Debt Problems

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1. My comments concentrate on the international debt of developing countries. I present some numerical estimates of future debt, discuss the possibility of avoiding default on debt service and estimate some effects on the U.S. trade balance. I comment, also, on some proposals for dealing with the problem and reducing risk to the U.S. banking system.

2. U.S. banks own 20% of the $500 billion debt of countries with recent debt service problems and 23% of the $250 billion owed by the three largest debtors -- Brazil, Mexico and Argentina. Growth of aggregate debt has slowed from 20% to less than 3%.

3. Of the three major debtors, Brazil has the best prospect of returning to the market by 1990. Assuming 2 1/2 - 3% average growth in the world economy and interest rates averaging 10 to 12%, Brazil can return to the market early in the next decade if growth of its debt is held to 3% a year and exports continue to rise at the average rates achieved for the past ten or twenty years. Mexico is, at best, a marginal candidate to return to the market by 1990, and Argentina is an unlikely prospect.

4. The U.S. will continue to run relatively large trade deficits. With debt growing at 3% annually, the 15 debtor countries included in Secretary Baker's recent proposal will require combined trade surpluses of $40 billion, on average, to pay interest for the next five years.

5. Debtor countries often demand more loans. The more debt increases now, the more exports must grow every year in the future to service the debt. Increases in debt now also increase the size of future trade deficits that the U.S. must run.
6. Faster inflation and efforts to push the dollar down by monetary expansion gives some short-term benefits to the debtors but probably make the debt problem less tractable. The policy risks a subsequent return of inflation, a renewed anti-inflation policy, a new recession and higher interest rates.

7. Regulators should encourage banks to negotiate exchanges of debt for equity, including equity in state owned corporations. Equity participation by creditors in state corporations would encourage privatization and efficiency while reducing the outstanding debt.

8. Secretary Baker's proposal to make lending conditional on economic reforms lacks an effective means of enforcing the reforms and probably does not provide sufficient incentive for the debtors. The plan puts the U.S. government into a position of greater responsibility for loans and loan losses.

9. Increased equity, increased loan loss reserves and reduced lending have lowered the risk to the U.S. banking system, but the risk level remains high. Additional steps should be taken. Instead of discouraging banks from increasing reserves, bank regulation should encourage banks to build substantially larger reserves against loan losses, as the European creditor banks have done. Also, banks should be encouraged to sell some of their holdings of debt on the market to reduce exposure.
DEBT PROBLEMS
by Allan H. Meltzer

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My invitation, to discuss problems about debt and debt service, covers a wide range of issues. There are problems of varying degrees of severity about some international loans and domestic loans for farms, real estate and energy held by banks and other financial institutions. Recently, there has been much public discussion of the use of debt to finance mergers and acquisitions. Some would add rising consumer debt to the list. Others add the recent change in the U.S. international position from net creditor to net debtor. In my opinion, recent discussions of corporate and consumer debt and the net debtor position of the U.S. typically overstate the importance of these issues. And I share the view recently expressed by several government agencies that additional regulation of corporate debt issued in mergers is undesirable at this time.

I have chosen to concentrate on the international debt problem. Many different explanations of this problem have been offered. Three factors are common to many countries. First, in the late 1970's, many borrowers believed that either inflation would continue or that some prices, particularly energy prices, would continue to rise rapidly, so investment was diverted to oil wells or costly substitutes for oil. Second, governments used borrowed money to finance redistribution, subsidization of inefficient enterprises and many inefficient or non-productive investments. Third, local observers, many of whom had experienced wasteful and inflationary policies in the past, invested abroad. Capital flight continues and is not likely to stop, or reverse, until the governments establish credible, stabilizing policies that reduce inflation, reduce subsidies and encourage efficiency. Since many of the governments are not sufficiently stable to provide such assurance and, in
any case, have made very few changes that would encourage such beliefs, soundly based U.S. policy should anticipate continued capital flight.

