Towards a Solution of the International Debt Problem: a Pragmatic Approach

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It is a close matter whether it is worse to be lost in the woods of facts without a theory than to be lost in one's theory, pursuing it to the point where contact with reality is lost. Like any other economic issue, the international debt problem is caught in this dilemma.

Clearly, this time economists, financial journalists, bankers, and maybe even Central Bankers, seem to have erred for too long on the side of facts, as is usually the case in an acute crisis. And the woods of facts are particularly dense when it comes to international indebtedness: the latest on Argentina's willingness (or unwillingness) to pay, the US budget deficit and its influence on interest rates, the level of the dollar and dozens of other equally important facts are the trees that – taken separately – might well assume an undue importance and blurr our overall vision of the debt problem as a financial and *real* transfer problem between nations.

This is where some theory is called for. In order to gain some insights into the exact configuration of our forest, we need to raise ourselves slightly over the tree tops. Theory – defined as stylized facts – is today the only way to put the international debt problem into perspective. Of course, we do not mean to choke the reader in the rarefied atmosphere of pure theory; we leave that to the numerous professional economists. We only wish to hover slightly over the experience amassed during the past two years and, with the help of some very simple economics, tackle three topics we think of importance for the future of the world economy.

However, before looking at them more specifically, another general remark is in order. One sometimes hears or reads that Western banks would be much better off if they had not lent "so much" and that a return to normality requires massive repayments by "problem countries". Such arguments are misleading and show a total ignorance of what financial intermediation is all about.

By definition, the function of any national or international banking system is to transfer resources from surplus to deficit agents, sectors or countries. The recycling of the massive OPEC surplus has probably been the most challenging financial operation undertaken since the war; and the international banking community came out of it with flying colours. The huge OPEC assets deposited in Western banks would clearly have stifled the whole system if they had not been channelled towards LDC countries. And the new industrializing countries were the only deficit area that could absorb such an important financial – and subsequently real – transfer. People who argue that this money could have been recycled – say within the OECD area only – are simply day-dreaming.

Furthermore – and it would greatly help the discussion if people could admit it – the existing debts are not going to be repaid in the foreseeable future. Indeed there is no need for this, just as there is no need for the net debts of the US government, the US corporate, or household sectors *ever* to be paid back. Or, take another example: Switzerland has the highest per capita mortgage debt in the world. Nobody expects it to decline and, eventually, to melt away. In any case, what would our bankers do with all that money? Lend it? Yes, of course, but to whom and for what purposes?

It is quite natural for a country at the early stages of its development to be indebted since it may lack the resources to exploit existing oppor-

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tunities. Today, even industrialized nations such as Canada or Australia, relatively poor in labour and capital but well endowed with natural resources, need outside help to tap their development potential. Even the United States, a net capital importer until 1914 and later the net creditor of practically the entire world, may again become a net borrower on the international capital market some time in the next twelve months.

Clearly, there is nothing wrong with a country – or any economic agent for that matter – being indebted. The debt may even be allowed to grow over time, but and *this is the heart of the problem,* it must remain manageable. That is, it must bear some relationship to the size of the debtor's economy and its capacity to service it. It is worth noting that the countries with the worst ratio between debt service and exports were the ones that ran into serious payment difficulties. The central problem of today's debt situation is not the absolute volume of loans – a rather hypothetical entity – but the sharp and rapid deterioration of the borrowing countries' ability to service that debt.

Having outlined what we think to be the crucial issue in the debt problem, let us turn to the three main topics we want to consider in this essay.

We first examine briefly the medium- and long-term growth prospects for the debtor countries, then relate them to the problem of protectionism in developed countries and, finally, discuss the implications of the debt problem for the efficiency of the international financial system.

1. Medium- and long-term growth prospects for debtors countries

The improving economic situation in the Industrial countries – especially in the United States – is exerting a beneficial effect on the Third World. In 1984, for the first time in four years, output in debtor countries as a group is going to grow faster than population, and a further 4 to 5 percent is in prospect for 1985. The key issue today is obviously how developing countries burdened with debts can maintain such a growth rate over a sufficient number of years in order to regain the momentum of an economic advance that was brutally stopped in the early 'eighties. This question is of paramount importance to the IMF. In order to "sell" credible adjustment programmes to debtor countries themselves as well as to convince official and private lenders to keep up adequate financing to these countries, the Fund has recently carried out careful analyses of the future growth prospects for various nations.

