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Who Should Bail Out the Banks?
Allan H. Meltzer

The title of this session asks: "Who should bail out the banks?" The simple answer is "no one". I could give that answer and say no more, but there is more to be said.

Let me begin by discussing what I mean by a "bail out". A "bail out" implies that there are going to be losses. Banks are experiencing losses -- a shrinkage in the real value of their assets. I don't suppose one needs to dwell on that subject in Texas at this time.

As the value of the assets falls, while the deposit liabilities remain fixed in value, the value of the banks' equity--the residual value of the banks--shrinks. Beyond some point, the equity value becomes zero or negative. The fall in the value of the assets and in the income they produce means that there are losses. Who should bear these losses? Obviously, the first candidates are the stockholders. And, without doubt, the stockholders will bear some of the losses. But people who ask questions like "Who should bail out the banks?" may have in mind that the losses at some banks may exceed the equity. What will happen if we get beyond the stockholders equity? Should we let the banks fail? Should the taxpayers come to the rescue? Should the government prevent individual bank failures? If the government fails to step in, will there be a crisis or calamity? The answers to these questions concern all of us and give rise to the question in the title.

Failure, of course, means bankruptcy. Many people think of bankruptcy as disappearance. A recent example, one that is currently in the news, helps to illustrate that there is a common misinterpretation. The Bank of America has experienced large losses. It is not bankrupt, but the value of its equity is reduced. If oil, land and commodity prices continue to fall so that at some future date the Bank of America is no longer able to pay off its debts with its assets, the bank is not likely to disappear. There is value in the name and in the organization. The Bank of America has offices around the world; it has a client base; it has customers; it has depositors; it has a reputation which, despite the tarnish put on by recent losses, remains a valuable asset. Someone will be willing to buy those assets, so the Bank of America is not going to disappear. What may disappear from view is the management of the
Bank of America. Stockholders or investors in Bank of America, Continental Illinois, or any number of other banks that have had difficulties lose some wealth.

There is a common confusion here. Bankruptcy does not eliminate the existing physical assets or the entire value of these assets. Bankruptcy may eliminate the management of the assets; the people who have been responsible for the management of the assets may do other things, perhaps less well remunerated than they were in the past. The stockholders will lose some money. The assets will be reorganized, and someone else will take charge.

Bankruptcy of an individual bank does not create a social problem. It does not differ in many respects from the failure of a neighborhood grocery store. There may be some inconvenience, but neither failure is a disaster for society.

The Failures in the Thirties

A major difficulty in thinking about bank failures, and a major cause for concern, is that people remember the bank failures of the 1930s. They think that if there is one bank failure there may be an epidemic of bank failures which will end up in another Great Depression. Many people remember the period from 1929 to 1933, when 40 percent of the banks in the United States failed. About 10,000 banks closed in those few years. No one would like to see a calamity of that kind repeated. There is no reason to expect a repetition.

Most of the evidence developed in studies of banking systems and bank failures strongly suggests that the experience of the Great Depression was avoidable. It was a failure of regulators, rather than a failure of the banking system, that caused many of the 10,000 banks to fail and for all banks to close for three days in the 1933 bank holiday. That was a failure of public policy. The government had the opportunity to prevent that calamity, but it missed the opportunity.

The differences between then and now are important for understanding why the banking system experienced a wave of failures in the 1930s that need not be repeated. A story illustrates one particularly harmful mistake made in the 1930s. At the time, the government debt was very small, so banks invested in railroad bonds. The bank examiners would examine the assets of the banks. If the interest on the loans was paid, they would credit the bank with the face
value of the loans. Then they would look at the railroad bonds. Many of the railroad bonds were quoted on the bond exchange every day. The examiners would see that these bonds (because the railroads were losing money) were selling at less than face value. They would credit the bank with the market value of the bonds. Then they would add up the liabilities to depositors and others and estimate the value of the bank. The low market value of the railroad bonds often meant that the bank’s liabilities exceeded its assets. The examiners would declare that the bank was insolvent. They would close the bank and sell the railroad bonds on the market. The next day they would go to another bank, and since they had just put several hundred thousand or million dollars worth of bonds on the market, the price of railroad bonds would be depressed. They would again mark the railroad bonds to market and close the bank because it was insolvent. This procedure generated an epidemic of failures and, of course, without deposit insurance people began to anticipate what the examiners would do when they came. They withdrew their money in currency or gold. Under the fractional reserve system, this made the problem worse.

