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THE INTERNATIONAL DEBT SITUATION

by

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ABSTRACT

This paper examines several aspects of the problem of international debt that has been a feature of the world economy of the 1980s. First, the paper considers the sources or causes of these problems. It goes on to consider responses to those problems, the outlook for international lending, and the criteria that might be used to conclude that they have been dealt with effectively. The paper concludes by examining some of the risks to continued progress in dealing with the problem of international debt.

THE INTERNATIONAL DEBT SITUATION

Edwin M. Truman*

This paper provides from my own personal perspective an assessment of the "international debt problem;" where matters stand and what remains to be done? I address five questions.

QUESTION 1: What is the "international debt problem"?

QUESTION 2: Is the debt problem behind us?

QUESTION 3: What is the outlook for international lending?

QUESTION 4: At what point can we reasonably conclude that the international debt problem is behind us?

QUESTION 5: What is the prognosis for and what are the major risks to continued progress in handling the international debt problem?

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I. WHAT IS THE "INTERNATIONAL DEBT PROBLEM"?

Many observers have argued that the international debt problem is primarily a political problem, not an economic problem. Indeed, some economists espouse this view. Rudiger Dornbusch of the Massachusetts Institute of Technology has been quoted as saying, "Solving debt problems is mostly politics, not economics. Yet today, unlike the 1920s or 1930s, the problem is made to look as if it were solely an issue of economics." [Silk, 1985]

There is some truth in this viewpoint. International debt problems, like exchange rate problems, inherently involve the citizens of more than one country and, thus, the policies of more than one country; their solution, at a minimum, can be aided by international cooperation. From another perspective, a commitment by the political leadership in a borrowing country to the process of external and internal adjustment is essential to the successful resolution of its international debt problems. Moreover, in countries with the most severe adjustment problems, failure to solve such economic problems ultimately will adversely affect political stability.

Accepting the proposition that the problems of international debt have political dimensions is not the same as saying that a solution to those problems is likely to be advanced by a summit meeting between the heads of state or government of the seven major industrial countries and their counterparts in the eleven countries in Latin America that are members of the Cartagena Group.

Whatever one's school of economics, it is useful to look at some facts. What are the static dimensions of the international debt problem? Everyone uses a slightly different set of figures to illustrate the international debt problem, but let me cite a few with which I am comfortable.

At end of 1984, the combined, gross external debts of non-OPEC developing countries, OPEC members, and East European countries amounted to about $940 billion. Some might regard this as a large number. However, as of the same date, the debt of the U.S. government in the hands of the public -- at home and abroad -- was about 30 percent larger, and recorded U.S. public and private sector debts to foreigners were about $875 billion. What is at issue with respect to these debts is not their absolute size but, rather, the capacities of the economies that incurred the debts to service them in the future.

Twenty-one borrowing countries accounted for two-thirds of the external debts of all the developing countries (OPEC and non-OPEC) and Eastern Europe. These borrowers each had a minimum of about $10 billion in gross, external debts at the end of 1982. They include seven countries in Latin America (Brazil, Mexico, Argentina, Venezuela, Chile, Peru and Colombia), six countries in Asia (South Korea, Indonesia, the Philippines, India, Thailand and Taiwan), five East European countries (Poland, the USSR, Yugoslavia, East Germany and Romania), and two oil-producers and one other country in Africa

(Algeria, Morocco and Nigeria).[1]

The concentration of debts to banks is even greater: the same 21 countries account for more than three quarters of all bank claims on the developing countries and Eastern Europe as of the same date.[2] In other words, the debt problem, at least in terms of a significant threat to the smooth functioning of the international financial system, can be viewed as involving a limited number of borrowing countries.[3]

It is important to remember that claims on these countries are held by banks in many countries -- not just by banks in the United States. The share of U.S. banks in total bank claims on developing countries and Eastern Europe can be estimated at less than 25 percent as of the middle of 1986. U.S. banks hold one quarter of all banks' claims on non-OPEC

[1] There is a certain inaccuracy in all of these figures and a certain arbitrariness in the classification of countries. My classification has left out a few European countries (Greece, Portugal, Spain and Turkey) as well as Egypt and Israel.

[2] This estimate is based on the BIS quarterly series for December 1982; the share based on the revised series first released for December 1983 is a few percentage points lower. For an excellent guide to statistics on international lending by banks, see Mills, 1986.

[3] This is an oversimplification in two respects: a number of smaller countries have proportionately more serious debt problems and if these problems are mishandled, they too could have systemic implications.

developing countries, less than one fifth of claims on OPEC members, and less than one tenth of claims on Eastern Europe. The lesson I draw from these statistics is that while the U.S. banks make up the largest single group of international lenders to many of the heavily indebted countries, they are far from alone.

This situation has had two important implications for the handling of international debt problems: First, a large number of banks in addition to other lenders around the world are involved in lending to any particular borrowing country (in some cases, 500 to 600 banks alone); this has complicated the organization of responses to crisis situations. Second, in most cases a substantial number of "free riders" -- banks and governments in their home countries -- have been prepared to see U.S. banks or the U.S. government take the lead and the financial responsibility in "managing" such situations.

Figures such as those I have cited on the size of borrowing countries' external debts can provide at best only a bare statistical perspective on the basic problem. That problem arose from an abrupt change in the perceived capacity of these countries to carry, manage, and service their external debts. The causes of this change in perception, which is conventionally dated in the second half of 1982 but, in fact, occurred gradually over several years during the early 1980s, can be divided usefully into two categories: proximate and fundamental.

