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U.S. POLICY ON THE PROBLEMS OF INTERNATIONAL DEBT

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ABSTRACT

This paper discusses the problems of international debt from the point of view of the evolution of U.S. policy. The first section presents a brief historical review of the international debt problems of the 1980s. The next section examines the situation as of early 1989: progress as well as continuing concerns are discussed. In the final section, some thoughts on the prospects for the debt problems are presented.

U.S. POLICY ON THE PROBLEMS OF INTERNATIONAL DEBT

Edwin M. Truman[1]

The international debt problems of developing countries in the 1980s have been serious and complex. It is tempting, nevertheless, to seek simple, universal solutions to those problems. I believe that we must resist that temptation. It is for that reason, that this paper does not attempt to present the definitive statement about U.S. policy on these problems.

First, international debt problems are sufficiently complex, and the developing countries are sufficiently different, that it is inappropriate, in my view, to speak of a single policy.

Second, U.S. policy in this area has been evolutionary. Tomorrow's policy approach even for an individual country may well differ from today's, just as today's approach differs from that of yesterday -- or of last year or 1982.

Third, U.S. policy on international debt is a responsibility that is shared within the U.S. government; the Treasury Department, the State Department, the White House, the Congress, and the Federal Reserve are all involved in the formulation of various aspects of that policy, and its

1. Staff Director, Division of International Finance, Board of Governors of the Federal Reserve System. This paper represents the views of the author and should not be interpreted as reflecting those of the Board of Governors of the Federal Reserves System or of other members of its staff. This paper was presented at a conference sponsored by the University of California at Berkeley/Stanford University Joint Center for Latin American Studies on April 27-28, 1989.

implementation involves an even longer list of institutions. Moreover, the United States cannot dictate policies in this area because the problems of international debt are global in scope, affecting the interests of many developed countries around the world as well as many developing countries.

In this paper I will try to offer some perspective on where we have been, where we are, and where we might be going. I have three basic points to make.

First, I believe that there is a substantial common interest among the developing countries, the governments of creditor countries, the international commercial banks, and the international financial institutions in seeking cooperative, constructive and innovative approaches to handling to the debt problems of the developing countries. I believe the positive externalities associated with cooperative approaches are overwhelming and it is the responsibility of government to nurture and emphasize that common interest.

Second, significant progress has been made over the past seven years in dealing with the international debt problems and the associated economic and financial problems of the developing countries. In my view, insufficient attention has been paid to, or credit given for, this progress. Nevertheless, progress has been uneven and disappointing.

Third, U.S. policy in this area will continue to be evolutionary. Treasury Secretary Brady put forward some "ideas and suggestions" on March 10, 1989; these ideas were refined somewhat during the international meetings at the beginning of

April; they will continue to be refined. Moreover, even if Secretary Brady's initiative galvanizes progress beyond our wildest dreams, I suspect that the problems of international debt, and the implications of those problems in the 1980s, still will be with us at the end of this century. Indeed, it is fair to say that such problems have been with us since the first international loans were made many centuries ago.

<u>Where have we been?</u>

It is precisely because international debt problems are and have been always with us as well as because U.S. policies with respect to these problems are evolutionary, that I think it is useful to look back briefly at how these problems have evolved over the 1980s and what the responses to them have been to date.

I have presented elsewhere (Truman, 1986) my views on the origins of the international debt problems of the 1980s, but it may be useful to summarize them. I believe that the proximate cause of these problems lies in the changes in the environment of international lending in the early 1980s: recession in the industrial countries, deterioration in the terms of trade of the borrowing countries, and increases in nominal and real interest rates. These changes were part of a world-wide process of disinflation that began in the late 1970s but did not become a generally recognized feature of the international economic environment until several years later.

Among the more fundamental causes of the international debt problems of the 1980s were the extent of lending by commercial banks around the world to developing countries;[2] a failure on the part of the leaders of the borrowing countries to recognize that a day of reckoning (which could be defined in terms of a return to positive real interest rates) was inevitable; and the fact that many of these countries followed inappropriate macro-economic and micro-economic policies at the time.