People were aware of the problem. The Federal Reserve was aware of the problem. President Hoover was aware of the problem. Responsible officials discussed what might be done. They thought perhaps they could improve the earnings of the railroads by raising the prices that the railroads charged for freight, or perhaps they could cut the wages of the people who worked on the railroad to try to increase their profit by lowering their cost. Eventually the President came up with the idea that later became the Reconstruction Finance Corporation. The proposal was to buy the assets, particularly the railroad bonds, instead of placing them on the market.

The first attempt was made by Treasury Secretary Mellon and a group of leading bankers. The bankers agreed that they would contribute capital to a fund—which would be privately financed but supported by the government—to buy up the railroad bonds held by failing banks to keep the prices from falling further. They agreed to do this, but they wanted a provision that would enable them to discount their shares in the new corporation at the Federal Reserve if their own banks faced a bank run. The Federal Reserve was unwilling to accept the provision, arguing that if they agreed to discount these shares they might as well discount the bonds. So the plan did not achieve much and eventually returned, with government capital, as the
Reconstruction Finance Corporation, organized and run for many years by a famous Texan, Jesse Jones.

A main lesson of the 1930s is that public policy contributed to the problems of the period. For those who are concerned that we are about to repeat the past, let me say that no one can guarantee that we won't repeat the mistakes. More likely, we will make new ones.

Differences in the 1980s

The banking problems today have some similarities but also differences from the 1930s. In the 1970s banks made loans on oil, land, property and crops based on the belief that prices would continue to rise rapidly. In a period of disinflation, the face value of these loans is, in many cases, less than the collateral value of the assets purchased with the proceeds of the loan. Some of the loans are in default. The banks' assets have shrunk in value, but the banks' liabilities have to be paid at face value, so some banks have problems, and some banks are insolvent.

Loans to domestic borrowers are one part of the problem. A second part is the international debt. When we talk about the problems of the banking system, it is useful to separate domestic loans from foreign loans.

The problems of insolvency, falling prices and deflation or disinflation are common to the 1930s and the 1980s. One of the differences between the 1929-1933 period and the current period is that we now have in place organizations like the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC). While there are problems with the FDIC and the FSLIC, including the fact that both may be (or become) insolvent, there is a high probability that the federal government stands behind these insurance corporations and, ultimately, the taxpayers stand behind them as guarantors. The recent experience with the Federal Land Banks is instructive. The government treated these banks' liabilities as if they were guaranteed and found a way to provide funds. People with deposits in FDIC or FSLIC insured institutions can expect no less, I believe. In that sense, if need be, there would be a bailout--taxpayer money or subsidy paid to prevent the failure of the insurance funds. This is very different from saving the banks. The funds will be used to honor the government's guarantee (an overly generous guarantee) to insure all deposits up to $100,000.

The public seems to recognize that the government intends to honor the
guarantee. They act very differently now than in the 1929-33 period. In the earlier years, when people were concerned about a bank, they demanded either currency or gold. They certainly did not want their deposits in a bank. When there is a banking problem today people take their money out of the bank which is rumored to be in trouble, but they put it into another bank. The money is not withdrawn from the banking system. It does not go into currency, and people don't hide their money in mattresses or cookie jars. They don't try to get into currency—at least that hasn't happened so far. They take their deposits from a bank or financial institution which is in difficulty and put it into another financial institution which, they believe, is not in difficulty.

For the banking system, the difference in behavior is critical. There is no flight from private banks. The failure of one bank does not threaten others and does not require a policy response to prevent an epidemic of failures. When money moves from one bank to another, there is little strain on the system as a whole.

We can be pleased to see that, during the last few years, nothing approaching the panic situations of the 1929-33 decline has been repeated. The overwhelming majority of banks, of course, remain solvent. And they are not threatened by the failures of other banks.

