THE DEBT PROBLEM REVISITED

Introduction

About a year ago an interagency study of the debt problem was prepared for the SIG-IEP. The study concluded that, although major difficulties requiring complex US policy choices could be expected, the debtor countries could, over a reasonable period of time, work themselves out of the debt problem by rapidly expanding exports. The necessary conditions for such an export-led recovery were defined as: reasonably rapid economic growth (e.g., 3 - 4 percent a year) in OECD countries; the absence of protectionist policies; and appropriate adjustment policies in the debtor countries. This memorandum examines some of these judgments and perspectives in the light of developments in the past year and draws some tentative conclusions about the changing nature of some of the issues related to the debt problem.

KEY JUDGMENTS

The major LDC debtors are unlikely to quickly work themselves out of their debt problems through a rapid expansion of exports. Global economic trends are not favorable enough to bring this about, and the economic, institutional, and political barriers to the necessary shift in LDC resources are too great.

While the necessary changes in economic structure will take years, the debtor countries have had to drastically curtail imports to make ends meet, and these import cuts have been accompanied by severe declines in economic activity and per capita expenditures.

Political dissatisfaction with severe and continuing austerity is growing in the debtor countries, as is resistance to IMF-sponsored programs designed to aid also in longer-term restructuring. These reactions vary greatly among countries and are likely to become even stronger in the future, even as the economies begin to improve.

The willingness of the key institutions in the creditor countries--including banks, governments, and regulatory agencies--to provide or support continuing assistance to the debtor countries, is being linked increasingly to the implementation of IMF-sponsored austerity programs. Although these linkages provide a certain policy coherence, they also impose a great burden on the IMF and tend to reduce its flexibility in dealing with countries with vastly different economic and political circumstances. While specific countries' problems call for great flexibility, the IMF must be concerned about its credibility because of the impact on all its other programs. So far the IMF has done an excellent job steering a difficult course between competing objectives.

If ways are not found to ease pressure on the IMF, however, there is high risk that likely future confrontations between debtors and creditors--with the most likely near-term confrontation being with Argentina--cannot be satisfactorily resolved.

Macroeconomic Trends

Global macroeconomic trends in 1983 and projected for 1984 have been mixed--better than expected in some respects; worse in other respects.

- OECD GNP grew more than 2.5 percent last year, about 0.5 percent better than expected a year ago, pushing up the volume of LDC exports, and should be around 4 percent in 1984.

- In 1983, the terms of trade worsened for the oil exporting LDCs and stabilized or improved a little for other developing countries. Future trends in the terms of trade are highly uncertain. Although prices of some metals and other commodities have firmed in recent weeks, stocks, and in some cases excess capacity, remain ample.

- Interest rates, after declining substantially in the latter part of 1982 and the first half of 1983, have risen in recent months, with LIBOR rising to above 10 percent. If interest rates continue to rise, at least through the first half of the year as many market analysts expect, the effective cost of loans to many developing countries could, given the large spreads, return to close to the 1982 average level, and the ratio of interest cost to export earnings could also equal the 1982 levels of 30 - 40 percent for major debtors (table 1).

- Beyond 1984, most forecasters expect a slowdown in OECD economic growth to a rate of 2 - 3 percent, and some expect a recession in 1985-86. If growth slows substantially, there may not be much if any improvement in the LDC terms of trade.

Economic Adjustment

The debtor countries have had to make a massive adjustment to the changing economic environment. Fundamentally, they must adjust to what seems likely to be a lasting increase in real interest rates and a lasting decline in the size of current account deficits that can be financed. To make these adjustments without declines in income and output would have required a substantial shift of resources in the debtor countries to products which can be exported or can efficiently substitute for imports. Although any attempt to measure this necessary reallocation

Table 1

LDC Interest Burden

Ratio of Interest Obligations to Exports of Goods and Services

	1978	1981	1982	1983
All LDCs	9	14	15	14
OPEC LDCs	8	11	11	11
Non-OPEC LDCs	10	16	17	15
Argentina	13	45	43	35
Brazil	23	37	53	42
Chile	19	43	40	32
Mexico	20	38	36	30
Nigeria	1	6	10	12
Peru	20	28	27	25
Venezuela	12	20	21	20

of resources is arbitrary, it is probably in the order of 3 to 5 percent of GNP and 30 to 50 percent of export earnings in the major debtor countries, such as Brazil, Mexico, and Argentina. */ Resource transfers of this magnitude are difficult and may take years, particularly because of marketing difficulties for exports, institutional barriers, and the fact that in many countries import substitution has already been pushed very hard.

