# Economic Review

FEDERAL RESERVE BANK OF KANSAS CITY

January 1987

Debt, Financial Stability, And Public Policy

International Debt And Economic Instability

Commentary on "International Debt and Economic Stability"

The Rural Economic Policy Choice

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# Economic Review

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# Debt, Financial Stability, And Public Policy

*By Bryon Higgins and Thomas J. Merfeld*

Most major types of debt have grown rapidly in recent years. The most publicized aspect of the overall growth in debt has been the unprecedented size of federal government budget deficits. But debt of households and businesses has also grown rapidly, and the debt of developing countries has risen so much that exceptional efforts by international lending agencies, creditors in developed countries, and the developing countries themselves have been required to prevent widespread defaults.

The buildup in debt could imperil the stability of the financial system, according to some analysts. They argue that the heavy debt burdens have reduced the ability of financial institutions, borrowers, and the economy at large to withstand recessions and other types of adversity. The resulting increase in financial fragility could force the Federal Reserve to choose between financial stability and price stability as the primary goal of monetary policy.

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Several changes in public policy have been recommended to alleviate the effects of the high level of debt. Reform of tax laws, regulatory policies, and financial disclosure requirements—as well as changes in the government's fiscal policy—have been advocated as ways of reversing what has been called "the leveraging of America."

To gain a better understanding of the possible threats to financial stability from the buildup in debt, the Federal Reserve Bank of Kansas City sponsored a symposium on "Debt, Financial Stability, and Public Policy" on August 27-29, 1986. Symposium participants agreed that U.S. government budget deficits and the heavy debt burden of less developed countries (LDC's) threaten financial stability, but they disagreed on whether the debt of businesses and households was also worrisome. Except for a consensus that government budget deficits should be reduced, there was no clear agreement on what public policy actions are needed to protect the stability of the financial system.

This article highlights the issues raised by speakers at the symposium. The first section provides an overview of the growth in domestic debt and of the issues raised by that growth. The second section focuses on the consequences of the LDC debt problem and on policies for dealing with that problem. The third section presents possible regulatory and macroeconomic policy responses to the overall increase in debt. The final section provides the comments of three current or former policymakers on issues raised at the symposium.

## Domestic debt and financial stability

Presentations by Henry Kaufman and Benjamin Friedman documented the acceleration in growth of domestic debt and assessed its consequences. Both Kaufman and Friedman felt that rapid debt growth has imperiled financial stability. They also expressed concern that the Federal Reserve might thus become less aggressive in pursuing anti-inflationary policies.

### *Debt and financial stability: an overview*

In "Debt: The Threat to Economic and Financial Stability," Henry Kaufman developed his thesis that the high level of debt will result in major economic and financial disruptions unless structural changes are made.

The rapid growth in domestic debt has been accompanied by a deterioration in the quality of credit, according to Kaufman. Growth in total debt has increased both absolutely and relative to GNP. After increasing at an average rate of 7.3 percent in the 1960s, total debt grew at a rate of 11.1 percent in the 1970s and has grown at a rate of 11.8 percent so far in the 1980s. As a result, the ratio of debt to GNP has risen from about 1.5 in the 1960s and early 1970s to about 2.0 by the mid-1980s. While this rapid growth was occurring, the agencies that rate creditworthiness of debtors have lowered credit ratings for the business sector. For example, over the last decade, the number of Aaa-rated industrial and utility corporations has been cut by more than half, and the number of bank holding companies with the highest credit rating has declined from 14 to only one. Kaufman attributed the overall deterioration of credit quality to an "audacious leveraging strategy" that has resulted in many corporations substituting debt for equity.

Recent trends in the financial markets have contributed to the increase in debt. Financial markets have become more integrated both domestically and internationally, and depository institutions are not as "compartmentalized" as they were before deregulation. Moreover, such financial innovations as floating-rate financing, securitization of debt, and financial futures have reduced the cost of credit by reducing the risk incurred by borrowers. And the tax structure has encouraged the use of debt rather than equity because dividend payments and capital gains are subject to full taxation, while interest payments are tax deductible. Finally, deposit insurance and market perceptions that the federal government will not allow a large financial institution to fail have further reduced the perceived risk of borrowing. These developments, according to Kaufman, raise the vexing question, "Who is the real guardian of credit?"

Increased debt could also intensify the effect of a recession. Higher debt requires greater cash flows to make interest payments, but a recession would curtail cash flows. In the best case, debt servicing would preempt existing income, leaving less for investment and profits. In the worst case, the existing income would be insufficient to meet debt servicing obligations. In either case, Kaufman said, the high level of debt financing would make any recession worse.

Kaufman concluded that the Federal Reserve will be forced to follow an accommodative monetary policy to avoid the severe recession that the high level of debt could cause. It must be recognized that such a policy could reignite inflation. Yet moving away from the large budget deficits that have contributed to the financial

**Debt, Financial Stability, and Public Policy**
**A symposium sponsored by the**
**Federal Reserve Bank of Kansas City**
**August 27-29, 1986**

**Debt and Financial Stability**

Bruce K. MacLaury, President, The Brookings Institution, **moderator**

**Debt: The Threat to Economic and Financial Stability,** Henry Kaufman, Managing Director, Salomon Brothers Inc

**Increasing Indebtedness and Financial Stability in the United States,** Benjamin M. Friedman, Professor, Harvard University
**Commentary,** Allan H. Meltzer, Professor, Carnegie Mellon University

**International Debt and Economic Instability,** Rudiger Dornbusch, Professor, Massachusetts Institute of Technology
**Commentary,** Rimmer de Vries, Senior Vice President, Morgan Guaranty Trust Company

**International Debt and Public Policy,** A. W. Clausen, Former President, The World Bank

**Financial Stability and Public Policy**

Preston Martin, Former Vice Chairman, Federal Reserve Board, **moderator**

**Regulatory Policies and Financial Stability,** Robert A. Eisenbeis, Professor, University of North Carolina
**Commentary,** George J. Benston, Professor, University of Rochester
**Commentary,** William Peter Cooke, Associate Director, Bank of England

**Debt Problems and Macroeconomic Policies,** Lawrence H. Summers, Professor, Harvard University
**Commentary,** Alan S. Blinder, Professor, Princeton University
**Commentary,** Phillip Cagan, Professor, Columbia University

**Overview Panel**

Stephen H. Axilrod, Vice Chairman, The Nikko Securities Company International
John G. Heimann, Vice Chairman, Merrill Lynch Capital Markets
L. William Seidman, Chairman, Federal Deposit Insurance Corporation

strains could lead to a recession requiring such monetary accommodation.

The inflationary consequences of the necessarily accommodative monetary policy can be avoided, Kaufman said, by making structural changes to strengthen the financial system. He advocated that the regulation of financial institutions be centralized in a National Board of Overseers to standardize and improve regulatory oversight. Moreover, financial disclosure should be increased and aimed toward revealing the overall financial health of the institution. If these steps are not effective, financial regulatory agencies should make public the creditworthiness of the institutions they regulate. Tax policies should also be changed to discourage excessive borrowing. A major improvement in this regard would be eliminating double taxation of dividends and the capital gains tax on equities. Finally, international cooperation among regulatory agencies should be strengthened. Punctuating the importance he attaches to the problem, Kaufman urged that such policy changes be adopted before "the debt problem has completely overwhelmed us."

### *Dimensions of growth in domestic debt*

In "Increasing Indebtedness and Financial Stability in the United States," Benjamin Friedman developed in more detail many of the themes touched on by Kaufman. Friedman concluded that higher debt has increased the vulnerability of the U.S. economy to financial instability and has thus made the Federal Reserve more likely to err on the side of expansionary policy, risking higher inflation.

Friedman documented in detail the increased indebtedness in the U.S. economy. The ratio of debt to GNP has remained basically constant throughout much of U.S. history, but has risen rapidly in the 1980s. All major sectors of the economy have increased their indebtedness relative to income. As a result, the share of income going to service debt has risen for households, businesses, and the government.

The primary danger for financial stability is that a recession will interrupt the cash flows of households and businesses, making it difficult to meet debt servicing obligations. Default by some borrowers would reduce cash flows to their creditors, which would then be unable to meet debt payments and would be forced to reduce demand for goods and for workers. In this way, inability to service the high level of debt could lead to a cumulative crisis in the financial system and to a progressive decline in output and employment.

The concentration of debt in low to middle income households increases the likelihood of personal defaults in times of financial stress. Friedman's research reveals that the household sector as a whole maintained a fairly constant ratio of assets to debt in the recent debt surge. Therefore, in the aggregate, households have not increased their exposure to debt. However, consumer credit, often held by lower income households, has accounted for much of the household debt increase. Because low to middle income families have taken on such heavy debt obligations, a recession that disrupts the cash flow that these households depend on to service their debt could lead to a surge in defaults on household debt.

By substituting debt for equity financing, the corporate business sector has made itself heavily dependent on current cash flows. According to Friedman, the recent wave of leveraged buyouts is responsible for much of this substitution because corporations borrow funds to buy shares in their own firm or in other firms. While this increase in business's debt-asset ratio does not directly threaten financial stability, any disruption of cash flows could prevent firms from meeting their debt obligations.

Higher inflation could thus be the ultimate consequence of increased indebtedness. The increased likelihood of debtor distress during a recession could reduce the Federal Reserve's tolerance for allowing a business downturn, Friedman said. As a result, U.S. monetary policy is likely to be more expansionary during a period of high debt, leading to higher inflation on average.

In discussing Friedman's paper, Allan Meltzer argued that Friedman had overstated the danger of higher debt. According to Meltzer, the growth of business debt has been moderate. Whereas Friedman studied debt to income ratios, Meltzer proposed focusing on business debt relative to assets and net worth. By these criteria, debt is lower now than in the past. Those expressing concern over rising debt have ignored the parallel increase in asset values.

Meltzer also argued that the level of debt is not a good indicator for monetary policy. Debt gives ambiguous signals about the economy. For example, a high ratio of debt to income may indicate either high current consumption or increased business investment. According to Meltzer, the Federal Reserve will realize that debt is not a good policy tool and thus refrain from an overly stimulative policy response to it.

## International debt and financial stability

The sharpest disagreement at the symposium regarded the best approach to the debt problems of less developed countries (LDC's). Rudiger Dornbusch advocated a fundamental change in U.S. policies toward heavily indebted LDC's and their creditors. In contrast, Rimmer de Vries and A. W. Clausen urged that the current framework for resolving the LDC debt problem be retained, with only minor adjustments as needed to adapt to changing conditions.

### *The case for fundamental change*

In his paper, "International Debt and Economic Instability," Rudiger Dornbusch argued that the current approach to the problem of heavily indebted developing countries is a failure. He advocated more U.S. government involvement and reduced debt servicing burdens for LDC debtors as the most realistic alternative to the current policies, which he considers to be failures.

Dornbusch traced the origin of the LDC debt problem to both domestic mismanagement and deterioration in the world economy. Many LDC's held their exchange rates at unrealistically high levels in the 1970s while they removed constraints on international trade and capital flows. A resulting speculative flight into foreign assets caused capital flight of $70 billion or more from LDC's in the early 1980s. At the same time, world economic growth slowed and real interest rates soared, reducing export earnings and increasing the interest cost of foreign debt. As a result, Latin American and other LDC debtors could not service their external debt.

The LDC debt problem has not improved since 1982, when it became apparent that Mexico could no longer meet its foreign debt payments. Whereas the problem was initially viewed as merely one of liquidity that would be solved as the terms of trade and the world economy improved, it has become apparent, according to Dornbusch, that the problem is one of insolvency rather than illiquidity. Moreover, the world economy has not picked up enough to raise commodity prices. Yet higher commodity prices will be necessary for most Latin American debtors to improve their export earnings enough to service their external debt. As a result, most LDC debtors have continued to borrow, increasing their debt with no realistic expectation of being able to pay the interest, let alone the principal. Despite government spending cuts and other austerity measures by LDC debtors, the international debt problem has continued to worsen because large American banks, the U.S. government, and international lending agencies have followed a policy of "involuntary debt service." Dornbusch said this policy has led to "extraordinary costs to debtors and to the trading interest of the creditor countries."

Dornbusch concluded that a new approach is necessary to solve the LDC debt problem and reviewed several of the recent proposals. He characterized as naive proposals that contemplate a reversal of capital flight because the conditions that led to the capital flight from LDC's are still present. Moreover, swaps of debt for equity, in which a bank or an investor who has acquired LDC debt in the secondary market exchanges the debt for an equity position in a company sold by the LDC government, cannot be counted on for more than a small part of an overall solution. Such a solution requires, in Dornbush's view, that the LDC debt problem be viewed not just as a banking problem but also as a problem for U.S. industry, since the improvement in the trade balances of LDC debtors necessary to service their external debt has been associated with a major reduction in U.S. exports to those countries. The "Bradley Plan," for example, would be a major improvement over the current approach toward LDC debt, Dornbusch said. Senator Bradley has proposed targeting limited debt relief for LDC debtors in exchange for trade and other concessions in the overall interest of the United States. Under this plan, qualifying LDC debtors would be eligible for a three percentage point reduction in the interest rate on the debt and a 3 percent writedown of the principal. In addition, a pool of an extra $3 billion in funds from international lending agencies would be made available to LDC debtors. In Dornbusch's view, the Bradley Plan recognizes the LDC debt problem as a broad political issue in which the Congress should become involved to further the interest of the U.S. economy as a whole rather than "the narrow and shortsighted interest of banking only."

