FRBSF Weekly Letter

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An LDC Debt Update

Over the last three years, the international debt situation has seen several ups and downs. At times, the difficulties less-developed countries (LDCs) faced in servicing their foreign debts raised fears over the stability of the international banking system, but that system has survived. There is even optimism in well-informed circles that, under reasonable conditions and with further cooperative efforts by all concerned, normal international lending might be restored in three to five years. According to this view, a few individual debtor countries will continue to experience difficulty in servicing their external debts, perhaps for several years to come, but the overall situation has improved sufficiently to warrant the conclusion that remaining problems are manageable.

This *Letter* examines the basis for this optimism. Drawing on recent developments, especially those over the past year, it highlights lessons we have learned and which should enable us to assess the prospects for solving the LDC-debt problem.

Recent developments

Argentina and Mexico provide two interesting examples of how the LDC debt problem was managed in 1984. The first was involved in long negotiations that culminated in a debt-rescheduling agreement still beset by doubts that the agreement could be implemented. Mexico's situation has been widely regarded as a model of successful international cooperation and sound national economic adjustment for enhancing a debtor nation's international creditworthiness. Together, the two provide revealing tests of the international mechanism put in place for dealing with the LDC debt problem.

Like other LDC debtor nations, Argentina was hit hard by the protracted and severe world recession of 1980-82, the unprecedentedly high real interest rates then and subsequently, and the precipitous decline in international lending that occurred after 1982. On top of all this, the nation suffered from the ill-fated Falklands War and its aftermath, and from being a society deeply divided between powerful labor unions and a discredited military junta. By the time a newly elected president took office in January 1984, the country was running an inflation rate of over 400 percent a year and a government budget deficit amounting to 18 percent of the gross domestic product. With a $40 billion external debt, it started 1984 already $2.5 billion in arrears on debt service, with more external debts falling due during that year.

Shortly after taking office, the new government began negotiations with the International Monetary Fund (IMF) for a $1.4 billion loan to help refinance the nation's external debts. Although small relative to the total needed, the IMF credit was the key for gaining access to larger bank loans. Under the existing international strategy, banks would agree to debt rescheduling and extension of new credits to a debtor nation only after the IMF has approved the nation's economic adjustment program designed to put its house in order. In Argentina's case, the IMF demanded that the nation cut its budget deficit and resist inflationary wage increases, among other measures, to bring down its triple-digit inflation rate.

Negotiations were difficult. Deadlines for interest payment were met only by emergency short-term credits extended by foreign governments. Eventually, in September, Argentina reached an agreement with the IMF on an adjustment program. This was followed by an agreement in December with a committee representing all foreign creditor banks for rescheduling $10 billion in existing debts and extending $4 billion in new loans. Since then, inflation in Argentina has risen to 800 percent a year, raising questions as to the extent to which that country will be able to carry out the terms of its IMF agreement.

In contrast, the Mexican debt rescheduing in September 1984 has been hailed as exemplary and precedent-setting. Reportedly, the agreement was reached after only three weeks of intense discussion between Mexico and its foreign-bank committee. It rescheduled $49 billion in loans falling due in 1985-90 for repayment over fourteen years beginning with small payments in 1986. The negotiated interest rate

was a very favorable 1.125 percent over the London Inter-Bank Offered Rate (LIBOR). In part, these favorable terms reflected international recognition of Mexico's success in enhancing its external debt-servicing capability. By adjusting its government policies, Mexico was able to change its current account balance from a $12.5 billion deficit in 1981 to a $5.5 billion surplus in 1983 and an estimated $4 billion surplus in 1984.

Besides Mexico and Argentina, Venezuela also reached agreement in September with international banks to reschedule $21 billion of its maturing debts for repayment over twelve years. The Philippines received a critical IMF approval in December of a $615 million loan, paving the way for negotiations for rescheduling $5 billion of its debts to international banks. In February this year, Brazil secured a tentative agreement with its bank committee to restructure its external debts otherwise due in 1985-91 for repayment over sixteen years. This series of successful multi-year debt reschedulings on relatively favorable terms presents a sharp contrast to the oftentimes acrimonious annual debt negotiations in the preceding two years, and have helped considerably to calm the international financial scene.

Effective strategy?

Critics are quick to charge that all these debt reschedulings are no more than a "band aid" remedy to a basically unresolved LDC debt problem. They claim that rescheduling merely postpones the day of settlement by rolling over uncollectible debts. Banks, in this view, are caught in the game because playing along is the only way to forestall outright defaults that would compel them to write off the loans as bad debts against their current income. The governments of the lender nations and the IMF also are caught up in this game because they supposedly have to "bail out" the banks to prevent a collapse of the international banking system.

Appealing in its simplicity, this view is nevertheless unsound because it ignores the very large adjustments that the debtor nations have already made to reduce their external payments deficits in the short span of three years. Indeed, the LDC debtor nations have made large and difficult adjustments in the face of declining export receipts, rising interest burdens, and dwindling capital inflow.

