

Rewarding the Profligate and Punishing the Prudent and Poor: Some Recent Proposals for Debt Relief

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1. INTRODUCTION

At a conference organized in June 1986 by the Overseas Development Council on the future of The World Bank, former West German Chancellor Helmut Schmidt, investment banker Felix Rohatyn and the Chairman of the Federal Reserve Board Paul Volcker all suggested that the massive (\$60 billion) trade surplus of Japan be mobilized to solve what they termed as the debt problem of the Third World. Mr Barber Conable, the new president of the World Bank is quoted by the *New York Times* (3 July 1986) as saying "Clearly, there is the expectation that Japan, in view of the light defense burden it carries will participate fully in (solving) collective debt problems of the world." He characterized the Japanese surpluses as "a considerable world asset" and suggested that establishing a special facility (such as the one established by the IMF in the 1970s to tap Saudi Arabia's surplus petrodollars) to recycle them "would be one way of dealing with it."

Nearly a year ago in October 1985 at the annual meetings of the World Bank and IMF at Seoul US Treasury Secretary James Baker signaled a shift in the US approach to the debt crisis. The Baker Plan aimed to help highly indebted middle-income countries (15 were mentioned by Baker, 10 of them in Latin America) resume growth and achieve adjustment towards a sustainable debt position through the adoption of the following course of action by lenders, debtors and multilateral agencies: within the context of the (then) prevailing IMF-supervised case-by-case approach, commercial banks, the World Bank and other multilateral development banks were to increase lending to these countries. Baker suggested that the commercial banks commit a total of \$20 billion in net new lending over 1986-88 and the multilateral development banks an additional \$9 billion during the same

period. This increased net lending was to be in support of the adoption of market-oriented policies by indebted nations. Growth was to be promoted, inflation reduced and external balance restored by expanding the role of the private sector and of markets, both domestically and internationally.

The first offspring of the Baker Plan is the recent "growth-oriented" adjustment plan for Mexico, which was foisted upon a reluctant IMF (perhaps the world's last unreconstructed bastion of adjustment through austerity) by the combined pressure of the US Treasury and Federal Reserve Board and the Mexican threat of repudiation. (The IMF's reservations concerned the budgetary features of the package, not the novel real growth and oil price contingency clauses, which it supported.) The 18-month standby arrangement with the IMF provides Mexico with SDR 1.4 billion (about \$1.7 billion) in support of what is described as a comprehensive program of adjustment and structural reform. The total financing package amounts to \$12 billion of which \$6 billion is to come from the commercial banks. Mexico's economic problems had of course been intensified dramatically as a result of the drop in the price of oil.

Policies aimed at bringing Mexico's real GDP growth to 3.5% by 1987 (from recent negative growth rates of 4 or 5%) involve a variety of growth-oriented, market-friendly adjustment measures (increased public investment, current expenditure cuts, tax reform measures, market-based adjustments in tariffs and prices charged by public sector enterprises, liberalizing trade measures (Mexico is about to join the GATT) and only very mild (by traditional IMF standards) budgetary restraint (a reduction in the deficit-GDP ratio by three percentage points over 1986-87).

The aspect of the Mexican program of most interest for this discussion is the actions taken

by the multilateral organizations. In addition to the standby credit of SDR 1.4 billion, there is to be a \$500 million contingency fund to supplement investment if the economic recovery fails to materialize despite the implementation of appropriate policies. In addition there are provisions for additional financing in the event oil prices fall below nine dollars a barrel. The World Bank also increased its commitments to Mexico by \$2 billion in 1986.

