International Emergency Lending Facilities — Are They Adequate?

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Preamble on Latin American Debt

The central issue in the international financial system today is Latin American debt. That is why my remarks on international emergency lending facilities focus particularly on this special subject.

The table below makes clear why the problem is concentrated in Latin America:

Table 1
External Debt of Latin America and Other Developing Countries[1]
(in billions U.S. Dollars)

	Latin America	Others
Total outstanding external debt, incl. short-term, end 1983	345	383
Owed to commercial banks	232	130
Official lenders and bondholders	113	253
Merchandise exports, f.o.b. 1983	98	270
Ratios (in percent)		
1. Debt to exports	352	142
2. Floating rate debt to total debt	67	34
3. 1984 interest payments as percent of exports	46	16
4. Estimated proportion of debt denominated in U.S. $	79	57

[1]All other developing countries excluding centrally planned economies and Kuwait, Libya, Qatar, Saudi Arabia and the United Arab Emirates.
Source: Author's estimates derived from debt data of Bank for International Settlements, *Annual Reports*, and *Maturity Distribution of International Bank Lending*, and export data from IMF, *International Financial Statistics*.

First, the ratio of debt to exports in the case of Latin America is about 3.5 to 1 or more than double the ratio for the rest of the developing world. Only the Philippines has a ratio similar to that of the main Latin American

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debtor countries. While there are exceptions in Latin America—Colombia and Trinidad and Tobago have low external debts—the magnitudes for Latin America are dominated by Argentina, Brazil, and Mexico, which account for about 70 percent of the gross national product of the region.

Second, the proportion of debt owed to commercial banks and the proportion at floating rates is about 70 percent for Latin America and only 40 percent for the other developing countries as a group. Rising interest rates are obviously painful with such a high proportion of floating rate debt.

Third, as a result of the above, in 1983 Latin America paid out in interest the equivalent of approximately 40 percent of its merchandise export earnings; in 1984, assuming that the prime and Euro rates continue at their early May levels, that proportion would rise to 46 percent. For the other developing countries, the average is 16 percent. Finally, about 80 percent of the external debt of Latin America is dollar-denominated whereas I estimate the proportion for the others to be about 60 percent.

Latin America is a relatively high-income area in comparison with other developing countries but, given the large national markets of Argentina, Brazil, and Mexico, with relatively low exports as a proportion to GNP. The external debt is high in relation to exports and it has grown very rapidly, mainly at floating interest rates from commercial banks. While sweeping comparisons can be misleading, the rest of the developing world does not have the same problem. In the case of Eastern Europe, the debt-to-export ratios are much lower and the proportion of the debt owed to commercial banks is minor. African countries have a development and a commodity problem; Eastern European countries have had a productivity problem; most Latin American countries have too much debt and not enough exports.

Much of the discussion of the debt problem has so far focussed on the international banking system. Not enough emphasis has been placed on the setback for the debtor countries. Per capita income of most Latin American countries will not grow in the 1980s. While the debtors ultimately have the human and natural resources to overcome the problem in time, the question is what the cost will be in the interim.

The mechanism set up by the International Monetary Fund after the Mexico crisis in August of 1982 has worked reasonably well but we do not yet know what the outcome will be. There are major uncertainties, both on the political and economic side.

At the start of the crisis three elements were identified as necessary to overcome it: a renewal of growth in the world economy, especially in the United States and the other OECD countries; adjustment by the debtors; and additional resource flows.

As to growth, it is not yet clear whether the growth today in the industrialized countries has the same pulling power for developing country exports as in the past. There are structural reasons such as the relative decline of smokestack industries which mean that the industrialized economies are using fewer basic materials per unit of output, such as copper and steel. Another reason is the relatively high dollar which has kept dollar-denominated commodity prices lower than otherwise. Thus, the terms of trade of developing countries today are still 15–20 percent below their level in 1980. It is true that the U.S. economy is absorbing a large growth in imports but these are not primarily commodity imports of the type that account for 80 percent of Latin American merchandise exports.

