The Debt Problem: A Debtor's Point of View

by

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The problem of the foreign debt of the developing nations, particularly that of the Latin American countries, has become extremely acute in the last few months. The present concern has resulted in part from fear of the damaging effects of higher interest rates on these economies, especially in view of the variable interest rates attached to the majority of the loans outstanding.

Spokesmen for a variety of international interests have stated that, if the rising trend in interest rates continues, the international financial system might find itself in a situation with unforeseeable consequences. The search for a formula to prevent a crisis is therefore imperative. Some argue that debtor countries should not be subject to prolonged exposure to higher interest rates, since the adverse effects could lead many of them to suspend payments.

The recommendation has not been made only by debtor countries but also by high authorities in the United States government, such as Paul Volcker, Chairman of the Federal Reserve System, and Martin Feldstein, former chairman of President Reagan's Council of Economic Advisers. Similar statements have been made by such organizations as the International Monetary Fund, prominent figures in international politics such as Henry Kissinger and Helmut Schmidt, and even high officials in the creditor banks.

The debtor countries have been forced to assert the need to find new ways of managing their existing debts, not only in terms of interest payments but also in terms of restructuring those debts and attaining future access to credits. In this paper, we shall analyze the origins of the Latin American foreign debt problem, its implications, and some potential solutions.

Origin of the Problem

International Monetary Fund estimates [1] indicate that the gross debt of the developing countries almost quintupled in only one decade (1974-1983). By 1983 it had risen to US$ 767.6 billion. Most of that debt is owed by non-oil exporting countries, especially those of Latin America (44 percent).

That explosive growth has a number of causes, among which is the developing countries increased need for external financing to cover growing balance of payments deficits. That need, in turn, was due to:

a) The increase in oil prices in 1974.

b) The deterioration of their terms of trade because the prices of their export products had declined more than those of their imports.

c) A reduction in their exports to the developed countries which suffered through a recession during a large part of the decade.

d) The sharp increase in interest rates in the international financial markets in response to tight monetary policy implemented since 1979. [2]

These four factors are estimated to have generated financing needs of more than US$ 400 billion for the non-oil developing countries during the decade. [3] Taken together, they explain a large share of the level of indebtedness.

The change in policy toward foreign investments in the developing countries was another contributing factor. It became generally accepted that domestic investment with foreign financing was preferable to the attraction of foreign capital through traditional forms of investment. The traditional methods had been effective in contributing capital during the initial phase of development, but it subsequently produced undesirable capital drains in the form of remission of profits to the country of origin.

Consequently, many developing countries resorted to foreign borrowing to finance large-scale national investment projects, with the oil exporting countries taking the lead. Many of them, however, found that they could not generate the revenues necessary to service the resulting debts. In many cases, foreign credit was used to obtain working capital or to finance current expenditures of public agencies which provided subsidized services and could not even pay their own operating costs.

Another source of the foreign indebtedness of the developing countries, and especially those of Latin America, was the persistent need to cover recurring government deficits. The creation of needed basic infrastructure and the development of industry led those countries to implement highly expansive fiscal polices and to accumulate deficits. Given domestic financial limitations, they had to resort to foreign financing to cover those deficits.

Rational Processes?

We believe that many of the Latin American countries entered the present situation of indebtedness in a basically flawed manner, violating a number of basic rules of economic rationality. In addition to the errors mentioned above, several nations did not implement exchange policies aimed at preventing an erosion of the competitive capacity of their products abroad. Neither did they apply interest rate policies capable of discouraging capital drain caused by a search for higher yields in foreign markets. [4]

In addition, many of these countries contracted debt levels out of proportion to their financial capabilities. In some cases, debt service cost more than the whole of their export income.

