The International Debt Problem

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The International Debt Problem

by Allan H. Meltzer

The U.S. Treasury's policy toward the international debt of developing countries has some of the main features of the failed approach toward the thrift industry. Since 1982 the administration approached both problems with optimistic public assessments of the prospects for improvement, while it permitted inaccurate accounting and delayed the search for a lasting solution. The thrift crisis ended with a massive shift of liabilities to the taxpayers. The risk is that the international debt problem will end the same way.

Banks have been encouraged to carry their international debt at face value and to report interest as paid even if the interest payment was obtained by making additional loans to the debtor countries. At Seoul in 1985 Secretary Baker offered additional loans to countries that reformed their economies so as to promote efficiency and growth. Fifteen countries, known as the Baker 15, were given special attention. Since 1985, the interest rates on new commitments received by private creditors have been lowered and, in many cases, now differ little from the rates charged by international agencies despite the subordinate position of private debt. A few countries implemented reforms but most did not, and the growth of GNP for the group remained low.

WHAT HAPPENED?

The most important change in recent years has been the rising direct or indirect role of governments and international agencies and therefore of taxpayers. The rise in loans by international agencies has required increases in the capital of the International Monetary Fund and the World Bank, and further increases have been proposed.

These increases might be justified by evidence that the U.S. Treasury and the international agencies have a coherent plan for bringing the debt problem to an end within a reasonable time. The Baker Plan was not such a plan, and the current proposals by the Treasury do not fill the gap. In this respect, also, the debt problem is disturbingly similar to the experience that led to
the savings and loan bailout.

There is a fundamental flaw in a system that encourages lenders, whether private or public, to continue lending when the market value of the loan instantly falls to a substantial discount. Loans of this kind might be justified for a brief period, as in 1982, while a proper course is decided. To continue such policies for more than six years is a wasteful blunder.

The principal banks recognized the problem quickly. Since 1983, their net loans to the Baker 15 have been less than the interest payments they received. By reducing their lending and using debt equity swaps and other methods of debt conversion to reduce their outstandings they have systematically reduced the amount of their net flows to the debtor countries $15 to $20 billion below their annual interest receipts. Nevertheless the dollar value of the debt continued to rise for two principal, but very different, reasons. First, governments and the World Bank have increased their loans. Second, part of the debt is denominated in SDRs and foreign currencies, so the dollar value of the debt increased with the depreciation of the dollar.

To understand what has happened to lending, we should concentrate on net flows and transfers, not the dollar value of the debt. Table 1 makes this comparison.

Table 1

Growth of Debt, 15 Baker Plan Countries in Billions of Dollars

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Outstanding Debt</td>
<td>345.0</td>
<td>384.8</td>
<td>414.4</td>
<td>430.7</td>
<td>473.0</td>
<td>518.1</td>
<td></td>
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<tr>
<td>Change in Debt</td>
<td>60.7</td>
<td>39.8</td>
<td>29.7</td>
<td>16.3</td>
<td>15.0</td>
<td>27.3</td>
<td>45.1</td>
</tr>
<tr>
<td>Net Flows</td>
<td>26.1</td>
<td>29.2</td>
<td>20.0</td>
<td>14.5</td>
<td>7.2</td>
<td>6.0</td>
<td>7.7</td>
</tr>
<tr>
<td>Official Creditors</td>
<td>5.4</td>
<td>5.1</td>
<td>5.1</td>
<td>5.7</td>
<td>4.4</td>
<td>6.3</td>
<td>5.2</td>
</tr>
<tr>
<td>Private Creditors</td>
<td>20.7</td>
<td>24.1</td>
<td>14.8</td>
<td>8.8</td>
<td>2.8</td>
<td>-0.2</td>
<td>2.5</td>
</tr>
<tr>
<td>Interest Payments</td>
<td>17.0</td>
<td>20.6</td>
<td>20.0</td>
<td>22.8</td>
<td>25.1</td>
<td>24.2</td>
<td>22.6</td>
</tr>
<tr>
<td>Official</td>
<td>2.3</td>
<td>2.7</td>
<td>2.8</td>
<td>3.3</td>
<td>3.0</td>
<td>5.2</td>
<td>6.0</td>
</tr>
<tr>
<td>Private</td>
<td>14.7</td>
<td>17.9</td>
<td>17.3</td>
<td>19.5</td>
<td>21.2</td>
<td>19.0</td>
<td>16.6</td>
</tr>
<tr>
<td>Net Transfers</td>
<td>9.1</td>
<td>8.7</td>
<td>-0.1</td>
<td>-8.3</td>
<td>-17.9</td>
<td>-18.1</td>
<td>-14.9</td>
</tr>
<tr>
<td>Ratio Debt/Exports</td>
<td>2.0</td>
<td>2.6</td>
<td>3.0</td>
<td>2.8</td>
<td>3.0</td>
<td>3.5</td>
<td>3.6</td>
</tr>
</tbody>
</table>

Source: World Bank
Official creditors have been slower to reduce new lending. Their net payments continued to exceed their rising interest receipts until 1987. This has contributed to the increased share of the debt now held by official creditors. Since the public creditors typically have a preferred claim, the quality of the private debt declines as the public creditors share rises.