Nevertheless, those are reasons for concern. I want to focus on three questions or concerns: (i) Why do we have so much financial fragility in the United States? (ii) What would cause a financial collapse in the United States, and what can be done to prevent it? (iii) What should be done to prevent a financial collapse or make its consequences less damaging?

**Financial Fragility**

One of the obvious reasons for current weakness or fragility is the disinflation we have experienced. The rate of inflation has been lowered from the 8 to 10 percent average of five years ago to something in the neighborhood of 3 to 5 percent currently. Agricultural prices have fallen. Many loans, made on crops and on real estate which was bought in anticipation of rapidly rising prices, are in default. Oil loans, made in anticipation of ever-rising prices of oil, have to be revalued downwards because the assets have been revalued.

Disinflation as an explanation is incomplete, however. The same
disinflation problem which affects the United States affects all other countries of the world. Other countries too have experienced disinflation. Yet financial fragility, the weaknesses which have emerged in the U.S. banking system and the U.S. financial structure, is much more a problem for the U.S. than for other countries. There are financial problems in other countries, but much less than we observe here.

The weaknesses of the deposit insurance system and the regulatory system explain some of the differences between the U.S. and other countries. There are several reasons. First, the government has raised the amount of deposit insurance too high. It has insured deposits to $100,000. Of course, people can have multiple accounts, so $100,000 is not an effective limit. Banks which face insolvency have an incentive to take advantage of the government's guarantee. If you run a bank or financial institution that is near failure, it pays to offer higher interest rates to depositors. The deposits are insured, so the depositor is protected. Also, the depositor is compensated by the interest rate for any delays or inconvenience if the bank or financial institution fails. If the bank gets some new deposits and makes some profitable loans by taking a high risk, the bank may be able to avoid insolvency. The government's guarantee encourages the depositor to overlook the risk of bank failure, while it encourages banks close to failure to accept large risks. If the project fails, the government insurance corporation bears the loss. If the project succeeds, the banker and the owners gain.

One of the problems with our present deposit insurance system is that we've over-insured the banking system. When the system started, the amount insured was small. The system spared small depositors the cost of evaluating the bank. The present system leaves very little incentive for any depositors to pay attention to what their bank does. De facto, virtually all depositors, whether insured or uninsured, have been protected against losses. The case of Continental Illinois is instructive. The government did not say that the value of the assets in this bank have fallen and, therefore, we are going to close the bank and all the depositors who are not insured have to share in the loss. Instead, they paid all the depositors, insured and uninsured. They paid depositors who received a risk premium for keeping deposits in the bank. They even paid people, in full, who had non-equity claims against the bank's holding company which was never insured.

The Comptroller of the Currency is the regulator of national banks. The
Comptroller has said that large banks cannot be permitted to fail. His statement has been interpreted to mean that there is no risk of failure. Such belief encourages risk taking in the banking system. It pays the management, particularly the management of a bank which is in weakened condition, to take additional risks knowing that if the results are favorable they will salvage the bank. If the results are unfavorable, the owners and managers are not worse off; the bank was likely to fail.

Further, we don't have a full system of marking assets to market. The government has discouraged banks from writing down the value of international loans to reflect current market value. Some of these loans are sold between banks at prices ranging from 20 cents on the dollar to about 75 cents on the dollar, depending upon the country and its prospects. Yet these debts are carried on the bank's books at full value. This makes it difficult for depositors to monitor the valuation of the bank. For large banks, the problem is reduced or eliminated. The stock exchange values the bank. For smaller banks, there is no comparable market valuation. It would be better if assets were marked to market.

Finally, we have two problems resulting from the operating procedure of the insurance system. First, there is no relation between the deposit insurance premium that the bank or financial institution pays and the amount of risk that it undertakes. There have been proposals for 20 years, perhaps longer, for insurance premiums based on risk. Second the government has a monopoly. Private insurers can insure individual banks, and they have in the past. Private insurers cannot underwrite the risk of a banking system collapse, an epidemic of failures resulting, as in the 1930s, from mistaken public policy. To prevent a wave of failures we need the government to act as lender of last resort, but we do not require a government insurance monopoly.

