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Five Reasons for Opposing the IMF Quota Increase

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The title of my talk is "Five Reasons for Opposing the IMF Quota Increase." I'll try to give you a brief summary of those five reasons.

The first is that the IMF quota increase and the policy on which it rests is a type of international Ponzi scheme. The creditor banks have assets that are valued above their market value. If they were bonds, their value would be much lower on the books of the banks. Because they are loans, the banks continue to carry the assets at their face value. The bank examiners encourage this practice despite their obligation to protect safety and soundness.

The debtors cannot pay the interest on the debt, so the banks lend them more money to pay the interest on the old debt and extend the debt for a few years. They charge a fee for this service amounting on each go-around to hundreds of millions of dollars. The debts get larger, not smaller; the banks report positive profits based upon this bookkeeping arrangement, but the only way that they can collect the fee is by lending more money for interest on the old loans and for the fees. If there is an increase in the IMF quota, some of the interest and the fees which go to pay the banks will come from IMF loans to the debtor countries. This is the basic reason that the bankers want an IMF quota increase. It is not a good reason from the standpoint of the taxpayers.

If despite the Ponzi scheme, there was some reason to expect that in the future things would be better, the quota increase might be justified as a way to buy time. For that to be true, time would have to be used to develop a program that looks toward a solution. The IMF program does nothing of the kind. Instead it prolongs the uncertainty without solving any real problem. That is my second reason for opposing the increased quota.

The IMF program provides a mixture of hope and fear. The hope is that commodity prices will someday rise enough, so that the debtors will have more income, and that interest
rates will be lower in a year or two, so the cost of carrying the old debt and the extensions of that debt will be lower. If this were to happen, the debtors would have more revenue and lower costs. There is nothing in the IMF scheme that contributes to this outcome. In fact, as we'll see in a moment, the IMF scheme is counterproductive; it moves the financial system in the opposite direction, away from a solution.

So the hope is really nothing more than a hope, and the fear reminds us of the monthly perils of Pauline. Will Mexico pay? Will Brazil default? Will the Brazilians reduce their consumption enough this month to squeeze out the interest on their loans? Or will they require more loans from the IMF and the banks to sustain the fiction of no default? Can the exports from Argentina ever become large enough to pay some of the interest on their debt? Come back next month for another chapter featuring, "Will the banks fail?"

Much of this uncertainty is avoidable. Its continued presence shows that current policy does not reduce uncertainty. The IMF quota increase is not a policy. It is a way of delaying any introduction of a policy to deal with the problem that the quota increase is supposed to solve.

My third reason is that the IMF program – the program of conditional lending – makes very little sense. Applied to a single country, one country at a time, conditionality requires a country to agree to policies which cause a decline in real income and imports from the rest of the world and possibly an increase in exports to the rest of the world. The idea is that a country lowers production costs and brings its balance of trade into surplus. This enables the country to pay the interest on existing debt and possibly reduce the outstanding stock of debt. But applied multilaterally to countries that are each other’s customers, this policy makes much less sense, indeed very little sense at all. The reason is that Mexico, Argentina, Brazil, and the United States are linked together. When Mexico curtails its imports it curtails Brazil’s exports. When Brazil curtails its imports, it curtails Mexico’s and Argentina’s exports.
The IMF policy is a contractive policy for the world as a whole. It is, when judged *multilaterally*, a program that hurts many of the countries that it is supposed to help by shrinking the size of the world economy, contracting the amount of trade, and reducing the amount of exports. By contracting trade, the program forces other countries to seek assistance from the IMF. It is not at all surprising that more than twenty countries came to the IMF in 1982 and that others are on their way.

Many people refer to the IMF quota increase as a job increasing bill. It is nothing of the kind. The IMF program of conditionality lending is a job destroying bill. Brazil, Mexico and Argentina are large buyers of industrial exports from the United States. When we shrink the amount of their imports, we at the same time shrink the amount of our exports. We not only harm them through this policy, we harm ourselves. That might be a useful thing to do if it was part of the short-term cost of a program leading towards a solution to the longer-term problems of the debt or countries. But it is not. It will work only if commodity prices are substantially higher and interest rates substantially lower in the future. But if this does not happen, then the program is a costly program and is contractive. And the contraction of output in the debtor countries will be accompanied by inflation in the developed countries because many of the latter, – including the U.S., Canada, Great Britain, Germany, France, Italy, Holland and Switzerland – increased the annual growth rates of their money stocks to between 10 and 15% as part of a policy of inflating, or reflating, the world economy.