Two instructive conclusions emerge from these studies. First, and this is good news, *in the short term,* the prospects for an orderly handling of the debt problem are much better today than a year ago. In particular, and this is extremely good news, the adjustment process – as a result of this renewed growth – is now moving from the import compression phase to the export expansion phase in some of the most heavily indebted countries. Such a move is also making for faster output growth.

Second, once these short-term results have been secured, and subject to the proviso that sensible policies are implemented, this resumption of growth could not only be sustained in the *medium run,* but also be combined with a gradual reduction in the external debt burden. The latest medium-term projections of the IMF suggest that by 1990 the ratio of external debt to exports of goods and services could fall by as much as 40 percent for the seven most heavily indebted countries as a whole. Economic growth could increase to about 5 percent a year over the second half ot the decade.

What will *actually* happen obviously depends on the policies pursued by borrowing countries as well as by lending institutions. Nevertheless, the Fund's study shows beyond doubt that the debt problem could all but disappear within the next ten years, if national and international policy making bodies strive a reasonable and common course.

2. Indebtedness, growth and protectionism

The fact that international indebtedness and world trade are somehow related should be obvious to anyone. Only countries engaged in foreign

trade can accumulate foreign assets or liabilities. Closed economies – if there are any – can not have debt problems.

Ever since David Ricardo, economists have been convinced that international trade benefits all participating nations. By exploiting their comparative advantages, trading nations can increase their income and, if they so choose, consume more of all goods. International trade also tends to lead to a greater degree of economic stability by dampening the impact of domestic shocks, although it does expose domestic economies to foreign transfers. International trade allows for the transfer of wealth between nations. Countries can lend to the rest of the world by running current account surpluses, or, alternatively, they can borrow by running deficits.

The most important conclusion to be drawn from the theory about the advantages of international trade is that no economy can be protected on the net. Or, put the other way round, trade is not a fixed-sum game; every participant shares in the gain. Protectionism is almost always a suboptimal policy. It is often implemented on the basis of short-sighted considerations and under the pressure of special interest groups.

What we, the industrialized world, must offer the indebted countries is a setting favourable to international trade. LDCs must expand their exports. They need larger export revenues to service their debts and to finance development. To reduce their vulnerability to movements in commodity prices, they must diversify their production. This diversification must take place with export markets in mind. Efforts directed at import substitution under the umbrella of high local tariffs only lead to a misallocation of resources.

We must realize, of course, that our own export prospects to these countries will be rather limited in the near future. Third World countries will simply not have the means to import anything but necessities and the equipment goods for their economic development. This need not be an excessive obstacle to our development since the largest proportion of world trade by far takes place within the OECD area. It is clear, however, that, in the short run, such a policy will cost us jobs and production in the sectors most exposed to international competition, namely in the shipyards, in the steel, textile, and car industries.

Given the fact that these particular industries already receive above-average protection in some developed countries, the implications of this analysis are clear: other industrial sectors are penalized. This is the case for the export industries of the protecting countries in particular, according to the motto "a tax on imports is a tax on exports".

Any tariff war, even on a relatively small scale, might easily degenerate into a frantic "beggar-thy-neighbour" policy with damaging consequences for all parties involved. There is no need to remind you of the catastrophic results of the protectionist wave of the 'thirties. But what would the consequences of such an outbreak be for lenders and borrowers in today's world?

Protection against imports equals a redistribution of income and wealth among particular industries and sectors of a national economy. There is nothing to be said against the principle of redistribution as such; but, for one thing, this kind of redistribution is made behind the back of the public. And from a strictly economic viewpoint, it is an inordinate costly form of transfer. While reliable quantification is impossible, the impression is strong that the total additional costs for the transfers that protection brings about exceeds the net amount of wealth actually transferred.