### *The case for modest adaptation*

Rimmer de Vries gave a spirited rebuttal to Dornbusch's analysis. He emphasized that progress has been made through the current case-by-case approach to LDC debt, offering Brazil as one outstanding example. The Brazilian economy is growing rapidly without inflation, and its interest payments as a percentage of export earnings have dropped to half of the 1983 level. Moreover, U.S. banks have reduced their exposure to LDC's and have thus improved the stability of the U.S. financial system. And the debtor nations continue to work constructively with commercial banks in developing solutions to their mutual problems.

The remaining problems should be resolved on a case-by-case approach with an assortment of tools, de Vries said. Some policy recommendations may apply to some countries but not to others. For example, countries with weak internal economies should make structural reforms, while the most pressing need for others is to increase the private sector's ownership and control of businesses. The International Monetary Fund should be accommodative where the conditions warrant. In addition, debt for equity swaps could benefit all parties involved. Finally, de Vries argued that capital flight could be reversed, thereby reducing external debt without serious damage to the LDC economies or to the international financial system.

de Vries argued that neither banks nor creditor nations should pursue policies for the outright debt relief proposed by Dornbusch. Instead, facilitating LDC access to international capital markets should be the primary goal of all parties. Merely forgiving principal would dissuade new lending to LDC's for years. Proposals such as the Bradley Plan would politicize the issues and set the interests of U.S. banks against those of U.S. manufacturing and trade. Nor would these plans achieve the goal of increasing debtor countries' access to capital markets.

In his luncheon speech, A. W. Clausen urged a multifaceted approach to the solution of the LDC debt problem. He argued that sustained economic growth in the developing countries was necessary not only to restore their creditworthiness in international markets but also to alleviate the poverty that threatens political and social stability.

Developed countries have a key role in providing an environment for sustained growth in developing countries, according to Clausen. Sustained growth in developing countries is essential if LDC debtors are to expand their exports enough to service debt while making progress in alleviating domestic poverty. High government budget deficits in industrial countries impede sustained growth in the world economy and keep real interest rates high, forcing debtor nations to devote more of their incomes to interest payments on their debts. To Clausen, the implication is clear: economies with persistently high budget deficits must reduce them, preferably through cuts in public spending—especially spending for commodity subsidies that undercut efforts by LDC's to increase their commodity exports to industrial countries.

But controlling budget deficits will be inadequate unless developed countries make additional capital available to LDC debtors and maintain an open trading system that allows LDC's to expand their exports. According to Clausen, protectionism is one of the primary threats to the prosperity of developing countries and thus to their ability to service debt. Developing countries must also maintain adequate capital flows to the indebted countries, including support for the international lending institutions that play the central role in restoring growth and equilibrium to heavily indebted LDC's. Japan, in particular, could find it beneficial to increase its capital flows to developing countries.

None of the efforts of developed countries will succeed, however, without policy reforms in the LDC's themselves. A key to providing adequate economic growth in many developing countries is the revitalization of their agricultural sectors. Agriculture is typically the largest sector in the economy and, therefore, the one that promises the best hope for broad-based economic growth and rising incomes.

## Public policies for financial stability

Participants on the second day of the symposium addressed issues regarding policy measures to enhance financial stability. The role of regulatory policy in preventing debt growth from leading to a financial crisis was addressed first, and the possible role of monetary and fiscal policy in enhancing financial stability was then evaluated.

### *Regulatory polices and financial stability*

Robert A. Eisenbeis, in his paper "Regulatory Policies and Financial Stability," argued that many of the problems attributed to deregulation of the financial system are actually legacies of flaws in financial regulation and the deposit insurance system. He offered several suggestions for revising those policies to ensure that the financial system is less vulnerable to crisis.

According to Eisenbeis, ill-conceived regulations are the root causes of many of the problems in the financial system. Although financial innovations are often blamed for increasing financial fragility, these innovations are typically designed to circumvent financial regulations. While the regulations are well intentioned, they disrupt market efficiency and give rise to practices that weaken the financial system. Deposit interest rate ceilings and reserve requirements, for example, led depository institutions to rely increasingly on short-term funds, widening the maturity gap between assets and liabilities and increasing interest rate risk. Similarly, regulatory limitations on geographic and product expansion have prevented the asset diversification needed for limiting risk of depository institutions. As a result of these and other regulatory constraints, an increasing amount of credit is "securitized" or otherwise diverted to less regulated markets, including off balance sheet activities of commercial banks and the corresponding practices of brokerage firms. In short, Eisenbeis viewed many of the financial innovations that threaten the safety of the financial system as practices that "have been pursued and have prospered, not because they necessarily improved efficiency . . . but rather because of their productivity in regulatory avoidance."

The current deposit insurance system is particularly damaging because it encourages excessive risk taking. Because the cost of deposit insurance to an institution is based on the size of its deposit base rather than on the riskiness of its assets, the deposit insurance system allows institutions to acquire risky assets without incurring a commensurate increase in costs. The resulting subsidy to risk taking is a particularly acute problem in the case of weak institutions that can hope to survive only by investing in high yield, high risk assets.

On the basis of his analysis, Eisenbeis proposed several policy changes to enhance the safety and soundness of the financial system. First, deposit insurance should be priced so that institutions bear the cost of risk taking. Second, regulatory agencies should close financial institutions when their net worth reaches zero. Any plan to prop up failing institutions not only subsidizes their subsequent losses but also establishes a precedent that encourages other institutions to invest in risky assets. Third, the Federal Reserve should provide discount window loans only at rates above market rates to discourage institutions in financial difficulty from taking risks. More generally, Eisenbeis argued that financial deregulation should continue because only in this way can market forces exert the necessary discipline to discourage the type of risk taking that has endangered the stability of the financial system.

Discussant George J. Benston basically agreed with Eisenbeis, but added that the Federal Reserve should concentrate on preventing systemic financial crises by proper regulation of the money supply and interest rates. According to Benston, the Federal Reserve should not be concerned with the failure of a single financial institution, because a single failure would not induce systemic financial distress. On the other hand, an inappropriate monetary policy can cause a general economic depression or aggregate price inflation. Therefore, the Federal Reserve should concentrate on avoiding systemic instability through proper use of monetary policy.

In discussing the paper by Eisenbeis, William Peter Cooke agreed that deregulation did not cause the current stress in the U.S. financial system, but he disagreed with many of Eisenbeis's policy recommendations. First, the risk-based deposit insurance system proposed by Eisenbeis is unnecessary, Cooke believed. If regulatory authorities want to impose costs on deposits commensurate with the risks that institutions assume, they should discontinue the deposit insurance system altogether. The market would then conduct its own risk assessment and charge more for deposits backed by risky assets. Second, banks should not be closed when their net worth becomes zero, according to Cooke, because of the difficulty in valuing a bank. A zero net worth might be only temporary, and the valuation under an assumption of closure would be different from the valuation under an assumption of ongoing business. Third, the Federal Reserve should not charge penalty rates for discount window borrowing. The market itself could theoretically lend money at a penalty rate. But the function of the lender of last resort is to provide access to funds for a troubled but solvent bank. Lending at penalty rates would defeat the purpose of having the central bank as a lender of last resort and could thus force premature insolvency.

### *Macroeconomic policies and financial stability*

In "Debt Problems and Macroeconomic Policies," Lawrence H. Summers concluded that macroeconomic policies can best contribute to financial stability by keeping the real economy on an even keel. Reducing government budget deficits is particularly important for alleviating financial stress.

High growth in private sector debt is less of a threat to financial stability than is often thought, according to Summers. Financial stress depends on changes in net worth rather than on growth in debt. The ratio of farm sector debt to GNP has declined in recent years, for example, despite the evident agricultural financial distress, which has been caused by a shrinkage in the value of assets rather than growth in debt liabilities. While adverse shocks have led to financial distress in the agricultural, energy, and some manufacturing sectors, Summers argued that there is "little basis for generalized concerns about the excessive growth of private sector debt."

Nor is the ratio of total debt to GNP a good indicator for guiding monetary policy, Summers argued. Policy guides should give unambiguous signals of future movements in GNP. But broad debt measures do not give such signals. So, while broad debt aggregates can provide some useful information for monetary policy, they should not be the sole target variables.

In contrast, fiscal policy should be concerned with excessive debt growth because much of it has resulted from the unprecedented size of government budget deficits. Theoretical arguments that budget deficits could be offset by additional private saving are not borne out by experience, according to Summers. As a result, budget deficits increase the financial stress of private sector debtors by raising real interest rates. Moreover, budget deficits have particularly adverse effects on some sectors of the economy by creating disruptive shifts in the composition of output. For example, the strong dollar associated with high budget deficits has made U.S. agricultural exports less competitive on world markets. The most direct way of enhancing profitability and reducing financial stress of the agricultural and other depressed sectors would be to lower federal budget deficits. Overall, quick reduction in budget deficits would "enhance both financial stability and economic growth."

Summers proposed reforming the current tax law as another way fiscal policy could reduce debt growth. The tax system subsidizes use of debt finance by corporations by allowing tax deductions for business interest costs but not for dividend payments. Summers argued that without such tax distortions, "corporations would find it profitable to issue less debt and take on fewer risks."

To remedy this type of distortion, Summers advocated a consumption tax and elimination of all interest deductions. Both changes would reduce the tax incentives favoring debt finance.

Alan Blinder agreed with Summers's conclusions that rising interest obligations increase financial stress and that budget deficits exacerbate the problem. But he added some additional qualifications. He pointed out that, contrary to claims by Summers, higher private debt need not be offset entirely by higher assets. In recent years, for example, an increasing fraction of private borrowing has been from foreign lenders. Moreover, the high real interest rates of recent years pose a greater risk of default and economic instability than Summers implies, especially during a period of disinflation. The effect of high real interest rates are no longer predominantly the crowding out of such interest-sensitive sectors as business investment. Budget deficits have increasingly crowded out export and import-competing sectors by forcing up the exchange value of the dollar. Finally, Blinder felt that most of the tax distortions favoring debt could be remedied by indexing the current tax system, a change that would weaken the case for a consumption tax.

Phillip Cagan also agreed with the major conclusions Summers reached. He added that more emphasis should be given to growth of short-term debt, which he believes poses the greatest problems for monetary policy. A financial system characterized predominantly by long-term debt and money would reduce shifts between money and debt, thereby limiting the unpredictable changes in money demand that frustrate monetary targeting. When the effect of financial deregulation and innovation has abated, monetary targets will again become useful for implementing monetary targets, but debt targets will not, according to Cagan.

## Overview and conclusions

Three participants provided an overview of the issues raised at the symposium. The overview panelists were current or former members of government agencies charged with maintaining financial stability. For that reason, their comments focused on the policy aspects of the relationship of debt to financial and economic stability. Stephen H. Axilrod concentrated on macroeconomic policies, while John G. Heimann and L. William Seidman focused on regulatory policies.

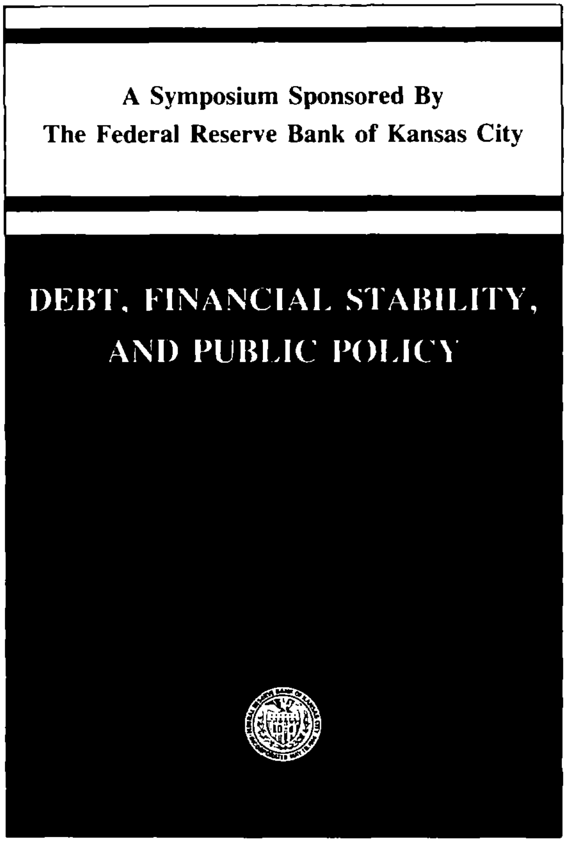
A major point of Axilrod's comments was that there are many subtle linkages among macroeconomic policy, debt, and financial stability. He rejected debt as a monetary policy target, but argued that macroeconomic policy has contributed to the buildup of debt and that the buildup has constrained macroeconomic policy. Some of the rapid growth in debt has resulted, he said, from inflationary monetary policy in the 1970s. More recently, high budget deficits have exacerbated the inflation mentality because "people may tend to think the government will reduce its debt burden...through inflation, which, to my mind, is a form of default." Thus, in Axilrod's view, financial instability has resulted partly from past inflationary monetary policy and the high budget deficits, which have raised real interest rates.