Background

The outstanding debt of all developing countries at the end of 1985 is in the range $850 billion to $875 billion and is rising at the rate of 4 to 5% per year. Approximately $500 billion of this total is owed by countries with recent debt servicing problems, and three countries -- Argentina, Brazil and Mexico -- owe about one-half of this total, $250 billion. In the late 1970s, debt of all countries with servicing problems rose about 20% per year. Recent growth is about 2 to 3%. Approximately, 32% of the debt is owed to official agencies (IMF, World Bank, etc.) 47% to financial institutions and 21% to other private creditors. U.S. banks own about 20% of the $500 billion owed by countries with recent problems and 23% of the $250 billion owed by Argentina, Brazil and Mexico. The gross debt of these three countries has increased at an average 6% a year for the past two years.

A long-term solution to the international debt problem occurs when debtors are able to return permanently to the marketplace and can borrow, pay interest and refund maturing debt without the intervention of debt committees, governments and conditional loans from international institutions. For this to occur, debtor countries must earn enough dollars (or marketable currencies) from exports to pay for imports of goods and services, to pay interest on the outstanding debt and to finance net capital flow (mainly net new borrowings plus net direct investment minus net capital flight). A widely used rule of thumb is that debtors can return to the market when debt is less than twice current exports.

The relatively slow growth of debt and more rapid growth of new exports in recent years has reduced the severity of the debt problem, particularly for the two largest debtors, Brazil and Mexico. Much of this progress occurred because the world economy, led by the U.S., has grown, interest rates have fallen, and Brazil and Mexico have severely restricted imports. Brazilian exports measured in dollars increased 50% from 1980 to
1984 while imports declined 25%. Mexican exports rose 45% in the same period while imports declined 55% from the unusually high level in 1980. This is the opposite of the pattern commonly found in developing countries and opposite to the pattern characteristic of Brazil and Mexico during the years of high growth before 1974. The recent, extraordinary reductions in Brazilian and Mexican imports has put these countries, particularly Brazil, in a position where import restrictions can be reduced. As long as imports do not grow much more than exports, net exports can continue to service a slowly increasing debt. In Argentina, where the debt to export ratio is higher, export growth is slower, and there has been less sustained effort to increase net exports. Reductions in consumption and imports must still be made.

Some Quantitative Estimates

Interest payments were about $22 billion for Brazil and Mexico at the end of 1985, and $45 billion for the 15 countries included in the proposal presented by Secretary Baker at the IMF meeting in Seoul. These sums are the approximate surpluses of net exports (exports minus imports) that keep the debt from growing. Zero growth of debt is too stringent a standard to be realistic. However, the more the debt grows now, the faster net exports must grow each future year to bring the debtor countries into a position from which they can service their debts in the market without assistance.

For Brazil or Mexico, net exports of $7 to $9 billion permit debt to grow by 3% a year if the interest rate is 10 to 12%. The net export surplus is within the range achieved recently, but the rate of growth of debt is below the average of recent years. To bring the debt/export ratio to 2 in the next five years, with interest rates at 10 to 12% and debt growing at 3%, Brazil's exports must grow by an average of 11% each year. The table shows these estimates for Brazil and similar estimates for Mexico, Argentina and the group of 15 countries. The numbers are approximate.
Table 1

Export Growth Rate Required to Reach
Debt/Export Ratio of 2 by 1990
(Debt Grows at 3% per year)

<table>
<thead>
<tr>
<th></th>
<th>Brazil</th>
<th>Mexico</th>
<th>Argentina</th>
<th>15 countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985 gross debt (billions $)</td>
<td>$103</td>
<td>98</td>
<td>51</td>
<td>437</td>
</tr>
<tr>
<td>Estimated 1985 net debt/exports</td>
<td>3.0</td>
<td>2.7</td>
<td>2.6</td>
<td>4.0</td>
</tr>
<tr>
<td>Estimated 1990 gross debt</td>
<td>120</td>
<td>116</td>
<td>60</td>
<td>508</td>
</tr>
<tr>
<td>Required annual export growth rate</td>
<td>11</td>
<td>9</td>
<td>17</td>
<td>8</td>
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Each 1% annual increase in debt adds 1% to the required annual growth rate of exports.