TABLE 1
External Debt Service Ratios as Percent of Exports, 1983

Country	Total	Interest	Amortization Long-Term	Amortization Short-Term
Argentina	200.0	55.1	3.0	141.4
Brazil	113.5	42.0	9.7	61.8
Mexico	146.5	35.2	21.5	89.8
Venezuela	106.9	18.0	0.9	88.1

Note: Figures correspond to total debt and services at the end of 1983.
Source: Morgan Guaranty Trust Company

This situation was abetted by the creditor banks that guaranteed automatic roll overs of outstanding loans every year, and the offering of new credits. The debtor nations found it easy to continue expanding their foreign liabilities irresponsibly, expecting that such easy access to credit would continue indefinitely.

The Role of the Creditor Banks

The private banks played a much more active role in this phase of rapid indebtedness than they had in the previous postwar period. They served as the main providers of the credits demanded by the developing countries. They could do so because of the unprecedented volume of funds deposited in them from 1974 on by the oil exporting countries, mainly those of the Persian gulf. The key to the recycling of the "petrodollars" was to lend those funds not only to customers in the developed countries but also to developing nations.

However, they practiced a credit policy that can be judged as careless, frequently making loans under conditions that violated basic rules of banking prudence. There are many examples of loans to finance projects of doubtful viability, and even to finance the current expenditures of institutions that could not hope to generate the funds to service their debts.

Several of these loans were syndicated, that is, they were granted by a large number of banks, including small or medium sized institutions, led by a few large banks that brought together the members of the syndicate. In most cases, the smaller institutions had little experience in the international lending field. They were lured from their regional operations by the magnitude of the new market and the excellent potential profits offered.

On accepting the invitation of the large banks to participate in foreign operations, they gave the latter credit allocations to be distributed among the different loans, trusting the leader institutions to conduct the appropriate credit analysis before proceeding to approve credits.

In many cases, loans were subsequently approved in violation of the rules of banking prudence. To illustrate this point are figures published by the

Board of Govenors of the United States Federal Reserve System. [5] They indicate that American banks lent 1.5 times their capital and a relatively high share of their assets to non-oil exporting developing countries. Still more serious, the nine largest United States banks had a very high degree of exposure and risk in Latin America, having granted, on the average, loans for 1.5 times their capital and 7 percent of their assets to only five countries in the area.

As a result, the international financial situation is now in a vulnerable condition, endangered by the crisis affecting many of the debtor countries.

TABLE 2
Exposure as Percentage of Capital, Major Banks, End-1982

Bank	*Argentina*	*Brazil*	*Mexico*	*Venezuela*	*Chile*	*Total*	*Capital (mm of $)*
Citibank	18.2	73.5	54.6	18.2	10.0	174.5	5,989
Bank of America	10.2	47.9	52.1	41.7	6.3	158.2	4,799
Chase Manhattan	21.3	56.9	40.0	24.0	11.8	154.0	4,221
Morgan Guaranty	24.4	54.3	34.8	17.5	9.7	140.7	3,107
Manufactures Hanover	47.5	77.7	66.7	42.4	28.4	262.7	2,592
Chemical	14.9	52.0	60.0	28.0	14.8	169.7	2,499
Continental Illinois	17.8	22.9	32.4	21.6	12.8	107.5	2,143
Bankers Trust	13.2	46.2	46.2	25.1	10.6	141.2	1,895
First National Chicago	14.5	40.6	50.1	17.4	11.6	134.2	1,725

Source: Cline, W. International Debt and the Stability of The World Economy.

The Crisis, 1982

The oil exporting countries have suffered a serious reduction in their foreign earnings since the international oil market began to weaken in 1981. Their losses have forced the OPEC members to reduce their reference price from US$ 34.00 to US$ 29.00 per barrel, and to set production ceilings in March 1982.

Their actions had a twofold impact on the international financial market. First, the OPEC countries that had been supplying the banks with petrodollars were obliged to reduce their deposits, thereby limiting the credit capacity of the banks. Second, certain oil exporting countries, such as Mexico, Nigeria, and to a lesser extent, Venezuela, were thrown into serious crisis, to the extreme that Mexico had to declare its inability to meet its foreign financial commitments. [6]

Simultaneously, numerous developing countries found themselves in a critical situation as a result of the continuing deterioration of their balance of payments, undermined by declining exports and worsening terms of trade. As a consequence, their need for external financing increased, and their ability to meet previously acquired commitments was further weakened.

