THE DEBT PROBLEM: POSTPONE IT OR SOLVE IT?

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In August 1982, Mexico suspended payments on its external debt. By August 87, seven Latin American countries had stopped paying interests to private banks. Five years after the inception of the debt crisis, the problem is far from being solved. On the contrary, there are signs of further overall deterioration.

For the ten major debtor countries, the debt to exports ratio increased from 264, in 1982, to 385 in 1987, that is to say, almost 50%. When Brazil and Peru were excluded, the 1986 growth rate for this same group of countries was a modest 1.5%. In general, the debtor countries have not been able to resume growth on a sustained basis; they have rather alternated years of growth with years of recession. As a result of this dismal picture, per capita income in Latin America has not yet recovered the 1980 level. Despite the adoption of painful adjustments, debtor countries have not been able to regain access to the market, a result which had been defined in the early days of the crisis as the ultimate goal of the debt strategy.

As far as the debt issue is concerned, neither are the creditor countries better off today. They have not been able – nor are they likely to be in the near future – to resume exports to debtor countries at the levels which had been reached in the early eighties. Furthermore, an increasing number of developing countries have been forced to suspend payments to official creditors as well. Export credit agencies, in their turn, have suspended coverage to some indebted countries, thus hampering the prospect for export expansion towards the developing world.

It is true that from 1982 to 1987 creditor banks have succeeded in increasing capital, boosting reserves and starting to reduce their exposure to the Third World. But the chances of collecting the debt are not better today than they were in 1982. On the contrary, there are signs coming from the market – such as the discount in the secondary market, the increase in bank provisions, the depreciation of bank shares – which point to the fact that part of the existing debt is not collectible. It is worth noting that the increase in provisions as well as the depreciation of shares correspond to the expected discount of the debt, or something around 50% of face value.

There are indeed serious impediments, both domestic and external, to the full servicing of the debt. Recent experience has shown how difficult it is for the Latin American economies to generate the trade surpluses required to pay the interest bill. Full interest payment has proved to be incompatible with sustained growth, with control of public finance and with price stability. Let us discuss these points.

a) the transfer of real resources – measured by the trade and non-factor service surpluses – required to pay the interest bill – depresses investment capacity. From 1983 to 1985, the average increase in real resource transfers from Latin America (5.3% of GDP) corresponded roughly to the average decrease in investment (5.8%). This means that the countries of the region are postponing essential investments in order to service the external debt.

b) in many Latin American countries, most of the external debt is owed by the Government (70% in the case of Brazil). In such cases, interest payments require a domestic transfer from the private to the public sector in order to enable the Government to buy – from the export sector – the foreign currency which is required to service the debt. This transfer normally requires additional borrowing, which raises domestic interest rates and therefore increases public deficit. In Brazil the interest paid on the public debt corresponds to 4.9% of GDP, of which 2.6% relates to the external debt. A higher public deficit affects public investment, while higher interest rates discourage private investment.

c) the attempt to expand trade surpluses through successive real exchange rate devaluations has led to a predatory competition among debtor countries and to further deterioration of the terms of trade. Devaluations have two additional negative effects: they increase the public deficit, since a larger amount of local currency is required to pay the same amount of interest, and they have a perverse impact on price stability.

There are also external constraints to debt service. On one hand, interest rates remain substantially high in real terms and have even moved upwards recently. There are no indications of a declining trend in the near future. On the other hand, growth projections for the OECD countries have been revised downwards again and growth rates are expected to remain below the 2.5% level for some time to come. The *World Financial Markets*, a publication issued by Morgan Guaranty, remarks that “if strong export is beyond reach, debtors can in principle contain their debt ratios by compressing imports sufficiently to generate trade surpluses large enough to effect the requisite net financial transfers to their creditors.” In other words, under the present circumstances, debt service will, once more, mean recession.