To sum up, government insurance and regulation has replaced market discipline. Individuals have little incentive to monitor the actions of the banks in which they hold deposits. To restore discipline, we should lower the level of insurance to $10,000 or $25,000, well below the current $100,000 maximum. We should charge premiums that are risk related. Perhaps we could introduce coinsurance for large deposits, by letting the portion insured decline with the size of the deposit. We should, in my opinion, allow competitive private insurers to enter the market, preserving for the government the role of the lender of last resort to remove risks of a failure.
of public policy.

Private Deposit Insurance

Private deposit insurance is often dismissed on grounds that banking risks are difficult to evaluate. This is an incomplete view. Every day markets evaluate the stocks and bonds of all companies, including large banks and evaluate the risks borne by owners. Shares of banks which have unreported loan losses, for example banks with international loans which are reported at face value but have lower market value, sell for less than book value. On average, these banks sell for about 60% of their book value. Shares of banks, that don't have these problems, and that have good earnings projections, may sell for twice their book value. The market looks at what the bank does, evaluates the risk, and marks a bank's shares up or down. A bank that has a large portfolio of risky international loans -- loans to Mexico, Argentina, or other large debtors -- is valued by the market at less than book value. The market marks down the value of the portfolio, thereby recognizing the losses that the bank fails to report. If small banks whose equity is not traded, were encouraged to sell bonds as a means of raising capital, these securities would be valued in the market place. We would get a valuation of the loan portfolio that would be very helpful for setting the risk premiums and for pricing private insurance.

Legislation in the 1930s establishing deposit insurance did not distinguish between the failures of single banks and the failures of the banking system as a whole. A private insurer cannot take the risk that the banking system will go through another period like the 1929-33 period. The reason is that when there is a scramble to become liquid, to get currency, a private insurer cannot supply currency. Like everyone else, he would be holding securities to earn a return. When everyone is demanding cash, the private insurer would have difficulty selling assets for cash.

To prevent bank runs from spreading when everyone desires to shift into currency, we have to give someone the authority to print money. That's the role of the lender of last resort, an institution that developed in the 19th century in response to periodic crises in the British banking system.

Lender of Last Resort

A clear statement of the duties and responsibilities of the lender of
last resort can be found in a book by Walter Bagehot. Bagehot was the editor of *The London Economist*. His book, *Lombard Street* is more than one hundred years old, but it is still very much worth reading, both because Bagehot was an extremely skilled writer and because his knowledge of banking was outstanding. He traveled around London's markets to gain at first-hand an understanding of the working of the banking system. His book summarizes what he learned and draws up principles to guide a central bank, such as the Bank of England or the Federal Reserve, when there is a crisis in the banking system.

Bagehot recognized that in time of crisis the central bank must act as the lender of last resort. It is the only agency that can provide new money when the public demands currency. Some people object that printing money is inflationary. While that is very often true, it is not true in the particular case. The reason is that, during a panic or bank run, people want to hold currency. They don't want to hold more bank money; they don't want to hold more of other assets; they want to hold more government currency or its equivalent. Once the public finds that currency can be obtained in exchange, the extraordinary demand for currency ends. The currency goes back to the central bank, where it is destroyed and has no effect on the price level.

*Lombard Street* tells some dramatic stories about how, when the Bank of England acted as lender of last resort, panics would be over in a day or two. A panic would start; many people would try to sell assets for currency. The banking system would be threatened with widespread failures. When the Bank of England responded by supplying currency in exchange for marketable assets, the panic would end.

Bagehot criticized the Bank of England for its failure to announce its policy in advance of the event. He did not complain about the Bank of England's policy; he praised its actions to preserve the integrity of the financial system. His complaint was that the Bank of England failed to let people know what they were going to do. In each crisis the Bank of England waited, allowing the crisis to worsen before acting. Bagehot wanted the Bank of England to preannounce the policy or rule that it intended to follow.

