International Debt Problems

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INTERNATIONAL DEBT PROBLEMS

ALLAN H. MELTZER*

A long-term solution to the international debt problem is achieved when debtor countries can return to the marketplace without assistance or negotiation with foreign governments and international agencies. The prospects of major debtors' returning are very different and are most likely for Brazil. Various proposals are discussed, including proposals to exchange bank loans at market value for equity. Secretary Baker's proposal, which is opposed by the Shadow Financial Regulatory Committee, is also discussed.

I. BACKGROUND

The outstanding debt of all developing countries at the end of 1985 was in the range of $850 billion to $875 billion and was rising at the rate of 4 to 5 percent a year. Approximately $500 billion of this total was owed by countries with recent debt-servicing problems, and three countries—Argentina, Brazil, and Mexico—together owed about one-half of this total, or $250 billion. During the late 1970s, debt of all countries with servicing problems rose about 20 percent a year. Recent average growth has been about 2 to 3 percent. Approximately 32 percent of the debt is owed to official agencies, such as the International Monetary Fund (IMF) and the World Bank; 47 percent is owed to financial institutions and 21 percent to other private creditors. United States banks own about 20 percent of the $500 billion owed by countries with recent problems and 23 percent of the $250 billion owed by Argentina, Brazil, and Mexico. The gross debt of these three countries has increased at an average of 6 percent a year for the past two years.

A long-term solution to the international debt problem is achieved when debtors can return permanently to the marketplace and can borrow, pay interest, and refund maturing debt without the intervention of debt committees or governments and without 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

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is less than twice current exports. This is an arbitrary standard, but no objective standard exists.

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

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

The required export growth rate for Brazil is less than the average growth rate achieved for the past 20 years, both before and after the 1974 oil shock. If debt grows by 6 percent, then exports must grow by 14 percent—faster than the average of the past 10 years. For Mexico, the safety margin is smaller than for Brazil and is reduced further if oil prices remain at recent levels. The recent oil price decline virtually eliminates the possibility that Mexico can return to the market by 1990 without a very large increase in the world
price of oil. A further setback may occur in 1988 when Mexico has national elections. The required export growth rate for Argentina is at the limit of the best Argentine experience, making it 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 thus far. For the 15 countries as a group, exports must grow at three times the projected average growth rate of the Organization for Economic Cooperation and Development (OECD) output for the five-year period. For some countries, the required export growth rate is implausible. Peru and Bolivia are examples.

A $4 oil price decline, which the futures market had forecast for 1986, would have reduced Mexico's exports to 8 percent below its 1984 levels after allowing for the effect of lower prices on oil demand. The recent decline of $14 or more requires either much more austerity—reducing consumption and imports—or more loans to service the existing debt. Increases in Mexico's debt now must be followed by future increases in net exports to service the debt. Because 60 to 70 percent of Mexico's exports are oil exports, Mexico is unlikely to substitute nonoil exports, dollar for dollar, for oil price reductions without a substantial real devaluation or a major change in its policies. Brazil, an oil importer, benefits from the oil price decline. However, Brazil now produces a much larger share of its oil and natural gas from domestic wells than it did during the 1970s.

These calculations suggest that some debtor countries, such as Brazil, can return to the debt markets during the early 1990s if they can achieve the export growth rates discussed above. No further reductions in consumption or imports are required in such countries. Imports can rise at about the export growth rate.

A net debt/export ratio of 2 usually is taken as a maximum. Export surpluses for many debtor countries must 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, respectively. Turkey returned to the market with a ratio slightly below 2.0. For Israel, the ratio is about 2.2.