The Baker Plan was soon followed by the more radical Bradley Plan for debt relief for the same group of middle-income, highly indebted countries. The exact nature and magnitude of the relief to be provided was left open. An initial suggestion involved three successive annual reductions of one percentage point in the interest rate charged on the debt. Partial write-downs (or write-offs) of debt principal could also feature. As in the Baker Plan, the debtor countries are required to liberalize their international trading arrangements and generally to adopt market-oriented reforms. In September a study commissioned by the Americas Society (Balassa *et al.*, 1986) called for the adoption of a larger-scale version of the Baker Plan, involving \$20 billion annually in capital commitments from the US and other industrial nations over the next several years. The study is skeptical about the willingness of the commercial banks to provide even the \$20 billion over three years called for under the Baker Plan and proposes a much larger role for the multilateral institutions such as the World Bank in the early years of the Plan.

Any approach to alleviating the debt problem that is likely to revive economic growth in the indebted countries and to improve their ability to service their debt in the long run is to be welcomed. Yet the Baker proposal, the suggested use of Japanese surpluses and the Bradley proposal all raise some disturbing questions both as to their feasibility and as to their desirability.

After briefly considering whether there is a global debt crisis (answer in the negative), we turn to the troubling fairness and efficiency aspects of the proposals. Fairness as between a few relatively rich (or less poor) major debtor countries with debt servicing problems, and other heavily indebted countries without debt servicing problems. Fairness as between the relatively rich troubled debtors and the large number of less indebted and very much poorer countries. Fairness as between troubled debtors whose plight is due to bad luck and those whose plight is due to bad policies.

Fairness, and incentive or moral hazard problems arise in the case of the Baker proposal, because while it provides no long-run relief to the

debtors it has become a program for passing part of the tab for the US commercial banks' developing country bad loan portfolio from these banks' shareholders, creditors and managers to the multilateral agencies. In the Conable or Japanese variant, it is the Japanese saver or taxpayer who is requested to sustain part of the loss incurred by the commercial banks.

The Bradley proposal is also subject to incentive and moral hazard problems (in addition to the already mentioned fairness problems). First, because the magnitude of the relief given to a country is in practice going to be independent of its debt servicing efforts and of the quality of its economic management, whatever the rhetoric concerning the strictly limited and highly selective and conditional nature of the relief. Second, because potential new private lenders, witnessing the *de facto* if not *de jure* "equitization" of bank debt under this proposal, will think twice before once more increasing their financial exposure in these countries.

In a nutshell these proposals, while varying in important respects, all appear to address the debt "overhang" or the problem of the existing *stock* of debt in a way that is both inequitable and likely to affect adversely the future *flow* of resources to the developing countries, particularly the poorest among them.

2. IS THERE A GLOBAL DEBT CRISIS?

To begin with there is no "collective debt problem of the world." It is primarily a problem of a few Latin American countries, that are relatively rich by the standards of developing countries. Of the 17 countries deemed heavily indebted by the World Bank, countries that owed \$446 billion out of a total of \$950 billion in outstanding total external liabilities of all developing countries at the end of 1985, 11 are in Central and South America. Just five countries, Argentina, Brazil, Chile, Mexico and Venezuela together owed \$311.7 billion. Nearly three-quarters of the debt of the five countries is owed to banks. Of the amount owed to banks, a little less than a half came from US banks.

3. FAIRNESS AND INCENTIVE EFFECTS

Undesirable features of the Baker and Bradley proposals include likely adverse effects on the future flow of private capital to the capital-hungry developing countries and lack of fairness. Any debt relief provided under these proposals

