The International Debt Problem, Insolvency, and Illiquidity: A Policy Proposal

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THE INTERNATIONAL DEBT PROBLEM, INSOLVENCY
AND ILLIQUIDITY: A POLICY PROPOSAL

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and U.S. Financial Policies

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1. The Problem

The total volume of international debt of developing nations rose from about $340 billion in 1978 to about $640 billion in 1982. This increase of almost 90 percent over four years, even after adjustment for world inflation, has outpaced the debtor nations' real growth. Interest payments measured in current dollars exploded from about $20 billion to approximately $66 billion over the same period. A marked increase in the average rate of interest payable on outstanding loans, reflected in a more than 300 percent rise of interest payments compared to the 90 percent increase in debt, aggravated the debtor nations' real debt burden. Over the same four years the proportion of international reserves to imports of developing nations fell from 27 percent to 17 percent.

A change in the debtor nations' structure of outstanding debt worsened their position. One-third of the $300 billion addition to developing nations' indebtedness was short term. The proportion of short-term debt in total international indebtedness of developing nations rose from about 18 percent in 1978 to approximately 28 percent in 1982. Commercial banks dominated international lending during the past four years. "Official sources" supplied less than one-third of total international loans.

The surge of international indebtedness exceeded any relevant real economic prospects and could be validated only by an acceleration of worldwide inflation, or at least, by an acceleration of inflationary policies in the United States. When major industrial nations shifted around 1980 to an anti-inflationary policy there were severe adjustment problems in all economies, and particularly for debtors, domestic and international, who had extended their debt position on the assumption that inflationary policies would continue.

The change from an inflationary to a disinflationary regime was not the only change affecting debtor nations. The variations in the real price of oil observed over the past four years first disappointed expectations of
oil-importing and subsequently of oil-exporting nations. That change did not dominate their economic fate, however. The variety of experiences among developing nations points to the decisive role of domestic economic policies. Fiscal and monetary policies in some countries raised inflation above the worldwide average, and induced a flight of capital or stimulated hoarding of foreign currency. Economic policies frequently obstructed exports and encouraged imports. Policies to control food prices discouraged agricultural expansion so foreign exchange has been used to import food.

The complex network of international credit began to crack with the suspension of payments on Poland's debt. The fissures widened last year and the events in Argentina, Brazil and other nations, foremost in Mexico, threatened a chain reaction of insolvencies in debtor and creditor nations and a spreading liquidity crisis. Many feared that the world economy would be pushed into a disastrous depression.

II. The Search for a Policy

A sense of emergency has gripped policymaking in Washington and Europe. Complex negotiations are under way to prevent defaults: to ward off the insolvency of creditors, and to exorcise the threat of financial collapse. Central banks have provided new credits and regulators have assured banks that they would disregard the low quality of de facto defaulted claims. Commercial banks have been urged and even prodded to extend additional credit to finance overdue interest payments. Perhaps most indicative of the current mood are the moves to enlarge the borrowing facilities of the IMF and related international institutions. The magnitude of the planned expansion of the IMF's facilities has been repeatedly raised over the past twelve months, particularly by the US government.

There is little evidence and almost no assurance that the series of piecemeal improvisations will provide a solution to the international debt problem. A policy dominated or publicly justified by panicky fears of a "debt bomb" or a deflationary collapse will most likely produce serious new problems in the future. The improvisations may obscure de facto defaults on actually prevailing moratoria, preventing deflation, but risking a drift into a new round of worldwide inflation or the wasteful use of potentially productive resources in various forms of a bailout.
The rush to improvise some urgent actions should not blur policymakers' vision. A long-run strategy is required to guide the tactical choices to be made in the more immediate future. The following criteria constitute a viable long-run strategy to overcome the current problem and provide a framework for the future.

No deflation: There is no reason to let the world or the creditor nations slide into a deflation and deep depression. A financial collapse or a major collapse in the financial industry should be, and can be, avoided.

No inflation: Similarly, there is no justification for recourse to inflationary policies to alleviate the debtor nations' real debt burden or to "provide additional liquidity" to debtors and creditor banks. Inflationary policies "solve" the debt problem by shifting the losses associated with the current state of international debt to the ultimate creditors, i.e., the holders of money and other nominal liabilities issued by banks and governments. This "solution" would reenforce the tendencies toward permanent inflation and impose high social costs.

No bailouts: There should be neither bailouts of debtor nations nor of creditor banks. The losses experienced or expected by the banks should be borne by their management and shareholders. Each case of potential default should be judged separately to determine the relative permanence of the underlying conditions. Additional loans cannot solve the permanent underlying problem of countries that have borrowed to maintain consumption above their prospective income; additional loans can assist countries faced with transitory adjustment difficulties. Poland and Brazil exemplify the two alternative cases. The probability that citizens of creditor nations will pay a tribute to the debtor nation under the guise of additional loans is comparatively small when loans are made to adjust to a transitory problem. The failure of the creditor nations to cope with de facto permanent default encourages the taxing of citizens in the creditor nations and imposing on them a corresponding loss of wealth. The loss could be contained if the permanence of the problem would be recognized now and acknowledged by policymakers, regulators, and banks.
The provision of additional loans without discrimination between permanent and transitory problems of debtors fosters incentives among debtor nations to continue policies that contribute to the current problem. Under the circumstances they find it useful to raise their demand for loans, to reject requests for domestic adjustments, or renege on implementing the policies that are agreed to when loans are extended.

