Federal Reserve Bank of Cleveland
Research Department
FD Box 6387
Cleveland, OH 44101

ECONOMIC COMMENTARY

Solutions to the International Debt Problem
by Gerald H. Anderson

During much of the 1970s, encouraged by their relatively rapid economic growth and by favorable interest rates, developing countries increased their international indebtedness. In the late 1970s and early 1980s, however, the international economic climate worsened. Interest rates rose sharply as industrial countries pursued anti-inflation policies. Because most international loans have floating interest rates, the interest cost on the loans increased. In addition, a worldwide recession in the early 1980s hampered developing country exports, making it much more difficult for these countries to earn the foreign exchange required to service their debts, that is, to pay the interest and principal when due. Moreover, banks became less willing to lend additional money to the developing nations. As a result, nearly all major debtor countries experienced disruptions in their ability to service their debts. The probability of serious default rose, sending waves of concern throughout the world’s financial community.

The developing nations have outstanding foreign debt totaling more than $500 billion and owe about $130 billion of this to banks in the United States. The total outstanding loans of the 204 U.S. banks that lend to developing countries currently equal 63% percent of their total capital. A major default could substantially reduce the earnings of these banks and is difficult to speculate on other repercussions of default, because they would be determined by the nature of the default and by the response of regulatory agencies, commercial banks, depositors, and the business community. However, the consequences of not finding a solution to the debt problem could be quite serious.


The Short-Run Problem
Debtor countries face a serious problem—how to acquire enough foreign currency to make payments required by their loan agreements. In the short run, debtor nations have many potential alternatives for acquiring foreign currency. They can earn it by exporting, or they can borrow more money from banks. They might receive grants or loans from foreign governments. Debtor nations can also acquire foreign exchange by reducing the reparation of investments previously placed abroad or by selling equity capital in their industries to foreigners. Of course, the debtor countries must not only service their debts, but also float their currencies and other capital outflows from these sources of foreign currency.

The Long-Run Problem
In the long run, however, the ability of the debtor nations to service their international loans is much more limited. Borrowing money to service existing loans is often a sign of a serious debt problem. Additional borrowing can offer temporary relief during which the debtor nation can introduce more fundamental and lasting solutions, but banks have become increasingly reluctant to make such loans. Borrowing more to service debts, moreover, will raise debtor nations’ liabilities and increase the annual amounts required to service outstanding debts.6

6. Banks also might begin wishing off part of their debt or increasing their loan loss reserves and reducing their dividends. While this would improve the banks’ ability to survive a serious disruption in loan servicing, it does nothing in itself to ease the debt problems of the developing countries.

Introduction
The crisis atmosphere that surrounded the international debt situation during the early part of the 1980s seems to have dissipated. The prospects of a major disruption in servicing international debt seem much smaller now than two or three years ago. Nevertheless, problems surrounding international lending remain a dark cloud on the economic horizon because many developing countries continue to have difficulty paying their foreign debts. As Federal Reserve Chairman Paul Volcker recently noted, “The simple fact is we have a lot of unfinished business before us in dealing with the problems of international debt.”

By discussing general economic conditions associated with the ability of developing countries to service their international debt on a timely basis, we can provide a framework that will allow us to examine possible solutions to the debt problem and to distinguish between proposals that are worthwhile and those that will merely paper over the problem.

Background
Developing countries often have an abundance of cheap labor and—sometimes—an abundance of natural resources. Most, however, lack sufficient domestic capital with which to take advantage of their economic resources. They must borrow or otherwise obtain money from outside sources. Ideally, as the economic growth of these nations’ industries and economies mature, they will grow, they will expand their trade with the rest of the world and acquire the foreign exchange needed to service their debts.