Until there is a change in policy, the two trends of the 1980s are likely to continue. First, private lenders will try to withdraw funds from debtor countries; their interest receipts will exceed their net flows. And their net flows will be small and, where possible, negative. Second, a rising share of the debt will be owed to official lenders, so taxpayers in the creditor countries will take on an increased burden.

A third trend, shown in the table, is the rising ratio of debt to exports. For the Baker 15, this ratio has increased steadily in the 1980s. A rule of thumb, widely used in the market, suggests that a ratio of 2 is near the outer limit at which countries can manage their debt without assistance, reschedulings and other interventions. Moreover, the average conceals the deterioration experienced by some large debtors. Argentina had a debt export ratio above 4 in 1982 and above 6.5 in 1987.

Every dollar of additional debt requires a country to raise exports permanently to service the debt. New lending that helps a country pay its outstanding interest adds nothing to the productive resources available to the country, so lending to pay interest postpones and worsens the problem for the future.

One fact, of great importance, is not shown in the table--the net assets owned by citizens of the debtor countries but held abroad. Estimates vary, but there is evidence that the amount of such assets for many of the so-called debtor countries is from 50% to 90% of the value reported for the debt, perhaps more. Omitting the assets blinds us to what has happened. It is as if we looked at the financial position of a typical American family by considering their home mortgage and auto loans while ignoring the value of the underlying assets.

The single most important source of capital for many of the debtor countries is the assets their citizens own abroad. Until they adopt policies that encourage their own citizens to repatriate capital and invest at home, it is hard to see why taxpayers in the U.S. or other developed countries should make new loans or guarantee repayment.
The central problem is reform—credible reform of the debtor countries economies to reduce subsidies, privatize parastatal industries, increase efficiency, align exchange rates, remove price and wage controls, control inflation, eliminate import substitution and protection, and foster competition and market discipline.

The Baker Plan did not fail because the case-by-case method or the idea of promoting growth and efficiency was flawed. The failure lies in the execution. The Treasury never developed a program to encourage efficiency, growth, and capital repatriation. It has not done so now.

The new Treasury proposal calls for writing down the debt and talks of some type of guarantee on the remainder. A guarantee requires the taxpayers to underwrite past mistakes of the bankers and regulators and the mistaken policies of the debtor countries.

**REFORM PROPOSALS**

Most proposals for reform call for some type of forgiveness of interest or principal or some facility that uses the public's money to buy up some of the outstanding debt. These proposals introduce perverse incentives and do little to encourage the types of reform required in the debtor countries.

The lesson of debt reductions or forgiveness granted by official lenders and paid for by taxpayers is that the debtor countries have much more to gain from waiting for the creditors to forgive the debt than from making the painful reforms that promote growth and efficiency. As the creditor governments tire of the problem, the pressure for forgiveness or reduction rises. Once granted, the principle is established. The payoff for delaying reform in the debtor countries rises. And, without reform much of the new lending, like the old, will flow abroad. We lend money to foreigners to buy assets here and elsewhere, then we forgive the debt. We borrow abroad, or sell our assets to foreigners, to finance part of the loans.

Under the Baker plan, the banks waited for the IMF, World Bank or U.S. Treasury to arrange financing that permitted the debtors to pay the interest and service the outstanding debt. Only after such agreements were in place would the banks agree to negotiate terms of new loans and rescheduling of outstanding loans. The banks had little incentive to recognize that the market value of the debt was less than the face value. The official agencies
worked to keep the debt service current, so debt would not have to be written down. The banks usually received interest payments when due, or within a few months of the due date. On balance, their repayments and reductions exceeded their new lending, and their interest receipts increased their reported incomes by $20 to $25 billion per year.

The proponents of a change in debt strategy are right to insist on an end to this policy but wrong when they urge greater involvement by governments and international agencies. The most urgent task is to get the incentives for creditors and debtors right.

The first step is to introduce greater incentives for reform. This can be done by tying any net new lending by official agencies to reform. Specific targets, applicable to each country should be set -- the number of state industries sold, the amount by which subsidies are reduced, the number of prices decontrolled (weighted by their importance in the consumption or production basket), etc. Payments should be made for performance -- for agreements carried out and sustained. With reform and a hospitable environment, flight capital will return. This is the key to success.

Second, the official agencies should leave the payment of interest on old debt to be negotiated by the debtors and creditors. The mistakes of the past should be settled by those who made them. With the official agencies no longer serving as interest collectors, the banks would have heightened incentives to negotiate about the value of the debt. Debtors have concern for their credit rating, a concern that is enhanced by the fact that any borrowing from private lenders in the future must be subordinate to the debt currently outstanding. They, too, have incentives to resolve the debt problem.

Markets have known for years that the outstanding debt will be written down. The U.S. government and the international agencies have squandered resources by failing to recognize this fact. Their error is a failure to consider the incentives implicit or explicit in the programs they adopt. We are about to make another costly mistake. This time the taxpayers should insist on reforms that get debtors and creditors working toward resolution while avoiding a new bailout or guarantees financed by U.S. (and other) taxpayers.