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Reflections on the Current International Debt Situation

Remarks by

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It is my pleasure to address colleagues from central banks on the issue of international indebtedness. This issue has touched on various responsibilities of central banks of both debtor and creditor countrie . In my presentation I would like to suggest several issues where I believe we have made progress in generating a broad consensus on international debt.

In my view there is a broad consensus that we have an international debt problem because in the main borrowers and lenders agreed to loans that appeared rational in a world of low, or negative, real interest rates and rapidly expanding export markets. These loans turned out to be problems when real interest rates shifted sharply upward at the same time that export revenues to service those international debts became substantially less than anticipated because of the sharp and largely unexpected recession in the countries of the OECD region. Calculations of investment returns that were reasonable under existing conditions were invalidated by the unanticipated change in the economic environment. The changed environment required an adjustment in economic policies by debtor countries that was recognized sooner by some countries than others. It is probably scant comfort to many countries striving to renegotiate and restructure their external debts, or to their creditors, that the same economic factors of high real interest rates and declining output prices also struck several important and highly leveraged sectors in the U.S. economy, including energy producers, agriculture, and commercial real estate in certain geographical areas.

A second broad consensus is that resolution of the debt problem must have both an internal and external component and that actions by borrowers alone, while necessary, are not sufficient for dealing with the problem. The external conditions are of course economic growth and open access to major export markets in industrial countries and the level of world interest rates that affects the size of the payments needed to service debt. In 1983 and 1984 economic growth in countries in the OECD region averaged about 3-3/4 percent per year and the terms of trade remained constant for the 15 heavily indebted countries identified in Treasury Secretary Baker's 1985 speech in Korea. In 1985 and 1986, however, the recovery in the OECD countries was not sustained as economic growth declined to about 2-3/4 percent per year, the terms of trade for these 15 countries declined significantly over these two years, and their aggregate exports of goods and services declined about $25 billion, or by about one-sixth, between 1984 and 1986. Somewhat more than one-half of this decline in export revenues resulted from reduced export earnings associated with the decline in the price of oil.

Stagnant growth and rising unemployment in countries in the OECD region, of course, generate political pressures for protection that further complicate efforts by indebted countries to resolve their problems. In this regard, it is critically important that all industrial nations strive to keep their markets open to the exports of the developing nations. It is also equally important that countries currently enjoying large current account surpluses, including industrial countries such as Japan and Germany, adopt appropriate macroeconomic and trade policies to help absorb more imports from Latin America and the Caribbean area. In this respect I am hopeful that the major industrial nations will implement the economic policy measures agreed upon at the meeting in Paris on February 22 of this year. The intention to implement these measures was reconfirmed by the G-7 nations prior to the meetings of the Interim and Development Committees in Washington in early April.

The internal component to dealing with the debt problem must also be recognized, and in this area much has been accomplished. The combined current account deficits of these 15 countries declined from an average of $50 billion in 1981 and 1982 to essentially zero in 1984 and 1985, with a small increase estimated for 1986 reflecting primarily the decline in oil prices. In 1979 and 1980 these countries imported an average of about $150 billion per year in goods and services. In the three-year period 1984-86 imports of goods and services of these countries averaged less than $110 billion per year, an extremely remarkable performance of domestic retrenchment.

The serious and painful adjustment by many of these countries has led to a third consensus, namely that any meaningful approach to the indebtedness problem must be growth-oriented. The decline in the investment to GNP ratio in many Latin American countries was recognized as a serious cause of concern because investment is the key to future economic growth and the consequent easing of debt service burdens. To improve their prospects for growth spurred by increased productive investment, developing countries will need to maintain some continuing inflows of foreign capital to supplement their domestic savings. This implies some continued current account deficits, albeit smaller deficits than those that prevailed in the early 1980s. Productive use of these capital inflows will justify some increase in total indebtedness at a time when the existing size of external indebtedness is also presenting a burden.

The consensus of the need for growth was embodied in the broad principles of the Baker Initiative. Under that approach, growth was to be encouraged by a variety of domestic economic reforms that would improve incentives to save domestically and create more effective utilization of domestic resources, often through private sector initiatives. In addition, fiscal and financial incentives were to be implemented to bring about a retention and repatriation of domestic savings that had sought higher yields and greater security abroad.

The movement towards greater private sector development in many countries is certainly encouraging, although it must be noted that when privatization simply replaces a state-owned corporation with a private monopoly, especially if there is access to subsidized credits, the gains in efficiency are likely to be limited. While defining, identifying, and measuring capital flight is clearly more of an art than a precise science, there does appear to be some evidence that a number of countries have had success in reducing or even reversing the outward flight of capital by their citizens. The establishment of confidence among local citizens is a very important development and should lead to increased confidence by non-resident investors.