The crisis led to an acceleration of efforts to restructure debt, but a final solution is still needed.

In Search of a Solution

Faced with the danger that several debtor countries would suspend payments and plunge the international financial system into crisis, the world financial community began to recognize the inadequacy of a mere restructuring of debts. International financial institutions, such as the International Monetary Fund (IMF), would have to play a dominant role in solving the problem. The IMF would not limit itself to providing financial assistance to the countries with balance of payments difficulties. It would take the lead in designing economic adjustment programs to correct the causes of their problems and give them the ability to meet their financial commitments, as well as to prevent subsequent crises as serious as the present one.

In reality, the IMF also has forced the creditor banks to continue lending to the debtor countries so that they could overcome the crisis, and has played an important role in renegotiating the debts. In fact, the banks began to demand that the debtor nations enact stand-by arrangements with the IMF as a precondition for concluding negotiations. Such arrangements involve economic adjustment plans and a commitment to achieve certain goals by specific deadlines. These preconditions are of fundamental importance to the banks, since the banks are unable to supervise the implementation of adjustment plans directly.

The severity of economic adjustment programs has led several countries into recessions and high unemployment, causing social and political instability in some cases. However, the refinancing efforts carried out since 1982 have permitted an extension of maturity and grace periods. They have alleviated the burden of foreign commitments to some extent, even though the spread over the basic interest rates (LIBOR or Prime Rate) has tended to rise and the commissions charged by the banks have also increased. [7]

Debtor nations remain in a vulnerable position since they have no protection against sharp increases in interest rates or shocks beyond their control. Furthermore, they have no assurance that new adjustments in the structure of their external commitments could be obtained in the event of further deterioration in their terms of trade or exports.

1984: a New Phase of the Crisis

The continuing rise in real interest rates in the United States during the first half of this year, in conjunction with the social and political pressures under which the governments of many of the debtor countries function, have led to new crises. In response, some of the nations have rejected the adjustment plans formulated by the IMF. The most prominent of these is Argentina, whose government has expressed the intention of carrying out an expansive economic policy and of assuring the stability of the worker's real income, despite the hyperinflation which the country is suffering.

In addition, Argentina has repeatedly stated its inability to make interest payments on its loans. This has not only led the international financial system to grant new credits to allow the country to meet its current obligations, but

even the United States government and those of other Latin American nations have provided assistance to prevent the third most heavily indebted country in Latin America from declaring a suspension of payments.

The last point is of the utmost importance, since a declaration of this type could have widespread effects in the international financial system. In addition to the runs on deposits that might occur in the banks most heavily exposed to the country in question, the affected institutions would be forced to declare the loans on which they have not collected interest for more than 90 days as nonaccrual assets. That would require them to record the uncollected interest as losses and these losses would amount to a reduction in their profits. Their dividends and the value of their stocks would decline as a result.

In addition, as we observed at the outset of this paper, the continuing rise in the interest rates in the United States has led the Latin American countries to make individual and collective declarations of the need to find some way to prevent being affected by those increases, especially since the causes are not of their making. Some estimate that the countries of the area must pay more than US$ 3 billion for each yearlong percentage point increase in interest rates. Such an increase would neutralize the gains made at great sacrifice through the adjustment policies. Thus, if international interest rates rose by more than two percentage points on average in 1984, the entire expected additional exports of Latin America for this year would have to be committed to paying the higher interest.

A Debtors' Club

The collective declarations made by the Latin American debtor nations recently created anxiety in the industrialized world, particularly in the international financial system. They raised fears of the formation of a "debtors' club," or united front against the creditor banks, that would seek to impose the debtors' point of view.

We believe that such a fear is groundless because a debtor's club requires a uniformity of interests and objectives that is unlikely among countries of such widely varying characteristics and economic situations. In any case, no such intention exists among the countries of the area.