Since the transfer costs of redistribution by protection are so high, it seems obvious that trade liberalization benefits the liberalizing country first and most. We often hear the opinion that "in a world where everybody protects its industries, nobody can afford to remain unprotected". Nothing could be farther from the truth. Even in a chaotic world, where most countries follow protectionist policies, a wise government would make the best of a bad situation by refusing to join the scramble and by maintaining open borders.

It was out of the awareness of these economic costs that post-World War II governments

agreed on the system of rules incorporated in the GATT and articulated around the Most-Favoured-Nation rule. The clear purpose of this system of rules is to reduce uncertainty about investment decisions and hence to maximize the flow of investment, job creation, productivity growth – in short, economic progress. All investment decisions involve risks because they are concerned with the intertemporal allocation of resources; that is, they depend on future unknown prices of input and output. The entrepreneur's function is to take such a risk while the government's role is to refrain from actions that could increase that risk above some kind of "natural minimum".

A government who wants to implement certain policies must have some idea of how other governments will react, what it can expect from them, or, at least an assurance of what they will *not* do. This kind of assurance as a basis for rational policy making by lender as well as by borrowing countries is what the GATT rules provide. And this is why, in our opinion, a reassertion of the commitment to non-discrimination by all countries should be high up on the agenda of any future negotiation on international trade. We would even go as far as to favour a greater responsibility of the GATT Secretariat for the surveillance of national trade policies. Governments would thus be faced with the necessity to go beyond the conventional reassertion that "free trade is best" while busily building up non-tariff barriers.

The developing parts of the world can be a source of enormous economic dynamism. The industrialization in progress there is an opportunity, not a threat to the old developed countries. Given a stable policy framework, private entreprise in the industrialized countries can be relied upon to provide a flow of investment which, using the opportunities offered by economic development in the Third World, will contribute to restore employment at home.

3. Efficiency and stability of the international financial system

In all likelihood, the international financial system will be under stress during the next three to five years. This is not new. But the debt problem has certainly not eased the burden already put on that system by the two oil shocks, the recycling of the OPEC surplus and the deepest recession since the war.

The basic dilemma is that improving the soundness of financial institutions' balance sheets may require a reduction of their exposure to indebted countries while – at the same time – those countries' ability to service their debt requires continuing or even increasing inflows from abroad. Or, to present the same idea in a slightly different way: how is it possible to restore stability and efficiency to the world financial system if Western banks must provide the borrowing countries with a cash flow that, today, has to exceed the debt service payments if these countries are to service their existing debt at all?

Since 1982, reschedulings and "quasi-forced lending" have been the two main measures used to avoid a collapse of gross lending to the developing countries and the defaults this would have triggered. The rather brilliant initial success of these operations should not lure us into too much complacency. Successful crisis management is never an adequate answer to structural problems. On the contrary, one might well consider that some of the recipes applied in the heat of the crisis have embedded instabilities and inefficiencies within the system. "Involuntary lending" or what the IMF has euphemistically dubbed "residual financing requirements" is *the* obvious example; it tends to increase the over-exposure of the banks, which are already heavily committed, and discourages new lenders.

Is it possible to find some clear and forward thinking on these rather fundamental matters? Apart from the *wishful* thinking to be found in the concluding sections of financial columns, the literature on the subject is rather scanty. Let us, however, examine some interesting ideas gleaned from recent and preliminary research by Cline, Sachs, Swoboda and Niehans.

Consider first the determination of the volume of loans and the lending rate in a competitive world of lenders and borrowers under *certainty*. For

any firm, it would mean borrowing enough to equate the cost of the marginal loan with the sum of the discounted profits expected during the entire life of the investment good purchased with that very loan. The rate of interest would adjust to clear the credit market as a whole.

In an international setting, such a simplistic model would describe a world in which capital flows from where its return is low towards places where its return is high. The marginal product of capital would thus be everywhere the same and the international allocation of resources efficient.

In such a world of perfect information and in the absence of risk-changing behaviour on the part of borrowers, interest rate differentials among debtors correctly reflect the specific risk premia put on each particular borrower. Recent financial events have particularly shown that real financial markets are hardly characterized by perfect information and that borrowers are able to affect the riskiness of the project they are engaged in.

Asymmetric information and risk-modifying behaviour are indeed at the heart of the debt problem.