Conclusion
Unfortunately, there is no quick solution to the financial problems of less developed countries. It is unlikely that creditors would be willing to forego part of the principal or interest payments that are currently required on international debt. Because other debt-servicing proposals are politically or financially impractical, the only feasible means that debtor nations have to obtain more foreign exchange for debt service is to reduce their imports and to expand their exports. This is not a quick or easy solution, so it is most likely that the international debt problem will be with us for some time to come.

Notes
2. It is not always inappropriate for a debtor nation to continue to borrow additional funds. If the return on invested funds exceeds the rate of interest paid, borrowing makes sense. Indeed, as a debtor nation’s economy grows and its capacity to service debt expands, one would expect its external liability to grow. As present, however, the levels of debt owed by many developing countries are too high relative to their capacity to service debt.

Address Correction Requested: Please send corrections to the Federal Reserve Board of Cleveland, Research Department, PO. Box 6387, Cleveland, OH 44101.
Debtor countries also seem powerless to force the return of private money that has been moved abroad. In fact, debtor countries are likely to experience a capital flight associated with continuing loss of capital as long as the debt problem persists because of investors' fears of capital controls and of the confiscation of assets denominated in foreign currency. Only when the debt situation has eased and a debtor nation has reestablished a climate attractive to investment, will native investors return funds from overseas. For the same reasons, nations with serious debt problems find it difficult to acquire foreign exchange by attracting foreign equity capital; foreigners are reluctant to buy stock in companies that are reluctant to buy stock in companies that are located in debt-ridden countries. Grants do not provide a lasting or reliable source of foreign exchange, because they depend on the generosity of other nations. The ability of debtor nations to acquire foreign exchange and to service their debts depends, ultimately, on their ability to export goods, to attract foreign investments, and to sell foreign assets. Because most debtor nations have few foreign assets to sell and, at present, offer a few attractive long-term investment prospects, they must earn foreign exchange through trade. Traditionally, trade has been the dollar earner, which is a competitive position. Finally, countries that erect trade barriers risk retaliation by countries whose export interests are threatened. These actions, if implemented, can reduce a country's export markets and increase its imports.


Recent Proposals to Deal with the Debt Problem

Recent Proposals to Deal with the Debt Problem

Over the past few years, analysts have proposed many measures to ease the debt problem. Table 1 summarizes many of these proposals. Only a few of these suggestions contribute to a fundamental solution of the problem. Most merely offer short-term financing for external liabilities and time to ease the transition to the longer-term solution; others seem either impractical or unwise.

Implementing an International Monetary Fund (IMF) adjustment program is probably the most straightforward approach to a fundamental solution to the debt problem. A debtor nation usually must agree to an IMF adjustment program as a condition for obtaining credit from the IMF, which then allows the debtor nation's debt and to lend additional funds. Despite being the only first step in a debt renegotiation effort, it is not the ultimate solution. A debtor nation must still raise taxes and reduce its spending.

Some proposals for helping debtor nations center on financial aid. Grants, for efficient change in capital outflows. For a general discussion of the solutions to their financial problems. These actions, if implemented, can reduce the debtor nation's debt. Certain proposals have been gathered from many sources. As noted in the Economic Commentary, several of the proposals are impractical or unwise.

Debtor countries also seem powerless to force the return of private money that has been moved abroad. In fact, debtor countries are likely to experience a capital flight associated with continuing loss of capital as long as the debt problem persists because of investors' fears of capital controls and of the confiscation of assets denominated in foreign currency. Only when the debt situation has eased and a debtor nation has reestablished a climate attractive to investment, will native investors return funds from overseas. For the same reasons, nations with serious debt problems find it difficult to acquire foreign exchange by attracting foreign equity capital; foreigners are reluctant to buy stock in companies that are located in debt-ridden countries. Grants do not provide a lasting or reliable source of foreign exchange, because they depend on the generosity of other nations. The ability of debtor nations to acquire foreign exchange and to service their debts depends, ultimately, on their ability to export goods, to attract foreign investments, and to sell foreign assets. Because most debtor nations have few foreign assets to sell and, at present, offer a few attractive long-term investment prospects, they must earn foreign exchange through trade. Traditionally, trade has been the dollar earner, which is a competitive position. Finally, countries that erect trade barriers risk retaliation by countries whose export interests are threatened. These actions, if implemented, can reduce a country's export markets and increase its imports.