Among the proximate causes, I would include various changes in the environment of international lending: recession in the industrial countries, the deterioration in the terms of trade of the non-oil developing countries (by almost 12 percent for these countries on average from 1979 to 1982, as market prices of non-oil primary commodities declined by 18 percent [IMF,1984]), and increases in nominal and real interest rates. These changes were part of a world-wide process of disinflation that began in the late 1970s but did not become a generally recognized feature of the international economic environment until the early 1980s.

Two aspects of these changes are not widely appreciated. First, part of the rise in nominal interest rates in the late 1970s only compensated for the higher inflation in that period. This phenomenon implied increased current account deficits for the borrowers.[4] The increase in this so-called inflation component of nominal interest rates led to higher interest payments which are recorded as part of the current account; this increase in the deficit generated a need for increased net capital inflows in nominal terms in order to maintain a fixed real value of the outstanding debt. In the

[4] The World Bank has estimated [IBRD, 1985, p. xiii] that the average interest rate on new long-term loans to public and publicly guaranteed borrowers from private sources increased steadily from about 8 percent in 1976 and 1977 and less than 10 percent in 1978 to a peak of more than 14 percent in 1981. From 1979 to 1981, net interest payments by the non-OPEC developing countries increased by 120 percent.

absence of such additional borrowing to cover the higher inflation premium, the real value of the debt would have declined. To the extent that the increase in the combined current account deficit of the non-OPEC developing countries and the accelerated borrowing to finance those deficits were merely a reflection of this phenomenon, the deficits and the debts were not particularly troublesome.[5] In the event, the borrowing countries did not have much difficulty borrowing in the late 1970s to cover the enlarged inflation premium in nominal interest rates.

The actual situation regarding interest rates in the late 1970s and early 1980s was more complicated, which brings me to my second point. In the late 1970s, many developing countries could borrow on international capital markets at negative real interest rates -- meaning that the interest rate they paid on dollar loans was less than the inflation rate in the United States. It has been estimated that from 1977 to 1980 interest payments in real terms on the net external debt (gross debt less official reserves) of the non-OPEC developing countries declined by 1 to 4 percent of these countries' exports of goods and services in each year [Terrell, 1984, p.757].

Under these circumstances, one might say that a country would have been foolish not to borrow extensively in international capital markets if it had the opportunity to do

[5] See Dooley *et al.*, 1983, for a more complete discussion of this point.

so. However, most of this borrowing was at floating interest rates and by the early 1980s the relationship between those rates and inflation had changed dramatically, as real interest rates rose sharply in 1981 and 1982. At the same time, with recession in the industrial countries and declining commodity prices, the nominal value of the borrowing countries' exports was essentially unchanged.

Recession in the industrial countries, deteriorating terms of trade, and higher real interest rates were the proximate causes of the international debt problem, but there were also more fundamental causes.

I would include among this, more important, second set of causes of the international debt problem the extent of lending by commercial banks around the world to the developing countries. Whatever the driving force behind such lending, and I suspect there were many forces, we can safely say, at least in retrospect, that it was excessive.

Fundamental problems on the side of the borrowers also contributed importantly to international debt problems. One problem was the implicit assumption by the leaders and advisors of the borrowing countries that real interest rates would remain negative forever, that inflation would float away tomorrow the debts incurred today, and that real interest rates would not rise. This failure might be regarded as merely a case of bad judgment, but a plausible excuse does not eliminate the need to suffer the consequences. An even less excusable failure on the part of the borrowing countries was the tendency to finance a growing proportion of their current account deficits through debt rather than through equity (encouraging borrowing from banks rather than direct investment), on commercial terms rather than on concessionary terms, and at floating interest rates rather than at fixed interest rates.

Finally, one must acknowledge, at least in retrospect, that many borrowing countries followed inappropriate macro-economic and micro-economic policies -- too little investment and too much consumption, too much government direction of the economy, too many incentives for capital flight -- although one result in some countries in the short run was a welcome expansion in economic activity. Real gross domestic product grew on average at an annual rate of 5.6 percent in the non-oil developing countries for the four-year period from 1977 to 1980, the same rate as in the 1967-76 period. Commenting on this record, one observer has noted, "successful use of borrowed capital made by the advanced developing countries during the 1970s caused almost as much concern as the more recent suspension of debt service by some of them ... [giving rise now to] covert pleasure at the present plight of some developing countries and their bankers."[6] Meanwhile, from 1977 to 1979 the industrial countries also matched the 3.7 percent average annual growth rate of real output that they recorded in the previous ten years, but growth dipped to 1.3 percent in 1980 [IMF,1984]. We know today that

[6] Mendelsohn, 1984, p.5.

this dip was a symptom of problems yet to come; economic growth in the industrial countries averaged the same rate for the next three years, but this was not the standard forecast at the time.

My division of the causes of the international debt problem between proximate and fundamental is essentially arbitrary. Another approach is that adopted by Enders and Mattione. They estimate that between 1979 and 1982 the seven major borrowers in Latin America experienced cumulative external shocks of $42.3 billion from terms-of-trade deterioration, higher oil prices, and higher interest rates. They also calculate that these countries had an increased external financing requirement of $93.2 billion -- more than twice the size of the collective external shock -- consisting of an enlarged current account deficit of $55.7 billion and capital exports of $37.5 billion.[7] These capital exports, also known as flight capital, were a manifestation of one of the fundamental causes of the debt problem -- macro-economic policies in the borrowing countries that failed to inspire the confidence necessary to induce domestic savings to stay home. (Today, international commercial banks complain about being asked to finance capital flight that they financed voluntarily in the late 1970s and early 1980s.)