First – and this has nothing to do with uncertainty but rather with the nature of the international financial system – conventional wisdom usually overlooks a fundamental difference between private domestic and international loans: in the domestic economy the cost of default is implicitly assumed to be always higher than its benefits. If a debtor defaults on his obligations he forfeits collateral and his assets can be turned over to his creditors by a bankruptcy court. This is no longer tenable in an international context, where repudiation is possible (economists call it endogenous default). Broadly speaking, the benefit to the repudiator is the present value of future interest and amortization payments; the costs – and think why no Latin American country has yet defaulted – include freezing of assets that are recoverable, exclusion from future borrowing, international financial and commercial quarantine and, of course, loss of political credibility and reputation.

In recent years, banks have unfortunately not clearly understood the implications of unenforceability; they probably did not realize early enough that the profitability of the loans made during the early stages of the recycling of the OPEC surplus was going to induce them to overshoot the sustainable debt level for many countries.

The second issue, linked this time with uncertainty, is what Stiglitz and Weiss have called *adverse selection.* The idea is simple but has already had strong negative influences on the efficiency of the international financial system. In a world where borrowers undertake projects with various degrees of riskiness, lenders, though they are aware of that variability, can not classify with certainty their loans into groups of equal riskiness. Their expected return will be a function of both the interest rate they charge and the loan's riskiness. The problem is that as the rate of interest is raised low-risk borrowers may be discouraged from borrowing, leaving the lending banks with a high risk-lower expected return loan portfolio. In other words, for the bank, the level of the interest rate affects the nature of the transaction involved.

This is why banks should use interest rates as a screening device. In this context, it might be rational for the lender to charge lower interest rates and simultaneously to ration credit to avoid the adverse selection effects of a higher interest rate. Other screening devices are possible, but credit rating by lenders and attempts by borrowers to signal their creditworthiness to lenders are either unreliable, difficult or both. The case of some low-risk Asiatic countries temporarily excluded from the international capital market in the wake of the debt crisis is a typical case of such an adverse selection process. Ultimately, both these countries and the lending banks were worse off.

Third, there is the all important question of *moral hazard.* Moral hazard occurs when risk-modifying behaviour is possible in an uncertain world. In our context, moral hazard creates incentives for borrowers to behave in a perverse way when interest rates rise, specifically to undertake riskier projects. It is highly probable that, with variable interest loans making up the bulk of recent

international borrowing, higher *Libor* rates have induced borrowing firms and countries during the past five years to undertake projects with lower probabilities of success but higher payoffs when successful. Some prestige projects in Latin America fit this description particularly well.

Once again: monitoring by lenders and pre-commitments by borrowers may somewhat ease the problem, but one can not escape the feeling that despite all sorts of loss-prevention schemes the credit market may well penalize the low-risk borrowers and subsidize "imprudent behaviour".

Moral hazard problems are of course magnified by the susceptibility of most countries. Any attempt at monitoring will meet with accusations of political interference. The understandable insistence by bankers that countries submit to IMF programmes can be seen as an indirect form of monitoring via a conditionality factor. Similarly, the more favourable conditions obtained by Mexico on debt rescheduling after the successful implementation of genuine stabilization programmes can be regarded as the result of reduced moral hazard for lenders: the new loans are priced in accordance with actual prudent behaviour.

The fourth and last element we wish to examine in connection with the efficiency and stability of the international financial system is of particular interest to Central Bankers. It has been known for a very long time that the discretionary power of most Central Banks to bail out banks may lead to a considerable increase of the degree of moral hazard. The existence of credible *lenders of last resort* does of course reduce the private cost of risk taking; or, in other words, the very existence of a credible commitment by Central Banks to lend freely in time of trouble may well lead to the assumption of excessive risk by commercial banks, just in the way the holder of a theft insurance policy might be excessively careless about locking up his car.

