

# THE INTERNATIONAL DEBT PROBLEM

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Several points should be made when considering the current international debt problem. First, I discuss the role of oil shocks, the most common explanation of the problem, and argue that the oil shocks do not explain why some countries are unable to make the interest and principal payments on their international debt. Second, I look at a more credible explanation of the problem, the policies chosen by particular debtor countries, and discuss some consequences of those policies. Next, I consider the proper method of evaluating a debtor's financial position. Finally, I briefly discuss some alternative solutions.

## Causes of the Debt Problem

Late in 1982, shortly after the debt problem was widely recognized, a group known as the Ad Hoc Committee on International Debt discussed the origins of the debt problem and some proposed solutions.<sup>1</sup> The Ad Hoc Committee noted that changes in the relative price of oil cannot explain the financial distress that developed in several countries at about the same time. The countries in distress included oil exporters like Mexico, Nigeria and Venezuela, oil importers like Brazil, and countries that neither export nor import oil on balance, like Argentina. Further, one finds many countries that import a large fraction of their oil imports but do not suffer financial distress.

There is simply no relation between a country's trade balance in oil or energy and its current financial position. Oil importers like

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<sup>1</sup>The committee members are Karl Brunner, Michele Fratianni, Morris Goldman, Jerry L. Jordan, Allan H. Meltzer, and Anna J. Schwartz. For their summary statement, see *Ad Hoc Committee on International Debt* (1983).

Japan, Korea, Malaysia, and Singapore remain capable of paying their obligations as they come due. Nigeria is in distress; Venezuela is on the brink of distress, and Indonesia's position is far more uncertain than some of the neighboring Asian countries mentioned above.

In three of the principal debtor countries—Brazil, Mexico, and Argentina—we can find a direct relation between public policy and financial distress. In these countries and others, investment and the allocation of resources has been controlled by the government, operating to a greater or lesser degree under the rules or procedures suggested by the Economic Commission for Latin America (ECLA). That Commission advises countries to sacrifice efficiency by placing main responsibility for the allocation of resources with the government rather than the market. And, ECLA urges governments to substitute domestic production for imports even if domestic production is more costly. This policy, known as import substitution, contributes to inefficiency.

There are, then, two main causes of inefficiency. One is the public allocation of resources exemplified by the building of Brasilia in an earlier period and more recently by the building of the Itaipu Dam between Paraguay and Brazil or the building of roads across the Amazon. One need only visit Argentina or Mexico briefly to find evidence of excessive employment and inefficiency in the public sector. Argentina taxes exports from the most productive sector, agriculture, to help support the bureaucracy. This makes the debt problem worse by reducing exports. In these countries and others, credit is allocated selectively and some types of borrowing are subsidized, further reducing efficiency.

These policies helped to build an industrial base, but they do not assure the efficiency of that base. When world growth slowed, or stopped, the countries that followed the advice from groups like ECLA did not respond or adjust. They continued to borrow in the world market, increased domestic money growth and aggregate demand, and offered "government guaranteed" loans to foreign banks. These guarantees encouraged foreigners to increase loans by 30 to 40 percent in a short period and brought on the present period of financial distress.

Distress is not uniform. Other countries continued to grow throughout this period. The famous gang of four in Asia did not follow ECLA's policies—they did not base the allocation of resources on political decisions of the government, but relied more on markets. As a result, these countries experienced much less difficulty when the world conditions changed from rising inflation to disinflation.

The International Monetary Fund has taken an incorrect reading of the debt problems of Latin American countries and has implemented a program based on this incorrect view. There may be some good results of the Fund's program of conditional lending when it is applied to one country at a time, but the program makes no sense when it is applied multilaterally to countries which trade extensively with each other. The conditional IMF loans require Mexico, Brazil, and Argentina to take steps that reduce imports and increase exports. But, Mexico, Argentina, and Brazil cannot increase their exports to each other while reducing their imports from each other. Standard conditional-lending policy seems to be inapplicable in the present circumstances.

Government guarantees of international borrowing by domestic firms encourage firms to borrow. The government's guarantee lowers the risk perceived by lenders, for a time at least. Borrowers pay a smaller risk premium because lenders believe that the governments will shift any losses from them to the domestic taxpayers.

In an excellent recent paper, Roland Vaubel (1983), building on an earlier discussion by Wilson Schmidt, looked at the effect of IMF lending on debtor countries. He concluded that all loans to developing countries are subsidized. Sometimes the subsidy is open; sometimes it is hidden. Either way the subsidy encourages borrowing, reduces a country's incentive to remain solvent, and increases the risk of insolvency or default when market conditions change, as they did in the early 1980s. Vaubel noted that reducing the incentive to remain solvent is a type of moral hazard.

A government's guarantee of foreign loans and debt is valuable only if the government's policies permit the central bank or the borrowers to accumulate foreign exchange. Policies that encourage inefficiency or capital flight, as in Argentina, debase the guarantee. By subsidizing loans, the IMF encouraged excessive borrowing and the risk of default or insolvency. Further, through its policy of conditional lending, the IMF encouraged lenders to believe that there would be no defaults.

Many people who discuss the moral hazard in international lending take a very different starting point. They see the problem as a failure by lenders to limit each country's debt to the amount that the country can service. They conclude that more loans, with larger subsidies, are required now to make up for the lenders' past errors.