A similar but somewhat more sympathetic view is presented by Anne Krueger who notes that by most objective

[7] Enders and Mattione, 1984, p. 22.

criteria the advanced developing countries as a group were "warranted" in increasing their international borrowing in the late 1970s, since their indebtedness was not increasing relative to their incomes and borrowing costs were low or negative. However, by the time conditions changed in the early 1980s -- borrowing costs rose and ratios of debt to GNP also increased -- these countries were forced in the short run to borrow more at a time when their sustainable levels of external debt were declining and at a time when the warranted size of their current account deficits was sharply reduced![8]

The problems of international debt have had a wide range of impacts depending in large part on the particular situations of the individual borrowing countries. The individual borrowing countries were differently situated when their problems started to emerge, their policy responses differed, and the implications of their particular problems for the smooth functioning of the international financial system depended to a considerable degree on factors beyond their immediate control.

Viewed in this light, it was no accident that the so-called case-by-case approach to dealing with these problems was adopted; each case, indeed, has been different. However, in its first phase in 1982-83 this case-by-case approach was implemented using a common overall framework with four main elements: (1) appropriate adjustment actions by the borrowing

[8] Krueger, 1984, pp. 31-32.

country, (2) in conjunction with those adjustment programs, restructuring of existing debts to banks as necessary and continued lending by banks on a moderate scale, (3) official bridge financing in special situations while the adjustment and financing programs were being put together, and (4) an increase in the financial resources of the International Monetary Fund (IMF), which was destined to play a central role in the overall process.[7] Of course, the entire adjustment effort would have foundered in the absence of a hospitable economic environment in the industrial countries in terms of providing expanding markets to which the borrowing countries had access for their exports. In this respect, it was fortunate that the recession in the industrial countries reached its bottom in the closing months of 1982, and it was also fortunate that the United States was, at least for a while, in a position to absorb in its own external accounts much of the external adjustment required of the developing countries.

This being said by way of background, whose responsibility is the debt problem? I would submit that the debt problem is one that necessarily involves almost every country whether it is a net borrower or a net creditor. From the parochial viewpoint of the United States, the "international debt problem" is one that reinforces the growing awareness in recent years that we live in an interdependent world.

[7] See Volcker, 1982, for an early exposition of the overall strategy.

II. IS THE DEBT PROBLEM BEHIND US?

In the fall of 1982, when the "debt crisis" was on the front pages of the newspapers, many observers felt that the cooperative, case-by-case approach to handling that crisis would not work. Some argued that the approach itself merely involved the application of one or more "Band-Aids" to the situation. Others argued that the main pillar of the approach -- the implementation of effective adjustment programs by the borrowing countries -- would crumble under the weight of internal political pressures.

No one predicted in 1982 that the combined current account deficit of the non-OPEC developing countries, which had roughly doubled in two years to more than $80 billion in 1981, would shrink by more than $60 billion by 1984. Even more impressive was the fact that the combined current account deficit of the seven largest Latin American borrowers, which was about $35 billion in 1981 and 1982, was eliminated in 1984. As might be expected, essentially all of this adjustment took place in the trade account. These Latin American countries already had a small trade surplus in 1981-82 which became a substantial surplus in 1984 of about $40 billion. In part, because of the recession in the industrial countries and, in part, because of the general weakness in these countries' terms of trade, most of the initial expansion in trade balances took the form of reduced imports by the major Latin American countries, which were almost cut in half between 1981 and 1983 but began to rise again in 1984. Meanwhile, exports declined between 1981 and 1982, were essentially unchanged in 1983, and rose by about 12 percent in 1984. Moreover, in most of these countries economic activity increased in 1984 but, with the important exception of Brazil, slowed in 1985.

This kind of progress on the external side helped to lay the groundwork for some countries to move into a second phase in dealing with their adjustment problems. One of the principal features introduced in this second phase has been the negotiation of multi-year rescheduling arrangements (MYRAs), which are designed to take the "mountain" of maturities of debts to foreign commercial banks coming due over the balance of the 1980s and transpose them into a smoother sequence of repayments extending well into the 1990s.

The MYRAs are based on the assumption that the new repayment schedules can be met in practice through a resumption of normal market borrowing and on medium-term projections for the external accounts of the countries involved. For these projections to have credibility, the commercial banks as well as the IMF feel that the borrowing countries must establish in advance a plausible record of adjustment.[10] As one

[10] The Managing Director of the IMF signaled his approval of this second-stage approach in a speech before the International Monetary Conference on June 4, 1984 [de Larosiere, 1984]. Less than a week later, this approach was endorsed at the London Summit.

test of the establishment of such a record, the commercial banks tried to rule out combining MYRAs with additional "involuntary" lending.

The approach was first used for Mexico, and Venezuela soon followed. Negotiations with Brazil were suspended in 1985 when that country indicated that it did not want to continue under the IMF's wing, but a limited multi-year rescheduling agreement was reached with Yugoslavia, and Ecuador and Uruguay now have MYRAs.

An interesting issue in these longer-term financial arrangements has been the question of the appropriate role for the IMF. The Fund acted as a catalyst in the first phase as countries came to grips with their debt problems, temporarily providing its own resources in support of adjustment programs that met its rigorous standards and mobilizing other lenders to provide additional financial support. The question has been whether the IMF can really cut the apron strings, on the one hand, and whether the banks want the IMF to do so, on the other.