(and there is of course little if any relief other than short-term cash flow relief for the debtor countries under the Baker Plan) will benefit primarily those heavily indebted developing countries that are in serious financial trouble (e.g., Brazil, Mexico and Argentina). No such relief will be given to those equally heavily indebted countries that have stayed out of trouble (e.g., Korea). No relief either will be given to those developing countries that, while equally or more adversely affected by external or internal shocks as the debtor countries, borrowed much less or hardly at all, whether by choice or necessity (e.g., Sub-Saharan Africa). The heavily indebted countries that are experiencing serious debt financing problems and account for most of the debt, while being poor relative to the industrial countries, are typically no poorer than the heavily indebted countries that are not experiencing debt servicing difficulties. The 1984 per capita GNP of Chile is estimated at \$1,700, that of Brazil at \$1,720, that of Mexico at \$2,040, that of Argentina at \$2,230 and that of Venezuela at \$3,410. The figure for South Korea was \$2,110. The troubled major debtors are very much richer (or rather less poor) than the large number of developing countries, accounting for the vast majority of the world's population, who stand to gain little or nothing from either the Bradley or the Baker plan and may indeed end up the losers if these plans divert resources to the middle-income debtor countries that would otherwise have gone to them. They include China with a 1984 per capita GNP estimated at \$310, India with \$260, Bangladesh with \$130, Ethiopia with \$110, and Indonesia with \$540. The 36 lowest income countries in Asia and Africa had an average per capita GNP in 1984 of \$260. While per capita GNP figures are known to understate true standards of living more the poorer the country, there is no doubt that large numbers of countries that are very much poorer than the major beneficiaries, will not benefit and may indeed suffer as a result of these proposals.

To the extent that these proposals contain aid or relief, the question therefore arises: why choose these beneficiaries when there are so many whose claim for relief, based on poverty and need are so much stronger?

Countries get into debt servicing problems for two kinds of reasons: bad luck and bad management or bad policies. (Among the latter we include those that get into trouble by design.) Bad luck includes such external (to the borrowing countries) shocks as the rise in world-wide real interest rates (largely made in the USA), adverse shifts in the terms of trade (the decline in the oil price in the case of Mexico, the decline in

the price of tin for Malaysia and of bauxite for Jamaica), and declining foreign remittances due to the world recession (Greece, Turkey) or the decline in the price of oil (Nigeria). Bad luck also includes internal unfriendly "acts of God" such as the Mexican earthquake, the drought in Sub-Saharan Africa and the recent plague of locusts there.

The proposals are unfair also between different troubled debtor countries (as well as inefficient), in that they do not make the magnitude or the terms on which the relief is provided contingent on whether the country's problems are due to bad luck or bad management. Past policy performance is not taken into account. Future policy reform and performance is of course put at the center of the stage, but it is doubtful whether this can be taken too seriously, precisely because past policies (or how a country got into the current mess) are not taken into account. By treating the existing debt as a bygone and focusing exclusively on (promises of) future policies for trade liberalization, privatization, fiscal probity etc., these proposals contribute to an environment in which countries are more likely deliberately to build up their debt once more to unsustainable levels in the expectation of a Bradley Plan Vintage II when the next crisis hits. There are few credible ways in which debtor governments can pre-commit to pursuing a politically unrewarding policy long enough to turn the situation around. When the way in which the issue of the existing ("bygone") debt is settled influences both lenders' and borrowers' expectations of the terms on which future new borrowing will be serviced, bygones are not bygones.

4. MACROECONOMIC MISMANAGEMENT AND ACCENTUATION OF DEBT CRISIS

A major source of the debt accumulation in the Southern Cone countries according to Professor Dornbusch of MIT "is the extraordinarily poor performance of domestic macroeconomic policy in virtually every Latin American country" (Dornbusch, 1985). One indicator of this is the inflation rate. Compared to a modest average *annual* rate of inflation of 6% during 1973-84 in low income countries, Argentina's inflation rate was a whopping 181%, Brazil's 71%, Chile's 75%, and Mexico's 32%. Only Venezuela had a relatively low 12% rate. The indexation policies intended to soften the impact of raging inflation in some cases worsened the problem. Except in Mexico where the average national savings rate increased from 20% of GNP during 1973-78 to

24% in 1979–84, it fell significantly in the other countries: from 26 to 17% in Argentina, 24 to 17% in Brazil, 12 to 7% in Chile and from 36 to 26% in Venezuela. In low income Asia, the national savings rate remained virtually constant at about 24% of their *considerably lower incomes*. Other indicators of macro-mismanagement in Latin America according to Dornbusch, are excessive budget deficits, (often the primary cause of the low national savings rate), exchange rate overvaluation, and failure to adjust to world prices. These policies induced capital flight and flight into importables.