The other two parts of the Baker Initiative were increased lending by both international financial institutions and private commercial banks. The international agencies appear to have been very constructive. The IMF has demonstrated flexibility in arranging innovative financing arrangements. In the early years of the debt problem, the IMF conditioned some of its lending on precommitments by commercial banks to provide financing of any remaining gaps. In several important cases enhanced IMF surveillance has facilitated agreements between the borrower and commercial banks for multi-year restructuring agreements (MYRAs). For Mexico, the IMF has been willing to accept pre-adjusted performance criteria in new stand-by arrangements that take into account contingencies about the level of world oil prices and the performance of the domestic economy. That particular arrangement, while well-suited to Mexico, may not be appropriate in other cases. In Mexico, as well as in several other heavily indebted countries, consultations with the World Bank have led to a credible agenda for restructuring changes that appear to be both politically feasible and economically efficient. Both the debtor countries and the World Bank deserve credit for these initiatives. In 1986, the multilateral development banks disbursed $4-3/4 billion net to the countries identified by Secretary Baker and such net disbursements are expected to increase further in 1987.

On the other hand, net new lending by commercial banks has been disappointing, even by the modest standards of the Baker Initiative of 3 percent per year for three years. The reluctance of many banks, particularly smaller banks, to lend is of course not surprising. While not wishing to appear as an apologist for banks, it is important to note that there are several technical reasons why flows of new bank credit estimated from changes in the total stock of outstanding bank claims on two dates may be underestimating the true flow of new credits. These technical reasons include writeoffs of loans, which reduce the reported stock of outstanding credits when no repayments are made, assumption of loans by export credit or other guaranteeing agencies, and sales of loans to nonbank creditors. When these technical issues are properly taken into account the lending response of banks may have been somewhat better than commonly reported. But, even allowing for these adjustments, the response by commercial banks has on balance been disappointing.

Continued net new lending by private commercial banks is an essential part of a cooperative effort to resolve this problem. As noted in recent testimony by Chairman Volcker, doubts about the availability of necessary finance from commercial banks may be undermining the resolve of many indebted countries to implement needed economic reforms. Secretary Baker, in remarks to the Interim Committee of the International Monetary Fund, indicated that creativity by banks in developing a menu of new money options for borrowing countries was a necessary component for continued implementation of the debt strategy.

A fourth broad consensus is that in the 1970s there simply were too many banks entering the international lending market that had no real long-term interest or expertise to remain in that market. A survey conducted for the Group of Thirty, an independent group of experts on international financial issues, indicated that between 1973 and 1980 an average of 66 new banks per year entered international syndicated lending. This vast number of participating institutions, with different interests and agendas, has complicated and prolonged the process of restructuring the debts of many countries.

While it is imperative that the market for international bank lending remain competitive and large enough to provide the capability for new financing, the shrinkage in the number of participants currently underway could be a healthy long-term development if achieved in an orderly and equitable manner. On the other hand, it clearly does not seem appropriate for major money center banks whose customer bases are heavily trade oriented to retreat precipitously from international lending. A method needs to be considered where banks that opt out of participating in new financing packages not receive the same collective benefits as those banks providing net new lending.

A fifth area of consensus is that the general structure of the external liabilities of the developing countries became too heavily weighted towards credit in general and bank credit in particular. According to an IMF study, between 1973 and 1983 the stock of foreign direct investment in developing countries grew at an average annual rate of 11.6 percent while in the same 10-year period the stock of debt to private financial institutions increased at an average annual rate of 28 percent. Consequently, direct investment as a share of total externally held claims on these countries declined from 36 percent in 1973 to 21 percent in 1983. The emphasis on debt, at floating rates, made the borrowing countries highly susceptible to risks of changes in world interest rates.

Currently we are witnessing important actions that recognize that the structure of external liabilities has become inappropriate. The innovative debt-equity swap programs announced by several countries in Latin America and elsewhere are a useful step in restructuring their external liabilities to reduce their vulnerability to interest rate swings. It is, of course, important not to overestimate the impact of these programs because they are mainly a restructuring of existing external liabilities with some reduction in required immediate future cash flows to service debts. Of themselves these programs do not result in any net new money. Debt-equity swaps may, if large, raise concerns about monetary management because they increase the net supply of domestic financial assets and thus require offsetting monetary actions that are sometimes difficult to implement.