The “muddling through” approach to the problem has clearly failed. There is now a consensus that new mechanisms and procedures have to be designed and implemented to solve the debt problem. The indebted countries were the first to point out the flaws of the approach adopted after 1982 and to suggest alternatives. The US Congress played an innovative role. Senator Bradley underlined the inadequacy of just piling up debt over debt through new money operations. (Indeed, there is no new money, since banks only provide resources in order to be paid back). Senator Sarbanes and Representatives Lafalce, Levin, and Morrison suggested the creation of a *Debt Management Facility*. Representative Schumer proposed more flexible regulations for debt rescheduling. Secretary Baker pointed out the need for innovation in the framework of a “menu approach”. The academic community explored and developed new mechanisms to cope with the financial needs of indebted nations.

There are indeed several good proposals on the table, which should be considered carefully. But, first of all, we have to listen to what the market is saying. The market’s judgment is that the existing debt is not worth 100% of its face value. It is worth 70%, 50%, 30%, 10% and even less. Indeed, the market value of Third World debt has been declining steadily. On average, its value may have declined to around 50% of the contract value. If the market value of the debt represents 50% of the face value, a market oriented solution may be the securitization of the debt taking into consideration the market indications. Two modalities of securitization might be envisaged: the first is to securitize the existing debt below the face value and schedule payments along a reasonable number of years, at market interest rates; the second is to maintain the face value of the debt, but to restructure it at fixed interest rates, below the market. If the debt is thus restructured, according to debtor countries capacity to pay, recurrent and never ending negotiations for new money and rescheduling will no longer be needed. Moreover, given an adequate amortization profile, even the recovery of the whole credit, at market rates, can be taken for granted, depending on the quality of the debtor country.

What assurances the creditor banks have that debtors will be able to service the restructured debt? Creditor countries might consider it in their interest to associate themselves in providing for some sort of guarantee to the restructured debt. The surplus countries, whose assistance in solving the debt problem is expected, may prefer to concentrate efforts on a lasting solution, rather than on short term relief. The multilateral financial institutions and the new debt management agency to be eventually created might well join together in guarantying the new debt. Nevertheless, the real assurance comes from the fact that the commitment by debtor countries to adjust and grow will thus become feasible, since the debt overhang and the transfer of resources will be reduced to realistic levels.

Such a solution may lead to advantages for all parties involved:

a) indebted countries would then be able to count on the resources needed for investment and growth. Furthermore, they would be able to encourage both domestic and foreign investment by eliminating the instability caused by recurrent negotiations and sporadic threats of payments suspension.

b) the reestablishment of realistic payment conditions would restore confidence in the quality of the assets of the banks. In some cases, losses should be accepted, in others, provisions could be reduced and further decline in the value of both debt and bank shares would be prevented.

c) Finally, creditor countries would also gain by expanding exports to markets which have already proved to be dynamic. There is no way to increase trade with developing countries without solving the debt problem. Expansion of trade is the bridge that will provide for a deeper and more balanced integration of developing countries in the world economy.

A question remains. If this solution seems to be possible, why has it not been implemented before? The answer is that in 1982, when the crisis erupted, the conditions for such a solution did not exist yet. Now, the players in this game have realized that the “muddling through” approach has not worked and that part of the debt is uncollectible. The market has already indicated that the debt as it is structured no longer is worth 100%. The banks’ capital has increased, reserves have been built up and the banks’ shares have already adjusted to the discount on the debt. It is now up to us to follow the steps which have already been pointed out by the market. The debt can be restructured taking into consideration market evidence. This will not harm the system, but improve it; this will not hurt the banks, but strengthen them. This is the only way to ensure that debtor and creditor countries will further integrate their economies, in a more dynamic and harmonious way.

Radical proposals consider some sort of repudiation as the only solution to the debt problem. I deliberately avoided mentioning these proposals because they are unacceptable. They would have a disruptive effect on the financial system, to which we ourselves belong. Even if repudiation were not to have such an impact on the system, it would certainly be disruptive to the financial flows between industrial and developing countries. The securitization of the debt, on the contrary, built upon a market reality may effectively solve the debt problem. This market oriented mechanism, instead of being disruptive, would help normalizing the relations between debtors and creditors, and pave the way for a further and desirable integration of developing countries in to the world market.