In a recent study, Steven Kamin, Robert Kahn, and Ross Levine (1989) have analyzed the interaction of heavy international borrowing from commercial banks, domestic economic policies, and the external economic environment during the 1970s and 1980s in terms of the actual and hypothetical effects of these factors on real GDP per capita in four of the major Latin American countries: Argentina, Brazil, Chile, and Mexico. Their results suggest the following conclusions:

First, each of these countries benefitted from external borrowing in the 1970s in the sense that real GNP per capita at its pre-crisis peak was from 4 percent (Mexico) to 16 percent (Chile) above the level it would have been if the rate of external borrowing had remained unchanged (in real terms) from

2. I am not a fan of the view that the cause of international debt problem was the excessive official encouragement on the private commercial banks to deal with the so-called recycling problem in the 1970s. The proportion of the OPEC surplus that was actually "recycled" through the banking system was very small judging by data on commercial banks' liabilities to the OPEC members, especially to the so-called "low absorbers."

1975 to the present (1987) and it had been used as efficiently as the actual borrowing was used.[3]

Second, under the same assumptions, three of the four countries (the exception is Argentina) would have been better off today (in terms of income per capita in 1987 both absolutely and relative to the pre-crisis level) if they had borrowed less in the 1970s and early 1980s. The reason is the abrupt change in access to international capital markets in the 1980s and the ex-post change in the terms of access that occurred before the crisis -- the rise in international interest rates in real terms.

Third, the countries would have been better off today if their external borrowing, at the actual rate or at the hypothesized reduced rate, had been used as efficiently as was the experience prior to the build-up of external debt in the 1970s. Even if they had sustained this higher level of efficiency of investment, the countries still would have been better off today with the hypothesized lower (but steadier) rate of external borrowing.

In any case, these four countries and many others in Latin America experienced severe external debt crises in the early 1980s. However, one should remember that the circumstances of each country as it entered the debt crisis were quite different. This was one reason the so-called case-by-case approach was adopted. In practice, of course, the case-by-case

3. Efficiency is measured in terms of incremental capital-output ratios and along with capital flight is assumed to be a function of the quality of economic policies. However, in the case of capital flight it was assumed that it would have been reduced proportionately with the volume of international lending.

approach has proved to be less flexible than that phrase suggests, which has been a source of considerable frustration for all involved. Nevertheless, the approach was implemented using a common overall framework consisting of four elements:

(1) Appropriate adjustment actions by the borrowing countries;

(2) Restructuring of existing debts to commercial banks and continued lending by them to the borrowing countries on a concerted basis;

(3) Official bridge financing, in some cases, while the adjustment and financing programs were assembled; and

(4) An increase in the financial resources of the International Monetary Fund (IMF), which was destined to play a central role in the overall process.

It was understood that the countries' adjustment efforts would have foundered in the absence of an improved economic environment in the industrial countries. Bilateral official credits, which were a relatively small proportion of the total debt of most of these countries, were in most cases rescheduled in the Paris Club.

During the crisis period of 1982-83, the various parties with an interest in the international debt situation worked together rather harmoniously. The parties had their differences, of course, but under the watchful eye of IMF Managing Director Jacques de Larosière the borrowing countries adopted economic adjustment programs, the commercial banks were called upon to support those programs through concerted "new money" loans and rescheduling of existing maturities, and the international financial community more generally worked effectively to support countries that adopted economic adjustment programs.

One key feature of the approach was that no party provided medium-term financing until all parties were ready to do so. This was the policy requiring a "critical mass" of financial support from the commercial banks and creditor governments. It was designed to reinforce the IMF's longstanding policy that, prior to its own disbursements, the Fund should have appropriate assurances that a program supported financially by the Fund would be adequately financed overall. This policy with respect to medium-term financing was reinforced in a few critical cases by temporary bridging financing provided by the major industrial countries, normally in cooperation with the Bank for International Settlements (BIS).

By early 1985, remarkable progress had been made in dealing with international debt problems; the immediate crisis phase was over. However, the underlying economic and financial problems of the borrowing countries were by no means resolved. The process of economic recovery stalled in the developing as well as in the developed countries. Tensions increased as international pressures for continued external adjustment on the part of the borrowing countries came into conflict with the natural desire of those countries to resume economic growth in an environment in which their political leaders could respond principally to the demands of their own citizens. Moreover, the international commercial banks were increasingly reluctant to continue lending on a concerted basis even to countries implementing strong economic reform efforts.

