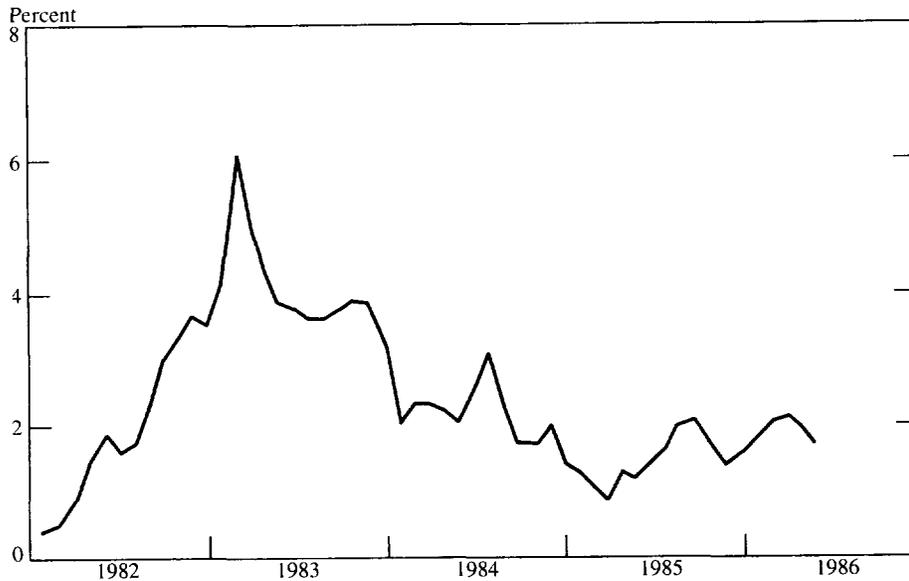


CHART 5
Yield on deutschemark bonds: Venezuela



reflow and when it does happen, it is the last wagon of the train. Einaudi once observed is that savers "have the memory of an elephant, the heart of a deer and the legs of a hare." Capital will wait until the problems have been solved; it will not be part of the solution.

It is often argued that if only countries adopted policies conducive to guaranteeing savers stable positive real rates of interest, the capital flight problem would not be an issue. But that argument is not very operational in two respects. First, in the context of adjustment programs, it is unavoidable to devalue, for example. Compensating savers for the loss they would have avoided by having dollar assets would place a fantastic burden on the budget that in turn would breed financial instability. Second, practicing high, positive real interest rates poses a serious risk to public finance. The public debt which carries these high real rates snowballs, and that in turn is the source of instability. Third, it is a very bad habit indeed to raise the return on paper assets above the prospective return on capital. That is terrible supply-side economics that ultimately erodes the tax base and deteriorates the financial system by souring loans. A country in trouble simply cannot opt to make the chief priority to keep the bondholders in place.

Capital controls, where feasible, are an essential part of a strategy to bring public finance in order rather than to paper over extreme difficulties for a while by extraordinarily high real interest rates. The latter strategy was, indeed, at the very source of the extreme mess in Argentina under Martinez de Hoz or in Mexico today.

It is also worth recognizing that the capital flight problem is to a large extent of our own doing. The administration, in an effort to fund our own deficits at low cost, has promoted international tax fraud on an unprecedented scale. The only purpose one can imagine for the elimination of the withholding tax on nonresident asset holdings in the United States is to make it possible for foreigners to use the U.S. financial system as a

tax haven. To compete with the tax-free U.S. return anyone investing in Mexico and actually paying taxes there would need a yield differential, not counting depreciation and other risk, of quite a few extra percentage points.¹²

There is much talk about the problems of banks putting in new money only to see it spent by debtors like Mexico on capital flight. The fact is that the big banks are the chief vehicles for and beneficiaries of the capital flight. This system, on all accounts, enhances the political explosiveness of the debt crises by placing on workers in the LDC's an even more serious adjustment burden. The treatment of capital flight by the banking community, with these ideas in mind, is not only outright cynical but also shortsighted.

Debt-equity swaps

The second solution that is finding a lot of favor in the financial community is a more extensive system of debt-equity swaps, preferably geared to a privatization effort. The mechanics are easy. An investor, say a U.S. corporation, purchases in the second-hand market Mexican debt at a 40 percent discount. The debt is presented to the Mexican Central Bank for redemption at par into pesos, preferably at the premium prevailing in the free market. The proceeds are then applied to purchasing Mexicana airline or some other asset being liquidated by the public sector in a distress sale.