However, the gravity of the international situation has led the Latin American nations to search for common perspectives and to develop a common position on certain fundamental problems. Thus, the Foreign and Finance Ministers of eleven countries of the region met in Cartagena, Colombia on June 21-22, 1984, and drafted a document containing a series of proposals to the authorities of the industrialized world and to other parties involved in the international debt problem. The proposals include:

1. Adopting measures to reduce international interest rates, or implementing mechanisms to cushion the impact of high rates on the debtor countries.

2. Taking into account the capacity of each country for recovery and payment in the renegotiation of debt.

3. Setting a reasonable limit on the commitment of debtors' export earnings in debt restructuring agreements.
4. Reinforcing the credit capacity of the international financial institutions.
5. Revising the criteria on which the International Monetary Fund conditions its loans to make the loans more bearable for the debtor countries.
6. Establishing longer repayment periods and more favorable interest rates in debt renegotiation agreements.
7. Eliminating tariff barriers and other protectionist measures in the industrialized countries to increase Latin America's export capacity.

The Cartagena participants also agreed to create an organization for consultation and follow-up throughout the region to facilitate the exchange of information and experience on advances achieved in debt renegotiation by the different countries. That decision is of the utmost importance, since in our judgment, one of the main goals to be pursued is the exchange of information to facilitate agreements and the adoption of common positions on specific problems. In this way, the proposals made in individual renegotiation efforts can become more coherent and uniform, and thereby increase the probability of success. In addition, the countries would learn of the achievements and benefits obtained in previous refinancing negotiations, and could then ask for the application of the same favorable conditions to their cases. [9]

A New Orientation

Since the beginning of the debt crisis, a number of alternative solutions have been proposed, all of them having one point in common: that the terms must be acceptable to all the parties involved since the radicalization and intransigence of any one party would be harmful to all.

Although it is true that a group suspension of payments by the debtors could precipitate a collapse of the international financial system, that outcome would be to no one's advantage. The debtor nations must maintain access to international credit. They need it to finance both their development programs and external commercial operations. Also, it is of the utmost importance for the banks to be able to continue to grant credits to solvent customers since that is their main function and way of life.

Among the alternatives proposed to overcome the debt problem are a group that calls for the creation of new international financial institutions or the expansion of existing ones, such as the International Monetary Fund or the World Bank. In these proposals these institutions would play the role of central debt banks at the international level. Creditor banks could transfer their foreign loans to them in exchange for instruments issued by the institution. Those instruments could subsequently be discounted by the issuing institution as it collects the debts from the debtor countries in accordance with a restructuring of the presently existing debts that contain more favorable terms for maturity periods and interest rates. [10]

One of the most serious criticisms against this group of proposals is that several creditor banks might feel relieved of the problem and, consequently, feel no obligation to continue lending to the debtor countries. That would be very serious, since the debtor countries require new loans in continually larger amounts and will need such loans in the foreseeable future.

Prof. Allan Meltzer [11] has suggested a new approach. Consisting of the partial or total capitalization of the credits, it would give banks equity positions in the debtor country companies. Those equities could be kept by the banks themselves or sold to other institutions. For example, a part of a nation's debt could be capitalized and then sold by banks to international consortia that would become stockholders and even participate in the administration of different companies of the debtor country.

The criticism we raised against the previous group proposals could be applied to this one as well. In addition, it is unlikely to be very attractive to the banks since they would then have to involve themselves in activities alien to their main business. It could also be risky for the lending institutions, since they might be constrained from selling their equity positions by limitations and conditions imposed by the debtor countries on foreign ownership in their companies.

Other proposals recommend converting the existing debts into long-term obligations in the form of bonds. Those bonds could be given to the creditor bank or sold in the international securities markets. In both cases, the attractiveness of the bonds would be a problem. If the intention were to place them with the creditor banks, the option of discounting them before maturity might enhance their acceptability. One or more international institutions prepared to carry out that operation would have to be found. The International Monetary Fund, the World Bank, or a new institution created for that purpose could be candidates. If the bonds were to be sold in the international securities markets, a mechanism to stimulate their sale on favorable terms, with a low discount, would have to be found. That would not be easy in part because of the low classification of the debtor countries in these markets and in part to the very high level of the operations in question. [12]

Other proposals fit into the traditional framework for restructuring foreign debts. They go no further than to suggest some changes in those frameworks. They have the advantage of facilitating immediate application.

