Comments

by

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on

"Perspective on the External Debt Situation"

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More than a year and a half ago, I went to a meeting about the international debt situation at which Bill Cline unveiled his model on which I am commenting here. He stated a now familiar conclusion of the model that the debt situation was manageable if the developed world were to grow at a rate of three percent. In that case, excessive debt ratios would come down, the debt crisis would turn out to be a liquidity rather than a solvency problem, and, by the end of the 1980's, creditworthiness would have been restored sufficiently to permit resumption of normal lending. There was a great deal of shaking of wise heads in the room at that meeting. Skepticism was rampant. But in late August I went to another meeting, at which Bill Cline presented an update of his model. In most respects, his
projections had been overperformed. Adjustment of borrowing countries had been better than expected. Moreover, his data for the most part did not yet capture recent improvements in developing country exports, which have initiated a new phase in the adjustment process beyond import contraction.

During the period over which this external improvement took place, Eduardo Wiesner, as Director of the Western Hemisphere Department of the IMF, played an important role in devising the kind of adjustment programs that have contributed to the success, so far, of external adjustment in Mexico, Brazil, and elsewhere. His paper, which is the other topic of my comments, is based on an intimate knowledge of the capabilities and problems of the borrowing countries. Both papers stress that many more problems remain to be resolved and that the end of the adjustment period is far ahead. But, with OECD growth in 1984 above Cline's critical figure of three percent, a constructive view of the situation can reasonably be taken. "Involuntary" lending may continue, in some degree, until the late 1980's, according to Cline's model. Banks, according to Cline, may be expected to lend about $20 billion per year, about half or less than the rate of lending of the late 1970's, and less than the interest payable on their loans. Countries on average, therefore, will be paying some of the interest out of their own export earnings, i.e., they can be expected to have export surpluses together with current-account deficits, as indeed is the case for many at this time. Given the gains made in 1984, an OECD growth rate of two and one-half percent, or slightly less, on average, for the rest of the decade seems adequate to reduce debt ratios to acceptable levels.

Cline and Wiesner see different reasons for the development of the debt crisis, at least in a proximate sense. The implications for results and consequences, however, are not very different. Wiesner sees the principal
proximate factor explaining the debt crisis in the fiscal deficits incurred by most of the major countries in the Western Hemisphere, recognizing that world recession and high interest rates aggravated the situation. The three largest countries of the region -- Argentina, Brazil, and Mexico -- more than doubled their nonfinancial public-sector deficits, from around six percent of GDP to well over 15 percent. For an official of the IMF this seems an appropriate starting point. Of course, he goes further and examines the causes and purposes of those deficits. Even large deficits may be justifiable if balanced by public investment. Finance ministers may weaken when bankers press loans at negative real interest rates upon them. Recessions make some degree of deficit almost unavoidable.

Wiesner argues that the level of borrowing, for public and private purposes, simply exceeded the capacity of developing countries to absorb capital productively. History and its interpretation seem to have come full circle on this. Many years ago, before techniques of project formulation and evaluation were adequately developed, it was frequently said that there was more money than projects, so that the availability of viable projects placed a ceiling on developmental lending. Thereafter, came a time when projects caught up with and began to exceed available money. In the third phase, project lending seems to have faded into the background as the banks went for balance-of-payments and budget financing with decreasing concern for the use of the money and, therefore, the quality of the lending.

In consequence of the limited absorptive capacity of borrowing countries, Wiesner points out, investment in major countries failed to rise or even declined. Wiesner's data, however, cover only the years 1980-1983
for Argentina, Brazil, and Mexico. Data for the mid- to late-1970's seem to show that there was some increase in investment/GDP ratios for these three countries. Econometric evidence for a group of 20 non-oil developing countries also seems to show that investment was positively correlated with current-account deficits, reflecting capital inflows. Also, such inflows frequently seem to have been associated with rising saving ratios. The 1980's may have been atypical, being in good part years of recession and capital flight.