It is true that the external shocks of 1980–82 such as dollar appreciation, real interest rate increases, fall in commodity prices and the reduced demand for exports due to the recession in the OECD played a role in Latin debt accumulation. But those shocks affected *all developing countries* though perhaps not to the same degree. For instance, the real interest shock may have affected to a greater extent those debtors such as the Latin ones, a large proportion of whose debt was owed to private creditors at variable interest rates. But this need not have created a crisis. For instance, the Republic of Korea whose external liabilities at \$43.1 billion at the end of 1984 are about the same as Argentina's and of which a greater proportion (43.5%) is at floating rates than Argentina's (36.5%), has not experienced debt servicing problems and is considered, by lenders, unlikely to experience them. This is because of its better macro-economic as well as microeconomic policies. Thus, one is led to conclude that perhaps *domestic mismanagement rather than external shocks explains the lion's share of the Latin debt accumulation*.

5. RECYCLING JAPANESE SURPLUSES, A SOLUTION?

The contrast between *prima facie* "profligacy" of many Latin governments and the "prudence" of governments of low income Asian countries has its counterpart in the contrast between the "profligate" US with its low savings, large budgetary and trade deficits and "prudent" Japan with its high savings and trade surpluses. But in suggesting that Japanese surpluses be "recycled" to solve the "collective debt problem" of the world, one should not forget an elementary arithmetical identity, that the world as a whole cannot run a deficit or surplus. This means that Japan's surplus equals the rest of the world's deficit including that of the US. Put another way, corresponding to Japan's surplus is her accumula-

tion of claims against the rest of the world, that is, her investment in real and financial assets abroad including US government obligations. Part of the Japanese surplus is financing the US budgetary deficit. The US was not making such an enormous demand on the rest of the world's savings in the 1970s when the Saudi surpluses were recycled. The US was not even a net borrower then.

If the Japanese current account surpluses are no longer available to finance unchanged US budgetary deficits to the same extent as at present, these deficits will exert pressure on world capital markets. The repercussions may well be adverse to the Latin debtors. *Ex-post*, a larger current account surplus or lower deficit would have to be squeezed out of the world outside of Japan. That process is likely to be painful to the developing countries.

If the invitation to the Japanese to solve the "debt overhang" is an invitation to them to exchange the stock of performing assets in their portfolio for the non-performing loans of American and other banks to Latin America, it is unlikely to be accepted. Recycling through greater borrowing by the World Bank in the Japanese capital markets depends on agreement being reached on a general capital increase for the Bank. Even that by itself will not permit an increased net transfer of resources to the debtor countries, unless the fundamental precondition for such an increased transfer is satisfied and an increased current account surplus of the combined creditor countries is generated.

6. BENEFITS AND COSTS OF FULLY MEETING DEBT SERVICE OBLIGATIONS

It is often suggested that making the Latin debtors service their debt fully now by running current account surpluses rather than by fresh borrowing involves an inappropriate and premature (on efficiency grounds) transfer of resources from the capital poor to the capital rich. Besides, their attempt to run trade surpluses at high levels of activity will succeed only if the industrialized countries including the US are willing to open their markets to their exports. Such a transfer is "inappropriate" on efficiency grounds only if there will be no reversal of it in the reasonably near future. On the contrary, the transfer by debtors can be viewed simply as an investment in re-establishing the lost confidence of the foreign private creditors (and their own citizens exporting capital) in their ability to service their debt and to pursue sensible policies. But once confidence is re-established, private creditors would

presumably resume their lending and capital flight would be reversed. If not, a stronger multilateral agency with a much enhanced lending role may be required to overcome the sovereign risk problem and enforce conditionality. If this too is not possible, a number of debtor countries would be rational in repudiating their debt, as they are unlikely to enjoy the benefits of future access to international finance in any case. The threat of protectionism in the industrialized world is real and has to be fought tooth and nail anyway.