During the past two years or so the debtor countries have had to adjust not only to what will probably prove to be longer term changes such as the above, but also to cyclical and short-term circumstances, which, for the most part, have been highly adverse. In addition to depressed exports and high interest costs, the debtors have been faced with massive capital flight in one form or another (estimated at over $40 billion in Latin America alone during 1981-83).

The adverse effect of these developments has swamped the emergency and new lending from the IMF, the commercial banks and the United States, and consequently debtor countries have been forced to adjust by drastically curtailing imports. Between 1981 and 1983 in 15 debt-ridden LDCs:

- o Imports fell by $55 billion, or 40 percent for the group as a whole, and by more than 50 percent in Mexico, Argentina, Nigeria, and Chile (table 2).
- o Exports fell by $14 billion, or more than 10 percent, mostly because of lower prices.
- o The trade surplus increased by over $40 billion.
- o The current account balance improved by over $50 billion.
- o And despite this enormous improvement on current account, these countries lost some $10 billion in official reserves.

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*/ On the assumption, for example, that the longer term increase in real interest rates in comparison with the late 1970s is 3 to 5 percent and that financible current account deficits are about half of the level during the late 1970s.

Table 2

Imports of Debtor Countries

Billions of US Dollars

	1981	1982	1983	% Drop 1981-1983
Argentina	9.5	5.4	4.5	53
Brazil	24.1	21.1	16.8	30
Mexico	24.1	14.6	8.2	66
Chile	6.4	3.6	2.8	56
Venezuela	12.1	12.7	6.3	48
Nigeria	17.4	13.2	7.8	55
Peru	3.5	3.6	2.4	31
15 LDC Debtors	135.2	111.2	80.1	41

In 1983, imports apparently were at or near the lows of at least the past decade in relation to GDP in the major debtor countries. There is some evidence that shortages of imported goods have adversely affected production, including production for export. Any further contraction of imports would probably have even more serious effects.

These massive import cuts inevitably were accompanied by substantial declines in economic activity and even larger declines in real income. Between 1981 and 1983 (table 3):

- GDP fell 8 to 15 percent in Mexico, Brazil, Argentina, Chile, Peru, and Nigeria.

- Because current account deficits were shrinking, real domestic expenditures fell even more than GDP--by 10 to 20 percent in the same countries.

- Per capita expenditures are down 15 to 30 percent since the 1980 or 1981 peak, and are also well below the average of the late 1970s in most of the debtor countries.

- Although investment has taken the largest cuts, real consumption has declined substantially, as a result of falling real wages and growing unemployment.

Debtor country exports should increase fairly rapidly this year and perhaps next year, but there are large uncertainties.

- Exports appear to have turned up during the last two months of 1983 and US trade data indicate that the recovery has continued in the early part of 1984.

- Some commodity prices have been firming.

- Several of the major debtor countries have achieved a substantial real devaluation of their currencies since 1980-81 (figure 1). For Mexico and Brazil, the real exchange rate is below the average of the mid 1970s. Brazilian exports jumped in the first quarter. If these real rates can be sustained, or further lowered, exports should be stimulated in the future. However, the Chilean exchange rate is still too high and Argentina is moving in the wrong direction.

- Venezuela and Nigeria, dependent as they are on oil exports, and probably facing a soft oil market for several years, face a particularly difficult task in achieving export diversification and expansion.

