DOES THE DEBT MAKE SENSE?

Remarks by

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The title of this talk -- "Does the Debt Make Sense?" -- is a phrase that comes up from time to time in discussions. The intellectual debt resulting from such explorations I gratefully acknowledge. But the trend of thought implied I find deeply disturbing. Underlying such views seems to be a feeling that developing countries made a mistake to borrow and that somehow they should call it quits. Sympathy with the tribulations of developing countries as they go through their adjustment process seems to play a primary role. Perhaps a certain lack of sympathy with banks and other lenders sometimes also shows through.

At the same time, there has been an increase in academic and other writings, usually highly sophisticated, that deal with the prospects and risks of default. Here the tendency is to regard default as a matter of possible advantage or disadvantage, and as a strategic element in the bargaining between borrower and lender. In a more moderate key, global modifications of debt contracts are proposed that would bring partial relief to hard-pressed borrowers.
My purpose in this talk is to put these ideas, often prompted by generous motivations, in a broader context. Today's developing country debt is a manifestation of one of the two most important processes in economic life -- that of accumulation of capital, the other being innovation. The two, of course, are linked, each supporting the other. The question whether the LDC debt makes sense questions the validity of one of the two great processes.

Capital accumulation is possible, of course, within economic units of all sizes -- the household, the family firm, the large corporation, the nation, the world. Progress is possible even when these units do not interlink by transferring capital from one to the other. But progress will be much faster if savings are mobile, among savings units in each country and internationally. Typically, savings flow from households to business units and, probably less productively, to governments. Internationally, an important, although by no means the largest, net flow of capital has been to developing countries. The productivity of capital can be expected to be higher where the capital-to-labor ratio is lower, although the vicissitudes experienced by investors in developing countries sometimes might make one wonder whether this is really so. The difference in living standards between the highly and less highly capitalized countries is perhaps the most plausible evidence.

The bulk of investable resources in most developing countries, to be sure, comes from their own savings. Imported capital plays only a marginal role. However, it needs to be remembered that large part of investable resources in any country with significant industry derives from depreciation allowances. These necessarily have to be generated within the investing unit. Net savings,
after depreciation, are smaller and imported capital accordingly looms relatively larger.

Some countries seem to have developed almost without importing capital. Japan is such a case. Since there has been neither foreign borrowing by the government, nor on the whole by Japanese businesses, Japan's rapid growth has rested on the very high rate of saving in the Japanese economy both at the household and the business level. Although Japanese banks in the early postwar years did borrow abroad to finance trade, foreign direct or portfolio investors have not contributed significantly to the growth of Japan's economy. With its continued high saving rate and very rapid advance, Japan, of course, long has become a major capital exporter.

Most industrial countries have been simultaneously both exporting and importing large amounts of capital. The net investment position of most industrial countries tends to be small relative to their gross claims and gross liabilities abroad, including equity and debt. In other words, foreign capital has played a much bigger role in financing economic development than would appear from the net investment positions. At present, the United States, as a result of its huge current-account deficits, is ceasing to be a net creditor (including equity) to the world and is becoming a net debtor.

In the business sphere, a telling example of the advantages of being able to attract outside money is provided by the family firm. A firm that refuses to go public can borrow, but only in amounts commensurate to its internally accumulated equity capital. Typically, although not invariably, this has led to competitive inferiority and slower growth for family firms. The same is likely to apply to developing countries.
Most of the examples of capital transfers that I have mentioned have as a common feature the prospective productive use of the money. There is, of course, consumer credit at home and a certain amount of international lending of questionable productivity. In the international sphere, borrowing for consumption, such as to pay for higher priced oil, or for food imports after a crop failure, has as its typical counterpart a decline in the country's savings rate. To be able to maintain their consumption, the people of the country borrowed abroad (an act of dissaving) and paid for the imports, instead of reducing their consumption to finance them. This is a decision that a rational consumer is entitled to make. It may be a decision that would cause a prudent lender to limit more severely the amount or the terms on which he lends. It is not a decision that, if the borrower later gets into trouble, should relieve him from his financial obligations.