For these reasons, Treasury Secretary Baker sought to breathe new life into the process through his call for a Program for Sustained Growth presented in Seoul in October, 1985. That program envisaged a continuation of economic reform efforts, but in the context of a resumption of economic growth. He called for net new lending of 2-1/2 percent to 3 percent per year by international commercial banks to a group of 15 heavily indebted, middle-income developing countries during 1986-88. He also advocated an enlarged role for the World Bank in promoting growth-oriented economic policies.

In my view, the Baker Plan as it came to be called was a plausible evolution in efforts to deal with the international debt problems that had been brought on by the changed environment for international lending in the early 1980s. It also had some positive results that are discussed below. However, the probability of its success was lowered by a new change in the international economic environment that developed shortly after the initiative was announced: the collapse of international oil prices. This collapse meant that the oil-exporting developing countries had no firm basis on which to calibrate their economic policies and calculate their external financial needs. The oil-importing developing countries experienced an unexpected windfall as the cost of their oil imports declined. This windfall weakened perceptions of the need to adopt economic policy reforms. The countries that were neither oil-exporters nor oil-importers were not sufficiently numerous to play a leadership role a new phase in dealing with debt problems. Therefore, by the time the Mexican program was developed in mid-1986, much of the momentum of the Baker initiative had been lost.

Where are we?

A careful analysis supports the conclusion that the economic policies of the developing countries are substantially better today than they were in the early 1980s. Although the process of reform of economic policies has not been even, and in a few countries there has been little or no progress, in the vast majority of the heavily indebted countries economic policies have substantially improved: exchange rates are more competitive, interest rates are positive in real terms, fiscal deficits (especially primary deficits) are narrower, subsidies have been eliminated, tariff policies are more rational, and recognition is widespread that the role of the public sector in the economy should be reduced and that market mechanisms and the private sector must be relied upon more heavily.

Moreover, in some countries economic performance has substantially improved. In five of the so-called Baker-15 countries economic growth has averaged more than 4 percent per year over the past three years: Chile, Colombia, Morocco, the Philippines, and Uruguay. In each of these countries except Uruguay, inflation is reasonably under control. In these five countries gross interest payments as a percentage of exports of goods and services have declined substantially. Ratios of external debt to exports of goods and services have declined as well. In one case (Chile), the decline has been dramatic (by 48 percent between 1985 and 1988); in the other cases, the decline has been in the range of 15 to 20 percent over the same three-year period. Interestingly, for Brazil the decline in the ratio of external debt to exports of goods and services has been 30 percent over the past <u>two</u> years, and the decline for Mexico has been 28 percent over that shorter period.

Despite some very positive accomplishments, the three-year period covered by the Baker initiative did not produce the breakthrough in economic growth and performance on the scale that was hoped for. One reason was that the strength of the economic reform efforts by the borrowing countries was less than had been envisaged when Secretary Baker laid out his ideas in Seoul.

One consequence of the shortfall in economic reform efforts was that many countries fell out of compliance with IMF-supported economic programs or declined to accept new programs; as a result, IMF disbursements declined. Over the period 1986-88, the IMF received net repayments of principal from the Baker-15 countries of about $3 billion. Given the revolving monetary character of the Fund, such repayments should be viewed as a positive development if they are accompanied by real economic and financial recovery in the borrowing countries; unfortunately, that was not the case.

A second consequence of the shortfall in economic reform efforts was a shortfall from anticipated disbursements by the multilateral development banks (MDBs). Secretary Baker had anticipated that MDB disbursements over the 1986-88 period would total $27 billion; in fact, they were about $22 billion -- a bit more than 80 percent of what had been expected. Moreover, in October 1985 it was anticipated that $27 billion in gross disbursements by the MDBs would translate into net disbursements of about $20 billion. In fact, net disbursements were about $10-1/2 billion -- roughly 50 percent of what had been expected. The explanation for the larger shortfall in net disbursements is that the dollar depreciated during 1986-87, which raised the dollar value of repayments of non-dollar borrowing from the MDBs; the dollar's depreciation also contributed significantly to the increase in the dollar value of outstanding MDB and IMF claims on the borrowing countries and to a rise in their share of the total outstanding debt of these countries relative to that of the commercial banks, a large proportion of whose claims are in dollars.