Heimann's comments focused on ways to enforce discipline in a changing financial system. He argued that banks have a special role in our financial system but that private market forces may be inadequate to enforce prudential standards for banks. Bank regulators are thus necessary and, in Heimann's view, have been doing the best job possible in a changing financial environment. One aspect of this "revolution in the financial services industry" is the securitization of credit, in which funds are ultimately raised in credit markets through sale of securities rather than through loans from financial intermediaries. Another aspect is interest rate swaps, which Heimann characterizes as a form of "credit bootstrapping." It is too soon to foresee the ultimate effects of these financial practices on financial stability, he said, because the practices have arisen only recently, during a period of relatively good economic and financial conditions. How the novel financial markets will function during periods of severe stress is, to Heimann, one of the major uncertainties about the final effect of rapid debt growth on stability in the financial system.

As chairman of the FDIC, Seidman focused on the vulnerability of the banking system during this period of higher debt. Although banks have increased capital as a buffer stock against shocks and developed new ways of diversifying risks, he said, they "have been failing at rates not seen since the advent of federal deposit insurance." Far more banks have failed so far in the 1980s than in the preceding four decades combined. Seidman predicted that about 150 banks could fail in 1986 and that even more could fail in 1987. He pointed out that bank failures have been concentrated in certain economic and geographic sectors. Almost 90 percent of the bank failures in the past two years were in states west of the Mississippi River, an area heavily dependent on agriculture and energy. Increased competition, interest rate deregulation, and disinflation have also taken a toll on many banks. In Seidman's view, the vulnerability of the banking sector to these developments has been accentuated by increased private sector debt.

Seidman offered several policy prescriptions to help ease strains on the banking system. Relaxation of restrictions on geographic and product expansion would help, he said. But moving toward risk-based deposit insurance to enforce market discipline is fraught with complications, including sensitivity to problems of innocent victims. Furthermore, enforcing discipline by forcing losses on depositors of failed banks could lead to loss of confidence in the entire banking system. In evaluating the effect of rapid debt growth on the FDIC's ability to protect depositors, Seidman warned that "the current trend line in bank failures cannot be extended for many more years without trouble; the climb it evidences is too steep."

# Debt, Financial Stability, and Public Policy

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Most types of debt in the United States have grown rapidly in recent years. To improve public understanding of the effects of the rapid growth of debt, the Federal Reserve Bank of Kansas City hosted a symposium on "Debt, Financial Stability, and Public Policy," on August 27-29, 1986, at Jackson Hole, Wyoming. The symposium proceedings, now available, discuss the implications of rapid debt growth on the nation's financial stability and consider appropriate public policy responses.

**Past Symposiums**

*The U.S. Dollar—Recent Developments, Outlook, and Policy Options* (1985)

*Competing in the World Marketplace: The Challenge for American Agriculture* (1985)

*Price Stability and Public Policy* (1984)

*Industrial Change and Public Policy* (1983)

*Monetary Policy Issues in the 1980s* (1982)

*Modeling Agriculture for Policy Analysis in the 1980s* (1981)

*Future Sources of Loanable Funds for Agricultural Banks* (1980)

*Western Water Resources: Coming Problems and Policy Alternatives* (1979)

*World Agricultural Trade: The Potential for Growth* (1978)

# 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 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 multilateral 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

[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).

Rudiger Dornbusch is professor of economics at Massachusetts Institute of Technology. The article is based on a paper given at a symposium on "Debt, Financial Stability, and Public Policy," sponsored by the Federal Reserve Bank of Kansas City at Jackson Hole, Wyoming, August 27-29, 1986.

[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 insufficently 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)

| | 1978 | 1982 | 1985 |
|---|---|---|---|
| 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)

| | LIBOR | Inflation | | OECD growth |
|---|---|---|---|---|
| | | Manufactures | Commodities | |
| 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)

| | 1977-82 | 1983-85 |
|---|---|---|
| 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.

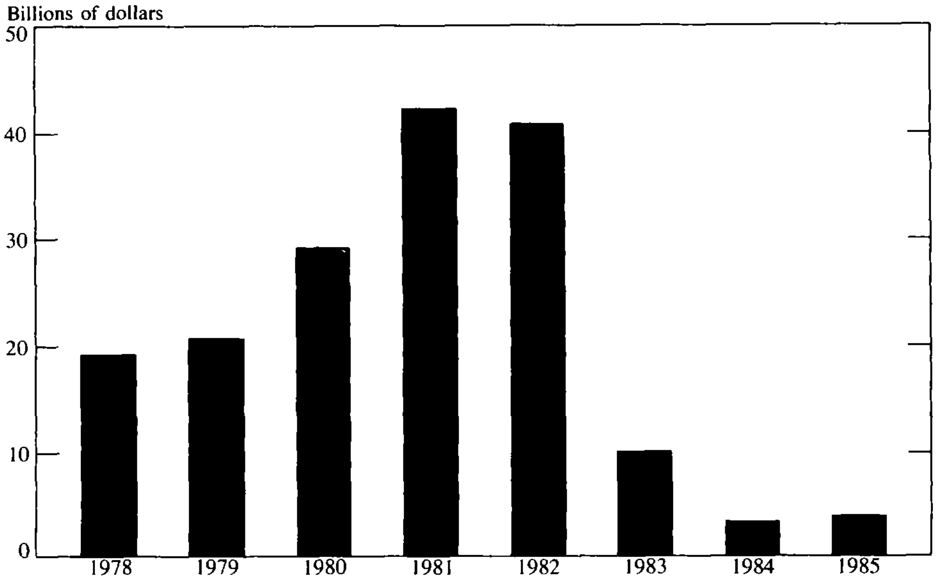
### *The transfer problem*

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 governnment 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

| | 1980-82 | 1983 | 1984 | 1985 | 1986* |
|---|---|---|---|---|---|
| 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)

| | All U.S. banks | 9 major banks | 15 major banks | All other |
|---|---|---|---|---|
| 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.

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

### *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.

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

| Date | Industrial | Argentina | Brazil | Mexico | Venezuela |
|---|---|---|---|---|---|
| 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

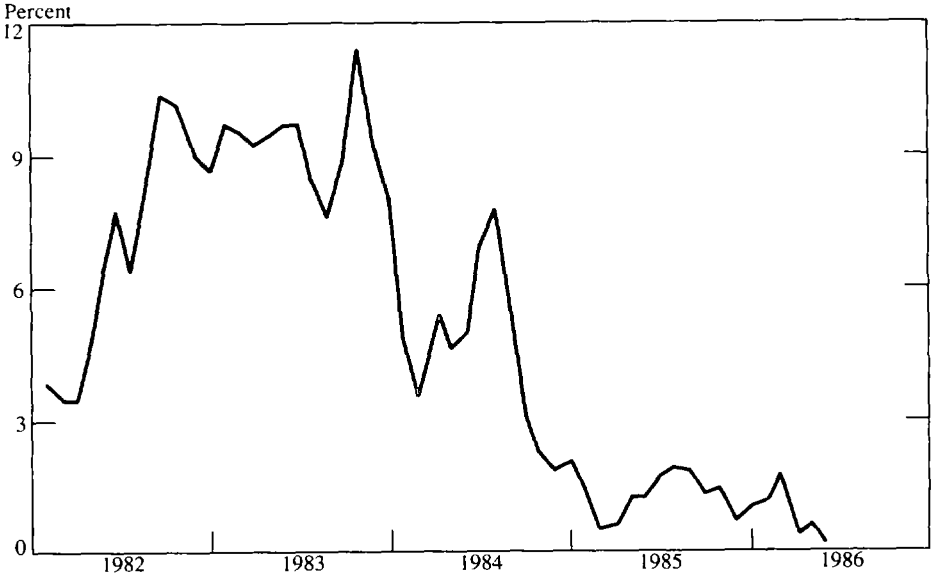



**CHART 3**
## Yield on deutschemark bonds: Brazil

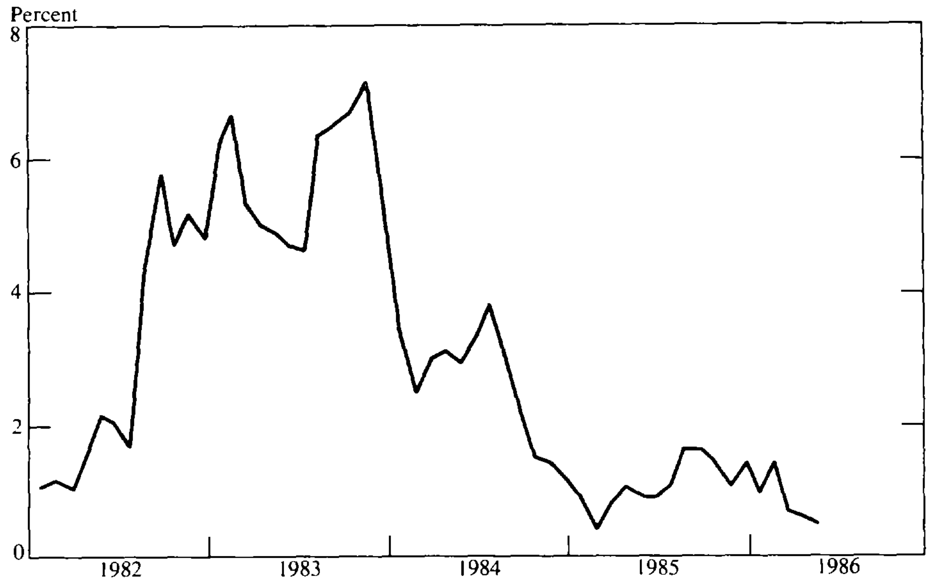


**CHART 4**
## Yield on deutschemark bonds: Mexico

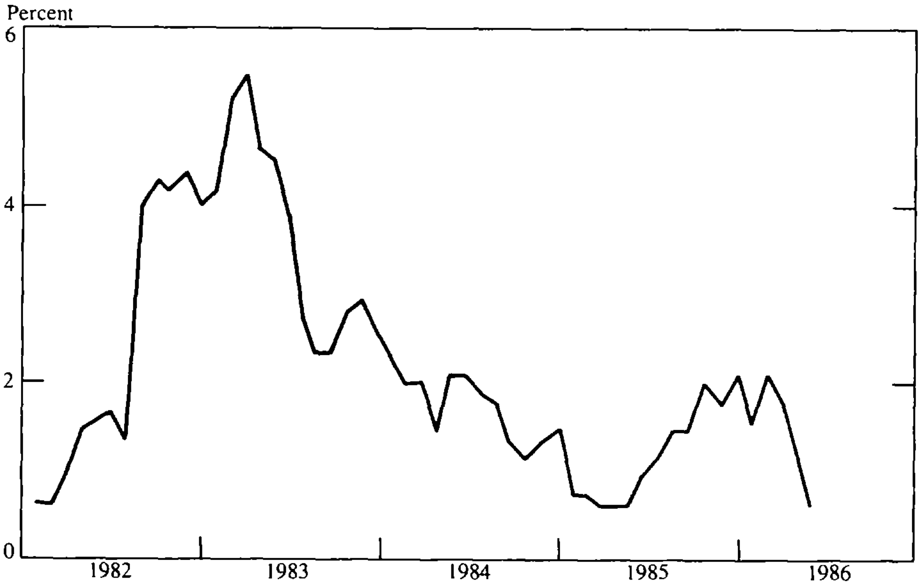
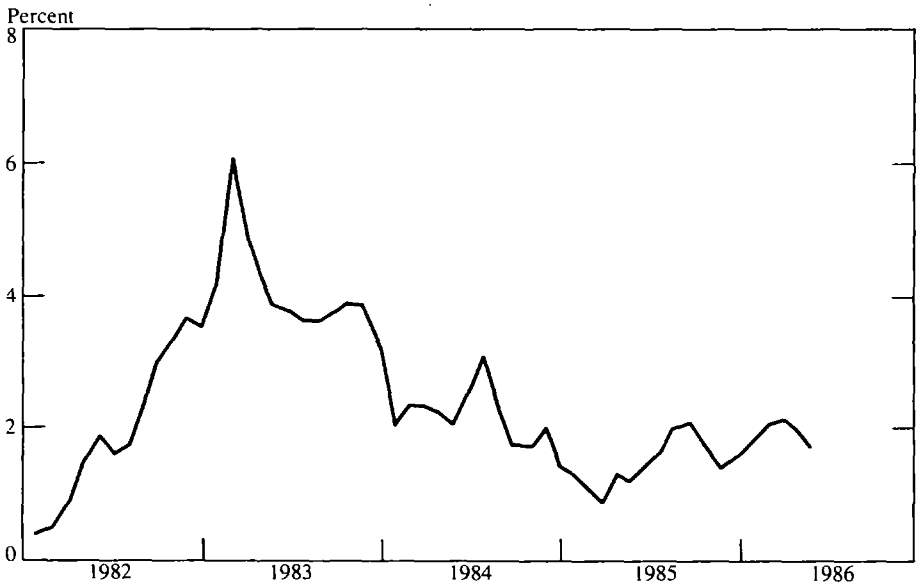



**CHART 5**
## Yield on deutschemark bonds: Venezuela



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 taxpayer 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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# Commentary on "International Debt and Economic Instability"

*By Rimmer de Vries*

Rudiger Dornbusch's skepticism about the fruits of the existing lesser developed country (LDC) debt strategy is understandable. Even with the boost the 1985 Baker initiative was intended to provide, the strategy that has been pursued over these past four years has not, at least not so far, delivered the goods in terms of what was and remains the ultimate objective—the renormalization of LDC access to the international financial markets. The latest figures show outright declines during this year's first quarter in the exposure of all Bank for International Settlements (BIS)-reporting banks to LDC's. If anything, financial markets appear to be more tightly closed now than at the peak of the crisis in 1982-83. It is little wonder that Rudiger craves a new, more "realistic" course of action.