In the event, a procedure of "enhanced Article IV consultations" has been established under which the IMF will have for an extended period a monitoring role with respect to the policies and performance of the countries with the MYRAs but will not have direct responsibility for guiding the process of further adjustment and will not participate in its financing. It can be argued that success in the entire effort to resolve the "international debt problem," as well as the future of the IMF, depends on the skill and delicacy with which the IMF performs this unique assignment.

Are the problems of international debt behind us? No. Has progress been made? Yes. Is the end in sight? Not really.[11]

In contrast with this cautiously optimistic view, observers such as Lawrence Brainard [1985] argued forcefully in early 1985 that the system had not so far dealt with the structural problems of economic development that were involved in the origins of the crisis -- the fundamental factors that I referred to earlier. He argued that growth in the industrial countries was not the answer[12] especially when it is driven by large U.S. budget deficits and accompanied by an overly strong dollar. He also argued that either the IMF or the commercial banks (or both) were deluding themselves if they thought that MYRAs and the accompanying arrangements governing international lending on a voluntary basis were the final

[11] See the 1985 pronouncements of Chairman Volcker. See also the introductory material in the *World Debt Tables* published by the World Bank, 1985. The Morgan Guaranty Trust Company [1984, p.1] declared in October 1984, "Lasting resolution of the LDC debt problem now is nearing the halfway mark in important respects." However, two years later, the same institution [1986, p.2] declared, "Recognition of the positive accomplishments of the last four years does not deny that LDC debt problems will continue a great deal longer than originally supposed."

[12] This appears to be an implicit criticism of Cline's work; see Section V below.

answer.[13]

It is clear that remarkable progress had been made by early 1985 in dealing with the international debt problem. Moreover, predictions of domestic political instability in the borrowing countries had, so far, proved to be wrong. Nevertheless, in 1985 the macro-economic environment was not as conducive to "adjustment" as it was in 1984. With lower growth in the industrial countries, the exports and trade surpluses of the developing countries declined, but interest rates and payments also eased, and current account positions were in the aggregate roughly unchanged. Partly as a consequence of this stalling out of the process of recovery, tensions rose between pressures for continued adjustment on the part of the borrowing countries -- accompanied by some form of international monitoring -- and the natural desire of those countries to resume economic growth in an environment in which their political leaders could respond principally to the demands of their own citizens.

These considerations contributed to the environment in which the Program for Sustained Growth, presented by the U.S. Secretary of the Treasury in October, 1985, in Seoul, was formulated. Another contributing factor was the outlook for international lending which is reviewed in the next Section.

[13] For an even more pessimistic analysis see Kaletsky, 1985, who observed that the current calm might be deceptive and that in the past most defaults occurred after the initial crisis period was over.

III. WHAT IS THE OUTLOOK FOR INTERNATIONAL LENDING?

Many observers are highly skeptical that there will be an early resumption of voluntary lending by banks to developing countries on a substantial scale. The argument is made that the international economic environment will continue to be severely disturbed and not conducive to such lending, that the banks feel they have lost control over such lending decisions as a result of their experience with "involuntary" lending in recent years, and that the debt levels of the borrowing countries will inevitably remain high.[14]

On the other hand, some observers recall the explosion of international lending by the banks in the 1970s. Much of that explosion occurred after a series of smaller "debt crises" in the middle of the decade that were associated with the first oil shock and the recession that followed. The question, therefore, is whether it can happen again -- whether lending by commercial banks to developing countries will, after a lull, resume again on a substantial scale. Indeed, after Brazil got caught up in the debt crisis in the fall of 1982, the government's adoption of a piecemeal approach to its economic and financial problems, rather than the more comprehensive strategy used by Mexico, was predicated on the assumption that by the end of 1983 Brazil would be back in the market for jumbo loans. This choice was based in part on Brazil's experience

[14] See, for an example of this view, Brainard, 1985.

with a mini-readjustment in 1981-82.

Some of the observers most inclined in the past to be critical of the process of international lending by banks and of the quality of supervision and regulation applied to that lending appear to believe that the situation has changed permanently [Lissakers, 1984]. This conclusion is based, in part, on the passage of the International Lending Supervision Act of 1983 as part of the package of legislation associated with Congressional approval of the increase in the U.S. quota in the IMF and the expansion and enlargement of the General Arrangements to Borrow (GAB).

That Act (Title IX of Public Law 98-181) among other things directed the U.S. federal banking agencies to intensify their evaluation of banks' country exposure and transfer risk, to take these factors into account in evaluating the capital adequacy of banks, and to increase the amount of reporting and disclosure by banks of their international lending activities; it also provided for the maintenance of special reserves by banks on their international assets whenever the quality of those assets has been impaired by the protracted inability of public or private borrowers in the foreign country to make payments on their international indebtedness, and for the amortization of fees on restructured loans over the life of the loan.

At the present time, banks are not eager to lend to developing countries. In 1984, banks in the BIS-reporting network increased their claims (adjusted to remove the influence of exchange rates changes) on non-OPEC developing countries by about 3 percent after an increase of close to 4 percent in 1983. Claims on members of OPEC declined by about 1-1/2 percent; claims on East European countries were essentially unchanged after declining for two years in a row. In 1985, reporting banks increased their claims on the East European countries (especially on the USSR), but claims on the non-OPEC developing countries increased no more than in 1984 (and those on the 15 heavily indebted countries associated with the "Baker Initiative" were essentially unchanged), and claims on OPEC members continued to decline. In the first half of 1986, bank claims declined vis-a-vis both the non-OPEC developing counties and the "Baker Countries."[15]

The slow pace of lending included lending by U.S. banks, and this reduced lending to developing countries, coupled with sizable increases in these banks' capital in recent years, has produced a significant decline in U.S. banks' claims on these countries relative to their capital. For all U.S. banks[16] claims on non-OPEC developing countries

[15] These data on net new lending by international commercial banks should be interpreted cautiously. The estimates are based on changes in stocks which are affected by the imperfections of the adjustments for exchange rate changes as well as by other factors, e.g., charge offs, that influence the level of the stock figures. See Terrell and Mills, 1985.