The long-run consequences of negative incentives produced by piece-meal improvisations seriously affect the productive use of our resources. A persistent stream of bailout funding directs portions of our savings away from the most productive use. The savings absorbed in bailouts most probably will be used by debtor nations to maintain consumption in excess of their expected income or to protect a large political apparatus that makes little contribution to real economic growth.

The requirement that short-run measures be formulated in the context of an explicit longer-run strategic conception helps to assure that policy will not decay into imaginatively camouflaged bailouts. The longer-run strategy imposes obligations on both creditor and debtor nations. The creditor nations must seek a stable pattern of financial policymaking to prevent major swings between inflationary and disinflationary phases of policymaking. Creditor nations must oppose protectionism. The expansion of world trade forms a necessary condition for the resolution of the longer-run debt problem.

Debtor nations also bear an important responsibility. Variations in the financial fate observable among many nations in the "Third World" direct our attention to the role of domestic policies. This overhaul is an important condition for the economic viability of the debt. Without the needed changes in the course of domestic policies the probability of de facto default remains high.

III. Aspects Bearing on Debtor Nations

The accumulated volume of international debt contains liabilities of both government and private institutions usually contracted in terms of a foreign currency. This latter condition exposes the debt to risks beyond those associated with the fate of a private business.

The financial failure of a private firm does not destroy the real resources it owns. These resources will not contact and can still be
operated to produce output in the future. The financial failure simply means that the balance sheet must be reevaluated and union contracts possibly renegotiated. Procedures exist to adjust valuations and to distribute the loss. Nothing in the procedures prevents the continued operation of productive resources. On the contrary, the adjustments described create an opportunity for a new management to put productive resources to work and to scrap unproductive processes. Financial failure of a private firm need not involve a social loss. It always involves a redistribution of wealth however.

Our current problem has an additional dimension that arises from the fact that foreign debt must be serviced in foreign currency. This exposes both private debt and government debt denominated in foreign currency to the risks of government policy. With all debt denominated in domestic currency the government can always prevent explicit default by taxation or inflation. International indebtedness closes this route. Servicing of foreign debt requires conversion of domestic money into foreign money at exchange rates that reflect the government's policies. Policies that obstruct activities with comparative advantage, that guide the allocation of investable resources to raise consumption at the cost of investment for political convenience, and lastly, that support highly inflationary monetary actions, all contribute to raise the cost of conversions into foreign currency. Whatever other conditions may have contributed, or may contribute in the future, the domestic policies pursued by the debtor nations are generally sufficient to create or avoid a permanent problem of de facto default on a nation's international debt.

The best opportunities for productive investments in private firms can be turned into highly risky prospects by a government's general economic or financial policies. The pattern of policies pursued by governments determines the usefulness of continued lending. There is clearly no justification to lend additional funds without a clear understanding that a debtor nation's policy if pernicious, will be substantially changed. Without such a commitment the underlying pattern will persist. Under such conditions it is advisable to recognize the actual default. The default acknowledges that the creditor nations have suffered a loss and that further lending will not prevent a future default. The creditors must be made to recognize that they have suffered a permanent loss that cannot be recouped by further transfers of wealth camouflaged as loans.
IV. Aspects Bearing on Creditor Nations

The improvisations emerging under the pressures of concerned policymakers and banks confronted with potential insolvency offer no assurance that they will not drift into an international Ponzi scheme. The absence of any lien on government assets, in contrast to what is customary in private borrower-lender relations, makes the problem of an insolvent government debtor very difficult indeed. The dependence of private debt servicing on government policy amplifies the problem. It becomes tempting under the circumstances to develop bailout policies benefiting both creditors and debtors at the expense of the ordinary citizen.

Once more, an explicit default without bailout is the better course whenever debtor nations show little prospect of accepting conditions that are consistent with the long-term economic viability of their international debt. This admission of default means recognition and acceptance of a loss in wealth by creditors. This loss, even in the case of a temporary insolvency, need not destroy the real resources used in the financing industry. Banks, like other firms that are temporarily insolvent, can operate after appropriate adjustments and pursue a prospective stream of earnings. The human and non-human resources would still be available to generate future earnings that would absorb the current losses over time. The losses would thus be borne by those groups responsible for them.

There is of course the possibility that recognition of such losses may invite liquidity problems. A run on banks, as in the early 1930's, may emerge. In contrast to the 1930's, the liquidity problem would appear as a consequence of insolvencies.