The rule, Bagehot's rule, applied today, would set the discount rate at the Federal Reserve Banks higher than the market rate. In the normal course of events there would be no discounting, no borrowing from the Federal Reserve. Everyone would borrow at lower cost in the market. The only time
the Federal Reserve would lend to banks or financial institutions would be when the market did not function. The appearance of many borrowers willing to pay a premium to borrow from the Federal Reserve would signal that there is a problem, for it is only in periods when there is a panic in the market place that the market would be unwilling to supply credit to banks.

Bagehot's rule called on the central bank to lend freely at a penalty rate, above the market rate. And, he added that the banks should not be overly cautious about the collateral. Discount the value, that's the penalty rate, but lend on any asset that is negotiable in the normal course of events. When people see that money is available, that there isn't going to be a liquidity squeeze or a wave of failures, the panic will come to an end.

The rule—lend freely at a very high rate—should be announced in advance. Any financial firm with marketable assets would then know that it can get accommodation at the central bank in case of emergency. The only financial firms that would be in danger of failing would be those that didn't have such assets, those which are already insolvent. Thus, the rule separates the solvent from the insolvent. And the use of a penalty rate prevents bailouts and subsidized lending.

I would add one new rule to reflect current conditions. The government, or the government insurance agency, should sell insolvent institutions at their market price. Losses should be borne by all people who are rewarded for taking risks. That includes uninsured depositors, bond holders and stockholders. We should treat banks like any other institution. When they fail, stockholders should take the loss first, then the bondholders. Uninsured depositors should take any remaining loss in proportion to the amount of their claims. This rule encourages lenders and depositors to be concerned about the quality of banks' assets and give them some incentive to learn about the risks of banking. Of course, it would also give bankers greater incentive to be concerned about the risks they accept.

The central point is that many of our banking problems result from the absence of market discipline. Market discipline is a necessary condition for market efficiency. Failure is a form of discipline. If we don't allow failures, our financial system will be inefficient and undisciplined. There will be too much risk taking without the requisite amount of risk bearing by those undertaking the risks.
Actual Policy

A rule like the Bagehot rule, if followed, provides consistency. In contrast, actual policy during the past decade shows no clear pattern. A banker or depositor who examines past history to learn what the regulators have done gains little information about what they will do. One case gives little information about the next.

In two cases, about a decade ago, involving the Franklin National Bank and the First Pennsylvania Bank, the regulators made large, subsidized loans to the banks. Unlike Bagehot's rule, the loans were made at less than the market interest rate, not at a premium or penalty rate. This subsidizes the behavior that the regulator should want to prevent. Both banks continued to operate. In the case of Franklin Bank, the management was replaced; the stockholders took some losses, and the bank was reorganized as the European American Bank. In the case of First Pennsylvania, the management remained, and the bank continued to operate using subsidized loans from the government to supplement its capital. Eventually, the bank repaid the loans.

In the Penn Square case, the bank was closed and liquidated. Some have suggested that the bank's financial position was so bad that the regulators had no alternative but to close it before most of the deposits were withdrawn.

The Ohio thrift associations which experienced a bank run were closed temporarily by the order of the state. Many were liquid and solvent, but the solvent and insolvent closed together. Later, some of these thrift institutions reopened as members of the federal insurance system.

In Maryland, there were sizable withdrawals, but most of the institutions remained open. The states of Maryland and Ohio responded very differently to bank runs, so there is no pattern that can be learned from these experiences.

In the Continental Illinois case the bank was taken over by the government. The government assumed responsibility for both insured and uninsured depositors of the bank and the holding company. In my opinion, this decision set a bad precedent and is evidence of the high cost of our failure to develop clearly stated policies and to apply them when a problem arises.

Many of the problems at Continental Illinois were derivative of the problems of Penn Square. The regulators had two years to study and plan for the problems at Continental Illinois. When the time came to act, there was no coherent policy. Instead of acting under rules which had been enunciated long before, like Bagehot's rule to lend money against collateral at a penalty
rate, the regulators urged other banks to lend money to Continental Illinois. This was a serious error. In effect the government announced that the regulators didn't think enough of the collateral to want to take the risk of holding it, yet it urged other bankers to take the risk. This action raised questions about what the government's policy was and why the risks were being redistributed within the banking system, instead of removing them from the banking system. In the end, the government took over the bank, discharged the managers (which is a correct action), shifted the losses on the equity to the equity owners, but bailed out the holding company lenders who had been paid to carry some of the risk by the rate paid on their loans and deposits.

