KEY ISSUES IN THE WORLD DEBT PROBLEM

Rimmer de Vries

Introduction

The paper by De Grauwe and Fratianni (1984) offers an extraordinarily lucid analysis of the risks in international lending from the perspectives of both central banks and commercial banks. The basic contention of their paper is that the debt crisis of the less developed countries (LDCs) encompasses significant long-run solvency problems as well as short-term liquidity problems. In dealing with the debt crisis, the authors argue that the Federal Reserve System must be ready to extend lender-of-last-resort (LLR) provisions to all international banks, not just U.S.-owned banks. The reason is that a large percentage of loans to LDCs (at least 75 percent) are dollar-denominated, and the ability of foreign central banks to come to the assistance of non-U.S. banks is limited by the central banks' holdings of dollar claims. According to De Grauwe and Fratianni, the willingness of the Fed to supply LLR service increases the cost of maintaining the international banking system for the United States, but the price—although rising—is worth it.

The remainder of the authors' paper is concerned with potential sources of inefficiency in international lending: the so-called moral hazard, "lemon," and free-rider problems. De Grauwe and Fratianni contend that each of these phenomena provides lenders with incentives to take collective action, such that banks will find it in their own interest to continue lending to LDCs so they can ride out the period of unusually high real interest rates. In the authors' opinion, however, "A significant part of the outstanding international [LDC]

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The author is a Senior Vice President at Morgan Guaranty Trust Company of New York and head of Morgan's International Economics Department.

debt should be classified as bad loans" (p. 147), and "it seems to be inevitable that banks, and their shareholders, will incur significant losses" (p. 166). De Grauwe and Fratianni are worried that banks will respond by trying to pass along the losses to taxpayers.

There are three basic issues I wish to discuss:

1. The costs to the United States of the Federal Reserve serving as LLR.
2. The extent of "bad" LDC loans, their impact on the banks, and the response of banks to the debt crisis.
3. The long-run reforms of the international lending system that are needed to prevent a recurrence of the LDC debt problem.

The Fed's LLR Function

On the first issue, I agree with the authors that it is, and remains, in the United States' own interest for the Fed to serve as ultimate LLR. Clearly, the United States and the entire Free World stand to lose considerably from a disruption of the international trade and payments system. De Grauwe and Fratianni, however, understate the extent to which foreign central banks can assist non-U.S. banks. The authors' calculations in Table 5 (p. 155), which express the ratio of central banks' foreign exchange reserves to commercial banks' foreign liabilities, exclude an important asset that central banks can utilize in the event of a crisis situation—namely, gold holdings. During the 1960s and 1970s foreign central banks, especially in Europe, augmented their gold holdings substantially. Excluding the United States, the market value of the gold reserves of the Group of Ten (G-10) countries and Switzerland currently stands at about $180 billion, or approximately 50 percent more than their foreign exchange reserves of just over $120 billion. The accompanying table demonstrates that if foreign central banks are prepared to use their extensive gold holdings and can sell or swap gold at market rates, they have considerably greater means for handling a potential liquidity shortage than is implied in the De Grauwe and Fratianni calculations.

Aside from central bank gold sales, other steps can be taken to reduce the potential burden on the Federal Reserve. One proposal calls for greater foreign-currency diversification in international lending, with the aim of reducing the proportion of dollar-denominated LDC loans from the present 75 percent to a level more nearly consonant with the share of the dollar in LDC international transactions—for example, closer to 50 percent. The Federal Reserve

RATIO OF CENTRAL BANK'S RESERVES TO COMMERCIAL BANKS' FOREIGN LIABILITIES IN 1982 (PERCENT)

	Excluding Gold	Including Gold[a]
Japan	19	29
France	11	34
West Germany	61	120
Italy	31	96
Switzerland	27	86
Netherlands	14	42
Belgium	4	21

[a]Valued at $400 per ounce.
SOURCE: International Economics Department, Morgan Guaranty Trust Company.

Bank of New York, in fact, has pushed the idea for the very reason cited in the De Grauwe/Fratianni paper. Some European central banks also are more comfortable with their banks lending in their domestic currencies for the same reason.

