Prospects for LDC Debt and the Dollar

By Scott E. Pardee

The debt problems of the less-developed countries (LDC's) will remain one of the most serious challenges of our decade. Many of these countries are already in a condition which five years ago we would have called default or bankruptcy. They simply have not been able to pay their debts or, in some cases, to meet their interest payments. To the markets, the prevailing view had always been that if one or more countries were unable to pay their debts a crisis would erupt.

The experience of the past year shows that such a crisis can be headed off by hard work and skillful negotiations by people in the commercial banks, the central banks, the Bank for International Settlements (BIS), the International Monetary Fund (IMF), and the governments that are most directly involved.

The flash point has shifted from purely financial considerations, which influence the ability to pay, to the political considerations, which might affect the willingness to pay. The fear in the markets now is that one or more countries will be forced by events to flatly repudiate their debts. Such an action is likely to be in a political context in which hard work and skillful negotiations by experts in international finance just won't matter.

There has already been considerable progress. Mexico has turned itself around, albeit with Draconian domestic measures that cannot be sustained for very long. Brazil has completed its negotiations with the banks and the IMF and has implemented a program which should bring about a significant international adjustment. Argentina has recently inaugurated a new democratically elected government, which is likely to improve substantially upon the chaotic economic policies of the latest military government. The Philippines loans are still a problem, but the problem revolves more around the question of who will be the successor to President Marcos than around the question of that country's ability and willingness to service its debt. In all, 33 countries have gone to the IMF, are submitting themselves to the Fund's economic discipline in the form of new adjustment policies, and are receiving some money from the Fund. Of these, 14 countries have completed debt

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rescheduling agreements with the banks.

The U.S. Congress has passed the bill to increase the U.S. contribution to the IMF, and Fund staffers are relieved that the resources they were promised by the member governments will now be forthcoming. A backstopping arrangement among central banks in the BIS has also been recently completed. But serious problems remain, and we are entering a prolonged, and perhaps the most dangerous, phase of the debt crisis. It will not be an easy workout.

Deputy Secretary of the Treasury Tim McNamar recently outlined the administration's strategy for dealing with the next phase of the international debt problem. The strategy has five elements:

1. Industrialized governments should adopt policies to sustain non-inflationary growth.

2. LDC's should follow sound economic policies and live within their means.

3. The IMF should be further strengthened.

4. Continued commercial bank lending must be encouraged.

5. And bridge financing should be kept available.

Each of these is a noteworthy objective, but all are difficult. Starting with the first point, I agree that the need for solid non-inflationary growth in industrialized countries is paramount. If we don't buy goods from LDC's, they can't earn enough to service their debt. If we allow U.S. inflation to revive, that might temporarily help the LDC's in terms of better prices for their products. But many of these countries are just beginning to grapple with their own very high rates of inflation, and more rapid inflation in this country could undermine their efforts to achieve greater price stability.

I see two serious roadblocks. First, although the United States is currently in a vigorous economic expansion, and western Europe and Japan are also doing somewhat better, the chances for sustained non-inflationary growth are clouded by the current U.S. policy mix.

The huge budget deficits, coupled with tight monetary policy, have led to punishingly high interest rates. In the United States, most consumers and businessmen have learned how to live with high interest rates, even in real terms, because interest costs are tax deductible. Tax systems in other countries are not so generous, and certainly a foreign government borrowing money in U.S. dollars gains no benefit whatsoever. So the LDC's argue that in addition to all the sound domestic reasons we have to reduce the deficit and allow interest rates to come down, there is also a foreign reason: lower U.S. interest rates would provide for a greater sustainability of growth in the industrial countries and would reduce the already staggering direct interest rate burden on the LDC's.

From my perspective, I see no significant actions by the administration or Congress to resolve the budget deficit before next year's election. Even in 1985, considerable time may elapse before budget cutting measures can be proposed, debated, and passed. We might not have a sound fiscal policy in this country until 1986 — nearly three years from now — at the earliest.

The second roadblock to promoting non-inflationary growth is the tendency toward increased protectionism. The LDC's cannot increase their exports in industrial countries if we won't let their goods in. The LDC's are selling their primary products at historically

reduced prices in an effort to earn dollars to service debt and pay for needed imports. But some of these items are also produced in the industrial countries, and the depressed prices from abroad have led domestic producers to ask their governments for protection or added subsidies. The LDC's are also hoping to increase their exports of manufactured and semi-manufactured goods. Here, too, they are running into increased barriers.

For all the talk about the need for trade liberalization, whether on a north-south basis or even among developed countries, there seems to be little effort to do anything right now. The latest ministerial meeting of the General Agreement on Tariffs and Trade (GATT) was a shambles. As barriers continue to be erected, the LDC's will increasingly find themselves odd man out.

