

## Commentary on "International Debt and Economic Instability"

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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.

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 forward 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 under way 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 payment 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 their 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 **all-weather** "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.