Even so, I do not accept that the trials of the last four years have been for naught. It is a mistake to generalize from Mexico's current difficulties, which were coming to light even before the rude shock of this year's oil-price collapse. Taking the LDC debt picture as a whole, however, important progress has been made on several fronts. The progress should be both acknowledged and taken to heart by the numerous, albeit simplistic, advocates of "debt relief."

Let me cite three principal achievements. First, several major LDC debtors show positive promise and several others already are performing well. Admittedly, opinions remain divided on Argentina and the Philippines. Still, in contrast to the despair manifest as recently as a year ago, hopes now run high because the governments of both countries evidence determination to realize their countries' economic potential.

In terms of actual performance, the honors go to Korea, Brazil, and Colombia. Amid fast economic growth, a strong balance of payments, and the many other positive indicators for Korea's economy today, it takes some effort to recall that just three years ago many observers thought the country was headed for financial trouble.

Rimmer de Vries is senior vice president of Morgan Guaranty Trust Company. The article is based on his comments on Rudiger Dornbusch's paper made at the symposium on "Debt, Financial Stability, and Public Policy," sponsored by the Federal Reserve Bank of Kansas City at Jackson Hole, Wyoming, August 27-29, 1986.

Brazil, which did not avoid rescheduling and recession, nonetheless has staged an impressive comeback. Its economic growth hit 8 percent last year and will be only a little lower in 1986. Even if some further slowing is needed in 1987 to sustain the Cruzado plan's counterinflationary breakthrough, Brazil will have achieved substantial per capita income gains four years in a row. At the same time, Brazil's current account is headed for a surplus of $3 billion this year and a like amount in 1987. Its exports will have grown at an average annual rate of 8 percent during 1984-87. Meanwhile, its external debt will have climbed only little. As a result, Brazil's debt-export ratio should be just a bit above 300 percent by the end of 1987—about a sixth less than the 1983 peak and the lowest since before the crisis. Interest payments will absorb only 20 percent of Brazil's export earnings next year, half the burden of 1983.

Elsewhere in Latin America, Colombia for a time teetered near the brink of rescheduling but chose at the last hour to work closely and constructively with the International Monetary Fund (IMF) and the World Bank. It thereby retained a degree of confidence on the part of the international financial markets and was spared the slide in per capita income suffered by most countries of Latin America. More recently, Colombia has been blessed by high prices for its coffee exports, such that its debt-export ratio now stands only a whisker above 200 percent (versus over 260 percent two years ago) and interest on the debt takes up just 15 percent of export revenues. If both sustain progress, Brazil and Colombia should be the first of the Latin American countries to re-enter the credit markets.

Second, by strengthening their own capital positions, the commercial banks have substantially reduced their vulnerability to any strains associated with their LDC credit exposure. On average, U.S. banks have brought down the ratio of their Latin American exposures to their own primary capital from a peak of 125 percent in 1982 to 75 percent at the beginning of this year. For the nine large money center banks, the ratio has dropped from 181 percent to 124 percent. For the 15 next-largest banks, the ratio has come down from 129 percent to 71 percent; while for all other U.S. banks, it has fallen from 65 percent to 33 percent.

Third, despite all the frustration and fashionable cynicism, the key players on the debt stage retain a constructive attitude—most recently on display in the new credit package for Mexico. The debtor countries are working in a cooperative, rather than confrontational, way to help themselves toward improved economic and financial performance. In much of Latin America—many of whose present leaders were educated so well by Rudiger and his colleagues in Boston and elsewhere—there is growing appreciation that, for the region to prosper, it must be competitive in the global marketplace. Thus, if Latin America is ever to attain the much-admired dynamism of many developing countries in Asia, it must turn its back on the stultifying statism of the past. Accordingly, there is a surge of interest in the growth-boosting potential of basic reforms to privatize inefficient state enterprise, strip away protection of vested interests in both public and private sectors, and open economies generally to the bracing draught of real competition.

Such reforms have long been urged by the region's external creditors. The climate for progress now is more promising than for many years. Practical steps are already being taken. Realistically, however, progress will be slow and setbacks inevitable. Although the key decisions belong to the debtor countries themselves, the policy-based lending activities of the World Bank—an institution now led by a new president with strong U.S. Treasury backing—can make a vital contribution through advice, encouragement, and financial inducements for public-sector reform and private-sector rehabilitation.

My stress on the positive accomplishments of the last four years does not deny the serious international debt problems that still exist. After the crisis, much of the banking community took the view that all could be well again in three or four years. With hindsight, that view seems naive. Instead, it is increasingly clear that the issue will be with us a great deal longer than originally supposed. However, it does not follow that the strategy pursued hitherto must be discarded lock, stock, and barrel.

Rather, the sensible approach lies in adapting the existing strategy, preserving the good and necessary features of what already is being done, and adding new ones to cope with changing circumstances. In this spirit, I am all in favor of constructive *initiatives* adapting and carrying foward today's case-by-case approach. What I reject, as both unnecessary and unworkable, is the imposition of some fixed *plan* that would pretend to meet the needs of every country in all circumstances.

Let me now set out what I regard as the *sine qua non* of any successful resolution of the debt problem. First, given the mood of the U.S. Congress and the reality of U.S. fiscal limitations, talk of a Marshall Plan for Latin America—implying year-in, year-out appropriation of substantial amounts of public money—is utterly unrealistic and counterproductive. Congress is not about to fund anything that might be construed as a bailout for the banks or vote foreign aid money over and above what is being given today.

Other public money will continue to dribble through from the regular activities of export credit and international lending agencies. But their funding is unlikely to grow rapidly. Having been burned in the past, many of the export credit agencies are keeping a low profile. Multilateral activity is circumscribed by the fiscal inability of the United States to contribute its normal share of any major step-up in funding and the reluctance of other industrial countries to step into the breach. Besides, the priority beneficiaries of additional official money may well be the very low-income countries of Africa and Asia rather than Latin America.

Since most of any significant increase in new money for the major LDC borrowers will, therefore, have to come from the private sector—certainly in the foreseeable future—the key objective remains the restoration of normal credit market access for the troubled debtors. To that end, debtors and creditors will have to work out their problems in a mutual and cooperative manner, avoiding resort to unilateral action, which would set back the realization of the ultimate goal for many years. Equally, it is a dead-end street to play up the notion of having the President of the United States convene a full-dress "relief" conference every year under the chairmanship of the president of the World Bank. The conference, according to proponents, would work for forgiveness of principal and interest on private and official credits according to some long-term plan for "debt relief." Mandating such action, however, would assuredly put an end to private-sector funding without providing any public-money substitute.

Second, achievement and maintenance of a favorable world economic environment are crucial. Complacency is not in order. Although the world economy is more supportive today than in 1981-82, it remains seriously troubled. Only in 1984, thanks to stellar U.S. performance, did the industrial countries approach 5 percent economic growth. Since then their growth has fallen back below 3 percent and, on present reading, is unlikely to pick up much for some years to come. Virtually the entire increase in LDC exports to industrial countries between 1982 and 1985 went to the United States, even though the latter accounted for only one-third of total LDC exports to the industrial world last year. Other industrial countries similarly became accustomed to feeding off the U.S. economy and the still-rising U.S. trade deficit. Japan and Europe remain extremely slow—indeed, flatly reluctant—

to take overt and significant measures to increase their domestic demand and, thereby, offset the deflationary implications of the inevitable shrinkage of the U.S. trade deficit. Yet without open and growing industrial economies, the LDC's cannot expect the increase in their exports that is indispensable to the restoration of their creditworthiness.

In his paper, Rudiger notes how a negative external environment helped cause the debt problem, but he glosses over this external factor in his call for a realistic solution. Admittedly, none of us can be proud of the present state of internationalist thinking, cooperation, and decision making among the G-5 countries. But that is no reason to throw in the towel. I am, therefore, disappointed—indeed amazed—that Rudiger has passed up a golden opportunity to point up the policy shortcomings of Japan and Germany. Rudiger is rarely so shy. Japan seems willing to settle for minimal growth. Europe remains in the grip of its mercantilist traditions. Incredibly, many Europeans maintain that, with the dollar now lower, the only policy changes still needed are for the United States to reduce its budget deficit and resume lending to the LDC's—thereby enabling the LDC's to buy more goods not only from the United States but also from Europe and Japan. That is a formula for Europe to hang onto its trade surpluses with the United States shouldering the risk—an interesting concept of burden-sharing!

Meanwhile, in the United States, muddle-headed analysis and sheer protectionism plague discussion of the nation's trade problems. The moans over "job losses" in the export sector too often overlook the huge increase in overall U.S. employment since the recession. Nonetheless, I look forward to the recovery of U.S. exports to Latin America. The resulting boost to U.S. jobs would be welcome. However, it is unrealistic to suppose that higher U.S. sales to Latin America will do much to remedy the overall U.S. trade deficit (of which the bilateral deficit with Latin America is less than one-tenth) or that there exists some financial fix that will enable a strong rise in U.S. exports to the region before those countries themselves achieve better export performance. Early improvement of the overall U.S. trade position will have to occur mainly relative to the other industrial countries. The turn of the LDC's will come later. If it is not to be at the expense of the LDC's through U.S. protectionism, it is vital that both developing and industrial countries recognize their common interest in mutual trade liberalization. Next month offers what may be the last opportunity to set that underway with the scheduled launch in Uruguay of the delayed new round of multilateral negotiations.

Third, structural reforms are essential for the return of confidence in the debtor countries. The first phase of the debt strategy successfully reduced the immediate balance of payments pressures on most. Confidence, nevertheless, remained low and it became obvious that attention had to turn to the strengthening of their internal economies. Even where effective in narrow terms, stabilization alone was not enough. It had to be supplemented with structural reforms covering a wide range of policy and institutional changes at both macro and micro levels. These include privatization, the creation of more profitable investment opportunities in the private sector, and less government intervention in trade and financial markets.

The Baker initiative, which stressed such reforms, gave rise to unrealistic expectations of speedy progress. Instead, the far-reaching and complex nature of reform efforts, and the political obstacles they inevitably encounter, suggests that progress will be gradual. Both the IMF and the World Bank could provide important support. Once the debtors' economies open up, become competitive, and offer attractive investment opportunities, money will begin to flow to them, both from foreign sources and through the return of assets their residents now hold abroad.

Fourth, the IMF should be more accommodating of countries in need of balance of payments assistance. The collapse of oil prices, from an average of $27 per barrel in 1985 to less than half that level at times in recent months, has caused major balance of payments problems for Mexico and many other oil-exporting nations. The IMF's Compensatory Financing Facility was designed for just such eventualities. The institution's ample resources should now be put to work on behalf of oil exporters, especially those making respectable adjustment efforts. In no way should this be interpreted as the shoring-up of cartelized pricing. It seems fair to recall that, when oil prices soared after the first oil shock of the 1970s, the IMF was quick to assist rich industrial countries, such as Britain, France, and Italy. With the shoe now pinching the other foot, it is hard to rationalize the IMF's present stinginess toward the much lower income oil-exporting nations. I believe the IMF can—and should—play a significant role in financing balance of payments deficits of oil exporters.

In a world of major current account imbalances, countries with large surpluses should be actively concerned with recycling those surpluses, either through the official international institutions or bilaterally. Saudi Arabia's constructive behavior in the 1970s should be emulated by Japan and Germany today. Japan reportedly is taking a positive, albeit modest, first step by extending a $1 billion export credit to Mexico. But Germany and the other surplus nations of Europe have yet to be heard from.

Fifth, I must take issue with Rudiger's cavalier treatment of capital flight. If capital flight is given a free ride in the caboose of the debt train, the train is going to go nowhere but off the rails. I find it both necessary and feasible that capital flight be handled up near the front of the train. It is necessary for both quantitative and psychological reasons. It is feasible because we are neither ignorant of the causes of capital flight nor without means to stem and reverse it.

Quantitatively, the assets that residents of the debtor countries have accumulated abroad total up to a substantial offset of these countries' gross foreign debt. Several of the major debtor nations—notably, Argentina, Mexico, and Venezuela—have net investment positions that are much better than their gross indebtedness suggests. Similarly, their financing needs would be modest and manageable in the absence of capital flight, but immodest and unmanageable if the hemorrhage resumes.