Turning to the second leg of the Treasury's strategy, the need for the LDC's to follow sound economic policies and to live within their means, problems abound here as well. The very reason some of these countries are in a bind is that for years they have not followed sound policies or lived within their means. It is unrealistic to expect those countries to change overnight. And even for countries that are following more reasonable policies, huge sacrifices will have to be made, not just for one year but over a series of years, to restore their international credit worthiness.

To develop a credible policy, the LDC governments must gain and maintain the support of both rich and poor alike. The wealthy have established channels for moving capital abroad or accumulating it abroad rather than investing it at home. And capital flight occurs whenever these people become concerned. If Mexico could persuade its own people to bring home the money they have placed abroad in recent years, Mexico would not need to borrow another cent from the U.S. banks or the IMF. The same is true of many other countries.

The poor can always rise up, whether in food riots, peasant rebellions, general strikes, or outright guerilla warfare. We read regularly of the tensions which are building up in one or another debt-ridden LDC, and we know of the hostilities that have already broken out in some areas. Additional economic restraints are difficult to impose on these populations, even if in the interest of greater stability over the long run. Many governments do not have much time for austerity programs to work their way through the economy. IMF programs are usually set up for three years, but the ability to carry out these programs in some countries may be measurable only in months. The Soviet Union and Fidel Castro, for example, have a great deal to gain if the governments run out of time. For the U.S., the stakes are particularly big in Mexico. Any sort of political or social upheaval there could send millions of people across our border looking for safety and jobs. Again, Mexico, is not the only source of potential substantial emigration to the U.S. For this reason alone, the LDC debt problem has to retain a high policy priority in the United States, even though many of the tough negotiations are behind us.

The Treasury's third point of strategy is the strengthening of the IMF and other international financial institutions. The IMF has done a superb job, and I believe that the U.S. officials directly involved with the IMF, including Richard Erb, its executive director, should be commended for the skillful work they have done during these long months of exacting case-by-case negotiations. Federal Reserve staffers also deserve great credit. These negotiations were within the present framework.

Many worthwhile proposals have been made for improving the IMF as well as the World Bank and its affiliates. The problem now is not the lack of ideas but the political willing-

ness of the United States to resume its role as leader in developing these ideas and implementing them. Earlier, the administration devoted a great deal of energy to the question of whether or not to revert to a gold standard, and so far has not made many initiatives in international finance. Moreover, I believe the administration mishandled its relations with Congress on the IMF quota increase bill, since the bill became hostage to domestic pork-barrel politics. Congress responds to leadership. In dealing with other countries, particularly our allies in western Europe and Japan, U.S. negotiators have worn thin the argument that they cannot join in one or another cooperative effort on the international level in which increased financing may be needed because Congress will not agree to it.

The financial authorities of other countries have similar problems at home and manage to overcome them. Unfortunately, I do not see the administration changing its approach. While we can hope that the IMF and other international financial institutions continue to do a good job, they are not likely to be given a substantially greater mandate, power, or resources to work with for the foreseeable future.

Turning to Deputy Secretary McNamar's fourth point — the encouragement of continued commercial bank lending — here, too, the picture is pretty grim. The internationally active banks, and the large U.S. banks, in particular, need to rebuild their own capital base and credibility. The public knows that banks have a lot of stale loans on their books which will take years to clean up. Investors in bank shares are skeptical about the write-off procedures, wondering if the loan losses have not been seriously understated in quarterly earnings figures. Investors in CD's and other bank paper also raise questions at every turn.

In my company, we have seen how quickly so-called flights to quality develop though shifts into Treasury bills from CD's. Investors are quick to sell out or run paper off at maturity whenever they hear of a new LDC problem. The banks are taking huge spreads now, improving their earnings, although it is not easy conceptually to measure what they are doing since the new loans are being made to allow borrowers to pay interest on old loans. The current comment on this topic is "a rolling loan gathers no loss." For those banks whose exposures are under reasonable control, some very good deals are opening up, as in Mexico. But top management and banks' boards of directors may not resume significant voluntary lending to the LDC's for some time. This is especially true for regional banks.

The Treasury's fifth point of strategy is to maintain the willingness and capability to provide bridge financing where necessary. My impression is that the recent experiences were so unpleasant for those involved, particularly in the BIS facilities, that less financing is probably available now than before. Bridge loans need to be for short terms against strong collateral with a secure takeout on the other side. These conditions did not hold in some of the bridge loans which were made and are even less likely to hold now.

To conclude this discussion of the LDC debt situation, the U.S. Treasury has set forth a useful structure for analyzing the problem but still lacks a comprehensive strategy for solving it. And yet, from the market's point of view, a proliferation of LDC debt repudiations, leading to a collapse of the international financial system, ranks second only to all out nuclear warfare as the most frightening international development we can imagine.

In the late 1970s, when the dollar was declining day-by-day in the exchange market and we at the desk at the New York Fed could do little to stop it, we cheered ourselves up by

saying "Buy dollars and wear diamonds." We even had some T-shirts made up with that slogan. The dollar has now been strong for two years, and it is the people in the market who are using the phrase, rather than those at the Fed. Anyone who has sold dollars has risked losing his shirt. Buyers of dollars may not have made much, because the markets have been very volatile, but at least they have had a chance.