[16] In fact, all U.S. banks completing the Federal Financial Institutions Examination Council's "Country Exposure Lending Survey," 189 banks as of June 1986.

declined from a peak of 149 percent of capital in June 1982 to 84 percent as of June 1986. For the most heavily exposed U.S. banks, the nine major money-center banks, the decline has been from 223 percent of capital in June 1982 to 134 percent in June 1986.

How about the future? An analysis performed in 1984 by Henry Terrell examined the many factors that influence such a projection. He developed a basic projection from a base of December 1983 consistent with a resumption of reasonable economic growth in the non-OPEC developing countries. His key assumptions were:

1. These countries would receive $40 billion in debt financing in 1984 and 1985.
2. That source of financing would grow by 6 percent a year through 1990, which implies an increase in real financing as long as inflation is less than 6 percent.
3. Half of the financing would come from banks, compared with about two-thirds in the late 1970s.
4. The U.S. banks' share of net financing from banks would be about 40 percent. (As we have seen the actual share of U.S. banks is less than one-third.)
5. U.S. banks' capital would increase at about 9 percent per year.

The assumptions ensured the projection of a continued decline in exposure ratios. It is interesting to note that by June 1985 actual claims of U.S. banks relative to capital had declined to below the point Terrell had projected for the end of the decade. Indeed, for all U.S. banks, claims on the non-OPEC developing countries as a percent of capital in June

1985 were below the previous low in December 1977 -- the earliest date for which these data were assembled on a consistent basis. The nine money-center banks were only 2 percentage points above that low and are now well below it.

It is too early to draw firm conclusions from these data. One can, however, speculate on the reasons for the experience of the past three years. The full explanation, no doubt, lies on both the supply side and the demand side. On the supply side, two factors are relevant: U.S. banks have been reluctant to increase their international exposures, and the banks covered by the calculations reported above increased their capital by two thirds over the four years after June 1982. On the demand side, the current account results for the non-OPEC developing countries were better than expected in 1984 and 1985, and as noted above bank lending to the heavily indebted countries tapered off in the second year.

A more serious concern is what will happen if this fortuitous combination of supply and demand factors does not continue to prevail. What if the developing countries need more external financing than has been assumed to achieve the resumption of growth that has been postulated, and it is not forthcoming from the international banking community?

One possible consequence would be that the financing would simply not be available and more internal adjustment would be required for the countries to achieve their desired growth rates. This may be desirable in any case, but it could also be disruptive to expectations and to the stability of the international financial system. Indeed, the observed reluctance of commercial banks to resume lending to most developing countries in 1985 was one of the factors motivating the U.S.-proposed Program for Sustained Growth and its call for net new lending of 2-1/2 to 3 percent per year to a group of heavily indebted, middle-income countries during 1986-88. Banks that had restored relatively healthy ratios of claims relative to capital were acting as if their objective were to induce the borrowing countries to compress their current account deficits until they no longer needed net new money from the commercial banks. At that point they seemed prepared to grant a country a MYRA and close down their international lending departments!

A second possible consequence of the drying up of external financing would be that the gap would be filled by additional bilateral or multilateral assistance. Additional bilateral assistance is highly unlikely: most of the borrowing countries with large borrowing needs are relatively well off and generally are no longer eligible for most bilateral economic assistance programs, except in market-failure cases such as during the depths of the debt crisis and in connection with export credits. An expanded role for the multilateral development banks (MDBs) now appears to be more likely; these institutions have been asked to play a major role in the Program for Sustained Growth. However, the U.S. Secretary of the Treasury made clear in his proposals in Seoul that stepped-up disbursements by the MDBs should only be available to the extent that a country qualifies for them and the commercial banks also play an appropriate role in each country's overall external financing.

A third possible long-run consequence of the drying up of external financing would be for the countries themselves to act to attract more non-bank capital inflows either through direct investment or through portfolio investment. However, the borrowing countries themselves will have to take the lead in this matter. In fact, one can detect some change in attitudes among developing countries about such sources of finance, and the Program for Sustained Growth is intended to support this type of change.

For many years, developing countries have had a general aversion to many forms of direct investment. Under the pressure of circumstances this may be changing. However, even in those countries where such investment has been generally welcomed in the past, other features of the economic environment -- price controls and heavy government regulation of the economy -- are often not conducive to such inflows.

In the case of portfolio investment, the challenge is even greater. Investors among the non-bank public are used to a high degree of professionalism and disclosure. They demand well-developed and open capital markets, where funds can be both invested and withdrawn without the threat of government interference or abrupt changes in the rules of the game. However, if the challenge is greater in this area, so too are the potential benefits to the borrowing country, since the improvements in domestic financial markets required to attract this kind of investment from abroad are likely to contribute to a better allocation of scarce capital and to the retention of domestic savings at home.