We propose an alternative which we believe to be viable and attractive: restructure the existing debt by tying its service to the export earnings of each country and to a system of variable interest rates with a maximum ceiling. If the interest obligations exceeded the established maximum, the debtor countries would receive an automatic long-term credit at a fixed low interest rate from an international financial institution such as the IMF. The funds in question would automatically be transferred to the creditor banks.

In this way, the fixed deadlines for servicing the existing debts would be eliminated, and the amounts to be paid would be variable and adapted to each debtor's ability to pay. If the payments made at any given time were equal to or

less than the amount of interest due, the whole of that payment would be accounted as such, and there would be no amortization of the outstanding debt. In other words, the capital payments would fluctuate and amount to the difference between the total amount paid and the interest on the outstanding debt.

Under this system, a reasonable percentage of export earnings would be allocated to debt service so countries would be less vulnerable to changes in the world economic situation adverse to their foreign sales or terms of trade. If that occurred, their debt service obligations would decline. In addition, the creditor banks would benefit directly by any improvement in the external situation of their debtors, since the debtors would increase their payments in direct proportion to the increase in their exports. Simultaneously, the automatic adjustment of the payment obligations, in conjunction with the maximum limit on interest, would reduce the pressure on the debtor countries' economies, and consequently diminish the likelihood of suspension of payments.

Finally, the ceiling on interest would not adversely affect the creditor banks since their collections would not decline even when the interest exceeded the maximum.

One criticism of this proposal holds that it constitutes the use of public funds to protect private banks. The industrialized nations, which are the main contributors to international institutions such as the IMF and World Bank, would presumably oppose the channelling of their funds through credit granted by those organizations.

A possible alternative is to change bank regulations to allow banks to register excess interest as revenue even though the interest would be collected in the future. This may encourage financial institutions to be more flexible in granting interest caps to debtor nations, since the postponement of payment of excess interest would not force the former to declare part of those loans as nonperforming.

Conclusion

In conclusion, the urgent need to find an alternative solution to the debt problem is clear. By insisting on the traditional methods, we would condemn the existing financial system to a crisis of unpredictable severity. Certain debtor countries could be forced to suspend payments in response to changes in the international economic situation.

All the parties involved in the problem need to unite to find a way to continue and expand the international banks' financing operations to the debtor countries. These operations are essential for the normal evolution of their trade and for the capital formation required for their development. In the search for a solution to the debt problem, the main responsibility falls on those parties most at fault for creating and worsening the problem: the debtor countries and the creditor banks.

TABLE 3
Developing Countries: External Debt Outstanding
(In billions of US$)

	1983	*1984*
Developing Countries	767.6	812.4
Short-Term Debt	126.2	97.6
Long-Term Debt	641.4	714.8
Non-oil exporting developing countries	668.6	710.9
Short-Term Debt	102.2	88.2
Long-Term Debt	566.4	622.8
Long and Short term debt by area		
Africa	66.3	70.7
Asia	165.0	179.3
Europe	74.8	76.6
Middle East	50.7	56.2
Western Hemisphere	294.4	310.5

Source: International Monetary Fund

TABLE 4
Gross External Debt

Country	*$ billions end 1983*	*As percent of GNP/GDP*	*As percent of Exports, Goods and Services*
Argentina	45.3	70.6	460.6
Brazil	93.1	41.1	380.8
Chile	18.6	89.1	381.5
Colombia	11.5	31.0	269.0
Mexico	89.8	60.5	320.1
Peru	12.5	79.3	331.1
Venezuela	34.9	52.6	198.5