If the market were to trade on the basis of fundamentals, the dollar would not be at the lofty levels it is. The U.S. has developed a substantial trade deficit — forecasters are pointing to a deficit in excess of $100 billion next year. Our inflation rate is much better than it was, but the Germans and Japanese are still beating us. The mismanagement of our economy — in terms of our fiscal policy — is unmatched by any of our trading partners. Today, I could give good solid reasons for selling dollars, and some of the factors involved are getting worse rather than better.

But the dollar is strong, and some traders are telling their clients they "would not be surprised if" the dollar were to move from the current levels of DM 2.75 or so to the dollar to DM 2.85 or even DM 3.00 to the dollar next year. Sterling has taken a drubbing recently on concern over the oil price, dropping to $1.42 per pound, and some traders are talking $1.25 per pound. These traders really will be surprised if these predictions come true, in my judgment, but if so they will "wear diamonds" because they are now long in dollars and are "talking their book."

The strength of the dollar, of course, stems from capital inflows. In my own company we see some of the huge foreign private demand for U.S. government securities. Foreign money has also come into our stock market, particularly since it began rallying in the summer of 1982. When I travel abroad, someone always asks me how he can find someone honest who can help him buy real estate in the U.S. One of the reasons for the inflows, of course, is that our interest rates are much higher than in many other countries. Another reason is a political perception that the U.S. is the last bastion of capitalism in a world going socialist, a phrase I hear often.

The last point may be debatable, but I have learned not to argue politics with a customer.

These are all reasons to buy dollars. People also cite factors which prompt them to sell other currencies to get into dollars. The list of reasons for not investing in western Europe is a long one. It includes the sluggishness of the economies, the ineffectiveness of economic policies, the stultifying effect of European bureaucracies on private enterprise, and the fear of a spread of Finlandization — governments which kowtow to the Soviet Union. And the nuclear debate has been particularly scary. "The Day After" has been showing in packed theaters throughout western Europe these past few weeks, with a particularly strong effect in West Germany.

Some of the capital inflow is not entirely rational. People buy dollars when they worry that Brazil may default, even though U.S. banks have by far the biggest exposure. People buy dollars when there is another dangerous confrontation in Lebanon, even though U.S. troops have been killed in so many of these incidents. And people buy dollars when the Russians engage in saber-rattling. Such events which prompt dollar buying now would have triggered selling waves in the late 1970s. The administration claims that this is because our strategic posture is more credible now. I am not so sure. It seems to me that people are frightened and believe they have no place else to go but to dollars. Gold, silver, and Swiss francs have lost their luster to hot money investors.

The dynamics of the exchange market have added to the dollar's strength. To the extent traders have made good money, it has been on long positions in dollars. And those who would seek to manipulate the market — including now the London banking arm of the Soviet Union — have found that the market will move quickest if they jump in as a big buyer of dollars. The dollar is already overvalued against several major currencies, and a further rise would compound the existing misalignment.

Most market participants believe that at some point the dollar will turn. It has been pushed up by a wide range of uncertainties and shocks. If there are two or three weeks of peace and quiet or there is a sustained decline in U.S. interest rates, money would stop flowing into the U.S. Once the inflows stop, or even slow down, the dollar will begin to decline. If capital outflows then develop, the decline will accelerate. Foreign central banks would not do very much to resist the decline of the dollar, as through intervention. So the dollar, having seriously overshot in the upward direction, could conceivably overshoot in the other direction.

I doubt that a devastating plunge of the dollar is likely, however. Foreign central banks are under pressure to reduce their own interest rates and would take advantage of a cheaper dollar to do so. Also, the Federal Reserve has a different kind of monetary policy than it had during most of the 1970s. Then, interest rates were negative in real terms; now they are positive. There is no longer the clear incentive to borrow dollars and short the dollar in the exchange market on the expectation of repayment with cheaper dollars.

As you know, I am concerned about the U.S. Treasury's current policy of non-intervention in the exchange market. The dollar is the world's leading currency. The U.S. should play a leadership role in assuring the world that exchange rates are reasonably well aligned and that exchange markets are reasonably orderly. U.S. leadership in the past was fitful, to be sure, as Administrations changed and Treasury officials came and went, but the need for close coordination was always understood. The Federal Reserve has a big stake in the foreign exchange markets which, after all, are money markets once removed. The Fed also has a big stake in maintaining the close working relationships which have been built up over the years with counterparts in foreign central banks.

But the Treasury has brought all of that to a halt by fiat. What little intervention we have seen recently has been haphazard, too small to be effective, and clearly motivated by politics. My hope is that we can restore in this country some sense of balance in international monetary affairs. The Treasury should concern itself about the big picture and about relations with Congress, and leave the Federal Reserve to conduct the day-to-day operations in the market and with foreign central banks in its usual, thoroughly professional manner.