Governments have a responsibility to prevent such runs. The appropriate central bank's response to bank runs has been clearly defined since Bagehot's *Lombard Street*, published more than one hundred years ago. The central bank needs to act promptly as a lender of last resort, offering whatever advances of base money may be required to finance the conversion of deposits into currency. The execution of this function presents no basic problem and can be carried out in various ways without recourse to accelerated monetary expansion and inflation.
Some confusion apparently prevails in the public arena about the distinction between a bailout and the execution of a lender-of-last resort function. Lending base money as a "last resort function" does not, and should not, mean that the loss of wealth is transferred to the central bank or the taxpayers. Nor should the central bank hesitate in extending loans because of inadequate collateral. Such hesitation would be entirely inappropriate as the banks involved would still, over time, have to bear their own losses.

V. The Components of a Policy

The characterization of the problem and the associated issues leads us to make seven recommendations.

1. Explicit Formulation of a Long-Term Strategy

The government has not formulated a long-term plan to guide its short-run actions. We run the risk of drifting into a policy of accelerated inflation and bailouts with burdensome long-term consequences. To stop this drift, governments must discriminate between countries that are unlikely to repay in the future and countries that can be expected to earn enough foreign exchange to repay principal and interest if payments are rescheduled. Countries that are unlikely to repay should be declared in default.

2. Rescheduling the Maturity Structure of Outstanding Debt

Insistence on repayment of maturing debt lowers any chance of a longer-run solution. Maintaining the flow of interest payments should be the immediate concern to protect the economic value of the loans. The magnitude of the problem and the long-term requirements of the solution suggest that rescheduling should be arranged at regular intervals. This approach offers an opportunity to monitor and assess the execution of commitments to adjust domestic policies that debtor countries accept as a condition of rescheduling.

3. Gradual Adjustment of New Loan Extensions

This aspect is similar to a shift from an inflationary to a disinflationary policy. A sudden halt in international loan extension is likely to aggravate the problem. It contributes to uncertainty and confusion. But further loan extensions by governments and the financial
industry without attention to a long-run strategy will worsen future problems. Loan extensions need to be tied to the debtor nations' commitment to alter their domestic policies. In the absence of such a commitment, interest payments may depend on further loan extensions even after the improvements expected with recovery from the current recession. This is not a viable solution. The veil of financial operations covering the de facto moratorium would rip open at some point in the future. Bailouts without reform merely postpone the day of reckoning. The ultimate reckoning would involve even larger losses of wealth for the western nations as a result of the implicit tribute or capital levy they paid to debtor nations.

4. The Role of the IMF

Monitoring and assessment of domestic policies of both debtor and creditor nations form a crucial element in our program. The IMF seems the only institution equipped to perform this duty. However this task requires a reexamination of the IMF's usual "austerity programs" that encourage countries to reduce imports. Concurrent reductions of imports by several debtor nations shifts the burden of adjustment onto other countries. Financial policies and the creation of incentives to produce and export should be the major targets of the IMF.

We admit at this point to some unease and reservations about a permanent increase in the IMF quota. The institutional interests of its bureaucracy contribute to the likelihood of a massive expansion of lending facilities with a disposition for bailout under one guise or another. The only justification for loans is to assist countries to solve a temporary problem. Temporary problems do not require a permanent increase in the IMF quota.

5. Illiquidity

No liquidity crisis has thus far emerged and no such crisis need be tolerated. The prevention of such a crisis with the consequent threat of deflation does not require inflationary actions by the central banks. The central banks, as lenders of last resort, should make a commitment in advance to provide the required amounts in central bank money to all banks suffering mass conversion of deposits into currency. This operation can proceed without accelerating monetary growth and without abandoning a policy of gradually moving to a stable price level.
6. Insolvency

The potential spread of insolvency in the financial industry presents a state of affairs very different from the 1930's. Insolvency then resulted from the mismanagement of the liquidity crisis by the Federal Reserve. In contrast, a liquidity crisis would probably result now from defaults by borrowers.

Insolvency involves a loss of wealth. The loss must be suffered by some group. Our stand against its "socialization" i.e., a bailout, means that owners of banks (i.e., their shareholders), management, and some groups of creditors (owning non-liquid claims) must bear the loss. This does not require a formal bankruptcy and a closure of the banks involved in all cases. Banks that possess capital in the form of human resources, organization and connections may be able to operate profitably. They should be enabled to continue as operating units if they can be expected to cover their losses from prospective earnings and reestablish their solvency within a stipulated number of years.

7. Long-Term Consequences

A proper long-run policy will induce a sharpened risk evaluation of the competing banks by borrowers and depositors. It will reward management with a better sense of the risks associated with various loans and penalize incompetent or reckless management. Divergent movements in share values, in the cost of capital for various banks, and in their respective liability costs will express these evaluations. The currency ratio maintained by the public will probably be somewhat larger for some time as a result. The average spread between asset yields and interest rates offered on liabilities will also increase. These adjustments to a long-term plan will reduce the risk of a reoccurrence. A bailout, with losses borne by the taxpayers, will teach the lenders and borrowers that there is little risk to them in international lending and low costs of following imprudent policies.