Table 3

Macro-Economic Trends in Major Debtor Countries

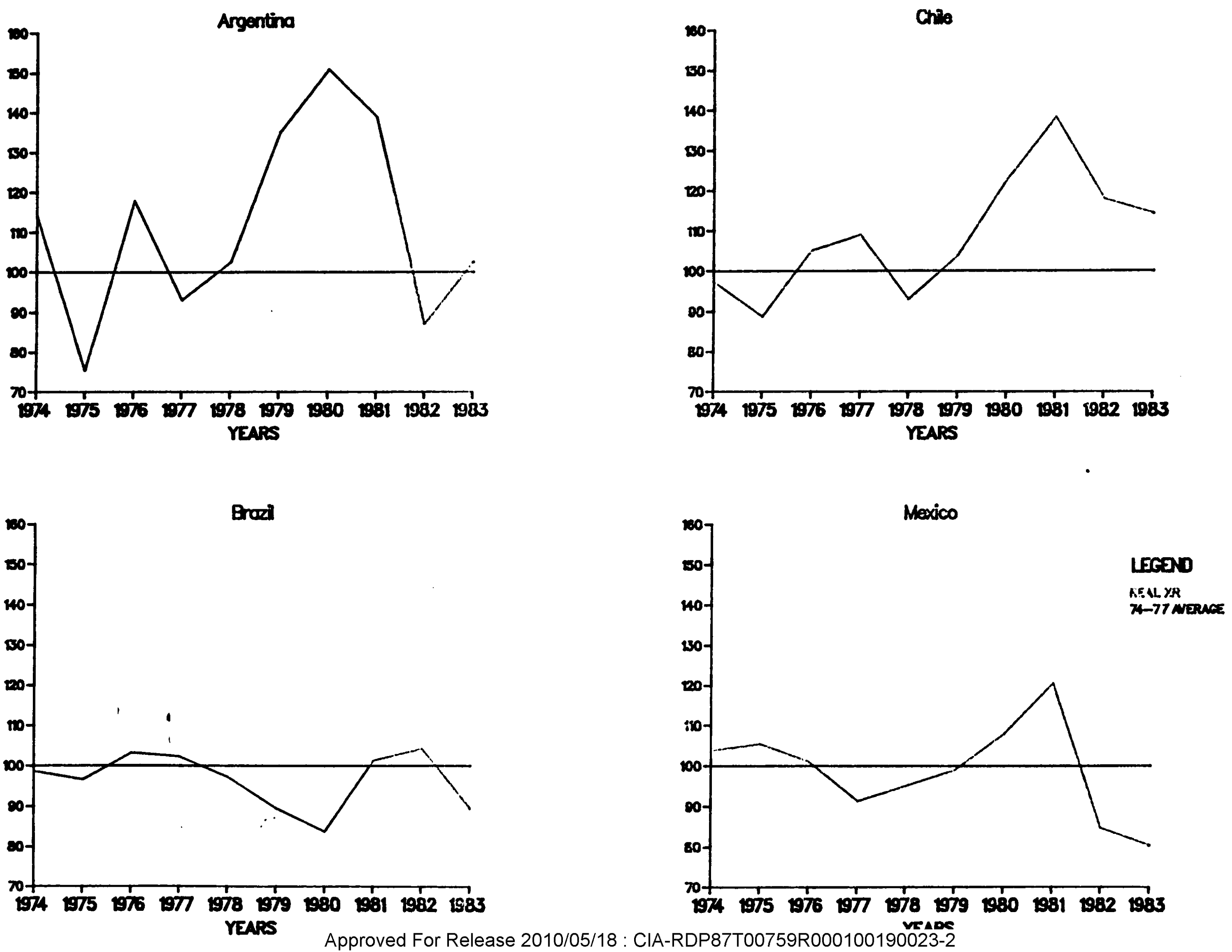
1981 = 100

	1978-80 Ave	1981	1982	1983
GDP				
Argentina	97	100	95	96
Brazil	96	100	100	95
Chile	88	100	86	85
Mexico	86	100	100	94
Nigeria	99	100	97	92
Peru	100	100	101	90
Venezuela	101	100	101	98
Expenditures per capita *				
Argentina	104	100	89	87
Brazil	100	100	97	87
Chile	86	100	76	66
Mexico	87	100	90	80
Nigeria	97	100	96	79
Peru	102	100	95	88
Venezuela	(1980) 96	100	102	73

* GDP plus imports, minus exports, per capita.