Wiesner's conclusion that foreign borrowing did not do much for the economies in question seems to be shared, however, by Cline. He notes that of an increase in the external debt of non-oil developing countries of $500 billion from 1973 to 1981, approximately $260 billion may be attributed to the exceptional rise in oil prices, while recession in 1981-1982 added another $100 billion, and the excess of real interest rates over historic averages added $40 billion more. This suggests that adjustment policies responding to the oil-price increases were too weak and too late and in that sense responsible for a large increase in unproductive debt. After accounting for these ill-advised uses of foreign borrowings, not a great deal can have been left for investment. This conclusion is strengthened when one takes into account the massive capital flight that took place particularly during the last years preceding the crisis. Summing up recorded current-account deficits and changes in exchange reserves as uses of borrowed funds and comparing the total with net borrowings, it becomes evident that for many countries uses fall far short of sources. Some other use there must have been, which, in the nature of a system of balance-of-payments accounts, can only have been capital exports, i.e., capital flight. For Venezuela, from 1974 to 1982 the outflow of capital implied by such calculations absorbs not far from the totality of net borrowings as of year-end 1982;
for Mexico and Argentina, approximately one-half; for Brazil, approximately one-eighth. Obviously, there is considerable uncertainty about these estimates, and no plausible way of making them fully consistent. The overall impression, which matches the views of Wiesner and does not seem to be at odds with Cline's, is that foreign borrowing fell far short of generating a capital stock in the borrowing countries from which debt could be serviced with a net gain or at least no net burden to the borrowing countries.

Wiesner explores the question of how the resulting damage should be allocated. The issue is one that he sees being adjudicated, laboriously, in the negotiations between the debtor countries and their various creditors, especially the banks. It could be added that the loss to be allocated is made larger by the perceived high element of risk that has been injected into the post-crisis debt situation. While the banks have made concessions mainly by accepting postponement of their receipts and less in the dollar amounts due, the stockholders of American money-center banks have indeed suffered a loss of not far from one-half of their invested capital. The stocks of many large money-center banks sell at close to one-half of book value and their price/earnings ratios often are little better than half of those of industrial enterprises.

Wiesner also explores the risk aspects of the debt situation and finds a gross underestimate of risk to have been one of the sources of the crisis. The lending banks assumed that a sovereign risk was a small risk and failed to pay sufficient attention to quality of debtors' economic policies or feasibility of investment projects. Borrowing governments on their part seem to have believed that if money was being offered freely, their policies could not be all that bad. These impressions are confirmed by the remarkably low spreads at which many Latin American countries could borrow, especially when
compared with the high spreads that banks at first sought to impose in reschedulings once the true nature of the risk had become apparent.

It is true, of course, that the oil-price increases, and the rise in real interest rates, could hardly have been foreseen as such. But it is not plausible that international risk can validly be evaluated on the assumption of permanent fair weather, continuing prosperity, political stability, and perpetual negative real interest rates. Over the life of a medium-term loan, lenders must recognize the possibility of major shocks. That is the difference between short-term commercial lending and medium-term lending. Evidently, the market was not well prepared to make that kind of risk assessment.

Indeed, one is almost bound to conclude that the organization of international lending contained strong biases against proper risk assessment. Loans are made by loan officers whose promotion depends on achieving volume, who are likely to be rotated in their jobs before their loans can go sour, and who (before the International Lending Supervision Act) had a strong interest in front-end fees. These loans are made to countries run by politicians, in some cases dictators, who are not primarily concerned with the economics of international capital flows. Bank regulators should have moved much earlier and more forcefully to limit exposure, not necessarily on the basis of superior insight into the risks, but on the old-fashioned grounds of risk diversification and limiting loans to a single borrower. It took a long time to realize or at least to respond effectively to the fact that, where transfer risk is concerned, loans to a single country are loans to a single borrower. For the same reason, banks should have recognized that countries are not simply markets in which each bank should aspire to its proper share, but, again, in an important
sense, single borrowers also from the point of view of the international banking community.

Finally, both Cline and Wiesner touch upon the amount of prospective borrowing and the appropriate debt ratios for borrowing countries. Wiesner would like debt ratios to come down and would even like to see an absolute reduction in debt. Cline anticipates a period of diminishing debt ratios during which countries nevertheless add to their debt, until debt ratios are reduced to levels at which countries used to be regarded as creditworthy.