In general, a clear distinction between consumptive and productive imports of capital is not easily made. Project loans, such as financed by the multilateral development institutions, indeed are associated with an increase in brick and mortar, productive infrastructure and other standard-of-living-raising elements. But who is to say with certainty that the local authorities would not have financed the same projects out of their own resources and now devote the money saved to other purposes, productive or otherwise. On the other hand, imports need not necessarily consist of capital goods to be productive. Food can be imported with borrowed money, capital goods produced locally. In general, a diversified flow of imports tends to be productive. It has been estimated that a one percent increase in imports raises GNP by 0.25-0.50 percent.
Even borrowings that lead to low imports and little investment are not necessarily a permanent loss. A typical misuse of funds is capital flight. However, it can never be certain whether, in the absence of borrowing, capital flight would have been decisively less. That depends on the national policies pursued and on the priorities of the capital flighters. Moreover, at least part of the money remains available abroad. It could be attracted back home in appropriate conditions, such as positive real interest rates, realistic exchange rates, adequate investor protection, and the right of the owner to take his money out again.

In many ways, the world has entered upon a period of giving great scope to international capital movements. Markets have become increasingly integrated. Financial intermediaries can move large sums more easily than in the past. Above all, a system of floating exchange rates such as we now have permits wide swings in the current and capital accounts of the major countries, as indicated by the large U.S. current-account deficit and the large Japanese surplus. These factors represent great opportunities for international reallocation of capital. They also represent, to be sure, considerable risks for misjudgment by lenders and borrowers.

Today, the limits to prudent international lending seem to have been reached at least temporarily, for many developing countries. In many of the larger debtor countries, evidence of this is reflected in the difficulties that are being experienced. More fundamentally, the approach to these prudential limits is visible in the trade surpluses that are now emerging. Very few as yet have current-account surpluses, with exports of goods and services exceeding imports of goods and services (including interest). The emerging trade
surpluses indicate that lenders have told borrowers (or borrowers have come to that realization on their own) that the full interest bill can or should no longer be borrowed and that some of it must be paid out of exports. In the balance of payments of a debtor country, the interest paid very broadly represents the difference between the goods (trade) account and the current account, since most of the other invisible items are small. A current-account surplus would mean that the country has become a net capital exporter. A combination of current-account deficit and a trade-account surplus implies that the country is covering part of its interest bill by borrowing and the rest by its own exports. A trade-account deficit implies that the country is borrowing the entire interest bill and more.

This is an important transition in the evolution of a country as a maturing borrower. In the early stages of a borrowing country's debt, while the debt is still small relative to GDP, the interest bill payable is moderate and can readily be covered by new borrowings. As the debt rises relative to GDP, that may no longer be the case. If all the interest due were to be borrowed year after year, the debt would grow at the rate of interest. In the United States, this kind of borrowing practice is often referred to as a Ponzi game. If the rate of interest happens to be equal to the rate of growth of the GDP, which under rather artificial conditions would tend to be the case, the debt and the GDP would grow at the same rate and remain in constant proportion. If the country were persistently to borrow
more, in order to have an opportunity to invest from the borrowed funds, the ratio of debt to GDP would rise persistently and at some point the market would not accept this borrowing.

Indeed, the market may compel the borrowing country to slow down its borrowing for a while until it reaches a more acceptable ratio of debt to GDP. At that point, which can be defined by one or more of the familiar debt ratios, the country would have to pay for at least part of its interest out of its own resources, i.e., out of exports. This is the level of debt ratios at which many countries seem to have arrived at present.

The trade surpluses that we observe, therefore, are a perfectly normal feature in the evolution of a maturing debtor. They do not represent a repayment of capital, or a net resource transfer from the poor to the rich. On the contrary, the borrower's debt continues to grow in absolute terms, even though not in relation to GDP. The net resource transfer, as correctly measured by the current account, is inward, not outward. Interest is paid for the services of the borrowed capital, like other services in the balance of payments. These payments sustain the use of the capital and pay for the benefits that it provides.
It should be clear, therefore, that the emergence of trade surpluses does not, in any economic sense, constitute a justification for modification of loan contracts aiming to hold down interest payments or, in an extreme case, default. The argument made at a theoretical level that the "rational borrower" will default as soon as present discounted value of his future payments begins to exceed the present discounted value of what he can expect to borrow, would put an end to most international lending. Domestically, a similar argumentation would be rejected by the courts where the creditor can enforce his claims. In the international sphere, there is no enforcement.