Trends in Inflation—Adjusted Effective Exchange Rates
Indexed on 1974—77 Average = 100

Figure 1



The decline in imports may be ending in most debtor countries, but a rapid recovery of imports cannot be expected for at least another year or two.

- Interest payments are rising.
- The net flow of capital to the debtor countries is unlikely to increase and may shrink further.
- Some earnings will have to be used to replenish foreign exchange reserves.

Even under favorable circumstances, it will take several years for major LDC debtors--perhaps until the late 1980s in Brazil--to regain pre-recession levels of per capita real income.

Credits, Assistance, and Conditionality

In an effort to protect their exposure and other interests in the debtor countries, and to stimulate economic adjustment in these countries, creditor banks and governments have increasingly linked their new credit and rescheduling programs to the IMF, which has become the linchpin of the entire system.

- New IMF funding has been made conditional on net new lending from the banks to several LDCs.
- The banks in turn make disbursements on their loans contingent on the debtors' observance of IMF conditions.
- Bank regulators, at least in the US, are making the existence and observance of an IMF program a critical factor in classifying outstanding loans on which some terms are not being observed.
- The US Government has made negotiation of a program with the IMF a condition for some of its loans.

The linkages to the IMF are not as strong in the case of debt reschedulings as in the case of provision of new credits.

- In Venezuela and Nigeria, neither of which apparently will accept IMF conditionality, the banks are in the process of rescheduling outstanding debt to protect their interest.
- In the countries which have accepted IMF programs, and consequently are receiving new money however, reschedulings, although separate, are influenced by the degree of success in following the IMF program.

The IMF's involvement in a large number of programs, each of which is closely linked to the programs of creditor banks and governments, while providing a degree of policy coherence to debt rescue attempts, also tends to reduce flexibility. In 1983, 34 IMF arrangements were initiated, compared with 19 in 1979. Although the programs differ, they generally involve similar quantitative performance criteria, such as an increase in international reserves, and reductions in foreign public sector borrowing, and the public sector deficit. Obviously, in negotiating these conditions, and especially in reacting to failures to meet these conditions, the IMF must worry both about the impact of its decisions on other creditors to the country in question, and about the precedent for its other debtor country programs. In short, the IMF must preserve its credibility, but this limits its flexibility in dealing with the unique conditions of particular debtor countries.

While the IMF will have increasing difficulty balancing the need for flexibility with the need to maintain credibility, the banks are likely to be increasingly reluctant to increase their exposure to LDCs with serious debt problems.

- Most of the net new bank lending to Latin American countries in 1983 (about $14 billion) was involuntary, consisting of loans by the major banks negotiated as part of a package with the IMF.

- Participation of regional US banks and many foreign banks in new loan packages is declining; many banks with only small exposure have pulled out what they could.

- As the debt problems persist, and regulatory pressures grow, banks will have to take losses to reflect the reduced real value of their LDC assets. In the US this has already occurred for private debt, and the process is just beginning for sovereign debt. In Western Europe and Japan, banks have been reserving against questionable LDC and East European loans for some time.

- Under these circumstances, it will be difficult to induce even the large banks to provide the several billion dollars in new funds likely to be needed in Argentina, Brazil, Chile, Peru, the Philippines, and other smaller countries in the next year or so.

Political Reactions in Debtor Countries

The political reaction to economic decline and to attempts at initiating structural changes in the debtor countries has been extremely diverse, reflecting each country's political traditions and institutions, as well as the structure of its economy and the severity of its economic problems. In general, resistance to IMF conditionality has been growing and some debtor countries have approached the fine line between cooperation and confrontation with their creditors.

Although the early impact of import cuts and other austerity measures on the population was buffered by drawing down stocks and drastically cutting investment, in some countries most groups of the population are now substantially worse off than they had been earlier.

- Argentina and Brazil are in the fourth consecutive year of recession or stagnation.
- For the oil exporters the decline has been sharp, but relatively recent--beginning early in 1982 for Mexico, late in that year for Nigeria, and in mid-1983 for Venezuela.
- In the Philippines, the government has postponed adjustment as long as possible, and living standards are just beginning to be affected.

Although the economic decline has caused widespread dissatisfaction, it has been efforts at initiating structural change that have caused the strongest political reaction.