When the accounts are done, the external debt is reduced, the banks are ahead, the investor is

¹² Let i , i^* and e be the interest rate in New York, in Mexico and the rate of depreciation with t the marginal tax rate. A risk neutral investor will equate expected returns in a common currency: $(1+i)(1+e)=(1+i^*(1-t))$ or the Mexican before-tax interest rate would have to be: $i^*=(i+e+ie)/(1-t)$. With a New York rate of $i=0.1$, a depreciation of the peso of $e=1$ and a marginal tax rate of $t=0.4$ the Mexican before-tax rate comes to i^*+2 or 200 percent. Of course, the 200 percent interest rate, even adjusted for inflation and depreciation, would kill real investment.

ahead, and the Mexican government can wonder whether they made a killing or they were had. Given the enthusiasm for debt-equity swaps, the latter is presumably the right view to take. Debt-equity swaps may be an extraordinarily expensive way to clean up the balance sheet. For one, there is no conceivable reason why debts should be redeemed at par if in fact they trade at a discount. Moreover, selling national assets under distress conditions may involve losses. Finally, the balance of payments consequences in the medium term do not amount to an improvement. Before interest was to be paid, and now it is profits.

But one certainly should not take an altogether negative view of the scope for foreign investment.¹³ Certainly it is worthwhile promoting foreign investment, both direct and portfolio investment. In fact, if that had been the strategy in the 1970s and early 1980s the debt crisis would hardly have happened. But at the present juncture, as a short-term solution, foreign investment is unlikely to make a large contribution. Perhaps a better strategy than individual swaps is to set up a national mutual fund, including public sector firms, or even formed out of public sector firms, provide sound accounting standards, and sell the claims abroad. The proceeds can be applied to buy back debt in the second-hand market. There is no need for the funds to be sold in New York or to nonresidents; even pesos are fungible. Nor is there a need to retire external debt rather than domestic debt, unless there was inside knowledge about the utter determination to service the external debt. In that latter case, it is well worth buying up debts in the second-hand market at the present discounts.

Perhaps the two strategies amount to much the same, but there is a suspicion that the former

implies more foreign control, which may be good or bad, and perhaps a much larger transfer to foreign creditors.

The Bradley plan

Senator Bill Bradley has recently advanced a proposal that would link the debt problem to U.S. foreign policy and trade interests. The proposal starts from the recognition that the debt problem is not only a banking problem but also a problem for manufacturing, since interest received means jobs lost. Premature and excessive debt collection goes against the interest of our manufacturing sector, which is already strapped by an overvalued dollar and now is hurt, in addition, by losses of export markets and a trade invasion from the South. Since 1981, our trade balance with Latin America, counting merchandise only, has deteriorated by as much as \$15 billion. Counting services, the number would be much larger still.

The proposal seeks targeted, limited debt relief under supervised, sensible growth programs. Countries opting for a program of debt relief would in exchange have to be prepared to offer trade concessions and presumably concessions in other areas of U.S. foreign economic interests. The specifics of the relief would be a three percentage point reduction in interest rates on debt outstanding, a 3 percent writedown of principal, and a pool of an extra \$3 billion in resources from multilateral agencies available for the participating countries. An annual debt summit would be joined to the General Agreement on Tariffs and Trade process to recognize that trade and debt come as a two-way street.

The important points about the Bradley proposal are two. First, the recognition that the U.S. Congress should get involved in the debt issue to broaden the debate because at present it is handled in the narrow and shortsighted interest of banking only. The second is that it proposes a specific action program. There are really only two ways

¹³ Perhaps the most impressive evidence on the benefits of direct foreign investment comes from the free trade zone in the north of Mexico. Employment growth and prosperity in that area contrast sharply with the rest of Mexico.

the current debt collection process can be derailed. One is a recommendation by Milton Friedman, that the government should get out of the process altogether, letting the banks try to collect their debts if they can. The other is to provide a sensible legislative package that achieves the difficult task of combining four elements: keeping the tax-

payer largely out, making the debts better (even if concessions and writedowns are part of the adjustment), and restoring sustained growth in Latin America while enhancing U.S. trade opportunities there. That sounds difficult, except when one recognizes that the trade and labor interests may swing the public policy debate.

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