I do not believe that anyone can study these cases and fail to conclude that the government does not have a coherent policy in this area. Regulators work on a case by case basis and provide little information about what will happen in the next case. This increases uncertainty and adds to the potential risk.

**International Debt**

A main reason for treating international debt separately is that many of the loans are guaranteed by foreign governments. These loans are called sovereign loans, loans made by sovereign governments or guaranteed by such governments. The maintained fiction is that the governments will not default, so the banks carry most of the loans at face value. The only time that these loans are marked down on the books of a bank, or written off, is when the foreign government stops paying interest, as Peru has effectively done.

The case of Peru is a example of the risks that banks face. Peru has decided, unilaterally, that it will not pay the full amount of interest as it comes due. Instead, it has tied interest payments to its exports, and it offers to pay a percentage of its export earnings. If the payment is one quarter, one third, one half or one tenth of the amount of interest owed, the rest of the interest is considered an additional loan and added to the value of Peru's debt. Consequently, Peru's loans sell in the market place at about 20 cents on the dollar. In my opinion, Peru has defaulted.

In late October 1986, loans to Mexico and the Philippines sold in the interbank market at about 60 cents on the dollar. Loans to Brazil have sold at about 75 cents on the dollar, and loans to Argentina at about 66 cents. The market estimates the probability that the interest will be paid and the
debt serviced. What the market tries to decide is whether the interest will be paid, whether the debt will be serviced, whether the country will be able to pay its obligations when due by borrowing or by renegotiation.

The regulators have a peculiar way of dealing with the problem. Instead of reducing the amount of the debt, they work to increase it. When a country such as Mexico, Argentina, Brazil or Nigeria, among others, is due to pay interest to a creditor bank, the country may not have the foreign exchange to make the payment. To keep the loans from going into default, the regulators and the international agencies urge the banks to make additional loans. Part of the new loan is used to pay interest on the past loans. The banks report the interest payment and, at the bottom of the income statement, the bank reports that it is making a profit. A bank may report record earnings, but some of the earnings are the result of loans to countries that paid interest by borrowing more money. The debtor country owes more. The bank has a larger foreign debt. And the problem is put off for a few more months.

Mexico is a recent example. Mexico can't pay the interest it owes. Our government offers to lend Mexico $6 billion either directly or through the IMF or another international agency if the banks will lend another $6 billion also. Mexico uses about $8 billion to pay the interest on previous loans. Next year, Mexico will owe interest on a larger amount. The only way that they can pay the interest is by exporting more or importing less. Mexico's exports have to rise relative to its imports to earn the additional dollars that they have agreed to pay.

What is true for Mexico is true for the other debtors. Each time they borrow more to pay past interest, their debt increases. The only way the debt can be reduced or the interest payments made without adding to the debt is to increase exports, or reduce imports, so that more dollars (or foreign currency) is earned. Some countries have made progress in raising exports, but many countries—including Mexico—are no nearer to a solution now than in 1982 when the problem became apparent.

At the end of 1985, about $850 to 875 billion of international debt was recorded. By the end of 1986, there will be between $900 billion and $1 trillion of debt. Approximately $500 billion is owed by countries that have had problems paying interest, and about $250 billion is owned by Argentina, Brazil or Mexico. Thirty-two percent is owed to the International Monetary Fund, the World Bank, and similar agencies. Approximately 20 to 25 percent is
owed to U.S. banks.

The U.S. government has not encouraged the banks to write down large parts of this debt on their balance sheets. Consequently, they carry much of the debt at book value and lend more.

To see how the market treats the regulators' decision, in early 1985, I calculated the relationship between the market value and the book value for about 40 banks. At the time the two were about equal; on average the market value and book value were about the same, although market value and book value differed considerably among banks. Recently, I repeated the calculation. I found there has been an improvement, possibly because the rate of increase in lending has slowed and interest rates have fallen, making it easier for some countries to service their debt. In October 1986, using approximately the same sample of banks as in 1985, I found the ratio of market value to the book value had increased to 1.37. The market valued the bank about 37 percent above book value. As before, there were major differences between banks.