Recent Proposals to Deal with the Debt Problem

Over the past few years, analysts have proposed many measures to ease the debt problem. Table 1 summarizes many of these proposals. Only a few of these suggestions contribute to a fundamental solution of the problem. Most merely offer short-term financing for external liabilities and time to ease the transition to the longer-term solution; others seem either impractical or unwise.

Implementing an International Monetary Fund (IMF) adjustment program is probably the most straightforward approach to a fundamental solution to the debt problem. A debtor nation usually must agree to an IMF adjustment program as a condition for obtaining credit from the IMF, which then allows the debtor nation's debt and to lend additional funds. Despite being the only first step in a debt renegotiation effort, it is not the ultimate solution. A debtor nation must still raise taxes and reduce its spending.

Some proposals for helping debtor nations center on financial aid. Grants, for efficient change in capital outflows. For a general discussion of the solutions to their financial problems. These actions, if implemented, can reduce the debtor nation's debt. Certain proposals have been gathered from many sources. As noted in the Economic Commentary, several of the proposals are impractical or unwise.

Debtor countries also seem powerless to force the return of private money that has been moved abroad. In fact, debtor countries are likely to experience a capital flight associated with continuing loss of capital as long as the debt problem persists because of investors' fears of capital controls and of the confiscation of assets denominated in foreign currency. Only when the debt situation has eased and a debtor nation has reestablished a climate attractive to investment, will native investors return funds from overseas. For the same reasons, nations with serious debt problems find it difficult to acquire foreign exchange by attracting foreign equity capital; foreigners are reluctant to buy stock in companies that are located in debt-ridden countries. Grants do not provide a lasting or reliable source of foreign exchange, because they depend on the generosity of other nations. The ability of debtor nations to acquire foreign exchange and to service their debts depends, ultimately, on their ability to export goods, to attract foreign investments, and to sell foreign assets. Because most debtor nations have few foreign assets to sell and, at present, offer a few attractive long-term investment prospects, they must earn foreign exchange through trade. Traditionally, trade has been the dollar earner, which is a competitive position. Finally, countries that erect trade barriers risk retaliation by countries whose export interests are threatened. These actions, if implemented, can reduce a country's export markets and increase its imports.


Recent Proposals to Deal with the Debt Problem

Over the past few years, analysts have proposed many measures to ease the debt problem. Table 1 summarizes many of these proposals. Only a few of these suggestions contribute to a fundamental solution of the problem. Most merely offer short-term financing for external liabilities and time to ease the transition to the longer-term solution; others seem either impractical or unwise.

Implementing an International Monetary Fund (IMF) adjustment program is probably the most straightforward approach to a fundamental solution to the debt problem. A debtor nation usually must agree to an IMF adjustment program as a condition for obtaining credit from the IMF, which then allows the debtor nation's debt and to lend additional funds. Despite being the only first step in a debt renegotiation effort, it is not the ultimate solution. A debtor nation must still raise taxes and reduce its spending.

