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Economic Commentary

Solutions to the International Debt Problem

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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 like 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."[1]

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 their economies grow, they will expand their trade with the rest of the world and acquire the foreign exchange needed to service their debts.

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 133 percent of their total capital. A major default could substantially reduce the earnings of those banks. It 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 basic 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 inducing the repatriation 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 must finance their imports 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.[2]

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1. Remarks before the Sixty-third Annual Meeting of the Banker's Association for Foreign Trade, Boca Raton, Florida. May 13, 1985.

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. At present, however, the levels of debt owed by many developing countries are too high relative to their capacity to service debt.

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 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 and services, to attract 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 an improvement in their trade balances. Those debtor nations with trade deficits must reduce or eliminate their deficits, while those debtor nations 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 public and private consumption of goods, imported and domestic, through austerity measures. These measures might include slowing the money growth rate and reducing the government budget deficit. The social costs of such programs in terms of unemployment and reduced incomes, however, often 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 products. Excessive devaluation, however, can depress imports to levels low enough 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 among domestic manufacturers by creating 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 increase profits through the development and sale of export items. Trade barriers also penalize consumers by forcing them to pay higher prices for domestic goods than they would for comparable foreign-made products.

Restrictions on imports can also hurt industries that use imported materials to make products for domestic consumption and for export. Trade restraint raises the cost of these products. Ironically, in the case of exports, the result is a worsening of the developing country's international competitive position. Finally, countries that erect trade barriers risk retaliation from trading partners, which could hinder efforts to increase exports.

Because there is a limit to the extent to which a debtor nation can sensibly reduce its imports, it is more important for the debtor country to increase its exports. In fact, the burden of international debts on a country can be measured as a ratio of annual real interest payments to annual exports.[3] Export expansion can occur only if the markets of the world absorb the exports of the debtor countries. In part, the rapid increase in developing country debt burdens resulted because the decline in industrial country economic activity in the early 1980s softened export markets.

Recent studies have suggested that growth of approximately 2.5 percent to 3 percent per year is necessary if the industrial countries are to absorb exports from debtor countries in sufficient quantities to enable the debtor nations to reduce their international debt burdens.[4]

The growth of U.S. markets, together with increased emphasis on exporting by Latin American nations, caused Latin exports to the United States to expand by $9.8 billion between 1982 and 1984, a 30 percent increase. Exports generate production, employment, and income in debtor countries and provide them with money to service their loans. Thus, a bright spot in the growing U.S. trade deficit is that it facilitates repaying the money that debtor countries owe to American banks.

Besides just allowing the renewed growth of the world economy to generate export growth and to reduce their debt burdens, the developing debtor countries also might seek to capture 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 export, improve productivity, and cut costs and profit margins to compete more effectively in world markets. Again, the task is not simple. If, for example, the demand for debtor country exports is not very sensitive to price changes, a small reduction in price might increase the quantity of exports, but might fail to generate increased revenues for the country.

Growth in the world market 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. Many of the products that debtor countries export compete against similar products manufactured in the developed countries. With unemployment in most developed countries still at uncomfortably high levels, there are substantial pressures to limit imports. In fact, sentiment for such protectionist measures now seems stronger in the United States and in many other developed nations than at any time since the Great Depression.

3. See Michael Dooley, et al., "An Analysis of External Debt Positions of Eight Developing Countries through 1990," *International Finance Discussion Papers,* Number 227, Washington, DC: Board of Governors of the Federal Reserve System, August 1983.

4. See *International Finance Discussion Papers,* Number 227; and William R. Cline, "International Debt: From Crisis to Recovery," in John G. Riley and Wilma St. John, eds., Papers and Proceedings of the Ninty-Seventh Annual Meeting of the American Economic Association, Dallas Texas, December 28 to 30, 1984, *The American Economic Review,* vol. 75, no. 2 (May 1985), pp. 185-90.

Sometimes these protectionist sentiments are directed towards developing debtor nations, because they are frequently the most aggressive participants in the market and because they frequently are newcomers trying to increase market share. Brazil and South Korea, for example, are debtor nations whose export successes are frequent targets of protectionism.

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 and to induce banks to reschedule the nation's debt and to lend additional funds. Despite being only the first step in the sustained effort that is needed, implementing an IMF program is not easy. A program might call for a government to raise taxes and reduce its spending, to reduce inflation by slowing money stock growth, to reduce subsidies on consumer goods and to inefficient industries, and to move controlled prices, interest rates, and the exchange rate closer to market levels.[5]

These actions, if implemented, can increase output by making the economy more efficient, can reduce consumption, and thereby can increase the quantity of goods available for export. Devaluing the currency to market level can improve the trade balance by making exports cheaper and imports more expensive, and it can discourage capital flight. Moving interest rates closer to market levels also can discourage capital flight and can encourage repatriation of previous capital outflows.