- Initial austerity measures generally took the form of drastic import cuts by means of tight exchange controls. These measures were widely accepted because there was no other choice--reserves and credit having run out. And although the measures were discriminatory, in most countries they tended to favor politically sensitive groups.
- Austerity policies became more vulnerable to political attacks when exchange rates and monetary, fiscal, and income policies began to be changed to allow for an easing of direct control and a shift of resources to exports. Changes in tax laws, wage indexing, subsidy levels, etc., are far more visible than exchange controls and often require legislative action, or at least political consultation with a wide range of interest groups. The consensus building process has generally been more difficult the more "democratic" the political system.

In Argentina, the new civilian government is pressuring the creditors to accept its judgment as to the political necessity of expansionary economic policies and to adjust debt servicing terms accordingly.

- Although elected unexpectedly by an absolute majority, the Alfonsin government's political base is not firm. To govern effectively, the government needs considerable support from organized labor, and consequently it must weaken the hold of the Peronist party over the unions.

- The government also must cope with the widespread dissatisfaction which was caused not only by the impact of the debt crisis, but also by economic mismanagement going back many years.

- The government believes that it must show some results quickly, especially an increase in real wages, if it is to retain a working political coalition. Moreover, Argentine economic nationalism has deep historical roots and the Argentines do not take kindly to economic policy conditions seemingly imposed from abroad.

- This means that the Argentine government may be unable to show much flexibility in negotiating conditions for an IMF program and may engage in confrontation tactics.

In contrast to Argentina, the Brazilian government is trying hard to cooperate with the creditors, but may be unable to implement all aspects of IMF mandated programs.

- Brazil is going through a transition from a military to a democratic form of government. Most of the military want to withdraw from government and there is no evidence that the economic crisis has changed their minds.

- As the transition has progressed, major decisions hve been made increasingly by consensus, with the legislature playing a growing role, at least in being able to block action. Although pressure for direct election of the President is growing, the chances are that the military will insist on indirect elections next November, which will mean a consensus candidate from either the government party or a coalition of moderate opposition parties.

- A new indirectly elected Brazilian President and his administration would probably make few important changes in economic policy and would continue cooperation with the IMF and the other creditors.

- There is, however, widespread unhappiness in Brazil over economic conditions and adjustment programs. Last year wage indexation was modified only with great difficulty, and it is highly unlikely that further major adjustments would be accepted by the legislature. Moreover, although the occasional food riots are probably not a serious threat to political stability, they are a signal to politicians to resist any further increase in austerity.

Mexico has been a success story for economic adjustment, but at an economic cost that cannot long be sustained. So far the government has given priority to rebuilding its international credit and has been willing to bear the domestic costs entailed.

- o In contrast to Argentina and Brazil, Mexico went from an intense boom to a deep recession in a few months.
- o Indeed, the adjustment went well beyond what was called for in the IMF program, as imports at one time fell by 75 percent, enabling a rebuilding of reserves and early repayment of some arrears.
- o Organized labor, the backbone of the ruling party, has been remarkably cooperative. Wage increases were sufficiently smaller than the growth in the cost of living, not only to cut real wages, but also to permit some slowing of inflation. Evidently, labor leaders became convinced that wage moderation was essential to prevent a much larger increase in unemployment.
- o Despite falling real incomes and growing unemployment, the sharpest reaction has come from the private business community, which was badly hurt by its low priority in access to foreign exchange and domestic credit, and whose confidence in the government was shaken.
- o Although the Mexican political system is under unprecedented pressure and the ruling party has been riddled with corruption and has lost several local elections, the government has been able to adopt coherent policies and to take decisive action.
- o The Mexican political system has a certain fragility, however, because it is highly dependent on effective leadership at the top. Should de la Madrid leave the Presidency prematurely or lose his touch as a leader, serious factionalism could develop within the PRI, with potentially disastrous results.

The political fallout of the debt problem also varies enormously among other major debtor countries.

- o In Chile, where the military government has held on to power despite opposition from most socioeconomic groups, largely because of the lack of an alternative on which there could be broad agreement, economic austerity is being eased to help reduce the level of political tension.