As for austerity, not every country has followed it, but the performance for Latin America as a whole is nevertheless eloquent: merchandise imports fell 45 percent in dollars between 1981 and 1983; the current account deficit of the region fell from U.S. $38 billion to U.S. $18 billion in the same period. Per capita income fell 13 percent and is by now 15 percent lower than it was in 1980. There is therefore no question about the extent of adjustment, only about its distribution.

Table 2
Latin America and Caribbean Countries[1]: Estimated Net Resource Transfer from International Commercial Banks, 1978–1984
(in billions of current U.S. dollars)

	1978	1979	1980	1981	1982	Est. 1983	Proj. 1984[5]
1. Net lending by banks[2]	20	27	29	31	13	7	11
2. a. Interest paid by countries to banks[3]	−14	−21	−29	−34	−31	−31	−34
b. less: interest received on net reserves held by debtor countries at banks[4]	2	4	4	4	3	2	2
c. net interest paid to banks (2a—2b)	−12	−18	−25	−30	−28	−28	−32
3. Net resource transfer (1—2c)	8	9	7	2	−15	−21	−21

[1]Excluding offshore banking centers as recipients of lending.
[2]Estimates by author based on Bank for International Settlements, 1982/1983 and prior *Annual Reports*, with author's adjustments for banks not included. Includes short-term debt movements.
[3]Based on outstanding debt at mid-year, estimated from same source as 2. Interest calculated at LIBOR plus 1.25 percent, which is probably an underestimate.
[4]Based on International Monetary Fund, *International Financial Statistics*, reserves less gold and IMF positions, adjusted for estimated cash; reserves thus defined assumed to yield London Eurodollar six-month deposit rate. This is probably an overestimate of interest received from banks, because part of reserves are held in other instruments such as Treasury bills, etc.
[5]Assumes U.S. prime and also LIBOR interest rates remain in 1984 at the average levels at the end of March 1984.
General Note: These estimates should be interpreted with care, although the general trend of the net resource transfer is probably a reasonable approximation.

As for resource flows, Table 2 on estimated resource transfers is clear enough: Latin America is now transferring to the commercial banks systematically more than it receives from them, a sharp reversal of the trend which prevailed until 1980. It is equally clear, of course, that the pace of lending in the late 1970s could not possibly be sustained over time, as the Latin American assets of major international commercial banks, especially in the United States, were rising by 20–25 percent a year compared to a 10 percent annual growth in their capital.

Interest rates have made the crucial difference between the scenarios of a year ago and the outlook today. William Cline in his excellent monograph assumed as one scenario that the average interest applicable to the external debt of Latin America would in 1984 be about 2 percent lower than in 1983. Similar assumptions were made by others. In fact the average interest is 2 percent higher: that 4 percent difference would cost Latin America U.S. $10 billion in 1984. This worrisome short-term outlook stems from the fact that real interest rates are particularly high for commodity exporters. Although Carlos Diaz-Alejandro disagrees with me, the "purchasing power" interest rate for Latin American countries on their debt to commercial banks is about 18 percent, namely the nominal rate of about 14–15 percent multiplied by the decline in the terms of trade since the peak period of borrowing which I have taken to be around 1980. While the inflation-adjusted real interest rate is about 10 percent, the purchasing power-adjusted interest rate is in effect much higher, hence the problem. Each percentage point increase in nominal interest rates on an annual basis represents 0.3 percent of the GNP of Brazil and 0.5 percent of the GNP of Mexico. As long as rates remain at their present extremely high levels, the prospect for an orderly workout of the debt of the principal Latin American economies will recede dramatically, even if the U.S. economy is pulling in manufactured imports at record levels.

Emergency lending can stem a temporary problem. However, a much more comprehensive approach is needed to help solve the long-term problem. An emergency facility does not really address that problem. At present interest is added upon interest and austerity programs are becoming politically difficult to defend because they tend to be viewed increasingly as a way of paying for an inflated interest bill.

Introduction and Summary

Can we be sure that the fire brigade can cope with a very large fire?

In this paper I will try to look at the question of whether existing institutional arrangements, whether formal (primarily the International Monetary Fund and cooperation through the Bank for International Settlements) or not (such as emergency lending by major central banks and nonmarket lending by consortia of commercial banks), are likely to be adequate to cope with possible crises in international payments.