Mexico is not the only debtor country that has made substantial improvements in its balance of payments. The combined current account deficit of the seven largest Latin American countries — Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela — fell from $35 billion in 1981 to $5 billion in 1983. The improvement was achieved largely through drastic import cutbacks, averaging nearly 50 percent for the group as a whole and as much as 68 percent for Mexico.

The deep cuts in imports were not achieved without cost to the debtor nations. The bulk of the cuts was made in imports of capital equipment and immediate goods needed for sustaining current production. For the seven Latin American nations as a whole, the size of cuts was about 50 percent for each of these two categories between 1981 and 1983. The reductions were especially remarkable given the average annual growth rates in these imports of 56 percent and 114 percent between 1978 and 1981, respectively. While imports of consumer goods were also halved, the absolute magnitude of reduction was small ($4 billion) relative to the reductions in the other two categories ($12 billion each) because consumer goods imports were not large to begin with. The cutbacks in producer goods imports were associated with a decline of 4 percent in real output from 1981 to 1983 for the group as a whole. Against a backdrop of continued population growth (averaging 2.5 percent a year), these adjustments translated into a decline in per capita income of about 10 percent between 1981 and 1983 — the sharpest since the 1930s.

Conditions for the debtor nations, however, improved considerably in 1984. The vigorous economic growth of the United States and the high value of the U.S. dollar have provided a rapidly expanding market for their exports. Total U.S. imports rose by 30 percent in 1984, with those from Asia rising by 45 percent, from Latin America by 17 percent, and from all developing countries combined by 23 percent. Led by export expansion, the total output of developing countries increased by 3.5 percent, reversing the declines for the preceding three years. For the seven largest Latin American countries, total exports rose by 12 percent in 1984, compared to an 8 percent decline from 1981 to 1983. Their combined current account deficit fell fur-

ther to an estimated $2 billion from $5 billion in 1983, while their total real output achieved a 2.5 percent rate of growth, compared to a 2.5 percent decline in 1983.

Conclusions and prospects

The LDC-debt situation has indeed improved significantly over the past three years, thanks to a combination of factors: international debt rescheduling plus new credits to help the debtor nations avoid a liquidity crunch; the strenuous efforts by the debtor nations themselves to reduce their payments deficits; and, finally, the vigorous economic growth in the United States and the strong U.S. dollar. The high value of the dollar, however, cuts both ways. While it has helped the debtor nations to expand their exports to the U.S. market, it has also meant an increase in the burden of dollar-denominated debts. Moreover, the continued high real interest rates, i.e., interest rates adjusted for inflation, have not helped ease the debt burden. Nevertheless, despite these difficulties, significant strides have been made in mitigating the severity of the LDC debt problem.

Particularly noteworthy in the developments last year was the rise of multi-year debt reschedulings. In the depth of the debt crisis in 1982 and 1983, the general view was to reschedule debts one year at a time as the debts fell due in order to keep up the pressure on debtor countries to adopt appropriate economic adjustment programs. Now that adjustment programs have been put into place and shown success in a number of cases, there is room for taking a longer term perspective and pursuing long-run economic growth objectives. Given continued international monitoring of the progress of economic adjustment programs, this approach provides a better framework for solving the LDC-debt problem.

The progress made in resolving the LDC debt problem does not mean that the road ahead is all clear. On the contrary, even now there are grave concerns over Argentina's failure to live up to the terms of its agreement with the IMF to reduce domestic inflation, and over the snag in Brazil's renegotiation of the terms of its IMF program required for the completion of its debt rescheduling package with international bankers. Distressing and even potentially serious as these developments may be, they provide little reason for pessimism. In recent years, both LDC debtor and creditor nations have gained sufficient experience with and understanding of the debt rescheduling process that one can be cautiously optimistic that, with patience and cooperation from all parties, current problems will be solved.

Hang-Sheng Cheng

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 03/27/85	Change from 03/20/85	Change from 03/28/84 Dollar	Change from 03/28/84 Percent[7]
Loans, Leases and Investments[1 2]	189,192	− 239	12,673	7.2
Loans and Leases[1 6]	171,641	− 286	14,825	9.4
Commercial and Industrial	52,877	− 262	5,376	11.3
Real estate	62,526	72	2,666	4.4
Loans to Individuals	32,133	147	5,922	21.7
Leases	5,322	2	323	6.4
U.S. Treasury and Agency Securities[2]	10,648	45	− 1,566	− 12.8
Other Securities[2]	6,903	2	− 582	− 7.7
Total Deposits	193,421	412	8,271	4.5
Demand Deposits	44,208	330	1,311	3.0
Demand Deposits Adjusted[3]	29,528	298	258	0.9
Other Transaction Balances[4]	13,091	− 109	1,034	8.5
Total Non-Transaction Balances[6]	136,121	190	5,929	4.5
Money Market Deposit Accounts—Total	43,885	24	3,326	8.2
Time Deposits in Amounts of $100,000 or more	39,064	104	954	2.5
Other Liabilities for Borrowed Money[5]	19,304	952	369	1.9

Two Week Averages of Daily Figures	Period ended 03/25/85	Period ended 03/11/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	67	63
Borrowings	36	32
Net free reserves (+)/Net borrowed(−)	31	30

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change