Psychologically, nothing has contributed more to the pervasive sense of frustration over the LDC debt problem than the realization that capital flight persisted, if on a reduced scale, almost throughout the 1983-85 period of "involuntary" lending. Creditors, both private and official, are reluctant in the extreme—and understandably so—to provide fresh funds unless the debtors put a stop to the capital flight. Still less can creditors look warmly upon the cyclical suggestion that a smart debtor—not unlike the proverbial millionaire panhandler—should borrow all he can, invest abroad, and then demand debt relief. Fortunately, albeit belatedly, most Latin America governments have woken up to the capital flight problem. For the time being, at least, the flight itself has more or less dried up. Argentina and Mexico have each seen reflows on the order of $1 billion.

With capital flight stemmed, the next priority becomes the repatriation of the earnings on the stock of overseas private assets. Regrettably, the new $12 billion financial package for Mexico—soundly constructed as it is in most respects—takes for granted that the earnings will remain abroad in large measure, presumably in view of the inadequacy of Mexican financial investment vehicles and the general state of uncertainty in that country. Mexico's creditors are being asked to put up $2.4 billion through the end of 1987 to cover nonrepatriated earnings, and a further $1.4 billion to boost the reserve position. Bank creditors would be a lot happier with the package minus those provisions. After all, when reserves build up, Mexico has a history of failure to maintain a realistic exchange rate, thereby engendering private capital outflows. Moreover, full repatriation of the estimated $3.5 to $4 billion of earnings on assets held abroad by Mexican residents would yield sufficient foreign exchange each year to pay the interest owed on about half Mexico's total external debt. That would be a lot healthier for Mexico than forced debt relief and its attendant negatives.

The reversal of capital flight is not the fantasy flight that Rudiger alleges. The decline in U.S. interest rates lessens one incentive for residents of Mexico and other troubled debtors to hold assets abroad. However, repatriation will not occur on a substantial scale unless the conditions also are right in the debtor countries themselves. Individuals and businesses respond to market forces—hence the importance of sound economic management, including realistic interest and exchange rates plus attractive investment opportunities in domestic financial markets and business enterprises. The incentive to hold assets abroad could be further reduced if the debtor governments were to take steps to improve their ability to collect taxes on residents' earnings on foreign assets. Tax and exchange rate inducements could be offered for repatriation of foreign assets. Amnesty programs also could be of value in recapturing capital sent abroad illicitly.

Sixth, with the recognition that not all may turn out for the best, what should U.S. commercial banks do? Their best strategy continues to be to build capital several times faster than exposure to the major debtors. No matter how worthy or promising the borrower's purpose, it is neither plausible nor prudent to expect creditors to lend from a position of weakness. Even though the banks' LDC exposure-to-capital ratios have come down in the last few years—they are now below end-1977 levels—the bankers generally regard these ratios as uncomfortably high. For the large money center banks, exposure to the four largest borrowers in Latin America—Argentina, Brazil, Mexico, and Venezuela—ranged between 75 percent and 135 percent of primary capital at the end of 1985. It was lowest for Morgan and around the middle of the range for most of the others.

What may constitute the upper limit of prudence is difficult to judge amid today's credit quality and world environment concerns, not to mention the worries voiced about the possibility of collective default. However, LDC exposure is not the only source of vulnerability. For many U.S. banks, credits to such problem sectors as agriculture, energy, and real estate are far more important quantitatively than international exposure. Clearly, given the range of risks confronting the banking system, this is not the time for bold adventures in debt relief, whether forgiving interest or principal.

In the case of interest relief—unilateral nonpayment or forgiveness by agreement—banks would suffer an immediate reduction of pretax earnings by no less than the amount of interest in question and possibly by the amount of all interest on the affected loans. Conservative management, its accountants, or the regulators might put such loans on nonaccrual status, requiring that any interest received be applied to principal reduction rather than taken as income.

Principal forgiveness would result in immediate chargeoffs at least equal to the amount forgiven, as well as earnings reduction. Most banks could withstand some earnings losses and chargeoffs on loans to a single major debtor country. Yet if debt relief were offered to any one debtor, political realities would virtually dictate extension of relief to others. That might shake confidence in a number of banks. Indeed, snowballing debt relief still could threaten the international financial system as a whole.

Besides building up capital, banks ought to explore alternative forms of lending to LDC's.

These might take their inspiration, if not literal specification, from the innovative instruments and techniques originating in other financial markets. Of course, not every device is appropriate. In particular, it is important for the integrity of the banking system now—and down the road, for the debtors' recovery of market access—that there be no forced capitalization of interest obligations nor any departure from market-related pricing. Swaps that lock in interest costs, or caps and collars that limit floating-rate exposure, conform to the latter requirement and may come to play a useful and significant role in LDC debt management as the markets concerned deepen and broaden.

Debt-equity swaps have considerable potential as a vehicle not only for attracting resident assets from abroad and foreign direct investment but also for reducing external debt. Such arrangements can provide for residents or foreign investors to purchase the debtor country's foreign-currency obligations at a discount abroad and redeem this debt for local currency with the debtor-country government or central bank at a smaller discount. The investors, thereby, obtain local-currency funds for all manner of business purposes, even to pay local taxes, using discounted dollar claims acquired through the emerging secondary market in securitized claims of foreign banks. Instead of being coerced into continuing an undesired position, these banks—small and medium-sized ones especially—may find this an attractive mechanism to work down their LDC exposure at a market-determined cost. Some banks, particularly in Europe, may even recoup more than book value. In the debtor countries themselves, the consequences for domestic monetary policies will have to be carefully handled. More important, attractive equity will have to be provided. That, in turn, will require more wholehearted acceptance of privatization and foreign direct investment than some governments display at present. Such acceptance is part and parcel of the broader challenge to improve investment opportunities.

As yet, the debt-equity swap market is not of great size or breadth. On the debtor side, Chile has been the most active, with deals that should approach $750 million this year, over half representing repatriation of Chilean residents' holdings of assets abroad. Also in Chile, Bankers Trust has exchanged loans for an equity interest in a local financial institution. In Mexico, deals involving public-sector debt purchased at deep discount and converted to equity investments by multinational corporations have amounted to about $150 million during the past year. Of these, the recent Nissan Motors deal came to $40 million. In Argentina, following a limited exercise last year that yielded nearly $470 million in swaps but that failed to ensure increased real investment, the prospects seem to be gaining for an improved and broader ranging approach. This is targeted by the government to generate swaps upward of $1 billion annually and boost investment too. Outside Latin America, the new government of the Philippines has recently decided to encourage swaps. Evidently, if the major debtors embrace the concept vigorously, the potential scale of debt-equity swaps could run to billions of dollars.

Altogether, debt-equity swaps and variants thereon bring benefits to all parties involved. The developing countries gain through increased domestic investment and reduced external debt. Banks can work down their exposure-capital ratios more speedily, and the smaller banks can obtain a means for graceful exit, although at a charge to their earnings. And confidence in the LDC's could be enhanced as they attract equity finance in place of debt obligations.

To sum up, it is understandable that a certain fatigue and frustration have overtaken many of the parties to the LDC debt problem. However, it does not follow that some radical clearing of the decks will enable a new deal to be struck to work instant miracles for all concerned. Besides, I prefer not to throw the baby out with the bathwater. I caution, therefore, against a politically negotiated allweather "plan" to solve the debt problem. This would require U.S. congressional involvement, which would surely politicize the debt issue. The deceptive promise of increased exports and jobs through debt relief would set the legitimate interests of the financial community against those of business and labor, while doing nothing to revive investor confidence in the debtor countries. When public money is as scarce as today, it makes no sense to alienate the private financial sector. If banks are required to write down their loans, simple prudence—and perhaps even legal considerations—would surely inhibit new lending to troubled countries for years to come.

My conclusion is that we have no realistic alternative to soldiering on within the precepts of the present debt strategy. They have the great virtue of keeping clearly in sight the ultimate objective of all concerned with the LDC debt issue—the restoration of the debtors' access to the international financial markets. Admittedly, that will not come about overnight or unfold in neat stages, as Mexico's troubles attest. The debtors will have to persevere with stabilization and structural reform. The commercial banks as a whole must stay in the game. So, too, must the official institutions—notably the IMF and, as never before, the World Bank. All parties involved will have to exercise patience and flexibility. They also will need openness toward new ideas, not least to cope with the inevitable setbacks and new problems that will emerge. Of course, not all "new ideas"—certainly not mandatory debt relief—are smart or wise. Those that are may not always meld smoothly with past positions and established practices. But the past should not be permitted to stand in the way of constructive initiatives. Nor should past failures preclude success in the future.

# The Rural Economic Policy Choice

*By Mark Drabenstott, Mark Henry, and Lynn Gibson*

Rural America is undergoing a serious economic adjustment. Traditional rural industries are depressed and relatively few rural communities have been able to find a new economic base from which to grow. In many parts of rural America, economic stress has raised unemployment while leaving some capital resources underutilized. Rural communities—and some predominantly rural states—are also having difficulty maintaining public infrastructure—roads, schools, and health care facilities. In short, the rural economy is struggling.

How should policymakers respond to the rural economic problems? Policymakers in Washington, state capitols, county seats, and small rural towns are grappling with this question. The difficulty in finding an answer arises from the elusive nature of rural policy. Traditionally, farm policy has been viewed as a convenient surrogate for rural policy. While farm policy has form and function, rural policy has no clear dimensions. While farm policy undergoes systematic revision at least every four years, rural policy has no timeclock in Congress or in statehouses. It is clear, however, that policymakers will implement rural programs of one sort or another in the near future. To prevent these programs from becoming a hodgepodge that lacks effect, policymakers should first consider what type of rural policy will guide their response.

Policymakers can choose between two rural policies, or some combination of the two. One is a rural transition policy. Fundamental economic forces are encouraging people and resources to move out of rural communities into other segments of the economy. Working in harmony with these market forces, a transition policy aims to facilitate and ease the costs of resource adjustments. The other choice is a rural development policy which seeks, to some extent, to reverse market trends. With a development policy, public funds are used to subsidize rural economic development, because social value is attached to the vitality of the rural economy.

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This article outlines the factors policymakers will weigh in the decision and describes what each policy might contain. First, the rural economic problems most likely to concern policymakers are discussed. Then, a rural transition policy and a rural development policy are examined in turn. For each policy, operating objectives are posed and program alternatives to meet objectives are reviewed and evaluated.

## Emerging rural policy issues

A recent article in the *Economic Review* showed that the rural economy is in the midst of difficult economic change.[1] That article showed that growth in rural incomes has lagged well behind growth in metropolitan incomes for the past ten years. The gap between rural and urban wellbeing has widened most sharply since 1979. In the 1980s, economic strain has been especially evident in traditional rural counties—those depending on agriculture, mining, and manufacturing. These counties account for more than half the rural population and income. The article further concluded that the gap in rural and metropolitan economic performance does not appear to be cyclical. Rather, the gap appears related to such structural factors as international economic forces, the shift to services in the U.S. economy, deregulation, and structural change in agriculture.

The changing rural economy is giving rise to two issues that will be the focus of much policy discussion. One issue is the mounting number of displaced rural workers faced with the prospect of finding employment elsewhere. The other is the strain beginning to show in rural public infrastructure as rural population dwindles and tax bases diminish.

### *Displaced rural workers and rural outmigration*

Unemployment is becoming a persistent problem for many rural regions. With the onset of economic woes in several basic industries in the 1980s, rural unemployment has climbed well above the levels of the 1970s to surpass urban unemployment (Chart 1). The unemployment problem is compounded by an ongoing underemployment problem. Studies indicate that a large proportion of rural workers—as many as a fourth in some cases—are in jobs below their skill levels, because no other work is available.[2] Furthermore, job skills of rural residents tend to be less versatile than those of urban residents and the range of employment opportunities is more limited in rural areas.

With the rural economy under stress, it seems likely that many displaced workers will leave rural communities and some rural states in coming years. Overall, rural population continues to grow slowly, but the number of regions experiencing net outmigration is increasing. In the 1950s and 1960s, more than half the nonmetropolitan counties in the United States were losing population (Chart 2). The outmigration then was generally associated with rapid job formation in metropolitan areas. In the 1970s, when the rural economy was generally prospering, the proportion of rural counties losing population fell to less than a fifth. But in the 1980s, the rural outmigration has again quickened, with nearly half the rural counties losing population between 1983 and 1985. With economic stress widely evident in rural counties depending on farming, mining, and manufacturing, many rural counties can expect further outmigration.