I think that there is little doubt that in the present world setting existing organizations and arrangements are adequate to cope with temporary payments disruptions among industrialized countries. The only exception might be a sudden loss of confidence in the U.S. dollar, but even then, past experience suggests that the network of treasuries and central banks can substantially mitigate the initial disruptions which would be part of such a crisis. Another possible problem might be a "third oil crisis" but few expect it now—which might be a sign that we should perhaps worry about it more than we have.

I will therefore concentrate on whether present international lending facilities are adequate to meet a crisis brought on by prolonged nonpayment of interest by major developing country debtors, and a much more complex question, whether such facilities can keep these countries from defaulting on current obligations and at the same time avoid socially catastrophic income declines.

In a sense, the way we ask the question already begs it: we are already in a crisis, with major interest payments arrears by some large debtor countries and a sharp reduction in incomes in Latin America—an estimated 12.5 percent decline in real per capita income for the region as a whole between 1980 and 1983.[1] On the other hand, emergency lending is supposed to take care of temporary problems: if we could distinguish with confidence between "temporary" as opposed to "fundamental" disequilibria, a task for which the last 40 years do not necessarily help us much beyond the work of the fathers of Bretton Woods,[2] it seems that the Latin American (and Philippines) debt problem is increasingly a long-term one, which needs rather basic internal and international solutions rather than emergency lending.

The first part of this paper will dwell on the nature of the debt-related problem of developing countries—particularly of Latin America. At the risk of adding to the already voluminous literature on the subject, I will then take a look at some of the requirements for a gradual unraveling of the problem. Finally, I will try to relate this background to the main question of this paper.

In fairness to those who would prefer to stop reading here, my thesis is that the problems of the over-indebted countries of Latin America, with the possible exception of Venezuela and the addition of the Philippines and a few other middle-income developing countries, are not manageable without the combination of a significant reduction in international interest rates, an improvement in commodity prices (themselves held back by high interest rates and a strong dollar) and in export markets, continued capital inflows, and intensified efforts at financial austerity and structural reform (especially in state enterprises) on the part of debtors. The only new element in this list is the need to reduce the burden of interest: rather than going down, as some students had assumed in 1983,[3] it is going up to even more unmanageable levels. The problem is therefore not so much emergency lending, as was successfully attempted in the last minute in the case of Argentina at the end of March 1984, but a coherent package of measures prepared well ahead of time

[1]U.N. Economic Commission for Latin America, *Balance Preliminar de la Economia Latinoamerican durante 1983*, Santiago de Chile, December 1983.

[2]See Ragnar Nurkse's famous piece, *Conditions for International Monetary Equilibrium*, Princeton Essays in International Finance No. 4, 1945.

[3]See, for example, the base case projection of William R. Cline in his *International Debt and the Stability of the World Economy*, Washington, D.C.: Institute for International Economics, September 1983.

in order to cut the interest burden and maintain capital inflows. Otherwise, austerity programs will become politically and economically unbearable, as they will be viewed by people and politicians as simply devices to pay an inflated interest bill.[4]

Three additional points are worth mentioning. First, the significant progress made by Mexico in its financial program has lulled many lenders and observers into believing that the debt problem was short-lived. They have not sufficiently taken into account the special factors in the case of Mexico: the dramatic internal economic adjustment, including a major reduction of real wages made possible by a historically strong political system, and the close links between Mexican exports and economic activity in the United States. Second, whatever action plan and lending facilities may be developed have to start from the premise that neither taxpayers in the industrialized countries nor bank stockholders are willing to make major contributions; even a major effort at persuasion is unlikely to elicit substantial government funds. Third, since we are already in a crisis, going from one payment deadline to the next, whatever action plans are developed must be practical and of the type that can be implemented quite quickly.

The Short-Term Outlook for Debtor Countries and the Level of Dollar Interest Rates

It goes almost without saying that problems and prospects of the debtor countries differ from country to country. All of the East Asian countries, except for the Philippines, are clearly outside the problem category. In the Western Hemisphere, Colombia, and Trinidad and Tobago have been able to maintain their credit standing, thanks to conservative external borrowing policies in the past among other reasons. Venezuela has to refinance its short-term external debt; with that, it has a manageable external position. Of the heavily indebted economies shown in the appendix table, Mexico has made the most progress so far, at the cost of a major decline in per capita income and a drastic reduction of industrial production. If it can continue its fiscal austerity program and combine it with some stimulus to the economy and to employment, it has the best chance of working its way out of the present predicament.