III. 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 U.S. The task falls most heavily on the U.S. because countries such as Japan and Germany generally export more than they import. To derive an approximate order of magnitude, assume that debt for the 15 countries grows at 3 percent a year between 1985 and 1990, as in table 1, and that interest rates on average remain in the 10-to-12 percent range. Interest payments will require a net transfer, and therefore a net export surplus, of about $40 billion a year from the debtor countries. This suggests that the U.S. likely will run trade and current-account deficits and increase its international debt for some time to come.
TABLE 1
Export Growth Rate Required to Reach Debt/Export Ratio of 2 by 1990
(Debt Grows at 3 Percent a 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*  (billions)</td>
<td>$120</td>
<td>$116</td>
<td>$60</td>
<td>$508</td>
</tr>
<tr>
<td>Required Annual Export Growth Rateb</td>
<td>11%</td>
<td>9%</td>
<td>8%</td>
<td>17%</td>
</tr>
</tbody>
</table>

Note: Each 1 percent increase in debt adds 1 percent to the required annual export growth rate.

* Computed as $D_{1990} = (1.03)^5 D_{1985}$.

b Computed as $E_{1990} = \frac{1}{2} D_{1990} = E_{1985}(1 + g)^5$, where $g$ is the required growth rate.

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

IV. PROPOSED SOLUTIONS

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

The first proposal, adopted unilaterally by Peru and later 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 percent in the case of Peru). If the interest paid is less than the interest owed, then the remaining interest is added to the debt. For Peru in 1985, the amount paid is about 25 percent of the amount due. Under this arrangement, debt and interest payments rise, but little incentive exists 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 nonpayment of interest as a partial default.

Second, some urge higher inflation in the U.S. to raise world commodity prices and to depreciate the dollar. Debtors gain some short-term relief from the rise in commodity prices. Interest rates rise, however, reducing the debtors' gain. 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 of high market interest rates, likely will follow. Although the policy of inflation likely will be unproductive, recent high money growth and efforts to push down the dollar suggest that the U.S. has either chosen or drifted into such a policy.

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 reportedly has made some exchanges of this kind.) If the exchanges are made after valuing the debt to be exchanged at market prices, then 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. Such exchanges also would complement Secretary Baker's proposal and the International Finance Corporation's plans for mutual funds in securities of Third World countries. Direct investment in all developing countries was $12 billion on average during 1980-1983. Thus, these exchanges, if continued for several years, can help reduce the debt burden and help increase privatization and efficiency. Care must be taken to reduce risks of confiscation, but this is a matter best settled in private negotiations.

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 $29 billion during the next three years. The average rate of increase for the 15 countries is about 2 7/8 percent a year and is lower than the rate of increase during the past two years. A slightly higher rate is used for the table 1 computations and for computing future export growth required to service the debt and reduce the debt/export ratio.

Secretary Baker's proposal seeks to encourage efficiency through tax reform, labor-market reform, and private ownership. If continued for a decade or longer, his proposed program likely would produce more stable growth and the benefits of competition. Many proposed changes would supplement the proposed increased privatization through debt for equity exchanges. The proposal, however, should not be treated as a substitute for expanding net exports. 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 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. Past history of many debtor countries is marked by many short-lived reform periods. These past experiences 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 placed on growth than on austerity, imports and domestic consumption may rise more rapidly, lowering net exports and slowing the return to the marketplace.
V. BANKING ISSUES

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

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

One recent improvement has resulted from 1983 legislation. Since early 1984, regulators have classified 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.")

When it can be done without impairing solvency, regulators should encourage banks to sell international debt in the marketplace so as to reduce banks' exposure. This has the advantages of distributing risk more widely and of reducing the risk of bank failures.

APPENDIX

(Treasury Secretary Baker's recent proposal calls upon banks in the U.S. to lend an additional $29 billion to debtors in 15 countries with recent debt servicing problems. This proposal interposes the government as a party in the negotiations and as a proponent of additional bank lending.

We oppose the Baker plan. The plan shows a lack of political discipline. The international debt problem is a problem for the banks to work out with the principal debtors. The Baker plan shifts onto the taxpayer, in an indirect and roundabout way, costs arising from prospective losses that should be borne by bank owners and managers.)