The differences become apparent when we compare the banks with the ten lowest ratios of market value to book value to the banks with the ten highest ratios. The banks with the ten lowest ratios had market values below their book value. They had net worth of $3.3 billion, on average, at the end of 1986. About 30 percent of their loans were to foreigners. The banks with the highest ratios of market to book value were very different. Their average size was about 1/6 the size of the banks with relatively low market value. Most of them had no international debt; others had 2 percent of their portfolios invested in international debt. Very little of their earnings came from loans to sovereign debtors made for the purpose of paying interest on past loans. The market valued them accordingly; their shares sold at twice book value at the time. In contrast, the larger banks had much more of their portfolios in international loans. The market valued their assets at about 60% of book value. If we apply that shrinkage to their loan portfolios, many large banks are insolvent at current market values.

The market has recognized that relatively large portfolios losses have occurred. Public policy should encourage the banks to report the losses to the shareholders. The regulators should encourage banks to write down the value of the foreign debt and should end the policy of encouraging banks to lend more. Additional loans postpone the search for a solution to the problem.
The aim of policy should be get the debtor countries back to the markets where they can borrow without the intervention of governments and international agencies. This is a long-term solution. To reach this solution, debt must be reduced relative to exports, and debt service must take a smaller share of net export earnings.

The Treasury has offered the so-called Baker plan to stimulate growth in debtor countries. If faster growth increases exports relative to imports, the debtor countries move toward a long-term solution to the debt problem. There are some obstacles, however. Typically, increased growth of output encourages imports more than exports. Given the very sharp reduction in imports by most debtor countries in recent years, and the reduction of domestic consumption, this pattern is likely to be repeated in the debtor countries. Further, the Baker plan calls for additional lending, so the debt grows while net export earnings may shrink, at least for a time.

A neglected aspect of the Baker plan calls for more attention to efficiency and productivity in debtor countries. One way to increase productivity is to transfer ownership and management of assets from state corporations (or parastatals) to the private sector. Subsidies should be eliminated as enterprises are sold to private investors.

The capital to buy these enterprises can become available if there are sufficient guarantees against expropriation or confiscation through edict, law, or through inflation and taxation. A main source of capital, particularly for Argentina and Mexico, is the capital that was taken out by nationals of the countries who foresaw the consequences of the policies pursued in the 1970s. If some of this capital can be repatriated, the debt problem can be put on the path to solution.

I propose three steps. First, the governments of the debtor countries should introduce appropriate guarantees to encourage repatriation. Second, the capital should be used to repurchase dollar denominated debt at market prices, or at negotiated prices, in the market place. Discounts of 30 to 40% are likely to be given, if current market prices accurately reflect the market's valuation. Banks should not be required to mark all remaining debt to market value. Third, foreign nationals should be permitted to exchange the debt for equity in firms owned by government, or in private firms. The equity should be denominated in local currency. The governments of the debtor countries would negotiate to receive part of the difference between book value
and market value. If foreign debt is exchanged for equity. If the 30 to 40% estimate of discount from face value is correct, the distribution of this discount between government and the investor has room for gains to both.

The response could be an exchange of foreign debt for domestic equity. The equity owners would receive payment in local currency, indexed for inflation and with guarantees against confiscatory taxation. The government would have saved foreign debt payments, so the foreign debt would shrink relative to exports and the country would move toward a solution to the debt problem without additional reductions of consumption. Society would gain from the increased efficiency, reduced subsidies and, possibly, from the prospect that borrowers would look forward to a limited reopening of the debt market. The lending banks would recognize some of the losses and write down the value of their assets.

This proposal applies to international debt the techniques that are widely used for domestic debt. When a domestic debtor cannot service his debt, equity owners bear the loss. The old debt is subordinated or exchanged for equity. Often the corporation is reorganized, and new managers take control. As long as there are valuable assets, reorganization is preferred by lenders and borrowers to liquidation. This procedure, applied to the international debt, begins to put the problem behind us.