IV. AT WHAT POINT CAN WE REASONABLY CONCLUDE THAT THE "DEBT PROBLEM" IS BEHIND US?

After World War II, the IMF was established and dedicated to the constructive management of the international adjustment process; that process has been analyzed in terms of offering a trade-off between financing and adjustment. Once the adjustment process has been set in motion, the question is how rapidly it should be completed and, importantly, how constructive it will be in terms of the smooth functioning of the system. Traditionally, the success or failure of these efforts has been evaluated in terms of the immediate results in the external accounts of the countries utilizing the resources of the IMF and in terms of the effects of their adjustment actions on the liberal international trade system. The reduction of external deficits is viewed as good as long as it is not accomplished through "measures disruptive of national or international prosperity."[17]

This traditional framework has faced a challenge from two directions in recent years: from those who criticize an

[17] See Article I(v) of the Articles of Agreement of the International Monetary Fund.

excessive focus on the external manifestations of the workings of the adjustment process and from those who, from one perspective or another, question the workings of the adjustment process from the standpoint of what might be described as international equity.

In the first group, are those who argue that the adjustment process will not be complete in the borrowing countries until they have taken the internal steps necessary to bring about sustained growth -- some would add, at reasonable inflation rates. I would accept this proposition as the first of three minimum tests of whether the debt problem is behind us.

What are these steps? They involve in large part actions in the micro-economic area. Relative prices must be allowed to adjust more freely. Two key elements in a country's price system are exchange rates and interest rates. The exchange rate, beyond its role in the process of balance of payments adjustment, can have a powerful effect in bringing about growth and structural adjustment in the economy. Interest rates can have an equally powerful effect in re-establishing confidence and attracting back flight capital. They must in each case be realistic in macro-economic terms -- for example, with respect to the overall external adjustment needed -- and be allowed to affect the micro-economic workings of the economy.[18]

[18] Exchange rates and interest rates are traditional concerns of the IMF; in part for this reason, the IMF has been assigned a continued central role in the Program for Sustained Growth, although the Program as a whole has a medium-term growth perspective.

More broadly, the economies of the borrowing countries have to be opened up more to the influences of competition at home and abroad. This means reducing the role of the public sector in the day-to-day management of the development process. However, these kinds of structural changes are politically difficult to implement and substantial results will not come easily or quickly. The enhanced role of the IBRD, and the other MDBs, envisaged under the Program for Sustained Growth is intended to facilitate this difficult process primarily through the increased availability of fast-disbursing structural or sectoral adjustment loans along with, in some cases, associated financing from the commercial banks.

It may well be in a number of cases that the external adjustment has proceeded too rapidly and in an unbalanced fashion. However, not all the blame for any such bias should be placed on the international financial institutions. Without their direct and indirect financial assistance, the adjustment forced on the borrowing countries by their external debt problems would have been even more abrupt than it was. Moreover, the political leaders in the borrowing countries have incentives to maximize the speed of their countries' adjustments. Their external creditors want it, and the borrowers may sense that once it has taken place the creditors will get off their backs and, perhaps, let them go back to business as usual -- including making new loans available -- without forcing them to take politically difficult decisions with respect to internal economic policies.[19] In

[19] As was noted in Section III, the part of this story about the resumption of lending by banks does not yet appear to be in the cards.

traditional terms, we may have had too much external adjustment and too little financing.

This brings me to what I described earlier as the "equity" issue. How much external adjustment should the borrowing countries undertake? At what point have they adjusted too much on the external side? Clearly one cannot lay down a general rule and apply it uniformly to every borrowing country. Clearly, also, this question has a short-run dimension as well as a longer-run dimension.

The basic proposition is that the borrowing countries that are now having difficulties servicing their external debts must adjust their economies to the level of their external debts or vice versa. Each country can do this by improving the capacity of its economy to service its debts, or a country can try to increase the rate of growth of its economy relative to the rate of growth of its debt.

In the short run, the second approach may involve running a current account surplus, which implies that the country on a net basis is reducing its external debt.[20] This may be the quickest and easiest way to adjust an economy's debt to its capacity to service that debt. It is the

[20] The qualification "net" is important; many of these countries incurred external debts on the part of the public sector which in effect did not finance current account deficits but financed large private capital outflows. To the extent that internal policies are changed and that outflow is reduced or reversed, less gross borrowing by the country as a whole is needed in the future.

only way that a country can actually pay off its debts on a net basis.

The more interesting question is the longer-run issue of whether these countries should be net capital importers. In theory, this issue should be settled on the grounds of the marginal productivity of capital in the country compared with that in the rest of the world. Many academic papers have been written on this issue, examining the implications of the presumption that developing countries, in particular, with their relatively low ratios of capital to labor, should have higher marginal productivities of capital and, therefore, should be net capital importers.

In the present circumstances, this question has a political dimension as well. Political leaders in those countries feel strongly that there should be a net flow of real resources from abroad to their countries. This net flow is the real manifestation of the current account deficit and the counterpart of the net capital inflow. This issue also has a political-economic dimension in the industrial countries. As long as the developing countries run sharply reduced current account deficits, or even surpluses, the industrial countries as a group must run reduced surpluses or deficits. This forces a degree of economic adjustment on the industrial countries that has not been universally welcome. Thus, increasingly in the United States responsible people, such as U.S. Senator Bradley [1986a, 1986b], have linked an improvement in the U.S. trade position with resolution of the "international debt problem."

This entire question of the appropriate level of external borrowing, or net capital inflow, has been complicated by some of the terms used. I have tried in my discussion to link a country's current account position and the net flow of real resources to a country with the net increase in its nominal debt. Aside from the question of unilateral transfers (gifts), this is the correct framework. However, much of the literature tends to associate the net flow of real resources to a country with its trade balance. As we have seen, many of the major borrowing countries have been running substantial trade surpluses for some time. Does this mean that they are not receiving a net flow of real resources? The answer is no, as long as they are running current account deficits. Despite what some economists and politicians might say, interest payments for the present use by an economy of past capital inflows is as much an import as are payments for its imports of machinery, wheat or oil. This proposition holds regardless of the use that was made of those funds and regardless of the terms of the borrowing; it is a matter of economic accounting, not ethics. If a country does not want to use the capital any more, it can repay it by running a current account surplus.