The required rate of growth of exports for Brazil is less than the average rate of growth achieved for the past twenty years, both before and after the 1974 oil shock. If debt grows at 6%, exports must grow by 14%, faster than the average of the past ten years. For Mexico, the safety margin is smaller than for Brazil and is reduced further if oil prices fall as is now anticipated. A setback may occur in 1988 when Mexico has national elections. The required rate of growth of exports for Argentina is at the limit of the best Argentine experience, so it is unlikely that Argentina will reach a debt/export ratio of 2 by 1990 or by the end of the century unless policies change more than they have. For the 15 countries as a group, exports must grow at three times the projected average rate of growth of OECD output for the five year period. For some countries, the required rate of export growth is implausible. Peru and Bolivia are examples.

A $4 oil price decline, that the market forecasts for 1986, reduces Mexico's exports 8% below the 1984 levels, after allowing for the effect of lower prices on the demand for oil. The anticipated decline in oil prices should not require a moratorium even if Mexico allows imports and domestic consumption to rise slowly from the 1984 levels. Growth of
Mexico's debt would have to be rigidly held to 2 or 3%. Brazil, an oil importer, would benefit. However, Brazil now produces a much larger share of its oil and natural gas from domestic wells.

These calculations suggest that some of the debtor countries can return to the debt markets early in the 1990s if they can achieve the rates of growth of exports just discussed. No further reduction in consumption or imports is required in these countries. Imports can rise at about the rate of growth of exports.

A net debt/export ratio of 2 is a maximum. Export surpluses for many debtor countries will have to continue after 1990 under the most favorable assumptions. On average, developing countries without recent debt service problems have debt/export ratios below 1. For Korea and Venezuela, the ratios are approximately 1.0 and 1.3. Turkey has returned to the market with a ratio slightly below 2.0. For Israel, the ratio is about 2.2.

Effects on U.S. Trade Balance

Export surpluses for the developing countries with debt problems imply net imports by the developed countries, including, and perhaps particularly, the United States. The task falls most heavily on the United States because countries like Japan and Germany generally export more than they import. To get an approximate order of magnitude, assume that between 1985 and 1990, debt for the 15 countries grows at 3% per year, as in Table 1, and that interest rates remain in the 10 to 12% range. Interest payments will require a net transfer, and therefore a net export surplus, of about $40 billion per year from the debtor countries. This suggests that the U.S. is likely to run trade and current account deficits and to increase its international debt for some time to come.

A rising percentage of the imports from Latin American debtors will be manufactured goods, including such imports as steel, steel products, footwear and possibly autos. Pressure for protection is likely to remain strong. Recourse to protection makes it more difficult, or impossible, for debtors to service their debts.
Proposed Solutions

Many different proposals have been made to reduce the international debt problem. I consider four types, omitting the many proposals that call for a unilateral reductions in debt or interest rates.

The first proposal, adopted unilaterally by Peru and more recently proposed by Nigeria, replaces debt rescheduling with a system of forced lending. The debtor country offers to pay a fixed percentage of its export earnings, 10% in the case of Peru. If the interest paid is less than the interest owed, the remaining interest is added to the debt. For Peru in 1985, the amount paid is about 25% of the amount due. Under this arrangement, debt and interest payments rise, but there is little incentive for the debtor to hold down the amount of forced lending or to pay interest. The debt rises, possibly without limit, until there is either a default or a change in the debtor's policy. Under current law and regulation, U.S. banks would recognize the non-payment of interest as a partial default.