We know the path we are treading is a controversial and dangerous one. But our guess is that, during the recycling of the OPEC surplus as well as more recently, there has been a perception that banks would not be allowed to fail. As a consequence, depositors have been willing to lend to banks even though they themselves would not have been ready to hold the assets the banks were increasingly buying with their money. And the banks acquired assets with rates of return so low that they would never have considered buying them if it had not been for the implicit guarantee the lending-of-last-resort function of their Central Bank offered them. Clearly, the social costs of bank failures are usually considered to be higher than the private costs to shareholders and depositors. But the implicit guarantee given by Central Banks distorts the allocation of resources basically because authorities tend to provide this insurance at to low a price.

All Central Bank governors, particularly at their monthly meetings at the Bank for International Settlements, are familiar with the policy issue raised by this argument. Removing implicit or explicit guarantees to banks requires that you accept that even the largest banks could be allowed to fail. The dilemma – well known to everybody who has been involved with the so-called Basle concordat – is how to implement such a policy without actually precipitating bank failures, without destabilizing the whole system and preventing capital from flowing to borrowing countries.

Nobody has succeeded yet in squaring this particular circle. For our part, we would tend to side with dear old Bagehot: it is better to rely on one's sometimes fallible judgement than to try to draw the line once, for all times and occasions.

Let us now turn to some policy conclusions and list some proposals for reform that can be derived from the preceding remarks.

The ultimate function of the international financial system is to bring about an efficient allocation of resources between surplus and deficit areas. This requires that risks be priced properly and put back where they belong. Any efficient market should enable individual risks to be dissociated from each other, and therefore to be priced and charged separately. To be more concrete, sovereign borrowing creates indivisibilities that hinder gains from risk diversification. Further-

more, the lack of secondary markets in syndicated loans and the absence of alternative financing instruments for LDCs precludes efficient trading of sovereign risks between financial institutions.

Promoting stable and clear regulatory frameworks is another important element. They would distribute the roles and responsibilities among agents and institutions and greatly help foster efficiency and reduce the cost of information processing for all.

Mechanisms for sharing losses are also needed; in particular, there should no longer be the choice only between total losses and zero losses. This is probably the most tricky issue in a field where difficult problems already abound. Keeping in mind the dazzling exercises recently performed within the US banking system, the absence of alternative instruments has had two major consequences: a rigid book valuation of old loans and a flight from new loans whenever the perceived value of old loans fell significantly below book value. A secondary market would help pricing old loans more correctly and, thus, contribute to loss sharing.

Using an excellent classification suggested by Professor Swoboda, let us examine the various proposals for reform scattered through a wide array of literature. They range from marginal changes in regulation to comprehensive plans for assistance for both lenders and borrowers.

One principle appears to clearly dominate all proposals – and it makes perfect sense to us: continuation of involuntary lending is essential in the short run while marginal regulatory and other improvements are being put in place. These proposals may be detailed briefly under six headings.

The first suggestion is that markets for instruments other than straight debt be actively encouraged. The second is that secondary markets for straight debt – mainly bank loans – be promoted. Third, debt relief should be given when needed, but only on a case-by-case basis to avoid contagion effects. Fourth, national governments should refrain from offering implicit lending-of-last-resort guarantees to their financial institutions for political reasons. Fifth, the current phase of involuntary lending should be ended as soon as possible. Sixth, an appropriate division of labour between banks, governments and international institutions (mainly the IMF) should be devised in order to give back to the markets part of the efficiency and stability they have recently lost: the allocation of private capital would be more efficient and the inherent risk of such an international financial intermediation put back onto lenders and borrowers, where they properly belong. These proposals, if carried out, should finally not obscure that the urgent need for concessional lending through existing multilateral agencies still exists for some very poor countries.

These recommendations might seem very modest indeed, but – in our judgment – they are fundamentally sound and reasonable. Efforts in these various directions would bring, probably within a not too distant future, substantial results.

Concluding remarks

Our concluding remarks, when all is said and done, can be mercifully brief: we can close our investigation in the confident belief that there is no need for grand new schemes or global proposals to solve the main issues we have tackled. There is no magic solution and we have no alternative but to plough slowly our way out of the present difficulties. Clearly, we must keep in mind an overall and long-term picture of the present economic and debt problems. But – to quote the words of a former French *ministre des affaires étrangères* – what we need most today are people who are ready to negotiate, to negotiate again and to keep negotiating until mutually beneficial solutions are found.

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