To present this idea as beneficial to the LDCs, however, is another matter. Had the LDCs diversified several years ago and borrowed more heavily in foreign currencies, they would have saved both interest and exchange rate costs. For example, a recent Federal Reserve Bank of New York study (1983) concludes that, had the non-oil LDCs diversified their new and maturing bank debt between 1979 and 1982, the LDCs would have saved over $30 billion, with 80 percent coming through exchange rate gains. But to start now with currency diversification is another matter, especially in light of the exceptional strength of the dollar. Thus, in the event interest rate differentials were to narrow and the dollar weakened substantially, currency diversification could actually raise the LDC debt-servicing costs. From the LDC perspective, therefore, timing is of the essence.

One issue that the De Grauwe/Fratianni paper does not delve into but that should be raised is the role that the Bank for International Settlements and the International Monetary Fund can play in assisting central banks in coping with systemic risks in international lending. To the extent these institutions are prepared to play a greater role, the LLR burden on the Federal Reserve could be reduced accordingly. In the event European central banks do not want to sell gold, for example, arrangements could be worked out with these institutions for swapping it. Also, I would not rule out the use of U.S. commercial banks providing temporary liquidity (for example, through gold swaps) to foreign central banks in case of a liquidity crisis.

The Solvency Question

A second issue that merits comment is the assertion by De Grauwe and Fratianni that a significant part of LDC debt should be treated as bad loans and that U.S. banks (especially several of the largest banks) will incur significant losses on these loans. This goes to the heart of the matter of whether the debt crisis is predominantly a liquidity crisis or to some extent also a solvency problem. The crucial question is how to quantify the solvency aspect of the debt issue.

At the onset of the crisis in mid-1982, it is fair to say that the banking community initially approached the difficulties of Mexico and Argentina as short-term liquidity problems that were triggered by external factors such as high real interest rates, world recession, and political upsets such as the Malvinas dispute and the Mexican elections. As the crisis spread and the facts became better known and the underlying performance of the major borrowing countries was better understood, it became apparent that external borrowing by several major LDCs far exceeded their ability to service debts out of actual or near-term export proceeds. It is now recognized that a proper relationship between external debt and debt-servicing capacity has to be restored.

Suppose we define a country that has a debt-to-export ratio of 2 to 1 as having the potential of creating solvency problems. At the end of 1983, the 21 major developing countries had nearly $130 billion of "excess" debt (as defined), or 23 percent of their total outstanding external debt. The excess is heavily concentrated in Latin America, where it amounted to 33 percent of outstanding external debt. However, under a scenario of modest OECD growth, flat oil prices, stable interest rates, and partial restoration of the terms of trade, this excess will be whittled down to much smaller numbers. By the end of the decade, the excess debt will be only 8 percent for Latin America, with most of the debt concentrated in Brazil and Argentina. In Argentina the excess could be reduced even further if confidence is restored and some of the capital flight is reversed. These projections tend to point out that what may appear today as a solvency problem is essentially a long-term liquidity problem. With sustained recovery and adjustment, the debt problem will be confined to a steadily declining number of countries.

Thus, while I recognize that there is a sizeable long-term liquidity aspect to the debt problem, I am less pessimistic than De Grauwe and Fratianni about the need for the banks to incur significant losses on their international loans. One reason is that I believe a workable strategy is in place to resolve the debt problem over time. Certainly, the LDC debt situation today appears more manageable than when the crisis surfaced. U.S. interest rates are down sharply from their 1982 peaks, a broad-based U.S. recovery is under way, and commodity prices have begun to turn around. LDC external adjustment has also far exceeded expectations as reflected in the stunning turnaround in Latin America's trade performance, with the seven major borrowers running a combined trade surplus of $30 billion in 1983. Equally significant is the fact that Latin American policy makers have realistically assessed the costs entailed in debt repudiation. Instead of threatening banks with default, LDCs have been pressing for temporary interest-rate relief and longer stretchouts.