Second, some urge higher inflation in the U.S. to raise world commodity prices and depreciate the dollar. The debtors gain some short-term relief from the rise in commodity prices. Interest rates would rise, however, reducing the gain to the debtors. In the past, creditor countries, including the U.S., have been unwilling to continue high inflation. A period of disinflation, slow growth or recession, and high market interest rates is likely to follow. Although the policy of inflation is likely to be unproductive, recent high money growth and efforts to push the dollar down suggest that the U.S. has either chosen, or drifted into, a policy of this kind.

A third proposal calls on debtors and creditors to exchange debt for some type of equity in corporations in the debtor countries, including state-owned corporations. (Chile has made some exchanges of this kind.) If the exchanges are made after valuing the debt to be exchanged at market value, the debtor would get some immediate relief from the debt burden. Debt for equity exchanges would be a step toward privatization of state
owned banks and other businesses and would complement the International Finance Corporation's plans for mutual funds in securities of Third World countries and Secretary Baker's proposal. Direct investment in all developing countries was $12 billion on average in 1980-83, so these exchanges can contribute, if continued for several years, to reduce the debt burden and increase privatization and efficiency.

Fourth, the recent U.S. proposal at Seoul continues conditional lending but changes the conditions under which new loans are made. The proposal calls for new loans of $40 billion in the next three years. The $40 billion of additional lending permits a rate of increase comparable to that of the last two years. The same rate is used for the computations in Table 1. Future export growth required to service the debt and reduce the debt/export ratio is the same as shown in Table 1.

Secretary Baker's proposal seeks to encourage efficiency through tax reform, labor market reform and private ownership. If continued for a decade or more, the program would be likely to produce more stable growth and the benefits of competition. Many of the proposed changes would supplement the proposed increased privatization through debt for equity exchanges. The proposal should not be treated as a substitute for expansion of net exports, however.

The proposal puts the U.S. government into a more central position of responsibility and probably obligates the U.S. to request increased contributions to the World Bank and the International Development Banks in the near future. The proposal lacks any effective means of enforcing conditionality and cannot provide enough new lending to give the debtors an incentive to make major reforms. Current costs, and potentially larger future costs, shift to the U.S. taxpayers.

The proposal is unlikely to reverse capital flight. The past history of many of the debtor countries is marked by many short-lived periods of reform. These have created an enduring skepticism that is likely to decay slowly in the face of current political and economic uncertainty. Further, to the extent that greater emphasis is given to growth instead of
austerity, imports and domestic consumption may rise more rapidly, lowering net exports and slowing the return to the marketplace.

Banking Issues

The most important banking issue is the risk in the banking system. There are two types of risk. First, exposure of assets and earnings to a major default, or a series of defaults, remains high. Some efforts to reduce these risks have been made since 1982, but more remains to be done to protect the solvency of the banking system. Second, bank earnings and reported profits remain heavily dependent on continued lending to debtor countries where the principal reason for the loan is to pay interest to the banks. Reported profits of the 100 largest banks in 1984 were $7.8 billion; the same banks received interest payments of about $10 billion from developing country loans. For the ten largest banks, the dependence of profits on "involuntary" lending of this kind is greater.

To reduce the risk of banking failures, banks should be encouraged to build substantially larger reserves against loan losses. Instead, bank regulators in the United States, and possibly the Internal Revenue Service, discourage banks from building reserves. European banks and regulators have taken the opposite approach, so the safety and soundness of the European banks has improved more rapidly.

One recent improvement resulted from legislation in 1983. Since early 1984, regulators have started to classify international loans as substandard or impaired and in some cases regulators now require banks to set aside reserves against possible default. (Peru and Liberia are examples of countries now classified as "value impaired.")

Regulators should encourage banks, where it can be done without impairing solvency, to sell international debt in the marketplace to reduce their exposure. This has the advantage of distributing risk more widely and reducing the risk of bank failures.