In looking at prospects for the most indebted countries, most of which are middle-income semi-industrialized economies, perhaps the first point to emphasize is the apparent truism that the sooner they can resume effective economic growth, the better. The longer high unemployment and declining per capita incomes continue, the less the chance of recovery—as popular resentment against austerity programs builds up and is fanned by political opinion—and the greater the chance of social and political upheavals. As it is, even cautiously optimistic analysts[5] foresee that it will take until 1987 or

[4]See Appendix Table 1 for an estimate of the interest paid in 1983 as a proportion of merchandise export earnings. Kuczynski, "Latin American Debt: Act Two," *Foreign Affairs*, Fall 1983.

[5]See, for example, Cline, *International Debt*. . . Also Ronald Leven and David L. Roberts, "Latin America's Prospects for Recovery," *Quarterly Review*, Federal Reserve Bank of New York, Autumn 1983.

1988 for regional per capita income to recover to its 1980 level. Since we are now down more or less to the 1976 level, such a projection implies strong growth in the period 1985-88, by no means a certainty.

Second,[6] it is clear that the U.S. economic recovery has not so far been accompanied by an equivalent recovery elsewhere in the industrialized world. As a result, the recovery in the growth of world trade is still slow, although accelerating, and the growth of the industrialized world is so far barely at the level envisaged a year ago by a number of observers as the minimum for major debtors to be able to meet the interest on their external debts.[7] In any case, the nature of the link between the growth of developing country exports and the GNP growth in the industrialized world is by no means entirely clear. In the 1970s, slow growth in the industrialized economies was accompanied by rapid growth in the more advanced developing countries—largely because of world inflation and a cheap dollar, which helped to sustain commodity prices, and because of large-scale bank lending to these higher-income developing countries. Unfortunately, while some commodity prices have rebounded from the depths of 1982, others—particularly minerals—are still extremely depressed, so that the terms of trade of a number of developing countries are about 15 percent (in dollar terms) below the peak levels of 1980. For producers of metals and tropical agriculture products, the shortfall is larger.

Third, perhaps the most important feature of the last months has been the extent of belt-tightening and austerity in a number of countries. Mexico has been the most visibly successful, and its efforts have been aided, as noted, by the close links of Mexican trade and services to the United States, and have therefore benefited from the economic recovery there. The adjustment effort in other countries has been very large also. In part, of course, it has been the unavoidable result of the lack of international loans and the shortage of foreign currency. The current account deficit of Latin America has fallen from U.S. $38 billion in 1981 to my estimate of U.S. $18 billion in 1983, mainly as a result of the squeeze in imports. At the same time regional income per person has declined sharply.

The size and suddenness of the adjustment give rise to questions about whether it is sustainable for very long from a political point of view, particularly considering that the bulk of the adjustment probably falls on urban lower-income groups. The fact that, given the lack of resources, there is no alternative to belt-tightening does not mean that austerity will necessarily be accepted or that the economic managers who are implementing it will be kept on.

The fourth factor to ponder in the short-term outlook is the severe scarcity of new capital flows to major debtor countries. While the external financing needs of Latin America have for now shrunk sharply, the availability of external finance has fallen even more. Earlier in 1983,[8] I estimated that net commercial bank loans—after repayment or refinancing of amortization—to

[6]The pages that follow are part of my contribution to a series of essays on Mexico and the Debt Problem to be published later this year by the Stanford University Press.

[7]See Kuczynski, "Latin American Debt: Act Two."

[8]Ibid.

Latin American countries for 1983 would be on the order of U.S. $8-10 billion, compared to about U.S. $25 billion annually in the period 1979-1981, an admittedly unsustainable rate. It now appears that actual net new disbursed lending in 1983 was closer to U.S. $7 billion or so because trade financing was cut and disbursements on major loans accompanying restructuring, especially in the cases of Argentina and Brazil, were delayed for several months when those countries were unable to meet various targets in the stabilization programs agreed to with the IMF.