Debt-to-equity conversions, as well as other programs to encourage foreign investment in the past, have raised concerns about foreign control over sensitive domestic industries. As a general matter, these concerns may be alleviated by programs that encourage non-controlling portfolio investments rather than outside control through the traditional mode of direct investment. Improvements in domestic equity markets and broadening participation by foreign portfolio investors in these markets can be important steps. The success of the International Finance Corporation in promoting closed-end mutual funds for developing countries such as Mexico and Korea is a helpful development that should be expanded.

A sixth, and probably most easily agreed upon consensus, is that the debt problem has gone on for a long time, participants are becoming increasingly fatigued and frustrated, and everyone wishes there existed a simple, neat and low-cost resolution to this problem. While actively sought, such a resolution appears to have eluded considerable analytic efforts. It is a complex, multidimensional problem that is not likely to yield to simple, single-dimensional solutions.

Having discussed several areas of broad agreement, I would like to comment on an issue that has been raised in recent months, namely the linking of the international debt problem and the U.S. trade deficit. Some commentators have suggested that the increase in the U.S. trade deficit since 1980, and a concomitant loss in U.S. employment, has been caused in large part by our deteriorating trade position with heavily indebted countries that have felt compelled to reduce their imports from the United States and that have succeeded in increasing their exports to the United States.

The facts do not appear to justify this simple linkage. Between 1980 and 1986 the U.S. trade deficit widened by about $120 billion, of which about $105 billion was accounted for by a declining trade position with Japan, Canada, and Western Europe. In this same period, our trade deficit with Latin America widened by only $12 billion. Clearly the decline in the U.S. trade position was broadly based and resulted from a variety of factors including an overvalued dollar and our higher relative growth rate. Altering our trade position with Latin America would not of itself make a great deal of difference in our trade deficit.

Secondly, in a complex economy such as ours, a loss of a particular export market does not automatically translate into a precise number of lost jobs by some mechanical formula. While there are certain real costs of adjustment, in a dynamic economy that is consuming at a very high rate, any resources released from production for exports may well be absorbed into production for the domestic market. I might add that the converse is also true. As the decline in the foreign exchange value for the U.S. dollar works through to improve our trading position, a large proportion of our improved net exports will come from resources bid away from domestic absorption. The decline in the dollar should improve the U.S. trade balance with Latin America as U.S. companies become more competitive and displace other companies in exporting to that region. This expected change in the direction of Latin American trade will not necessarily affect the ability of indebted countries of that region to service their debts.

Summarizing where we currently stand on the international debt situation is of course always difficult because events affecting individual countries or groups of countries evolve so quickly. The list of countries whose situations appear to be improving can also change quickly. In my view, some clear progress has been made in dealing with this problem. While the adjustment process has been painful, many of the more pessimistic predictions of a breakdown of world trade into economic autarky, a debtors' cartel, and so forth have failed to materialize.

The recently concluded new financing facility for Mexico is evidence that the banking industry is still willing to provide new funding to a major international borrower, although arranging such financing has clearly become more difficult and time-consuming. The resolution of financing packages for Chile and Venezuela and agreement on terms for the Philippines are also very important developments. The IMF and World Bank continue to be innovative and dynamic, and hopefully will remain adequately funded to perform their tasks. The exposure levels of U.S. and other banks relative to capital are below 1977 levels, which improves the stability of the financial system. World interest rates have come down considerably from their previous high levels. As noted earlier, current account deficits of the 15 countries identified by Secretary Baker have been dramatically reduced.

Balanced against these favorable developments are the continuing high levels of debt and interest service on debt of many countries relative to their domestic product and exports and the failure of these ratios to improve significantly since 1982. Hopefully, faster growth of the domestic economies, expanded exports, and continued low world interest rates, will result in an improvement in these ratios even if the absolute levels of external indebtedness continue to increase by modest amounts to facilitate growth. However, while progress can be cited, we must not rest on our laurels. We must build on the collective effort and the cooperative approach between borrowing countries, industrial countries, multilateral institutions, and commercial banks. The area where there is a particular need to improve is to speed the process of mobilizing commercial bank components of financial arrangements for borrowing countries.

In conclusion, it seems that despite the progress made in recent years to deal with the debt problem we can expect that it will be with us for a considerable time. The search for a universal solution to the international debt problem that will be demonstrably preferable to the flexible case-by-case approach currently being followed is likely to prove elusive. However, the current approach has been adaptive and, therefore, an open mind should be kept for all options that may prove applicable to specific situations.