Vaubel's argument shows that the mistake was to allow the development of international institutions that hindered the operation of the market. Many loans, we see with hindsight, were based on overvaluation of government guarantees. Lenders attached greater value

to the commitment of governments to maintain policies that would honor their guarantees than some governments proved willing or able to provide. When inflation slowed in the developed countries and recession spread, borrowers could no longer act as if there would be continuing inflation and continuing growth of the world economy. Some adjusted, but others continued to borrow and to follow inflationary policies. Many of the latter now experience financial distress.

### Evaluating the Debtors' Prospects

Lenders often use the ratio of debt to GNP or to exports or the ratio of interest payments to net exports to assess the position of debtor countries. These ratios are not very informative. Korea has had the same ratio of debt to GNP as Argentina in recent years though the prospects and positions of the two countries are very different. A main problem is that the ratios look *backward* while the market must look *forward* to evaluate a country's ability to earn enough foreign exchange to service its debt.

The proper way to evaluate debt is to compare the real rate of interest to the applicable rate of growth of output. Countries that encourage efficiency and productivity have higher growth rates, so at the same world real rate of interest they can service more debt if they choose to do so.

Countries that continue to use resources efficiently benefit in two other ways. Typically, the market evaluates the loan as less risky, so lenders charge lower rates of interest on the less risky loans. Also, efficient resource allocation enables a country to compete effectively in export markets and thus earn the foreign exchange to service the debt. Efficient use of resources often permits exports to grow for a time at a faster rate than domestic consumption or total output.

We can approximate the difference between the real rate of interest and the real rate of growth for a developing country by comparing the current growth rate (expressed in U.S. dollars) to the current market rate of interest on dollar loans. (Both numbers include an estimate of the actual or anticipated rate of inflation in the United States.) The comparison shows that if the current rate of interest on these loans is in the neighborhood of 14 to 15 percent, then nominal GNP growth in those countries, evaluated in dollars, must average at least 14 percent. In real terms, growth must be about 8 to 9 percent on average. If not, each year the debtor will have to increase debt to pay interest on the outstanding debt. The debt will grow without limit. This is not feasible.

No one should doubt that in the near term the debt in these countries will continue to increase. The reason is that servicing the existing debt requires interest payments on the order of \$10 billion or more from the foreign exchange earnings of some countries. Further, these countries were developing and, if development resumes, they will import capital. But currently they must invest to achieve average growth of 9 percent just to pay the interest on the old debt. If you believe that Mexico, Brazil, and Argentina can grow in real terms at 9 percent for the rest of the decade, the problem is transitory. If you believe that maintained real rates of growth of 8 to 9 percent per year in Mexico, Brazil, and Argentina are not likely, then you recognize that there is a persistent problem. The interest payments on outstanding debt are going to rise because these countries will not experience growth of their exports at a rate sufficient to earn the foreign exchange needed to service their outstanding debt.

### Proposed Solutions

In the latter case, where real growth rates fall below 8 to 9 percent per annum, there are three types of solutions. One is to muddle along from one period of financial distress to the next, as we have been doing for the past several years, and as we will continue to do under the current set of national and international policies. That way preserves uncertainty and promotes distress by continuing episodic rescheduling and by deferring a solution to the longer-term problems of these economies.

The second way, the way which seems most probable given the proclivities of the international organizations, is to move further toward a system of forced lending. Instead of periodic financial distress and periods of international, financial tension, debtor governments will offer to pay a share of their export earnings to service outstanding debt. Any remaining debt service will be added to the debt. Creditors will lend, through forced loans, the amount of additional foreign exchange required or demanded by debtors under policies chosen by the debtors. One sees the beginning of this system in the recent negotiations with Poland, and also in some demands that Argentina has made.

The third, and I believe the most appropriate solution, starts by recognizing that mistakes have been made in the past. These mistakes were not due to market failure. Countries pursued inefficient policies, but lenders believed that governments would be able to honor their guarantees. Whatever the cause, the problem remains. I believe that any long-term solution must begin by revaluing the debt

at market prices. We know something about what this implies because there are Mexican bonds outstanding. These bonds are traded in London and pay interest to maturity of about 16 percent per annum. The bonds sell in the range of 70 to 80. This suggests the proportion in which the real value of the debt lies below the face value. I propose that the banks act as if the loan is a marketable bond that has fallen 20 to 30 percent in value. The banks should offer to write down the value of the debts in market value and write off the losses. In exchange, they should require governments to exchange a portion of the remaining debt for marketable equity claims to the real assets in government corporations.

This proposal takes the guarantee seriously by asking governments to convert part of the debt that is now outstanding into equity claims against public sector corporations and to allow the creditors to sell their equity to third parties. The proposal treats the debt of these sovereign governments as if it were commercial debt in an illiquid enterprise. Converting a debt claim by the banks into an equity claim uses the traditional banking procedure to reduce the volume of outstanding debt.

This proposal lowers the interest burden on the debtor countries in two ways. First, the outstanding debt is written down to its market value, as the market would have done if the debt took the form of bonds instead of loans. Second, converting part of the debt into equity reduces current debt service. Together, these steps lower the interest burden and the real rate of growth required to service the debt. The debt burden becomes manageable. The losses are shared by the debtors and creditors. The debt shrinks, but the debtors receive a better guarantee.

## Conclusion

Having traced the debt problem from its causes to some proposed solutions, we can conclude by noting that there is as yet no reason to believe that this period of financial distress must end in a crisis or a breakdown of the financial system. To reduce the risk of a crisis, however, we must change policies. The system of forced lending and IMF conditionality seems counterproductive. It perpetuates and extends both the debt and the problem. It is time to replace that system with one that treats these debts as we would the debts of any private borrower who is unable to meet his obligation on time.

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