It is possible that the austerity necessarily involved in generating the surpluses will adversely affect the relatively worse off in the debtor countries. Whether it does or not is in part a matter of domestic policy choice in these countries. After all in many countries substantial cuts can be made in subsidies to inefficient public sector enterprises, expenditures on the military establishment and unproductive activities without affecting the poor significantly. Internal redistribution, through land reform and other measures, is a means to help the poor whose potential has by no means been exhausted in many of the debtor countries. In any case some Latin governments have not been particularly noted (at least in the past) for any excessive concern about the welfare of their poor. It is regrettable that much of the debt of two Latin American countries where democracy was restored only recently (Brazil and Argentina) was incurred under the old military regimes. Having a democratic government has, however, never been necessary or sufficient for receiving aid. There would have been very few recipients, had it been necessary.

7. THE FLOW OF EXTERNAL RESOURCES TO POOR DEVELOPING COUNTRIES

The United States was responsible for preventing a substantial expansion of the resources of the International Development Association (IDA), the soft loan window of the World Bank that lends to poor countries on concessional terms. Nor has it looked favorably upon a general capital increase for the World Bank that will enable it to borrow more from the world's capital markets and augment its lending. Further, the US has often suggested that a poor country like India which has not borrowed significantly from private capital markets on non-concessional terms should indeed do so. It is not obvious that the Baker and Conable proposals will substantially expand the volume of World Bank lending to

the poor countries. It will be grossly unfair to the poor countries if the proposals end up merely diverting to the heavily indebted countries World Bank resources that might otherwise have gone to them without at the same time expanding the resource flow from IDA and thus pushing them into the private (non-concessional) market.

8. CONCLUSION

On both equity and efficiency grounds there is a strong, indeed an overwhelming case for a significant net transfer of resources from the industrial countries to the developing countries as a group.

The aid or concessionary component of this transfer, which should go to the poorest, is urgent and cannot wait. It must be kept in mind as regards aid, that transferring resources to the poorest countries is not the same as transferring it to the poorest in these countries. This legitimate concern should be a spur to more effective design of aid programs rather than an excuse for cancelling the entire effort. Because many potential recipients first have to re-establish the credibility of their future debt service, the non-concessionary part of the transfer towards the developing countries may not take place immediately but instead will be medium-term in nature. It is here that international institutional reform may conceivably speed up the reconstruction of debtor credibility. A stronger reformed IMF-cum-World Bank (a "World Fund"?) with the expertise to design or evaluate stabilization and structural adjustment programs and the authority to enforce financial and real conditionality might help overcome or at any rate reduce the problems of sovereign risk and borrower credibility. However, the first problem with such a proposal is that an institution with the required degree of expertise and authority may be impossible to create. The second is that even if it were possible, the problems of national sovereignty of debtor nations in their relations with this "World Fund" would make its survival very dodgy.

The Baker and Bradley proposals fail where they involve, in different ways, undesirable distributions of the concessionary component of transfers at both ends (among the industrial "transferring" countries and among the receiving developing countries). In addition to the fairness issues, these proposals are problematic because the way in which the aid, concessionary, non-commercial or non-market part of the transfer is arranged interferes with and generally reduces the commercial or market part of the transfer.

The Baker proposal involves no long-run concessionary transfer to the developing countries and mainly concerns concessionary transfers within the industrial world: a transfer towards the shareholders, creditors and managements of the industrial countries' exposed commercial banking sector and, through the multilateral agencies' acquisition of bad bank debt, away from the industrial countries' taxpayers in general or, in the "Japan variant," from the Japanese saver or taxpayer. It will encourage a repeat of the often careless and incompetent sovereign lending policies pursued by the commercial banking system. Since debtors at most get temporary cash-flow relief, this incentive to "over lend" created by the Baker proposal may not be translated into a significant increase in net bank lending because of the reluctance of potential borrowers who have lived through the early and mid 1980s.

The Bradley proposal involves a significant net transfer towards the developing countries, but as the amount of relief given is likely to vary only with the magnitude of the debt and the magnitude of the debt problems, both equity and efficiency appear ill-served by it.