The displacement of rural workers, then, is not a new development. Rural residents have been

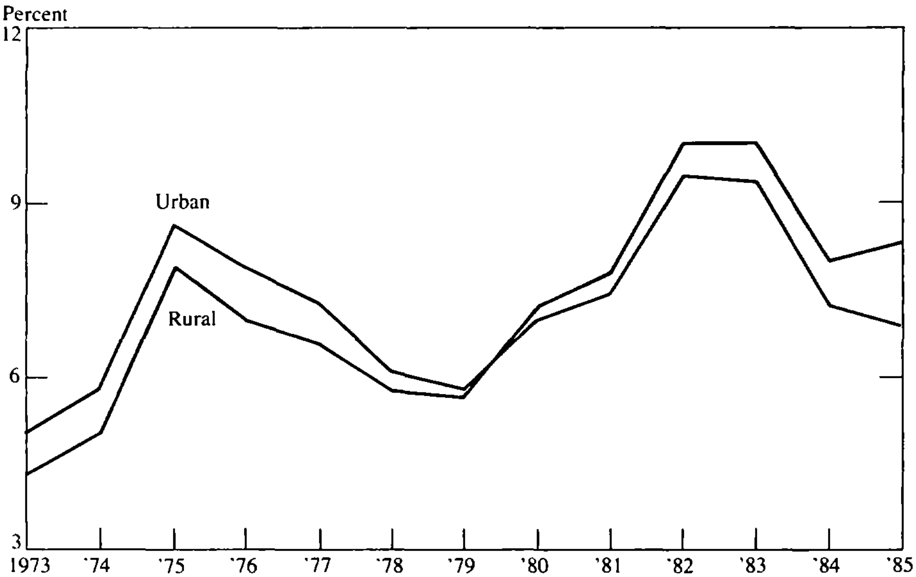
[1] Mark Henry, Mark Drabenstott, and Lynn Gibson, "A Changing Rural America," *Economic Review*, Federal Reserve Bank of Kansas City, July/August 1986.

[2] For example, the underemployment problem in Nebraska was analyzed by the Nebraska Department of Economic Development and Labor in *The Nebraska Project: State of the Labor Market Economy*, Lincoln, 1985.

**CHART 1**

**Rural and urban unemployment rates**

Annual average unemployment rate




moving to the city to find new employment throughout this century. The difference today is that job opportunities are much different. Rural residents that left farms and small communities in the 1950s and 1960s usually found well-paying, semi-skilled jobs in industry. Now, with the goods-producing part of the economy not performing well, most new jobs are either low-paying service jobs or well-paying jobs requiring specific technical skills. Another disturbing aspect of rural workers in transition is their apparent lack of mobility. A 1984 survey of farmers that had gone out of business in Iowa showed that more than three-fourths of them remained in the same community, but at a much lower standard of living.[3]

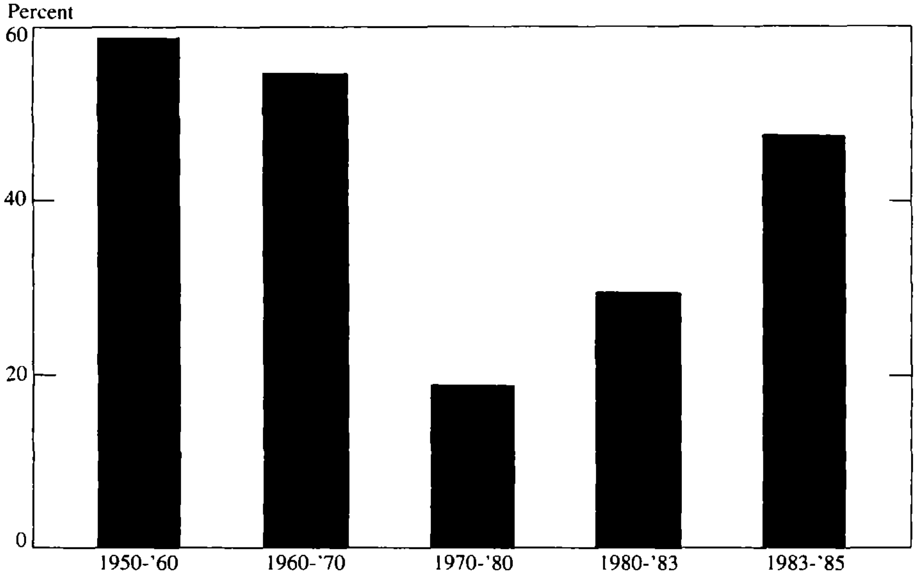
[3] See Daniel Otto, "Analysis of Farmers Leaving Agriculture for Financial Reasons: Summary of Survey Results from 1984," Iowa State University, 1985.

In short, one principal problem facing policymakers is to ease the transition for displaced rural residents with skills that may not give them good job opportunities outside their local areas.

### *Strained rural infrastructure*

Rural areas increasingly face a dual infrastructure problem. On the one hand, economic stress is creating fiscal pressures that make it difficult to maintain infrastructure and public services. On the other hand, many of the same areas and communities lack sufficient infrastructure to support a successful transition to a new economic base. Thus, many rural communities and some rural states find public funds scarce while the need is great not only to meet existing demands but also to invest in the necessary infrastructure to diversify.

**CHART 2**
## Percent of rural counties with declining populations




As the economic viability of many rural communities starts to wane and population declines, maintaining infrastructure and public services becomes especially difficult. Adjoining small communities often find that they are simultaneously trying to maintain what have become redundant public facilities. For example, some communities may find that one hospital now can serve the needs of more than one community. Similarly, some rural counties are struggling to maintain the full complement of county government services.

The strains on rural tax bases are clearly mounting, but no comprehensive assessment has been made of the magnitude of the problem. A 1986 report by the Senate Subcommittee on Intergovernmental Relations concluded that many local rural governments face the prospect of a shrinking revenue base for the rest of this decade and longer.[4] Rising tax delinquency rates in rural areas, dramatic declines in agricultural land values, and significant declines in nonfarm incomes and property values all support that conclusion. The report found that property tax delinquencies in eight selected farm-dependent regions rose from 1.5 percent in 1981 to 9.5 percent in 1986. To offset shortfalls in revenue while maintaining only essential public services, the report suggested that local rural governments would have to implement a combination of tax increases and spending cuts amounting to as much as $200 per capita.

The fiscal strain in rural America is compounded by the revenue strains of many predominantly rural states. Table 1 shows that of

[4] U.S. Senate, Subcommittee on Intergovernmental Relations, "Governing the Heartland: Can Rural Communities Survive the Farm Crisis?" May 1986.

**TABLE 1**
**Fiscal stress symptoms in rural states***

| State | 1984 Tax Capacity | Tax Effort Change From 1975 to 1984 |
|---|---|---|
| Arkansas | 75 | +11% |
| Idaho | 89 | +4 |
| Iowa | 78 | +20 |
| Kansas | 100 | +12 |
| Kentucky | 77 | +5 |
| Maine | 88 | +2 |
| Mississippi | 70 | −1 |
| Montana | 95 | +10 |
| Nebraska | 93 | +16 |
| New Mexico | 103 | 0 |
| North Carolina | 87 | +4 |
| North Dakota | 106 | +1 |
| South Carolina | 77 | +11 |
| South Dakota | 83 | −1 |
| Vermont | 95 | −13 |
| West Virginia | 79 | +17 |
| Wyoming | 181 | +51 |
| 17 rural state average | 92.7 | +9 |
| Nonrural U.S. average | 102.4 | +3 |

Source: Advisory Commission on Intergovernmental Relations, Washington, D.C.

*Rural states are those where the ratio of nonmetropolitan population to metropolitan population is greater than the average for all 50 states. The unweighted average ratio in 1984 was 1.09.

Note: Tax capacity, as developed by the Advisory Commission on Intergovernmental Relations, measures the multiple resources that state governments can claim through a variety of taxes. A tax capacity greater than 100 indicates the state has more fiscal capacity than average for the 50 states. Similarly, tax effort measures a state's total tax collections relative to its total capacity.

17 states with higher than average percentages of rural population, all but four had tax capacities below the national average for nonrural states in 1984.[5] As farm and energy problems continued to intensify in 1985, many of the states probably experienced some additional erosion in fiscal capacity. To offset revenue shortfalls, 13 of the 17 states increased taxes between 1975 and 1984. Tax capacity and tax effort are only two of many possible indicators of fiscal pressure, but these statistics suggest that some rural states face the same problems in supporting infrastructure and public services as many local governments.

[5] For an analysis of fiscal pressures facing rural governments, see James Hite and Holley Ulbrich, "Fiscal Stress in Rural America," invited paper presented at the annual meeting of the American Agricultural Economics Association, Reno, Nevada, July 1986. See also, "The Agricultural Recession, Its Impact on the Finances of State and Local Government," Advisory Commission on Intergovernmental Relations, Staff Report, June 1986.

Rural states and communities face an especially acute infrastructure problem as they try to diversify away from total dependence on a traditional economic base that is now depressed. Attracting new industry often entails putting in place new infrastructure, such as roads, industrial parks, and water and sewer facilities. The adequacy of rural infrastructure is difficult to assess, but a 1984 Farmers Home Administration survey concluded that many rural communities still lack some basic public services.[6] For example, only 55 percent of the rural communities in the United States were served by public water systems, and fewer than a third had wastewater treatment plants. In addition, firms considering sites for location often have special needs for infrastructure that cannot be met by rural areas without additional investment.

Thus, rural communities are left with the dual problem of trying to maintain existing services while improving their infrastructure enough to attract new industries. Growing needs and weakened capabilities to meet those needs may characterize the fiscal condition of many rural areas if current trends go unchecked.

## The rural transition policy

Displaced rural workers and strained infrastructure are the byproducts of structural change in the basic fabric of the rural economy. Market forces are driving down the return to rural resources and encouraging those resources to find other uses in the economy. Labor and capital resources alike probably will leave rural areas and look for more productive use in urban areas. What role should public policy play in such a transition?

One response is a rural transition policy that aims to facilitate the structural change already underway in the rural economy. Rural outmigration and reduced rural infrastructure may not be popular in rural America, but from the perspective of the whole economy, they are simply reallocations of rural resources to more productive parts of the economy.

There is sound economic justification for a rural transition policy. Put simply, rural resources are not perfectly mobile and social costs attend rural resource adjustment. When rural labor or capital resources are idled, as they now are in many places, information on other opportunities is often limited. As a result, the time that the resources are unused or underused tends to lengthen. Even when information is available, rural resources may simply lack mobility. Moreover, the social costs of adjustment—in the form of unemployment insurance and other income support programs—rise as rural unemployment rises. Thus, it is in the public interest to reduce the social costs by facilitating resource adjustments.

### *Transition objectives*

What operating objectives should guide the selection of rural transition programs? Three goals appear relevant: easing human resource adjustment, easing public infrastructure adjustment, and supplementing rural incomes.

*Easing human resource adjustment.* The easing of human adjustments appears to be the most pressing objective of rural economic policy. Economic theory suggests that labor resources gravitate toward opportunity, yet rural workers—whether displaced farmers, factory workers, or lumber workers—may lack complete information on these opportunities, the means of relocating, or the ability to acquire the skills new jobs often require. Many public programs have been aimed at keeping farmers in business, but far fewer programs have addressed what may be the more important problem of retraining displaced farmers and other rural workers for productive employment elsewhere in the economy.

[6] See J. Norman Reid and Patrick J. Sullivan, "Rural Infrastructure: How Much? How Good?" *Rural Development Perspectives*, U.S. Department of Agriculture, October 1984.

*Easing public infrastructure adjustment.* Funds for schools, public health facilities, and other public services are under pressure in depressed rural areas. The federal government and states may be able to assist communities that lack the funds for essential public services. Education infrastructure is especially important to meet retraining needs. Nevertheless, under a rural transition policy federal or state assistance would not be regarded as permanent. Rather, assistance would be part of an overall goal of facilitating market adjustments in rural resources.

*Supplementing rural incomes.* Incomes are low in many depressed rural areas. Temporary direct government income support to rural residents linked to retraining programs may be appropriate as a bridge to new employment elsewhere. Also, many rural communities are being left with a concentration of elderly citizens as younger workers leave to find employment in other places. For these communities, income support programs become more important.

### Rural transition programs

What transition programs will meet the objectives suggested above? Retraining programs, assistance to maintain public infrastructure—especially educational facilities—and assorted income maintenance programs appear to be most suited.

*Programs to ease human resource adjustment.* Retraining is the basic response to human resource adjustment problems. The federal government has long had job training programs, but the programs generally have not been directed at rural problems. Some states have recently launched programs to assist displaced rural workers.

At the federal level, the existing comprehensive job training program was created under the Job Training Partnership Act in 1983 to replace the Comprehensive Employment and Training Act (CETA). The program's chief objective is still to provide job training to unskilled workers and disadvantaged workers, whether rural or urban. The new act seeks to link training with the opportunities in local job markets by placing more of the administrative responsibility at the local and state level. This added flexibility does allow the program to address the problems of rural displaced workers. But the program does not appear to have been used widely enough to ease career transitions for significant numbers of displaced rural workers. Criticisms of the program include its failure to use community colleges and existing local training efforts and its failure to link training programs with local economic development programs.[7]

State efforts to address rural worker adjustments are relatively recent in origin. Just in the last two years, many midwestern states, including Kansas and South Dakota, have initiated retraining programs for farmers and other rural residents out of work. Most of the programs provide tuition credits for classes at local colleges, universities, or vocational schools, as well as opportunities for on-the-job training. A few programs offer relocation benefits when the training is completed, in some cases, including relocation from the state.