Turning to the commercial banks, Secretary Baker in Seoul called for about $20 billion in net new lending to the heavily indebted countries during the 1986-88 period. It is very difficult to estimate with any degree of precision the amount of net new lending by commercial banks to the Baker-15 countries during this period. Clearly, however, it was substantially less than had been anticipated.

Total disbursements under concerted lending packages negotiated after 1985 were about $12-1/2 billion during 1986-88. One way of assessing this figure is to ask what proportion such disbursements were of total scheduled interest payments to the commercial banks by the Baker-15 countries. The answer is about 21 percent; for the three major borrowers in Latin America (Argentina, Brazil, and Mexico), the figure is about 27 percent. That is, banks disbursed about two bits for every dollar they received in interest. During the 1983-85 period, disbursements under concerted lending packages represented about one-third of scheduled interest payments; about 43 percent for the three major Latin American borrowers.

Some might argue that this declining coverage of interest payments is symptomatic of the growing lack of consensus among the international commercial banks in support of the Baker Plan. From another perspective, one that recognizes that concerted lending is an unnatural process that at best mimics normal market practices, the declining coverage of interest payments might be viewed as progress. The important point is that the borrowing countries do not see it that way.

It is also important to recognize that Venezuela repaid a substantial amount of public sector debt during the 1986-88 period, and a few other countries repaid smaller amounts. Meanwhile, significant amounts of private sector debt were repaid or otherwise settled. Moreover, in 1987 and 1988 many commercial banks adopted strategies of aggressively reducing their exposures to the heavily indebted borrowing countries. For example, claims of U.S. banks on the Baker-15 countries dropped by about $15 billion, or almost 20 percent, during this two-year period. In most cases, these reductions in claims were at a discount, with the borrowing countries capturing a part of the discount.

Thus, debt reduction by international commercial banks has been going on for some time. In other words, the recent emphasis on debt reduction in U.S. policy can be viewed as representing a further evolution and recognition of what has already been occurring.

Overall exposures of commercial banks -- U.S. banks as well as foreign banks -- to the heavily indebted developing countries have declined dramatically -- absolutely and relative to capital -- since the outbreak of the debt crisis. For all U.S. banks reporting on the Country Exposure Lending Survey, exposure to the Baker-15 countries relative to capital has declined from 136 percent in June, 1982 to 54 percent in December, 1988. On average for the nine large money-center banks, the ratio has declined from 201 percent to 92 percent over the same period. While the average reduction in exposure relative to capital has been substantial, neither banks nor bank supervisors have cause for complacency. The U.S. banking system needs to continue to add to capital as we go forward.

This very progress to date in reducing banks' exposures has contributed to a diminished sense of urgency among the commercial banks in dealing constructively with the continuing problems of the heavily indebted countries. This, in turn, is one of the many factors underlying the widespread perception that something new is needed to reinvigorate the process of dealing with international debt problems.

In my view, two other notable features of the current situation are that most of the progress that has been made to date in terms of economic performance (positive growth rates combined with moderate inflation) has been by smaller countries, and the fact that performance externally has been superior to performance internally.

It is worth considering this last factor more carefully. External adjustment is easier to bring about than internal adjustment. All that is necessary is a competitive exchange rate and reasonably supportive macro-economic policies. However, unless the country gets its macro-economic policies right the result is either very high real interest rates, very rapid domestic inflation, or both. Thus, an important element of the overall adjustment process involves getting the internal balance between savings and investment right. Given the limited scope for supply-side adjustments to take hold in the short run, this usually means reduced fiscal deficits or fiscal surpluses. Moreover, when the incomplete process of internal adjustment is manifested in rapid rates of inflation, it undercuts political support from the middle class for the overall process of economic reform.

<u>Where are we going?</u>

It was against this background that Secretary Brady on March 10, 1989, called for a revitalization of the debt strategy. His proposals built importantly on the lessons and achievements to date.