Banks, for their part, have responded quite constructively to the debt situation. They have been prepared to extend new credits to LDCs (about $15 to $20 billion in 1983), and to rollover existing obligations pending implementation and adherence to IMF stabilization programs. Banks have also recently begun to lower their spreads where lending risks have been reduced as a result of IMF-backed stabilization programs. Reverse free-riding or dropouts have been kept to a minimum because of the banks' own interests. At the same time, some banks have been setting aside reserves against potential loan losses. Swiss banks reportedly have made reserve provisions covering 20 percent of their LDC loans on average, while Dutch, Scandinavian, and Japanese banks apparently have acted similarly. Loan-loss provisions by U.S. banks have not been as extensive as those of European banks, partly because of differences in regulatory and tax treatment. Nevertheless, these provisions are substantial. Morgan Guaranty Trust, for example, has set aside approximately $475 million for loan-loss reserves, with a good part covering LDC loans. Although no figures have been compiled, I would venture a guess that the major international banks in the world have allocated somewhere between $5 and $7 billion in loan-loss or special reserves against sovereign risks in addition to having written off perhaps $3 to $5 billion of international loans. It should be emphasized that despite this, some major banks have been able to report significant increases in overall earnings.

Another reason that my own views are less pessimistic than those of De Grauwe and Fratianni is that they have defined the issue of solvency in terms of the ability of developing countries to *repay* their debt over time. Repayment, however, is not the issue that concerns the banks: Countries, like companies, can be expected to add to their debt over time. What is relevant from a credit-worthiness standpoint is the ability of countries to *service* their external debt. As indicated earlier, the solution to the LDC debt problem essentially requires that countries bring their external debt more in line with their export earnings. Banks have been willing to continue lending to LDCs, instead of pulling out, mainly because they believe that a combination of a more favorable global environment, better domestic economic policies in the LDCs, interest-rate relief for some countries, and long-term development assistance offers a reasonable prospect for sustained reductions in LDC debt/export ratios. In this respect, the relevant condition for assessing the solvency issue is whether the rate of growth of export earnings exceeds the interest rate on LDC debt. If this, indeed, is the case—provided only that the current account less interest payments is in balance—LDC debt/export ratios will decline over time and credit-worthiness and access to credit markets will be restored eventually.

I hasten to say that there are still major challenges ahead. One is the need for LDCs, especially in Latin America, to sustain large trade surpluses in order to service their external debt. So far, the surpluses have been attained through radical import contraction, which in some cases has led to reductions in consumption and living standards rivaling those of the 1930s. The only viable solution over the long run calls for Latin American countries to increase their export capacity so that debt-servicing capabilities are enhanced and economic growth is restored. This will require a fundamental change in development strategies pursued since the 1950s. Priorities will have to be reordered away from import substitution toward more active export promotion, and the development role of the state will have to be reassessed in order to free resources for the private sector. Clearly, reversing such long-term trends is not an easy matter.

It must also be acknowledged that the global scenario sketched earlier is based on a stable international economic order. Considering the amount of time it takes to bring debt/export ratios of certain LDCs down to more manageable levels (for example, under 200 percent), allowance should be made for fluctuations in oil prices, interest rates, or exchange rates that are difficult to forecast, as well as for unforeseen but inevitable political disruptions—each of which could delay progress in restoring credit-worthiness. Moreover, considering the sharp erosion of confidence over the past two years, it is unrealistic to expect that restoration of voluntary lending to the LDCs will occur quickly once debt/export ratios fall below a critical threshold range. Rather, the transition from organized lending to strictly voluntary lending is likely to occur in stages as confidence is rebuilt gradually. My guess is that "managed" lending, whereby banks condition rollovers of existing obligations and extensions of new credits on IMF performance criteria, will remain with us for the remainder of this decade for most, although perhaps a declining number, of key LDC borrowers.

Long-Run Reforms

The third issue involves long-run reforms that can be taken to prevent a recurrence of the LDC debt problems. De Grauwe and Fratianni have correctly emphasized a major source of risk in international lending; namely, the moral hazard problem. Commercial banks have no means of enforcing limits on the overall indebtedness of sovereign borrowers. Even if an individual bank acts prudently in assessing LDC debt capacity and refrains from participating in a new loan to the country, its existing credits to the country can be jeopardized by the LDC's ability to obtain financing from other sources. De Grauwe and Fratianni acknowledge that one way of handling this problem is for the IMF to exert leverage to limit the country's overall indebtedness. The authors point out, however, that in the past the IMF has been unable to prevent LDCs from accumulating excessive debts. Instead, the IMF ultimately has had to extend credits to these countries once their foreign-exchange reserves have been depleted, so that the IMF has wound up holding "lemons."