The state programs are too new for any comprehensive evaluation of their effectiveness. On the whole, the programs appear well guided. In many cases, public funds may be better spent on retraining than on efforts to keep financially ailing farms or rural businesses from failing. However, program budgets often fall short of meeting projected needs. In Kansas, for example, the Rural Employment Assistance Program (REAP) had a 1986 budget of $1.2 million, enough to reach about 600 workers. An estimated 7,000 Kansas farmers

[7] See Ted K. Bradshaw, "Economic Development in Rural America: The Hard Case," *Looking Ahead*, The National Planning Association, Vol. IX, No. 2, Spring 1986, and Sigurd Nilsen and Frank A. Fratoe, "Job Training Partnership Act, CETA, and Rural Communities," *Rural Development Perspectives*, U.S. Department of Agriculture, October 1984.

left farming in 1986, with another 9,000 under severe financial stress. Thus, only a small percentage of the target group can benefit from the retraining program. The same is true in many other rural states.

Some predominantly rural states face a social and financial dilemma when they undertake retraining programs. States that do not have a realistic prospect of developing a new economic base may face the unpleasant likelihood of declines in population. Workers that are retrained, largely if not totally at state expense, may find employment only in other states. Thus, the state that bears the cost of training may not reap its benefits. Yet without the retraining programs, many displaced workers might remain tied to state welfare programs.

The solution to this dilemma may lie in regional and federal cooperation. Neighboring states might reduce costs by sharing retraining programs, with each state furnishing the training it is best suited to furnish. There also appears to be a role for the federal government in sharing retraining costs when the budget of an economically depressed rural state is stretched and the state has little prospect of recouping human capital investments in its own economic development.

Overall, no federal program is in place specifically to retrain displaced rural workers. The Job Training Partnership Act can be used for rural workers, but its use remains fairly limited. Fine tuning that program—adding a clearer rural emphasis and linking training to available rural education programs—might be sufficient direct federal involvement in easing human adjustment in rural areas. Much of the retraining task will fall to the states in conjunction with local communities. State programs are just now emerging, but the budgets of many rural states are seriously strained. The rural displaced worker problem is national and retrained rural workers promise dividends to the national economy. Thus, a fairly strong case can be made for the federal government sharing in the cost of state administered programs.

*Programs to ease public infrastructure adjustment.* The basic program for meeting the need for infrastructure adjustment is grants-in-aid linked to maintaining essential services in declining rural communities. Neither federal nor state programs of this type are now in place. Although the federal government will spend nearly $8 billion on rural infrastructure in 1986, funds will go to economic development, not transition assistance to maintain rural infrastructure. The principle behind transition infrastructure programs is to assist communities in such a way that services are provided for a sufficient transition period, but not in such a way as to subsidize communities permanently. The challenge, therefore, is to craft programs that effectively channel funds to communities that need them while allowing structural changes to continue.

The greatest rural public infrastructure need for the near future is schools and universities. Rural communities and some rural states will have great difficulty maintaining high-quality education because of scarce resources and dwindling enrollments. Programs will be needed to maintain those facilities for two purposes: first, to keep overall education standards high for resident elementary, secondary, and college students, and second, to provide adequate facilities for retraining displaced workers. An appropriate federal program might be to provide grants to universities in rural states. The grants could be linked to the establishment of quality retraining programs and then be phased out over a period of years.

States may want to consider programs to encourage the pooling of rural infrastructure. For example, two neighboring communities may find that they lack the resources or population to support two hospitals but may be unable or unwilling to address the problem. Rather than further dissipate public funds, state grants-in-aid could be linked to community agreements to share responsibility for essential public services, such as health care. In doing so, states encourage the market flow of resources while increasing the efficiency of public spending at both state and local levels. A similar approach could be used to encourage neighboring counties to combine public services. That issue remains controversial, but some states are beginning to consider such combinations.[8]

*Programs to supplement rural incomes.* Farm programs and other income transfer programs have been the two main approaches to supplementing rural incomes. Both approaches simply direct government transfer payments to rural residents. The programs continue to receive support, though they are not long-run solutions to the gap between rural and urban incomes.

Federal farm commodity programs have mushroomed into large income transfer programs in the 1980s. Designed originally to stabilize farm prices and farm incomes, the programs have become a mechanism in recent years for large federal infusions into a depressed industry. The 1985 Farm Bill moves agriculture to greater market orientation but provides substantial income protection as the transition occurs. As a result, farm program spending has increased dramatically. Between 1971 and 1975, net outlays for farm commodity programs—both Commodity Credit Corporation (CCC) loans and deficiency payments —averaged only $2.4 billion a year. Between 1981 and 1985, outlays increased to an annual average of $11.9 billion. Program costs swelled to $26.0 billion in 1986.

The question must be asked whether farm programs meet an objective of supplementing rural incomes. Federal farm programs do keep farm incomes high and, thereby, improve business activity in areas dependent on farming. But only a fourth of the nation's 2,400-odd rural counties—and less than 12 percent of the rural population—depend primarily on agriculture. Meanwhile, counties depending on manufacturing and mining—the other traditional rural counties—also have experienced downturns in the 1980s, and nearly half the rural population lives in these counties. Moreover, farm programs increasingly benefit a relatively small number of larger farms. In 1985, for instance, the 27,000 farms with annual sales greater than $500,000 represented only 1.2 percent of all farms but received 13.3 percent of direct farm program payments. These large farms, which had an average net farm income of $647,037 in 1985, received an average of $38,000 in direct government payments and also held an average of $113,200 in nonrecourse CCC loans. Farm income programs, then, may be too narrowly focused to meet broad rural objectives.

A host of federal and state income transfer programs, ranging from social security to food stamps also have significant effects on rural incomes. Social security has become especially important to many rural counties. Counties with depressed economies often lose large portions of their younger population and are left with a much larger concentration of elderly people. Social security, then, becomes an even more important source of income to such rural counties. Not only does the program meet an objective of improving incomes of the elderly, it also helps soften a region's downward economic adjustment.

Overall, direct income transfer programs probably meet fairly limited policy objectives. Most economists and policymakers agree that programs which encourage economic growth offer a better long-run solution than programs that create dependency on government assistance. Nevertheless, with the ongoing stress expected to confront many rural communities in the next few years, some existing direct income transfer programs will serve a short-run objective of easing rural economic adjustment. Farm income support

[8] In the fall of 1985, the Iowa legislature briefly discussed the possible need to consolidate the state's 99 counties into fewer counties that would be more fiscally sound.

programs, the traditional channel to raise rural incomes, probably are too narrow to meet truly rural objectives.

### Summary

A rural transition policy aims to facilitate the difficult structural change underway in the rural economy and to ease the costs of the change. The most urgent need will be retraining programs to ameliorate the adjustment of displaced rural workers. The Job Training Partnership Act could be refined to target rural workers more specifically. In addition, the federal government should consider partially funding the retraining programs of rural states where budgets are stretched and the states are unlikely to keep retrained workers. State retraining programs are beginning to emerge, but greater emphasis on these programs will be needed. Both federal and state assistance could be used to maintain public services while encouraging the adjustment of rural infrastructure to new market realities. Finally, income transfer programs likely will serve a useful purpose while the rural economy is in transition, but questions must be raised whether farm income programs meet broader rural needs.

## The rural development policy

A rural development policy would be a much different response to current rural economic problems. Rural transition policy is a short-run commitment to ease the costs of resources adjusting to market trends already at work. Rural development policy, on the other hand, is a long-run commitment to stimulate economic development in rural areas, even though such development may run counter to current fundamental economic trends.

Adopting a rural development policy may not preclude a rural transition policy. Rural economic development policy logically includes a transition component for the parts of the rural economy that are unlikely to recover from current depressed conditions. Thus, a rural development policy can be regarded as a two-pronged response: on the one hand, an effort to ease resource adjustment in areas with little likelihood of economic revival and, on the other hand, an effort to stimulate economic activity in areas that offer more promise for future growth. The difficulty with this dual policy is that it forces policymakers to decide which rural areas fall into which category. The first step becomes a sort of triage, a determination of the rural areas that are not likely to grow, the areas with some growth potential, and the areas most likely to grow. What remains unclear is whether policymakers have sufficient information, knowledge, or discipline to make such decisions.

### Justification for rural development

Rural transition policy can be justified on solid economic grounds, but the justification for rural development policy lies apart from economics. Two reasons can be given for rural development policy: the social value of the rural lifestyle and the past history of U.S. rural development policy.

The United States has attached social value to rural living from the founding of the republic. Thomas Jefferson was a leading exponent of rural virtue.

> Cultivators of the earth are the most valuable citizens. They are the most vigorous, the most independent, the most virtuous, and they are tied to their country, and wedded to its liberty and interests, by the most lasting bonds. As long, therefore, as they can find employment in this line, I would not convert them to . . .anything else.[9]

[9] Saul K. Padover, *Thomas Jefferson on Democracy*, Mentor 1939, p. 68. Quoted from a letter Jefferson sent to John Jay in 1785.

From Jeffersonian roots, an economically strong rural population soon came to be regarded as a national asset. Such thinking resulted in congressional action, like the Homestead Act of 1862, which encouraged widespread ownership of rural resources.

Public opinion still supports rural causes. This support is frequently expressed in public backing of farm policy. A wide majority of voters continue to support farm policy.[10] Voters may be treating farm policy as a surrogate for rural policy, though that is unclear. As the public becomes more aware that farm programs benefit large, well-capitalized farmers more than small farmers, farm programs may be redirected, possibly to reflect rural goals more closely.

The second justification for rural development policy stems from historical fact. The United States has had a rural development policy of one form or another for nearly 100 years and is likely to continue having such a policy. Table 2 shows that from the Country Life Commission under Theodore Roosevelt to the Agricultural Adjustment Acts, Resettlement Administration, and Rural Electrification Administration under Franklin Roosevelt, federal rural development policy grew into a diverse set of programs.[11]

Current rural policy derives from the Rural Development Act of 1980.[12] The act established a framework for implementing rural development policy. The act requires the Secretary of Agriculture to review the nation's rural development strategy every year and to identify federal involvement in meeting the rural objectives stated by Congress.[13] In practice, however, the Rural Development Act does not serve as the motivating force behind most federal spending for rural development. Diverse federal programs, most unrelated to rural policy objectives—or to each other—continue federal spending on rural projects (Table 3).

The United States, then, has a national rural development strategy. But the strategy is only a loose guide to rural policy, not a policy blueprint. The Secretary of Agriculture facilitates rural development policy and implements a few discretionary programs within the Department of Agriculture. But the strategy falls short of being a comprehensive policy statement that clearly marks objectives and programs. Most federal spending in rural areas happens apart from any such rural policy blueprint.

### *Rural development objective*

If the United States does want to encourage rural development, it should work from a comprehensive policy that guides the selection of specific programs. The first step toward a comprehensive policy is identifying primary policy objectives. Easing the transition from narrower traditional economic bases to new, more diversified rural economies appears appropriate as the major objective of a federal rural development policy. A diversified economy is no guarantee against economic stress, but diversification helps buffer the wide economic swing many rural areas have experienced in the 1980s.

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[10] Recent public opinion polls reveal that two out of three U.S. citizens support farm programs.

[11] For a discussion of rural development policy history, see Wayne D. Rasmussen, "90 Years of Rural Development Programs," *Rural Development Perspectives*, U.S. Department of Agriculture, October 1985.

[12] PL96-355, the Rural Development Act of 1980, was enacted September 23, 1980. The act extended the Rural Development Act of 1972.

[13] Harking back to traditional goals, the act identified five rural objectives: to raise rural incomes, to improve rural business and employment opportunities, to improve the management capabilities of rural governments, to "strengthen the family farm system," and to maintain and protect the environment and natural resources of rural areas. See "Rural Development Strategy: 1985 Update," Office of Rural Development Policy, U.S. Department of Agriculture, and "Rural Communities and the American Farm: A Partnership for Progress," U.S. Department of Agriculture, Office of Rural Development Policy, July 1984.

**TABLE 2**
**Summary of federal rural development programs**

| Year | Rural Characteristics | Major Developments | Goals |
|---|---|---|---|
| 1908 | 33% of population live on farms, 54% of population live in rural areas | Country Life Commission appointed | Major report on needs of rural population |
| 1920 | 30% of population (32 million) live on farms | | |
| 1935 | 35% of farms electrified | Rural Electrification Administration organized | Bring electricity to farms |
| | | Resettlement Administration organized | Resettle farm laborers and disadvantaged rural residents in part-time farming communities |
| 1940 | 23% of population (30.5 million) live on farms, 43% of population live in rural areas | | |
| 1955 | | Rural Development Committees organized | Aid local communities in establishing new training programs and other activities<br>Coordinate federal efforts in rural development |
| 1960 | 8% of population (15.6 million) live on farms | | |
| 1965 | | Housing and Urban Development Act passed | Improve rural and urban housing |
| | | Rural Community Development Service replaces Office of Rural Areas | Coordinate USDA's rural activities |
| | | Development Interagency Task Force on Agricultural and Rural Life established | Recommend legislation to improve rural life |

**TABLE 2 (continued)**

| Year | Rural Characteristics | Major Developments | Goals |
|---|---|---|---|
| 1966 | | National Advisory Commission on Rural Poverty | Develop major program for attacking rural poverty |
| 1970 | 26% of population lives in rural areas | Rural Community Development Service transferred to USDA Rural Development Committee | Coordinate USDA rural development programs |
| | | USDA Committee for Rural Development set up in each state | Coordinate USDA programs for rural development within states |
| 1972 | 5% of population lives on farms | Rural Development Act | Broad authority for rural development programs |
| 1978 | | White House rural development initiatives on health, water, sewers, communications, energy, transportation | Secure cooperation in solving these problems |
| 1980 | | Rural Development Policy Act passed | Extend authorizations for appropriations |
| | | USDA establishes National Advisory Council on Small Community and Rural Development | Give groups opportunity to participate in policy and program planning |
| 1982 | 3% of population lives on farms | National Advisory Council on Rural Development established | Identify rural problems and support rural development policies |

Source: Wayne D. Rasmussen, "90 Years of Rural Development Programs," *Rural Development Perspectives*, October 1985, pp. 6-7.

