

Third World Debt

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PARIS - The debts of developing countries should be consolidated in a way that achieves the following strategic objectives:

Non-Communist debtor nations should be able to repay their debts at a pace that is politically bearable. Communist debtor nations should be treated within the present geopolitical context. We must signal to them that there will be no favors whatsoever made by the non-communist world to the totalitarian states. The lending banks should be able to amortize their losses at a pace that does not disrupt the world banking system. Inflation shouldn't be rekindled, so there should be no massive injection of liquidity into the world monetary pool.

Like it or not, the reality is that many of the huge loans to developing countries are lost. We must recognize this. If not, we will attempt to recover funds that are irrecoverable. And that would force debtor nations to impose austerity measures upon their economies that would squeeze out a positive balance of payments. This might appear to be the moral thing to do to debtors who cannot pay their debts. But it would be foolish and contrary to our true interests. In Latin America, it would be supplying a perfect demagogic platform to populist, left-wing anti-American political movements on which they could come to power. They would claim that their nations' austerity, unemployment and high food costs were the price extracted by American banks and Western capitalism. Once in power, the new governments would repudiate any previous agreements with the International Monetary Fund. So not only would the Western banks have lost their money, but hostile governments would have been established as a result of our shortsightedness. The early symptoms of this situation are already evident.

Communist debtor countries are different since hostile governments are already established there. The West must signal to the world that friends will be treated as friends and that those who are allied to Communism will be treated accordingly. In their case, there are two possible courses of action. We could give them time to pay their debts progressively - if they take whatever internal economic measures are necessary - or we could bankrupt them. If we do the latter, then we should be tough. We should seize their international assets and their future exports. We should only trade with them on a cash basis plus something for amortization of outstanding debt.

The two alternative routes should be assessed without any starry-eyed or romantic delusions. Such delusions have blinded us for too long. Self-interest, economic and political, short-term and long-term, should be the only consideration.

The total debts of the developing countries amount to nearly \$450 billion. Western banks have lent much more than their combined equity. (It is estimated that the combined equity of the 130 leading Western banks at the end of 1982 was about \$145 billion.) If the banks are forced to recognize the losses on these loans at too brutal a pace, the resulting shock would devastate world economic confidence.

Some say so what? It's the banks' own fault. Again, that is stupid. Serious turbulence of this kind in the world banking system could create panic. In any case, it is not altogether the fault of the banks. Not long ago it was conventional to say that it was their social responsibility to act as the conduit for recycling petrodollars to poorer nations. Pressure was applied to them by governments, central banks, etc. In fact, it is likely that their relative success in recycling the surplus funds limited the severity of the recession following the successive oil shocks. But now we are suffering the consequences of confusing business with social activity. The banks should only have been expected to recycle petrodollars to the extent that it was compatible with sound business practice. Any needed surplus should have been handled through the international organizations whose responsibilities (and therefore criteria for doing business) are social and political.

A solution, though unpalatable, is available. There is no agreeable solution, only the least disagreeable.

The necessary loans to non-Communist developing countries should be consolidated so that repayment of principal would be spread over 25 years. The rate of interest to be paid annually by the borrowers should be fixed at the currently low figure of six percent to seven percent. Interest payments should be guaranteed by the IMF or by central banks for the lending banks in their respective countries. The principal needn't be guaranteed because on a discounted basis it represents only about 8.5% of the value of the total cash flow (including payment of the principal) over 25 years from a 6.5% loan. (Discounted on the basis of current prime rate, \$1 million repayable after 25 years is valued at about \$75,000 today. However, total interest payments of 6.5% annually payable over 25 years, ie \$65,000 each year, is valued at \$550,000 today on the same basis.)

The total loans to non-Communist developing countries (including Yugoslavia) is estimated at \$365 billion. Interest at 6.5% would amount to about \$24 billion annually. That is the guarantee, to be shared among the Western world.

In return for the guarantee, the lending banks should agree to hold the loans until maturity, thereby limiting the amount of newly created liquidity. In any case, the inflationary effects of those loans are behind us. The loans have been made and the money has been spent. On the other hand, if the debtor nations were to default and the banks have to write off the assets, then the effect would be deflationary. So, subject to the lending banks retaining the loans to maturity, the creation of extra liquidity would only amount to the difference between the interest guaranteed and the interest actually paid by the debtor nations.

Loans to Communist countries, estimated at \$82 billion, would be restructured after a decision has been reached as to which road should be followed. If they are to be given extra time to pay, then a similar guarantee would be granted by the IMF or the central banks, but with some form of option for the central banks to buy the loans from the lending banks at a reasonably fair current value. This would keep open the option to switch to the harder road of bankrupting the debtor nations. If it is decided to move straight to bankruptcy, then the loans should be purchased by the central banks in a way that allows the lending banks to amortize their losses over a reasonable period of time.

The result of such an overall restructuring would be:

Non-Communist debtor nations could repay their debts over a long period of time. Interest payment would be economically and politically bearable and the nations would have little incentive to repudiate such an agreement. We would have helped our friends and therefore ourselves.

The lending banks would lose the difference between the 6.5% or so interest they receive and their cost of funds from year to year. (We might find that as interest rates decrease the differential will not be very great.) They would still be at risk for the principal repayable at the end of the term of the loan, but as we have seen, this risk is relatively manageable. Banks could provide for such a loss in an orderly way over the 20- to 25-year period. The guarantors, the IMF or central banks, would risk losing the difference between the interest guaranteed and the interest actually paid by the debtor nations.

We would have avoided the consequences of imposing a politically unacceptable dose of austerity. We would have avoided a massive injection of new liquidity into the system and the inflationary consequences. Furthermore, the IMF, free from the obligation to attempt to recover the irrecoverable, could work with the governments of the debtor nations to reestablish reasonably credit-worthy economies. The new plans should allow the financing on the basis of current trade as well as the payment of interest on outstanding loans at the lower rate. Thus, troubled nations could 'float off the rocks.'

The debt problem tends to get neglected by governments unless the pressure becomes acute. It would be prudent to find and implement a solution before an explosion.