Some proposals for helping debtor nations center on financial aid. Grants, for efficient change in capital outflows. For a general discussion of the solutions to their financial problems. These actions, if implemented, can reduce the debtor nation's debt. Certain proposals have been gathered from many sources. As noted in the Economic Commentary, several of the proposals are impractical or unwise.
Debtor countries also seem powerless to force the return of private money that has been moved abroad. In fact, debtor countries to domestic funds faced with the continuing loss of capital as long as the debt problem persists because of investors’ fears of capital controls and of the confiscation of assets denominated in foreign currency. Only when the debt situation has eased and a debtor nation has reestablished a climate attractive to investment, will native investors return funds from overseas. For the same reasons, nations with serious debt problems find it difficult to acquire foreign exchange by attracting foreign equity capital; foreigners are reluctant to buy stock in companies that are located in debt-ridden countries. Grants do not provide a lasting or reliable source of foreign exchange, because they depend on the generosity of other nations. The ability of debtor nations to acquire foreign exchange and to service their debts depends, ultimately, on their ability to limit private and public foreign investments, and to sell foreign assets. Because most debtor nations have few foreign assets to sell and, at present, offer few attractive long-term investment prospects, they must earn foreign exchange through the trade balance. Moving funds from overseas can only be done by increasing the trade balances. Those debtor nations with trade deficits must reduce or eliminate their deficits, while those with trade surpluses must expand their surpluses. While it might sound easy, practically speaking it is difficult for a country to increase its exports and decrease its imports, and it could take years to accomplish sufficient change.

Countries that wish to reduce imports have three broad policy options. The first option is to reduce the cost of goods and services to encourage domestic consumption of goods. Reduced import costs can free up resources for domestic consumption. The second option is to reduce the demand for foreign products. The third option is to limit the inflow of foreign currency. Only when the debt is reduced, the developing debtor countries will also need to seek a growing share of the world’s market and reduce their debt burdens at a faster pace. To do this, a debtor nation must expand production for foreign and domestic markets. Reducing the cost of products and profits margins can produce a more effective new market. Again, the demand for debtor country exports is not very sensitive to price changes, a small reduction in the real exchange rate and quantity of exports, but might fail to generate increased revenues for the country.

The decline in world trade and a more aggressive approach to exporting, however, will not help resolve the international debt problem if developed nations limit access to their markets with tariffs, quotas, or so-called voluntary marketing agreements. These actions, if implemented, can reduce inflation by slowing money stock growth, to reduce subsidies on consumption goods and to inefficient industries, and to move controlled prices, interest rates, and the exchange rate closer to market clearing.

These actions, if implemented, can increase output by making the economy more efficient. They can reduce annual exports. Export measures might be taken to the money growth rate and reducing the government debt deficit. The social costs of such programs in terms of unemployment and reduced incomes, however, make it very difficult for countries to maintain austerity measures for very long.

A second option is to devalue the home currency in the foreign exchange market to induce switching consumption from foreign to domestic goods. While such a devaluation may be effective in the short term, it can cause depresion imports to levels too low to hamper economic growth and can push up the general price level.

The third option is to limit the inflow of foreign products by using tariffs, quotas, and exchange controls — that is, restrictions on the use of foreign exchange to buy foreign goods. These trade barriers, however, can cause a variety of problems. They contribute to long-term inefficiency and, in some cases, to higher manufacturing costs by destroying an artificial environment in which it becomes profitable to use inefficient production methods to compete with foreign manufacturers. As a result, domestic manufacturers have little incentive to try to improve profits through the development and sale of export items. Trade barriers also penalize consumers by forcing them to pay higher prices for domestic products. For example, to pay higher prices for domestic products, they will pay higher prices for domestic goods, while they would have paid for comparable foreign-made products.

Reducing restrictions on imports can also hurt industries that use imported materials to make products for domestic consumption or to sell products to other countries. In the case of textiles, the result is a worsening of its competitive position. Finally, countries that erect trade barriers risk retaliation by other countries and, in turn, risk retaliation in return. While it might sound easy, practically speaking it is difficult for a country to increase its exports and decrease its imports, and it could take years to accomplish sufficient change.

The ability of debtor nations to acquire foreign exchange and to service their debts depends, ultimately, on their ability to limit private and public foreign investments, and to sell foreign assets. Because most debtor nations have few foreign assets to sell and, at present, offer few attractive long-term investment prospects, they must earn foreign exchange through the trade balance. Moving funds from overseas can only be done by increasing the trade balances. Those debtor nations with trade deficits must reduce or eliminate their deficits, while those with trade surpluses must expand their surpluses. While it might sound easy, practically speaking it is difficult for a country to increase its exports and decrease its imports, and it could take years to accomplish sufficient change.