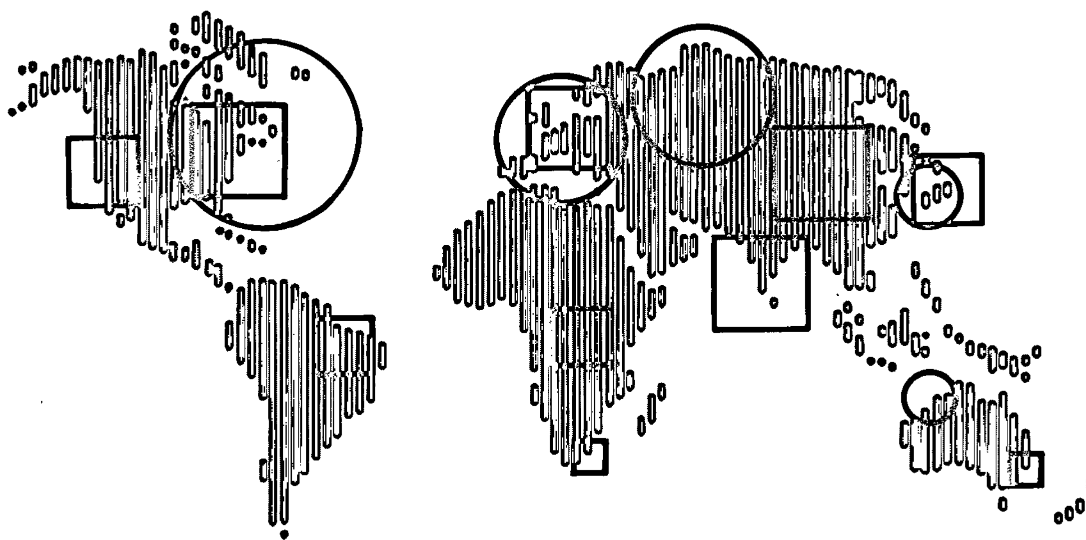
Sources: Morgan Guaranty Trust & Company

1. International Monetary Fund, *World Economic Outlook 1984* and *International Financial Statistics.*
2. The United States prime rate reached 20.5 percent in December 1980, and was above 20 percent during the whole third quarter of 1981.
3. See Cline, W.R., *International Debt and the Stability of the World Economy* (Washington: Institute for International Economics, 1983), p. 25.
4. See Maroni, Yves, "How to Borrow Reasonably", *Foreign Debt and Latin American Economic Development,* Jorge A. and others, eds. (New York: Pergamon Press, 1983), pp. 77-84.
5. Federal Reserve Board of Governors, *Exposure Lending Survey.*
6. In August 1982, Mexico announced its inability to meet its international financial obligations to the creditor banks.
7. See Brau, E. and others, *Recent Multilateral Debt Restructurings with Officials and Bank Creditors* (Washington: International Monetary Fund, 1983).
8. According to the International Monetary Fund, Latin-America's merchandise exports will grow by US$ 9 billion in 1984. *World Economic Outlook 1984,* p. 191.
9. See Aranibar, E. and Palma, P., "Controversia; Deuda Externa: Negociaciones Bilaterales o Club de Deudores?" *Nueva Sociedad,* No. 66, May-June 1983, pp. 20-25.
10. The proposals made by Peter B. Kenen of Princeton University and Felix Rohatyn fall into this category. For more information on these and other proposals, see Cline, W., *International Debt and the Stability of the World Economy,* pp. 114-121.
11. Meltzer, Allan H., "A Way to Defuse the World Debt Bomb", *Fortune,* November 28, 1983; pp. 137-143.
12. At the meeting of Andean countries on foreign debt affairs held in Lima, Peru, from July 9 to 14, 1984, the desirability of finding a mechanism of this type to solve the problem of these nations' debt was discussed.

INTERNATIONAL MONETARY STABILIZATION AND THE FOREIGN DEBT PROBLEM

Proceedings of a Conference Co-Sponsored by Project LINK and the Federal Reserve Bank of San Francisco

Edited by
Bert G. Hickman



August 29, 1984