In the nature of the maturation process of a borrowing country, the point at which part of the interest must be paid out of exports rather than entirely out of new borrowing tends to be reached at a fairly early stage. The concept of "rational default," therefore, would put a very low ceiling on international lending. In a world ruled by contract, such an approach to debtor-creditor relationships would be totally retrograde. It would also be anti-economic in that it would deprive a borrowing country of the benefits from investment of imported capital, which may greatly exceed its cost.

In a more realistic vein, the fact of default would impose substantial costs. The borrowing country would find itself isolated in the world, exposed to legal action, attachment, with a need to manage foreign-exchange balances out of reach of creditors, arranging for transportation in shipping other than his own, and with greatly increased difficulty of access to new technology. Illustrative calculations have been made on the assumption that these costs would amount to 5-10 percent of the value of trade. A plausible case can be made
that, combined with the cost of being on a cash-and-carry basis, default would be more costly than a normal rescheduling for the major Latin American debtors. Discussion of default sometimes focuses on the fact that, historically, defaults have not been altogether rare. Defaults of developing countries (and of states of the Union) have occurred from time to time. The foregoing discussion, however, deals with default as a deliberate instrument of debt policy intended to maximize the borrower's advantage. The usual case historically has been one of force majeure imposed on the debtor by circumstances largely beyond his control. In the numerous cases of force majeure default, the debtor has not generally been exposed to the full rigor of creditor action so long as he did not repudiate the debt and maintain some semblance of intention to renegotiate it. Even for such less stringent cases, it seems that defaulting countries became unable to borrow in world markets sometimes for several decades.

But it is not only default by which the debtor may lose his credit standing. Any modification of the loan contract that causes the lending bank injury is apt to have an adverse effect. Therefore, if the principal objective of maintaining debt service is to remain creditworthy or return to creditworthiness, even minor modifications of the original loan contract that give rise to a change in supervisory treatment may affect creditworthiness. This is significant because


it may have the effect of impeding moderate changes in the loan contract that, other things equal, would make debt service more convenient or stable.

Numerous schemes have been proposed that would ease the debt burden for developing countries. Some are already in use, and acceptable to banks. These include multi-year rescheduling, reduction in spreads compared to prior reschedulings, and in fees. Others are more severe, including capping of interest rates, capitalization of interest, buying out of banks at a loss, limiting debt payments to some fraction of export receipts, and many others. The proponents of these try to justify the loss inflicted on banks with the need to make the banks share in the cost of a perhaps basically misconceived loan. But loss of creditworthiness for an indefinite future is a high price to pay for current debt relief. In principle it might mean that, if the country amortizes loans already outstanding, it would become a capital exporter. That is contrary to the structure as a developing country. Regularizing the debt service must lead, with a lag perhaps, to renewed creditworthiness as debt ratios are reduced. Creditworthiness must imply ability to replace maturing loans as well as obtain new loans that would raise total indebtedness although not the country's debt ratios.

The premise that a country must continue to borrow and its debt be able to rise over time rests on the willingness of the banks to make such loans. Banks have shown a willingness to continue lending to creditworthy countries. In East Asia, most countries have had no difficulty in accessing the market. In other parts of the world, Turkey has been able to go back to the market after a period of troubled debt. Hungary and the DDR, after some market hesitation
but no interruption of debt service, are again welcome in the market. Broad support for lending, therefore, seems to exist, even though some smaller banks have indicated that they wish to withdraw from this business.

In any event, however, banks are limited in what they can do by their capital. Bank capital has been increasing, partly under regulatory pressure, providing a broader base for lending. Nevertheless, it must be recognized that medium-term bank credit is not the ideal form of developmental financing. Neither is floating-rate credit, although it may be the best that can be had under today's circumstances. But the great proliferation of new instruments, and the increase in the mobility of capital, provide opportunities for new efforts of development financing. Many have been suggested. The structurally most appealing would be an emphasis on equity financing. Developing countries have emphasized debt because it was cheapest, at least while real interest rates were low or negative, and because it avoids handing over to the supplier of capital a piece of the action. This is not a sound financial technique where significant risks must be incurred. The growth of corporations has had to have an equity base in addition to debt financing. The same must apply to developing countries. It is in the direction of equity investment, in the form of direct investment, portfolio equity investment, investment funds, and the like, that recent progress in the capital markets can best be put at the service of developing countries.