He stressed the central importance of economic growth, the crucial role of sound economic policies and policy reforms to achieve that growth, the continuing need of borrowing countries for external financial resources, and the case-by-case approach. At the same time, he recognized the need -- which in some cases may be more political than economic -- for voluntary debt and debt-service reduction, and he called for support for such operations by the international financial institutions (the IMF and the World Bank). However, he clearly stated that the resources available from these sources for this or any other purpose are limited. Therefore, he called upon developing countries to adopt policies that would encourage the exploitation of alternative sources of external financing -- the return of flight capital and direct foreign investment.

On March 16, following Chairman Greenspan's return from a trip to Europe, the Federal Reserve issued a statement by him that it is useful to quote:

> I fully support the principles put forward by Secretary Brady last Friday [March 10] for helping the heavily indebted developing countries to resolve their economic and financial problems: continued economic reform in order to achieve sustained economic growth; timely and adequate external financial resources to support economic development; and . . . voluntary debt reduction supported by the international financial institutions. The challenge ahead for all of us is to reinvigorate the process and to ensure that it works.

How are we -- borrowing countries, commercial bankers, international financial institutions, and creditor countries -- going to make this process work?

The initiative properly lies with the borrowing countries. Fortunately, and in contrast with the situation in 1986 following the start of the Baker initiative, a number of countries are ready to restart their economic reform efforts or to build upon the progress that they have achieved to date. The list includes Mexico, Venezuela, the Philippines, Morocco, and Costa Rica. The readiness of the leaders of these countries to embark upon a new phase is an advantage, but it also underlines the sense of challenge and urgency.

One problem is that some other countries that are not similarly situated with respect to the need for IMF support of their economic programs face economic and political pressures to produce results in their dealings with the international financial community. One such country is Colombia, whose jumbo refinancing loan is almost, but not fully, completed. Another such country is Uruguay, which has compiled an admirable record of economic reform and growth over the past several years, but lacks the kind of access to the international financial markets that might have been expected as a result of these achievements. It is important that a way be found not to penalize countries like Uruguay, but rather to reward them for their accomplishments.

In another category are countries such as Argentina and Ecuador that are struggling to put economic reform programs in place. The people and leaders of these countries must have a sense of hope and the confidence that they will not be left behind. Of course, the easiest way not to be left behind is to catch up, but that is easier said than done.

Another problem is excessive expectations about the scale of the assistance from the international financial community to those countries that are prepared to help themselves. The international financial institutions have limited amounts of resources to support debt and debt-service reduction operations.

The limited experience to date with such operations suggests, as a first approximation, that countries get what they pay for in such operations. If the secondary market price of a dollar of a country's debt is 40 cents, a dollar can be used to buy back $2.50 of debt, saving about 25 cents (gross) in annual interest payments, assuming an interest rate of 10 percent -- 15 cents net of the interest paid, or that otherwise could be earned, on the dollar. If, instead, a dollar is used to enhance the principal and/or interest in an exchange offer, more old debt may be retired, but part of it will be replaced with new debt and the net interest saving would be about the same. This equivalence should not be surprising because the calculations assume in each case that the borrower is offering cash, or collateral with a cash value equivalent, in return for promised payments with the same present discounted value to the marginal creditor. However, these types of approximations fail to distinguish between banks that might be differentially situated and, therefore, might prefer one type of debt-reduction or debt-service-reduction operation over another and be prepared to act accordingly.

These types of calculations also assume that debt and debt-service transactions are voluntary in the sense that the size of the discounts are not imposed by the debtor on a take-it-or-leave-it basis and in the sense that participation in this aspect of any financing package is voluntary. This thought underscores the importance of maintaining as orderly and as businesslike a process as possible. Otherwise what is now a positive-sum game, yielding net benefits to all participants, easily can be turned into a negative-sum game in which the borrowing country probably will be a loser along with most commercial banks and the international financial community. These calculations also suggest that voluntary debt or debt service reduction transactions, backed by limited funding from the international financial institutions, are likely to provide only limited near-term cash-flow relief to the borrower. Thus, borrowers with large external financing needs will continue to need "new money" loans.