Even such institutions as the World Bank have contributed to the confusion on this point. The Bank traditionally uses a concept of "net transfers" to describe the difference between disbursements of long-term lending to a country and the service payments (interest and amortization) on its long-term debt.[21]

All of this, of course, is related to the size of the real adjustment that is facing some of these developing countries. Their more thoughtful leaders point out that, even on the basis of optimistic projections, incomes per capita in their countries generally will not have returned to the level of 1980 until 1990. They have difficulty explaining to their fellow citizens why this is so, and one must admit there is no simple explanation. These economies were advancing at annual growth rates of 5 percent in real terms from 1974 to 1980; why did this record have to end? Thus, Cline [1984, pp. 194-97] refers to the "lost decade" of the 1980s during which he estimates that the GDP per capita of seven major developing countries (Argentina, Brazil, Chile, Mexico, Peru, the Philippines, and Venezuela) will rise at an average annual rate of only 0.7 percent. Moreover, to the extent that these countries' external deficits shrink in real terms, the increase in domestic absorption -- consumption, investment and government expenditures -- will be less than the increase in domestic production because some of that production will be exported or merely replace imports.

The simple explanation of this situation is that these countries were living beyond their means in the late 1970s -- advancing at a rate that was unsustainable -- though few of

[21] In the 1985 version of its *World Debt Tables,* the World Bank tried carefully to explain that this is an analytical concept not a normative concept [IBRD, 1985. p. xii].

their leaders or citizens recognized it at the time. The more complete and more correct answer lies in the complex interactions of the factors affecting the international economic environment that I discussed earlier. The borrowing countries were not able to insulate their economies from the influence of these factors just as the industrial countries were not able to insulate their economies from them or from the feedback effects of the adjustments forced on the developing world.

It is because of these considerations that the U.S. proposals on debt that were presented in Seoul in October 1986 placed an emphasis not only on restoring the conditions for sustained growth but also on a record of actual growth. In terms of the question asked at the start of this Section, I would, therefore, include the return of incomes per capita to at least pre-crisis levels in the borrowing countries as a second minimum test of whether the systemic problem of international debt is behind us.

As we have seen, the restoration of incomes per capita to pre-crisis levels may take until the end of the decade. By that time, the borrowing countries will not have paid off their debts. Instead, there should have been -- my third test -- a resumption of voluntary lending to these countries that will enable them to service both the interest and principal on their old debts on their original or restructured schedules and enable them to continue to take on new debt that will, in effect in most cases, at least replace the old debt. Without such normal access to international capital markets, the borrowing countries cannot be said to have overcome their external debt problems. One obvious implication of this rather simple test is that arrangements in the interim should be designed to facilitate the resumption of normal market access by retaining as many of the elements of voluntary lending operations as possible; in that regard, such arrangements could delay such access to the extent that they involve the forced writing down of existing claims.

This is the basic test that proposals that call for mandatory forgiveness of interest and principal by private and official creditors do not pass. Such an approach would impose uncompensated losses on those creditors and would delay, rather than hasten, the return of the borrowers to normal market financing. Moreover, such proposals have other shortcomings. First, is unclear how such an approach could be enforced on the hundreds of banks and other creditors involved around the world. Second, it would be difficult in practice not to apply such an across-the-board solution to the "less deserving" borrowers in terms of their records of economic reform while applying it to the "deserving" borrowers. Third, the threat of such an imposed solution would be likely to inhibit new lending to those developing countries that still enjoy access to international financial markets. Thus, it would appear at this stage that there is no viable alternative approach to the complex problem of international debt other than to rely on a strong sense of mutual interest and common commitment by the borrowing countries, the commercial banks, the international institutions and the creditor governments to a responsible process of restoration of growth and stability.

V. WHAT IS THE PROGNOSIS FOR AND WHAT ARE THE MAJOR RISKS TO CONTINUED PROGRESS IN HANDLING THE INTERNATIONAL DEBT PROBLEM?

The borrowing countries and lenders alike should recognize at this point that the international debt problem is not going to be one that lends itself to quick, magical solutions. All parties should be prepared for the long haul. This was one of the essential messages of the Baker Initiative.

The key to the progress in handling the international debt problem to date has been the external adjustment efforts of the borrowing countries. A collective failure of those countries to follow through on their efforts could easily jeopardize the accomplishments of the past four years.

For those countries that have largely completed the adjustment of their external accounts, the focus must shift now to the more politically sensitive and less glamorous task of further internal adjustment while sustaining the external adjustment that has been achieved. Only through this kind of follow through over a period of many years will these countries lay the foundation for a resumption of sustained economic growth.

In the meantime, the rest of the world must understand that all progress is not linear, and countries will not all advance at the same rate. In the end, some countries may not advance as far as others. Thus, the case-by-case approach will continue to be required across countries and over time.

Given the nature of the difficult external and internal adjustment efforts that still lie before the borrowing countries, a second major risk is that the international macro-economic environment will not remain supportive of those efforts.

Numerous studies have examined the implications of different global macro-economic scenarios for the evolution of the debt problem.[22] The results of these studies depend in general on assumptions about real economic activity, inflation rates, interest rates and exchange rates in the industrial countries; on parameters linking these assumptions to the external accounts of the developing countries; and on feedback effects through the developing countries to the industrial countries.