Countries that wish to reduce imports have three broad policy options. The first option is to reduce the cost of goods and services to encourage domestic consumption of goods. Reduced import costs can free up resources for domestic consumption. The second option is to reduce the demand for foreign products. The third option is to limit the inflow of foreign currency. Only when the debt is reduced, the developing debtor countries will also need to seek a growing share of the world’s market and reduce their debt burdens at a faster pace. To do this, a debtor nation must expand production for foreign and domestic markets. Reducing the cost of products and profits margins can produce a more effective new market. Again, the demand for debtor country exports is not very sensitive to price changes, a small reduction in the real exchange rate and quantity of exports, but might fail to generate increased revenues for the country.

The decline in world trade and a more aggressive approach to exporting, however, will not help resolve the international debt problem if developed nations limit access to their markets with tariffs, quotas, or so-called voluntary marketing agreements. These actions, if implemented, can reduce inflation by slowing money stock growth, to reduce subsidies on consumption goods and to inefficient industries, and to move controlled prices, interest rates, and the exchange rate closer to market clearing.

These actions, if implemented, can increase output by making the economy more efficient. They can reduce annual exports. Export measures might be taken to the money growth rate and reducing the government debt deficit. The social costs of such programs in terms of unemployment and reduced incomes, however, make it very difficult for countries to maintain austerity measures for very long.
ECONOMIC COMMENTARY

Solutions to the International Debt Problem
by Gerald H. Anderson

Introduction

The crisis atmosphere that surrounded the international debt situation during the early part of the 1980s seems to have dissipated. After a major redistribution in servicing international debt, less developed countries seem much smaller now than two or three years ago. Nevertheless, problems surrounding international lending remain as evident as the economic horizon. Many developing countries continue to face difficulties in repaying their foreign debts. As Federal Reserve Chairman Paul Volcker recently noted, "The simple fact is we have a lot of unfinished business before us in dealing with the problems of international debt."

By discussing general economic conditions associated with the ability of developing countries to service their international debt on a timely basis, we can provide a framework that will allow us to examine possible solutions to the debt problem and to distinguish between proposals that are worthwhile and those that merely paper over the problem.

Background

Developing countries often have an abundance of natural resources — sometimes an abundance of natural resources. Most, however, lack sufficient domestic capital with which to take advantage of their economic resources. They must borrow or otherwise obtain money from others to earn the foreign exchange required to service their debts. With foreign exchange brokers in their industries, of course, access to capital is not always appropriate for a debtor nation. In the long run, the ability of the developing nations to service their debts, but must finance their imports and other capital outflows from these sources of foreign currency.

The Short-Run Problem

Debtor countries face a more acute problem — how to acquire enough foreign currency to make payments required by their loan agreements. In the short run, debtor nations have many potential alternatives for acquiring foreign currency. They can earn it by exporting, or they can borrow money from banks. They might also receive grants or loans from foreign governments. Debtor nations also acquire foreign exchange by inducing the rehabilitation of international lending institutions, and by increasing their exports. This is not a quick or easy solution, and it is most likely that the international debt problem will be with us for some time to come.

Federal Reserve Bank of Cleveland
Research Department
P.O. Box 6387
Cleveland, OH 44101

August 1, 1985

Federal Reserve Bank of Cleveland

BULK RATE
U.S. Postage Paid
Cleveland, OH Permit No. 385

ISSN 042R-1276


2. It is not always appropriate for a debtor nation to continue to borrow additional funds. If the return on invested funds exceeds the rate of interest paid, borrowing makes sense. Indeed, as a debtor nation's economy grows and its capacity to service debt expands, one would expect its external liability to grow. As present, however, the levels of debt owed by many developing countries are too high relative to their capacity to service debt.