- In Peru, the Belaunde government's attempts to follow IMF prescriptions have engendered growing opposition and recently forced an easing of austerity as well as cabinet changes which portend more expansionary economic policies.

- In the Philippines, Marcos has done everything he could to minimize the impact of the debt crisis on incomes and employment, hoping to get through the elections due in May before the inevitable steep economic recession sets in.

- In Venezuela, the new moderate left government is coping fairly well with the immediate foreign exchange crisis through exchange controls, but there is little political support for the drastic steps, starting with a major devaluation, needed to begin reducing the country's excessive dependence on oil exports.

- In Nigeria too, the military government has been unwilling to risk a major devaluation for fear the negative impact on urban living standards would trigger a new coup from lower ranking officers. The Nigerians are more likely to try to improve their economic situation by increasing oil exports, although it would be difficult to get OPEC agreement on this so long as the oil market is soft. The Nigerians are negotiating with the banks to pay off arrears and reschedule existing debt.

The political fallout of the debt problem does not seem likely to spawn the establishment of a "debtors' cartel," even though individual debtors will push the creditors hard, probably successfully for an easing of debt service terms.

- The economic interests of the debtors varies greatly.

- The small debtors could benefit from joint action because they have little clout.

- The large debtors can probably negotiate improved terms on their own, and have more to gain than to lose by tying themselves to a cartel.

- Each of the large debtors, however, will try to take advantage of any concessions the others may gain, and at least some of them are likely to informally discuss how these debt strategies can serve common interests.

Problems for the Future

In general, the creditor countries and institutions may not have the flexibility to deal effectively with the increasingly diverse needs of the debtors.

- Programs for new funding by banks and governments are closely tied to IMF conditions.

- The IMF has limited funds and, because of all the interactions, and the problem of precedent, limited flexibility.

- Many debtor countries are likely to need new funding for several years at least because of the difficulty of major structural change. A period of adjustment will in any case be substantially longer than the two to three year programs of the IMF.

- Debtor country financial needs and the possibilities for changing their domestic economic policies to facilitate adjustment will vary enormously because of varying political conditions.

- The beginning of economic recovery in the debtor countries is likely to make them more, not less inclined, to engage in confrontations with creditors. The creditors, the IMF and the US in particular, will be accused of holding back the upswing.

Some specific problems which are likely to put severe strain on debtor-creditor relations are:

- A likely confrontation this spring between Argentina and the IMF over terms and policy conditions for new loans.

- Later in the year, increasing slippage by Brazil on some key domestic financial conditions, especially inflation and the fiscal deficit.

- Increasing demand for adjustment of conditions and terms in Chile and Peru.

Even if payment of the interest obligations of debtor country governments can be negotiated on mutually acceptable terms, this may be at a heavy cost to the private sector in the debtor countries, and to its creditors.

- Servicing of private debt has been given a low priority and there have been large writeoffs in creditor banks.

- Private firms in debtor countries generally have had a lower priority than public corporations in allocations of foreign exchange for imports and of domestic credit. This is unlikely to change quickly in countries such as Brazil and Mexico, where public enterprises have far more political clout than does the private sector..

- With the private sector suffering a severe squeeze, direct private foreign investment, far from becoming a substitute for bank lending, is likely to continue declining.

Should OECD economic growth falter after 1984--a slowdown to a rate of 2 percent or less--the debtor countries would be able to finance their interest obligations only by holding imports and the domestic economies at severely depressed levels. Almost certainly the debt would have to be renegotiated on much easier terms. This could happen in any event, but is far more likely if the world market outlook became unfavorable.

Implications for Policy

This analysis suggests that the creditor countries will need not only considerable new funding, but also broad flexibility to deal effectively with LDC debt problems in the next year or two. Some possible steps would be:

- An expansion of World Bank lending for multi-year structural adjustment--to relieve the IMF of some demands and provide stimulus for a larger adjustment period.

- For the near term consideration of ways to enhance trade financing.

- Greater emphasis in IMF programs on external (i.e., trade and balance-of-payments) objectives and less emphasis on internal (i.e., inflation, wage policy) objectives to avoid unessential political conflicts.