To call for a reduction in the absolute level of debt implies that developing countries would become net capital exporters. This seems contrary to their economic structure, and to the international gradient of the productivity of capital. Temporarily, to be sure, it is quite possible, as the cases of Mexico and Venezuela in 1983-84 indicate. A reduction in debt ratios seems entirely possible, since it could be associated with an absolute increase in debt but at a slower rate than the scale variable. Cline and Wiesner seem to ignore the question whether exports or GNP is the appropriate scale variable. But when, as in most of the post-World-War-II years, exports grow substantially faster than GDP, ultimate reliance on GDP seems inevitable. The distinction is not unimportant—granted that GDP presents statistical problems including the need to use an exchange rate, whereas exports usually are stated in foreign currency—because it bears on the familiar comparison of interest rate and growth rate. If the interest rate exceeds the growth rate, the borrowing country in time will be compelled to pay some of the interest out of exports, if the debt ratio is not to explode.
Payment of part of the interest out of exports is a common condition for debtor countries today, implying that they will run a trade surplus but also a current-account deficit. This is essential if debt ratios are to be reduced to levels considered creditworthy before the crisis. Cline views the condition as a net outward resource transfer, the political vulnerability of which he notes but largely puts aside on grounds that countries would not want to hazard the consequences of a drying up of trade credit, possible seizure of export shipments, and long-term damage to their credit reputation. Whatever the politics of outward resource transfers, it is not clear why such transfers should be measured by the movement of goods alone instead of goods and services, including interest. Interest is paid for the use of capital much as rent is paid for use of ships and planes, premia are paid for insurance, and fees are paid for banking services. The net resource transfer, in other words, must be defined in terms of the current account, not of the trade account. The current account, as noted, is likely to remain in deficit and the resource transfer, correctly defined, accordingly to be inward.6

That a country should not and cannot indefinitely borrow all the interest that it pays does not seem an unreasonable proposition. Starting from a low debt ratio, debt can for a while rise faster than exports or income. This implies that, if the interest rate is equal to the growth rate, more than all of the interest is being borrowed. Once the debt has built up to a stable relationship to exports or income, borrowing all the interest does not leave the country any net yield of the loans for local investment. Only if the interest rate is lower than the growth rate would it be possible, without raising the debt/income ratio, to borrow all the interest required and have something left over for domestic investment.
Cline gives reasons why an export surplus should not be troublesome, but seems to envisage that eventually it may disappear. Historically, that has not been the pattern among industrial countries. Many, including the United States, have been heavy borrowers early in their development, with capital inflows producing both current- and trade-account deficits, and have eventually shifted to a position of trade surplus and ultimately current-account surplus, becoming capital exporters. This transition has been made smoothly, without giving rise to the mentioned concerns, and in my view misinterpretations, about net outward or inward transfers. One reason for this has been, of course, that countries have not behaved as single borrowers and lenders. There have been large numbers of borrowers and lenders simultaneously, with gross flows in and out, mostly between members of the private sector, all with strong interests in the performance of contracts. Concern about the political acceptability of a trade surplus can arise only if a country is viewed as a unit, making monolithic decisions with regard to the totality of its financial flows. That is not the case even today, where substantial private-sector borrowers and, probably, also lenders continue in operation. Moreover, even for a single monolithic decisionmaker, the appearance of an export surplus is not evidence that continued debt service is contrary to his interest. He is bound to be uncertain about the future, is likely to value the possibility of access to international capital markets for cases of emergency, and is likely to be aware of the problems that default would create for his country certainly in the short run and very likely also in the long. For these reasons, the "net resource transfer" issue is not likely to rise to a decisive level so long as economic growth is satisfactory and some volume of credit is flowing.
This returns us to the major condition derived from Cline's model. Solution of the developing country debt problem requires growth. This means growth in real terms, and not an inflationary rise in nominal values that, in some circumstance, would tend to inflate away the debt, even though nominal interest rates, on floating rate debt, might move with the price level. Three percent growth for the OECD area is an average over time, which was exceeded in 1984. Cline now estimates that growth at a rate slightly less than 2.5 percent is needed for the remainder of the 1980's. This is not a high requirement, on the average of the years. In a cyclical economy, there are likely to be pauses if not recessions, even though the average is achieved or exceeded. It will be important to maintain enough flexibility to prevent downward phases of the cycle from generating a new debt crisis. At the same time, it is important to do what can be done to minimize sources of cyclical instability. For the United States, this boils down to the familiar prescription of a vigorous reduction in the budget deficit that would bring down interest rates, permit some settling of the dollar, and enough of a rise in investment and reduction in the current-account deficit to offset the negative effect of a declining budget deficit on economic activity. That is the policy direction, of course, in which the United States should move in its own interest.
Footnotes


6. This is also a view taken in World Debt Tables, 1985, World Bank, Washington, D.C., forthcoming.