### *Rural development programs*

Three program approaches can be taken to facilitate rural economic diversification: infrastructure investment, business development, and information dissemination. The federal role might best be confined mainly to infrastructure. State and local governments might best bear responsibility for the other two approaches.

*Infrastructure investment programs.* Investing in rural infrastructure and then allowing market forces to determine the location of business activity is a long-standing tradition in federal rural development policy. Infrastructure investment

**TABLE 3**

**Administration's proposed fiscal 1986 budget for selected rural development programs**

| Development programs | Nonmetro share (millions of dollars) |
|---|---|
| Community and infrastructure development | |
| Spending programs | 7,554 |
| Credit programs | 881 |
| | 8,435 |
| Business and government economic assistance | |
| Spending programs | 1,014 |
| Housing and credit assistance | |
| Spending programs | 120 |
| Credit programs | 4,660 |
| | 4,780 |
| Other selected programs | |
| Spending programs | 2,180 |
| Credit programs | 3,596 |
| | 5,776 |
| Total selected programs | |
| Spending programs | 10,868 |
| Credit programs | 9,137 |
| | 20,005 |

Source: U.S. Department of Agriculture, Office of Rural Development Policy.

appears to be the main program area where the federal government can still play a role in rural development. Two major program areas in infrastructure development have been evident in the past.[14] The one is Economic Overhead Capital (EOC), which consists of public works, such as power systems, sewer and water utilities, and highways and other transportation facilities. The other is Social Overhead Capital (SOC), which is comprised of such human resource development programs as education, public health, and rural housing. Federal policymakers might appropriately view SOC as part of a rural transition policy.

Federal spending on rural infrastructure most often has been for loans or grants for improving water and sewer systems and developing highways into isolated regions.[15] Federal rural development

[14] See, for example, Niles Hansen, "Development Pole Theory in a Regional Context," *Kyklos*, Vol. XX, 1967, pp. 709-725.

[15] For an overview of government and private agencies involved in rural development, see Judith M. Richards, *Rural Economic Development*, Southern Rural Development Center, Mississippi State University, Spring 1984. The Economic Development Ad-

policy continues to emphasize the public works aspects of infrastructure development. More than $8 billion was budgeted for spending on community and infrastructure development in fiscal 1986 (Table 3). Many of these programs are intended to make plant sites in rural areas more attractive and accessible to new businesses.

Federal infrastructure programs do appear to have stimulated income growth in rural counties. Counties receiving Economic Development Administration (EDA) aid have consistently grown more rapidly than counties without aid. Furthermore, EDA investments in infrastructure have been more successful in boosting rural economic growth than have direct EDA loans to businesses.[16]

The success of the Appalachian Regional Commission in bringing rural parts of its constituent states into the mainstream of the U.S. economy may offer a paradigm for other federal investment in rural infrastructure. Increased growth in the Appalachian region can be attributed largely to public investment in the area's transportation network. The programs also appear to have facilitated the outmigration of labor to urban areas. Thus, EOC infrastructure development can serve both transition and development objectives in rural areas by enhancing the attractiveness of the area's resource base while making rural resources more mobile.

The future success of federal investment in rural infrastructure will depend on carefully targeting funds. Public investment in EOC seems warranted where funds are targeted to communities that already have characteristics that will attract private investment. Such characteristics might include low-cost energy, a favorable location relative to existing transportation, a pool of adaptable labor —possibly associated with declining rural industries—and availability of a natural resource base. Under such conditions public investment in EOC serves as the catalyst for private investment in the rural area rather than merely accommodating private investment. Increased EOC investment in lagging rural communities, however, is not likely to be effective in promoting sustained growth in areas lacking other growth potential characteristics.

*Business development.* Programs to develop local business are almost entirely the province of state and local governments. Federal funds might be directed to investment in infrastructure, but it falls to state and local governments to stimulate further development. Business development programs take essentially one form, a subsidy to entice business investment.

Many rural communities and states continue to emphasize various forms of investor subsidies to attract industry. Common forms of local investor subsidies in rural areas include tax abatement, interest subsidies through industrial development bonds, and subsidized production inputs.[17] Since such subsidies are a cost to local communities, do they pay off in terms of new jobs and income to local residents?

Investor subsidies appear to have only limited effect on industrial location for two reasons. First, companies select a general region in which to locate on the basis of market potential or resource availability. For example, a manufacturer of textile products might first consider locating in the South because of the availability of experienced

ministration (EDA), U.S. Department of Commerce, and the Farmers Home Administration, U.S. Department of Agriculture are two important sources of federal funds for public works projects in rural areas.

[16] For analysis of infrastructure programs, see Randolph C. Martin and R. E. Graham, "The Impact of Economic Development Administration Programs: Some Empirical Evidence," *The Review of Economics and Statistics*, February 1980, pp. 42-52, and Randolph C. Martin, "Federal Development Programs and U.S. Problem Areas," *Journal of Regional Science*, May 1985, pp. 157-170.

[17] For an exhaustive guide to incentives, see *Directory of Incentives for Business Investment and Development in the United States: A State by State Guide*, Urban Institute Press, Washington, D.C., 1983.

labor and relatively cheap land. Local subsidies have little or no influence on the decision, because the subsidies are often a small part of the cost differentials between regions. Second, nearly all communities offer new plants some sort of subsidy. The general availability of subsidies reduces their locational pull. Accordingly, investors are not likely to locate in an area solely on the basis of local subsidies.

Industrial revenue bonds illustrate the relative ineffectiveness of investor subsidies. First introduced in Mississippi in 1935, industrial revenue bonds are tax-exempt municipal bonds issued by local public agencies on the behalf of private firms. They were originally intended to attract new businesses to areas with little indigenous capital, but evidence suggests that they are now widely used and available to existing local businesses as well as new business interests. As such, they have little effect on location decisions. Rather, they serve as a general subsidy for new investment, with the costs borne by the federal Treasury, since municipal bonds are exempt from federal income tax.[18] Moreover, the recently passed federal tax reform further restricts the use of industrial revenue bonds.

Tax abatements and subsidizing production inputs, such as manpower training, also have drawbacks as development tools. There is some evidence that location decisions—the choice, say, between neighboring states or counties—are influenced by special tax abatements or offers of subsidized inputs.[19] However, the value of subsidies varies greatly with the capital needs, marginal tax structure, and resource requirements of potential investors. Accordingly, rural development agencies would do well to provide an array of incentives that can be tailored to the needs of potential investors in rural areas.[20] It should also be emphasized that the locational advantages of tax abatement could be offset if lower tax bills result in poor public services. Finally, states that want to direct new development to lagging rural areas will need to provide special state incentives for location in those areas since investor subsidies are generally available in all areas of a state, whether urban or rural.

Many rural areas likely will find recruiting industry more difficult in the future. Recent evidence suggests two reasons for this outlook. First, low-wage, labor-intensive jobs increasingly are going to foreign countries with outright comparative advantage. Second, many of the new jobs in manufacturing are being directed toward the more diversified labor pool and more highly developed infrastructure found in larger cities.[21] As a result, some states are proposing to stimulate local business formation through training and seed capital programs. Examples of such approaches are to use colleges and technical schools as centers for small business development and to provide local development agencies with technical assistance to broaden their perspective. The effectiveness of seed capital programs remains unclear.

*Information dissemination programs.* Federal, state, and local governments all have past experience in providing information on development opportunities. The basic aim of the information programs is to promote rural communities as places to invest or to promote the goods rural communities produce.

[18] Matthew Marlin, "Industrial Revenue Bonds: Evolution of a Subsidy," *Growth and Change*, Vol. 16, No. 1, January 1985, pp. 30-35.

[19] W. Warren McHone, "State Industrial Development Incentives and Employment Growth in Multistate SMSA's," *Growth and Change*, October 1984, pp. 8-15.

[20] See D. Rasmussen, M. Bendick, and L. Ledebur, "A Methodology for Selecting Economic Development Incentives," *Growth and Change*, January 1984, pp. 18-25.

[21] For example, see MDC Panel on Rural Economic Development, "Shadows in the Sunbelt," MDC Inc., Chapel Hill, N.C., May 1986.

The federal government has a long history in stimulating foreign demand for goods produced in rural areas through information dissemination and export promotion. The federal government has dozens of programs for facilitating export expansion, such as the International Trade Administration, the Export-Import Bank, the Small Business Administration, the U.S. Trade and Development Program, and perhaps of greatest significance to many rural areas, the Foreign Agricultural Service (FAS) of the U.S. Department of Agriculture.[22] These programs are not specifically targeted at rural products, but they have considerable influence on the rural economy and probably serve a useful purpose in rural development.

States are taking several steps to stimulate rural exports, both to the rest of the U.S. economy and to foreign buyers. Many states are trying to provide rural communities with technical assistance to expand their exports out of the region. Accordingly, many state universities have community and rural development personnel to help small communities identify development goals and attract industry. States are also becoming more involved in promoting export goods from their states through programs that seek market niches for locally produced goods.[23] To be successful, programs that promote local processing of raw goods need to be based on products that offer comparative cost advantages over competing regions. Products based on traditional local raw materials and processing activities will not necessarily offer a comparative advantage in the changing market. For example, the cotton-producing states of the Southeast may no longer have an advantage in textile production. On the other hand, the Mississippi catfish industry is an example where state programs have been coupled with comparative cost advantages to develop a rural industry.

Local governments tend to specialize in providing information about communities through local chambers of commerce or county industrial recruiting offices. No comprehensive evaluation of the effect of such programs on economic development is available, but the low cost of such efforts and the perceived need to match the recruiting efforts of neighboring counties and states ensure that the policy will continue to be popular with local leaders.[24]

## *Summary*

In sum, rural development policy involves a long-run commitment to stimulating economic growth in rural areas. Such policy would aim to reverse, at least to some degree, structural changes now at work in the rural economy. This approach is justified by social goals, not economic ones. The federal role in rural development appears to be investing in rural economic infrastructure. States can play a part by providing special business development incentives and information programs to enhance markets for goods produced in rural areas. Rural policymakers should set clear priorities for infrastructure investment. Scarce public funds should be spent only when there is a reasonable likelihood they will spur private economic activity. Local communities will be left with the greatest rural development task—that of attracting businesses to rural locations. Local communities will offer a variety of investor subsidies, but the results of these efforts may fall short of expectations.

[22] For a description of specific programs, see International Trade Commission, *The Export Trading Company Guidebook*, U.S. Department of Commerce, March 1984, pp. 77-80.

[23] See Judi Hackett, "Agriculture and Rural Development," mimeo, Center for Agriculture and Rural Development, Council of State Governments, Lexington, Ky.

[24] For a discussion of program effects, see Charles Leven, "Regional Development Analysis and Policy," *Journal of Regional Science*, Vol. 25, No. 4, November 1985, p. 574.

## Conclusions

The rural economy is undergoing fundamental change. The effects of this structural change are showing up in an increasing number of displaced rural workers and mounting strains on the public infrastructure of rural communities and states. Policymakers are just now beginning in earnest to decide how they will respond to rural economic problems. Before going further, policymakers need to decide whether a rural transition policy, a rural development policy, or some combination of the two will guide their responses.

Rural transition policy is the logical starting point for responding to rural economic stress. The structural change unfolding in rural America is creating resource adjustment strains that policy can effectively address. Retraining programs for displaced rural workers and programs that maintain essential public services and encourage the pooling of rural infrastructure can facilitate rural economic change while holding social costs to a minimum. States will carry the principal responsibility for administering many of these programs, but the federal government likely will play a role in funding the programs.

Whether the United States goes beyond transition policy and pursues a rural development policy depends on the social value attached to the economic growth of rural areas. The United States has explicitly pursued rural development goals for more than a hundred years. If those goals are still considered worthy, a comprehensive policy needs to be formulated to guide rural development programs. Infrastructure, business development, and information dissemination programs should be targeted to rural communities that have a reasonable likelihood of attracting private investment. Finally, policymakers should decide if farm programs, currently the primary policy link to the rural economy, may be too narrowly focused to meet rural objectives. If so, some of the public funds now going to farm programs may need to be redirected to rural programs.

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