I share these concerns and would agree that these are major issues that must be tackled. In view of the costs that banks have incurred and will incur from past LDC loans, as well as the pressure for greater regulatory oversight of international lending, I would be very disappointed to see a return to business as usual once LDC creditworthiness is restored. It is clearly in the banks' interests to develop a specific set of yardsticks and guidelines for assessing debt-service capacity so they are less vulnerable to unforeseen developments. While debt-service capacity has proved to be an elusive concept, experience has shown that banks cannot rely primarily on current market views in making their lending decisions.

It must be recognized, nonetheless, that even if an individual bank or group of banks based lending decisions on careful assessments of debt-servicing capabilities, sound lending decisions could still be upset if the rest of the market did not follow suit. It is imperative, therefore, to have a mechanism in place to lessen the risks that De Grauwe and Fratianni have described.

There are essentially two ways in which problems of overlending or overborrowing can be avoided. One entails greater control over the *lender*, while the other involves increased leverage over the *borrowers*. Future reforms are likely to entail both of these elements. However, the most practical and efficient route would be to influence the decisions of individual borrowers rather than the collective actions of the lenders. In particular, it is vital to expand the surveillance role of the IMF and World Bank and to increase their leverage with their member countries. This expanded role would entail these institutions compiling more timely and comprehensive information on external debt, developing suitable measures and yardsticks to assess debt-servicing capacity for individual countries, and assisting countries in their external debt management. The IMF's Executive Directors already have agreed that the Fund should be more active in counseling countries in these areas, and that the annual surveillance exercise should include a much more systematic and in-depth analysis of the external debt situation and prospects of individual countries than in the past. The ability of the Fund and the Bank to work closely with their member countries and guide them about appropriate debt levels and structures offers the surest way of providing for the financial stability and long-term economic growth of these countries.

To enhance the Fund's leverage over borrowing countries, it is also essential that the close working relationship between the Fund, the commercial banks, and central banks over the past year and a half continues to evolve. In the event that countries do not follow the advice of the Fund, it must be prepared to make its views known to the financial community, either directly to commercial banks or indirectly through the various central banks and regulatory agencies. Once the Fund's views have been conveyed, central banks and commercial banks must cooperate closely. Clearly, a major lesson of the international debt crisis is that we cannot afford to return to a situation where the commercial banks and the Fund go separate ways.

References

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SAFETY-NET MECHANISMS: THE CASE OF INTERNATIONAL LENDING

Gerald P. O'Driscoll, Jr. and Eugenie D. Short

Introduction

We have just emerged from the longest, and, by some measures, the most severe postwar recession. It is not surprising, therefore, that financial-sector problems have emerged. In economic downturns, certain phenomena typically occur. Included among these are sharp adjustments in risk premiums and yield-curve configurations, increases in the number of problem loans and loan losses, a rise in the number of troubled financial institutions, and a higher failure rate among financial institutions. This list in fact encompasses most of the financial difficulties experienced during the past recession. As the U.S. and world economies continue to recover, the current volume of problem loans will tend to be worked off, lessening the level of financial stress. Available evidence on credit exposure indicates, however, that, at least in the near term, the U.S. bank-failure rate will remain above the average rates established during the pre-1975 period. This suggests that current financial-sector difficulties may reflect structural as well as cyclical problems, a prognosis that raises concerns about the long-run strength and stability of the U.S. financial system.

In this paper, we hypothesize that the incentive structure provided by financial safety-net mechanisms has altered the risk preferences of U.S. financial institutions. This change, in turn, has led them to accept an excessive amount of risk. Similar changes may have occurred

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Gerald P. O'Driscoll, Jr. is a Senior Economist and Eugenie D. Short is an Assistant Vice President and Senior Economist at the Federal Reserve Bank of Dallas. The views expressed in this article are solely those of the authors, and should not be attributed either to the Federal Reserve Bank of Dallas or to the Federal Reserve System. The authors wish to thank Anna J. Schwartz for her helpful comments on an earlier version of this paper.