More lending, more inflation and more contraction is not a solution to the debt problem. There must be an expansion of world trade. Any discussion of a solution, or the steps toward a solution, to the current problem of indebtedness must include a proposal that reduces the burden of the debt enough to permit trade and trade finance to increase. Pushing each of the debtor countries into mutually reinforcing contractions is the very opposite of an effective policy.

My fourth reason for opposing the IMF quota increase is based on the views which were so often enunciated by my former colleague on the Shadow Open Market Committee,
the late Wilson Schmidt, President Reagan's nominee to be the American Executive Director to the World Bank. Schmidt pointed out years ago that countries can always pay their debts. As long as a country has real assets, they have the ability to pay their debts. More than 60% of the productive assets of Brazil and Mexico are owned by state corporations. It is inconceivable that these countries will be forced to default by inability to compensate their creditors.

A solution to the debt problem begins, as I will suggest in a moment, by recognizing the nature of the problem. It is a fact that the guarantees of governments are not much of a guarantee at all. But we could make those guarantees into meaningful guarantees by converting some of the debt claims into equity claims.

The fifth reason is more constructive. It addresses a problem that the IMF neglects. Expansion of world trade cannot take place under the uncertainties and restrictions that the IMF policy engenders. We must reduce the uncertainty and move toward a solution that encourages trade expansion and not contraction.

The key is to recognize the two sources of the problem. First, the banks have on their books assets which are overvalued relative to what they would command in the marketplace. But the banks earn fees by pretending that this is not so. As long as that remains true, the banks have no incentive to write asset values down to their current real market value. Second, much of the debt is guaranteed by governments. What does that mean in practice? The government's guarantee is a promise to pay foreign exchange that it can only obtain by borrowing or by following policies that produce a trade surplus.

Suppose a borrower has mortgage on his house and cannot pay. The solution to the problem is obvious. The bank would exchange its debt for an equity claim, and it would sell the equity claim at the current market value. The residual owner would get whatever was left. The same would be true in most commercial lending.

The international debt problem arises precisely because neither of those principles is applied. On the one side, the banks don't want to write down the value of their debts, and are paid – according to accounting conventions – for not doing so. The borrowers have no incentive to improve the claims.
A solution to the problem starts by removing the causes of the problem. First, the borrowers should give an equity claim in their country against some of the real assets. Brazil owns large real resources, iron mines, for example. They can convert debt claims into equity claims by giving preferred stock or common stock in exchange for debt. Many of the state companies are profitable. Or, U.S. banks can be allowed to purchase equity in local banks or to increase the equity investments made in the past.

The claims would be improved; it would be a matter of negotiation to decide how much the claims would be improved. On the other side, that is from the side of the creditors, the claims would be written down from their face value to their current market value. Once we have the value of the claims reduced to market value and the quality of the claim improved, we have the possibility of making a market in these debts, or claims, or equities. That would reduce the problem and halt the process of deferring the problem to some unknown future time.

Those banks that do not want to hold equity claims could sell them in the marketplace and get them off their books. Once that is done, we can look forward to an increase in world trade. Uncertainty would be reduced, and the IMF restrictions on trade would be removed.

The proposal recognizes that a mistake has been made. It isn't important to decide who made the mistake, whether it was the result of the OPEC cartel, mistakes by the bankers, or excessive borrowing. All of those decisions are in the past. The need is to find a solution. A main reason that the problem persists is that the current value of the debts on the books of the banks is greater than the present value of the earning stream that the banks can expect to receive. As in any commercial lending transaction that reaches this stage, the value of the debts must be lowered. In the process, the banks will recognize some losses, but the value of the claims will improve. A market will form to distribute the debts and claims around. And trade will expand.