Turning to the commercial banks, there is also a risk that on their part they will have unrealistic expectations about the amount of financial support that is available from the public sector -- the international financial institutions or bilateral lenders (e.g., Japan) -- in connection with debt and debt-service reduction operations. Except in the case where a bank is able successfully to dispose of its debt in a cash buyback operation, commercial banks must expect to retain considerable risk on their books even if their claims have been enhanced as to the probability of principal or interest payments.

As I noted earlier, different commercial banks in different circumstances can expect to have different preferences regarding types of debt or debt-service reduction operations. Moreover, some banks will prefer not to engage in such operations at all unless they take the form of so-called debt-equity swaps. In fact, for some borrowing countries, the majority of the banks weighted by size of existing claims may prefer to advance "new money" or capitalize some or all of interest payments coming due instead of participating in debt or debt-service reduction operations. The preferences of these commercial banks should be accommodated as well.

Some might argue that banks preferring the new money process would be adding to the debt burden of the borrowing countries and would be failing to assist the borrowing countries in debt or debt-service reduction operations. I would argue that what is important is that a commercial bank participate in a reasonable manner in the borrowing country's overall financial needs; the form of its participation is much less important.

This brings me to the issue of the long-term external financing of these countries' economic development. It should be clear that debt or debt-service reduction is an abnormal form of financing, and it has natural limits. It should also be clear that jumbo loans to governments with recent debt-service interruptions that are priced at LIBOR plus 13/16 percent do not represent normal market access; the perceived risk associated with funds advanced by commercial banks through such arrangements is much higher than what is reflected in the spread. Moreover, in the foreseeable future, the role of most commercial banks in the direct financing of developing countries is likely to be limited to trade financing and the financing of small projects, primarily in the private sector.

It is, therefore, natural to ask how these countries can expect to finance their development needs in the future. This is the central issue raised by Secretary Brady's speech to the Bretton Woods Committee in March. Aside from domestic savings that one might hope would be more efficiently employed than in the past and aside from limited financing from the multilateral development banks, the developing countries must look primarily to three external sources for financing: direct foreign investment, international capital markets, and the return of flight capital.

In the near term, direct foreign investment probably represents the most promising source since the investor obtains a direct claim on assets in the country and can employ those assets to produce a real return. However, it is important that the climate for such investments be conducive to them. This refers not only to rules governing the repatriation of earnings and access but also to the macro-economic (and micro-economic) policy environment.

As for access to international capital markets, the yields implicit on commercial bank claims that are traded in secondary markets suggest that such financing today would be rather expensive. However, the yields for a few countries -- Chile and Colombia come to mind -- are not that far above those bonds of below investment grade. Mexico recently raised $100 million through a bond placement with a yield of about 17 percent. Clearly, access to such markets offers the best long-term hope for private sector financing from abroad. A stable financial climate and a demonstrated record of servicing existing obligations are necessary conditions to the achievement of such access.

In the meantime, the return of capital that domestic residents have sent abroad is a potential source of financing.[4] However, the return of flight capital in substantial magnitude is likely to be a medium-term phenomenon coming after macro-economic stability has been reestablished but before full access to international capital markets has been achieved.

In summary, I believe that a great deal has been accomplished in the past six years in dealing with the multiple underlying problems included under the rubric of the international debt problem. The economic policies of most of the borrowing countries are substantially improved; many of these countries have made considerable strides in laying the foundation for sustained growth; a few may have achieved it. The fresh

8. It is important to appreciate that flight capital is difficult to measure and links between measured capital flight and economic variables that are important to the development process, such as investment, are difficult to establish; see David Gordon and Ross Levine (1988). Nevertheless, the fact that some residents of many developing countries hold a substantial of their wealth abroad is undeniable.

appreciation of the role of market forces and economic incentives by the leaders of these countries is impressive.

At the same time, I believe that we are engaged in what is at least potentially a positive-sum game. It is important that both the borrowing countries and the commercial banks continue to recognize this fact. It justifies a role for the public sectors of the creditor countries, acting primarily through the international financial institutions. It also imparts to the entire effort a sense of the consequences of failure and an associated sense of urgency.

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