These studies generally conclude that, under the right combination of circumstances, the debt problem -- defined in terms of some ratio involving external debt -- is likely to get better for most countries, but slowly. What the studies cannot

[22] See Cline, 1984, Dooley *et al.*, 1983, and Morgan Guaranty Trust, 1984, for relatively optimistic studies; see Enders and Mattione, 1984, for a study that reaches less optimistic conclusions based on the political costs of follow through; see Fishlow, 1984, for a study that reaches less optimistic conclusions based on his assumptions and his parameterization of the basic model.

tell us is how fast an improvement is fast enough, and they really do not address the crucial issue of internal adjustment in the borrowing countries.[23] Moreover, a close reading of these studies suggests that there is a lot of slippage in the estimates presented.

Developments to date have on the whole been better than those projected by the studies; economic activity in the industrial countries has averaged about 3-1/2 percent per year during 1984-86, compared with the 3 percent generally found to be necessary for progress in dealing with the international debt problem; and the extent of adjustment in the form of lower imports by the borrowing countries has been greater than assumed. With respect to the first factor, one should put the "overperformance" of 1984 and 1985 in the bank, so to speak, for withdrawal when the industrial world experiences a growth slowdown between now and the end of the decade, as it almost inevitably will. This is easier to say than to accomplish. The more serious concern in this respect is that most of the impetus to growth so far in the industrial countries has come from the United States. As a consequence, the United States is the only major industrial country to which the developing countries of the Western Hemisphere increased their exports between 1981 and 1984, although the other industrial countries generally shared in the cutback in imports by the developing

[23] The Enders and Mattione study is a partial exception to this generalization, and it reaches a negative conclusion.

countries of the Western Hemisphere. However, for this area of the world, as well as other regions, the issue is whether, as U.S. growth slows, the other industrial countries -- Japan and Germany in particular -- will take up the slack.[24]

A related question concerns the so-called trade-off between higher interest rates and faster growth in the industrial countries. The studies generally conclude that the short-run impact of lower interest rates by one percentage point on a particular indicator of the burden of debt service is greater than that of higher growth in the industrial countries by one percentange point, but that over the longer run the relationship is reversed as the effects of growth on the exports of the developing countries are compounded.

What these studies fail to address is the nature of this trade-off. As a first approximation, more rapid growth in the industrial countries means more nominal demand. This would tend to put upward pressure on interest rates, but the trade-off may well not be one for one. Indeed, the nature of the trade-off depends crucially on the mix of macro-economic policies in the industrial countries.

In this connection, insufficient attention has been paid to the implications for the unwinding of the debt problem of higher inflation rates in the industrial countries. Faster real growth in the industrial countries may be accompanied not

[24]Recent statements by James A. Baker III, 1986, and Paul A. Volcker, 1986, on the international debt situation have placed increased emphasis this point.

only by higher real but also by even higher nominal interest rates -- the latter because of more rapid inflation. In an environment where the developing countries implicitly face an external borrowing constraint that is expressed in nominal terms and limits the size of their current account deficits, a higher inflation premium in nominal interest rates increases nominal interest payments on floating-rate debt and, as was discussed earlier, forces these countries to reduce the real value of their external debts more rapidly.

Thus, a major risk to continued progress in handling the international debt problem could be generated by a hostile external macro-economic environment. In other words, the developing countries have a large stake in minimizing the economic mismanagement in the industrial countries. This interest was recognized in the Cartagena Group's "Declaration of Montevideo" in December, 1985; that declaration, among other things, called for the developed countries to adopt policies to ensure the return of real interest rates to historical levels.

More broadly, continued progress in handling the international debt problem could be jeopardized by a serious disruption to the international adjustment process. One obvious source of potential disruption is in the trade area. An outbreak of more severe protectionism not only would damage the external adjustment process in the developing countries but also would call into question the prospects for positive growth in these countries. This is one reason why the planned new round of multilateral trade talks is important; it would contribute to momentum in the other direction.

A second area of potential concern about the adjustment process would be a severe recession in the United States, especially if it were preceded by a rapid acceleration of inflation and not accompanied by an increase in economic activity in the other industrial countries. Success in handling the debt problem does not require 3 percent economic growth in the industrial countries year in and year out, but a reasonable expectation of a continuing moderate expansion of demand on average is necessary to ensure continued progress.

A third area of potential concern is whether the international financial institutions (in particular the IMF and the World Bank) are up to their assigned tasks. These institutions will be required to demonstrate their tact and sense of mutual cooperation as well as their technical prowess.

A fourth area of potential concern about the adjustment process is the willingness of commercial banks around the world to respond positively to proposals such as those made by U.S. Secretary Baker and make available over the next three years the needed margin of external financing in support of medium-term programs of growth and adjustment. Without a willingness to lend on roughly the scale envisaged in the U.S. proposals -- an increase in banks' claims on the 15 indicated countries of 2-1/2 to 3 percent per year during the next three years -- it is difficult to see how growth can be established and sustained in the borrowing countries and how voluntary lending can be restored. It is too early to reach firm conclusions in this area. In the year since the Baker Initiative was launched, international commercial banks demonstrably have not become more eager to increase their lending to heavily indebted borrowing countries. On the other hand, few countries have come to the banks. In part, the lack of specific results in this area reflects a reluctance on both sides. In part, it reflects the fact that the large change in international oil prices over the past 12 months has affected the capacity of borrowers to anticipate their needs and that of lenders to assess them.

Risks such as these serve to underline what is, I think, the central lesson of the experience to date in coping with the international debt situation: the economic and financial interdependence of the world today.

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