Groups that have benefited from previous policies, however, will find the changes involved in an IMF adjustment program painful. These programs lead to a beneficial reallocation of production resources but, in the process, might temporarily reduce national income. Public protests may then make it politically difficult for a government to sustain an adjustment program.

Reducing restrictions on direct foreign investment in local companies is also a sound proposal for debtor governments. Permitting such investments, if accompanied by other efforts to solve the debt problem, could lead to beneficial inflows of foreign capital. Another worthwhile suggestion is that creditor governments reduce their trade barriers which, as discussed previously, would help debtor nations acquire more foreign exchange.

Many analysts would like the Federal Reserve System to lower market interest rates, because much of the debt carries interest rates that are tied to current dollar interest rates. Unfortunately, this is impractical because sustained efforts to force interest rates down would be inflationary. If the Federal Reserve pushed excessive amounts of reserves into the banking system, interest rates might decline initially, but if the money supply responded with accelerating growth, expectations of inflation would eventually rise, carrying nominal interest rates higher. Substantially reducing the federal deficit would be a much more effective way of lowering interest rates.

Some proposals for helping debtor nations center on financial aid. Grants, for example, have been suggested, but are unlikely because of large budget deficits in creditor nations and because the grants would be criticized as a bailout of borrowers and lenders. An alternative, such as loans, would merely result in transferring debtor's liabilities from the banks to the government of the creditor nation. Loans would not alter the debtor nations' ability or need to acquire foreign-exchange earnings and would be useful only as a stopgap measure — a method of stretching out annual servicing requirements while debtor nations searched for more fundamental solutions to their financial problems.

Table 1 Various Analysts' Proposals for the Debt Problem[a]

Debtor Government Actions
- Implement IMF adjustment program
- Reduce restrictions on direct investment

Creditor Government Actions
- Reduce trade barriers
- Reduce market interest rates
- Insulate debtor nations from interest rate increases
- Give financial aid

Banks' Acceptance of or Preparation for Loss
- Reduce interest rates or cancel part of principal
- Write off debt or add to loan loss reserves to reduce dividends

Debt Restructuring
- Interest rate cap
- Multi-year rescheduling
- More generous repayment stretchouts and grace periods
- Graduated repayments
- Repayment based on export earnings
- Convert debt to long-term bonds

Debt Conversion
- Convert debt to equity

a. These proposals have been gathered from many sources. As noted in this *Economic Commentary*, several of the proposals are impractical or unwise.

5. Details of programs for specific nations are not released by the IMF. For a general discussion of adjustment programs, see "Adjustment Programs Supported by the Fund: Their Logic, Objectives, and Results in the Light of Recent Experience," Remarks by J. de Larosiere, Managing Director of the International Monetary Fund, before the Centre d'etudes Financieres, Brussels, Belgium, February 6, 1984.

Other types of aid might take the form of transfers from banks to the debtor countries. It has been suggested, for example, that the creditor banks reduce interest rates, or cancel part of the principal of loans to those debtor nations that are experiencing loan-servicing problems.[6] Naturally, eliminating part of the debt or servicing requirements would ease the debtors' situation, but the banks are trying to avoid doing this because they would lose money. The debtor nations would also be hurt, because such actions might cause them to lose access to credit in the future. Moreover, it would create an incentive for debtor nations *not* to adopt the difficult policies that are necessary to reduce debt burdens and would penalize those debtor nations that have adopted such policies.

Many of the proposals for helping developing countries involve restructuring debt. These proposals include establishing interest-rate caps, rescheduling payments, or tying repayment more directly to export earnings, which would be intended to align changes in service payments with changes in ability to pay. Rescheduling does not reduce debtor nations' external liabilities, but does attempt to ease the period of adjustment by stretching out the payments. Rescheduling lowers the annual servicing cost in early years, but does not create a mechanism to reduce the overall debt. A large number of loans have been rescheduled in the last three years.

Some analysts have suggested that international debtors and creditors convert troubled loans into equities. In this case, the creditors would acquire the stock of firms in the debtor nation. Instead of receiving interest and principal payments on loans, the banks would receive dividends tied to the profits of the firm. The conversion to equity requires that creditors be willing to assume much more risk about repayment of the loan because, if the firm is not profitable, no dividends would be forthcoming. There are also regulatory limits on what banks are allowed to take and to hold in equity.

6. Banks also might begin writing 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.

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-solving 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.

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