Where will the resources come from under the Bradley proposal, or under any proposal involving a net flow of resources towards the developing countries? Not by "tapping" the Japanese surplus, as the ODC recommends (Feinberg, 1986, p. 10). That, and more, is already fully tapped by the US current account deficit (a "considerable world liability"?), itself a reflection of the US budget deficit. Do we want the Japanese to run an even larger current account surplus to allow, *ceteris paribus* the developing countries to lower their surpluses or increase their deficits? Whatever the academic merits of the case, one can imagine the howls of outrage in Europe and the USA if the Japanese were in fact to pursue policies aimed at increasing their surplus. That leaves Europe and the USA. No prizes will be awarded for guessing the correct answer. A turnaround of the US current account deficit, which requires a significant reduction of the US budget deficit, is the *sine qua non* of a healthy net transfer of resources towards the developing countries. It is essential that this fiscal correction be achieved without a US and world recession. The required US current account surplus is a *full employment* surplus, not a recession-induced surplus. Here Europe and Japan can help, through coordinated fiscal and monetary policy measures aimed at keeping demand in line with potential supply.

It is apparent that the driving forces behind the Baker proposal are the exposure of the US

banking system in Latin America and the geographical proximity and/or geo-political significance to the US of the major debtor countries. The Bradley proposal does not share this concern for US commercial bank profits, but is even more emphatic on the need to provide relief to an area that is of great political and economic importance to the United States. As regards the US banking system, it is clearly essential to prevent a financial panic, a "run on the banks" if the banks are forced to value their foreign loans at true market values rather than at book value. This, however, is what the Federal Reserve Board's lender of last resort function is all about. It need not involve a "socialization" of the banks' losses, the form of socialism for the rich much favored by the banking community. It is not beyond the combined wits of Paul Volcker and James A. Baker III to safeguard the integrity of the US payments and credit mechanism while letting the shareholders, creditors and managers of the commercial banks with the bad loans take the full measure of the losses caused by bad luck and/or bad bank management. Continental Illinois, where the shareholders lost everything and the management was fired but the bank survived, is one example of what can be done.

Should the Southern debtor countries get aid and relief from the industrialized countries? If the US government wishes to provide relief because this serves its perception of the US national interest in Latin America, it should do so using its own resources. Multilateral agencies, which are not supposed to serve any individual country's national interest, should base their policies on criteria of global equity and efficiency. On those grounds, the major beneficiaries under the Baker and Bradley proposals should not in fact be given relief in preference to countries that are poorer and/or have pursued superior policies. It is not obvious why, as in the Mexican program, one country should be compensated for a deterioration in its terms of trade or for real growth disappointments due to reasons beyond its control, without the arrangement being extended to every developing country.

On efficiency grounds, resources should flow to the country whose investment projects offer the highest rate of return. Unless there are clearly diagnosed reasons for international capital market failure, such resource transfers can take place efficiently on commercial, market terms. Sovereign risk and the inability of borrowers to make credible commitment to commercial lenders concerning future economic and debt servicing policies, are one such crucial cause of capital market failure. We have already argued

that a more powerful multilateral organization (the "World Fund") might be able to overcome the problem of sovereign risk on its loans to developing countries. This would call for a large expansion of its lending activities, "crowding out," but less than one-for-one, commercial bank lending. This supranational lending, however, would still be lending on non-concessional terms. It would not be aid or relief. If such an arrangement (or any other one achieving the same objective) were to be in effect, of course, the spread over Libor currently charged to rescheduling countries by the commercial banks

would be much reduced or even eliminated and the fat rescheduling fees would disappear. This is observationally equivalent to aid or relief, and the Southern Cone debtor countries, like all other debtors, are entitled to it. Neither proposal tries to address the issue of how to overcome sovereign risk and to restore borrower credibility. It is time to think twice before the human and financial resources of the multilateral agencies are concentrated excessively on one relatively small problem area and before scarce aid is diverted away from those most in need of it.

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