Finally, the continuation of the present high level of international dollar interest rates puts a major obstacle in the way of recovery in the heavily indebted countries:

— most obviously, by dampening growth prospects in industrialized countries, particularly in capital goods and in a number of depressed industries which need capital to restructure themselves. The fact that these industries are usually heavy importers of commodities is an additional consideration.

— high interest rates, and the associated exchange rate imbalances to which they have contributed, are greatly intensifying protectionist pressures against important exports which come in part from heavily indebted nations. On top of traditionally protected products such as shoes and textiles, cut flowers, specialty steels and the pending copper imports quota case in the United States come to mind.

— needless to say, high interest rates constitute a very heavy burden for highly indebted countries. With relatively low commodity prices and limited capital inflows, it is not an exaggeration to say that present interest service burdens are, as long as these variables remain unchanged, unmanageable. So far, the major focus of debt rearrangements has been on the postponement of principal, while little has been done to reduce the interest burden.

Before we turn to this crucial question, it may be well to look at the impact upon GDP and the balance of interest payments on the external debt. The model recently described by two Federal Reserve economists[9] assumes that average interest rates payable by Latin American countries on their total external debt would trend down from about 12 percent to 10 percent by 1984. They estimate that if such a decline does not take place, the growth of GDP would be reduced by .5 percent annually over the projection period 1984-87. If this estimate is roughly correct, it means that Latin America's prospects for recovery would be substantially diminished as long as dollar interest rates (because about 80 percent of the external debt is in dollars) continue at their present relatively high levels. The corollary of these high interest rates is an expensive dollar; while this helps to attract imports into the U.S. economy, thus stimulating exports from Latin America, this beneficial effect is offset by the lack of competitiveness, at present exchange rates, of Latin American ex-

[9]Leven and Roberts, "Latin America's Prospects..."

ports in Europe and Japan, given the traditional relationship between Latin American currencies and the U.S. dollar. Moreover, the possibility that the average interest rate on Latin America's external debt would be about 13 percent in 1984, based on the U.S. prime and LIBOR (London interbank offer rates) rates at the end of March 1984, would lead to an adverse shift in the current account balance of the region of almost U.S. $8 billion in 1984 in comparison with the forecasts made in 1983 by the various observers already cited. That amounts to about 40 percent of the 1983 current account deficit. This explains in part the strains experienced by a number of countries, Argentina being the most recently publicized.

A final less obvious aspect has to do with the real burden of interest in economies with weak or declining terms of international trade. "Real" interest rates are usually measured as nominal rates adjusted downward for inflation, on the theory that on average interest payers' income will go up with inflation, thus decreasing the effective burden of their payment obligation, and vice-versa for interest income recipients. Today, it is often said that real interest rates for borrowers are not that high, once inflation is taken into account and the adjustment is made to a net-of-income-tax cost basis for a borrower. This is true enough for domestic U.S. borrowers with sufficient income to reduce the net after-tax cash effect of interest paid. But it is certainly not true for international borrowers. And this is so especially when the inflation adjustment which matters to such borrowers is not just the negative effect of domestic prices in industrialized economies upon the cost of their imports but especially the overall terms of their international trade, including the purchasing power of their exports.

In the case of Latin America and much of the developing world export prices have fallen since 1980—with some recovery in 1983—so that "real" interest rates are probably in a range around 17 to 18 percent[10] instead of the 6 or 7 percent "real" level estimated after adjusting for the U.S. inflation rate.

Since interest payments on the external debt in the case of Latin America in 1983 absorbed about 41 percent of merchandise export earnings, the major more or less predictable source of foreign exchange, and absorbed higher percentages in the cases of Argentina, Brazil, Chile and Mexico, a reduction in the burden of interest over time is crucial to recovery.

The size of the import reductions which have taken place in 1982-83—ranging between 20 and 60 percent for the larger Latin American economies—and the heavy burden of interest payments have fostered a need on the part of economic planners to make rather heroic assumptions. Whereas a few years ago, in the growth period of the sixties and seventies, careful model-building and lengthy discussions took place about small differences in prospective growth rates, the present financial squeeze means that policymakers think nothing of assuming major cuts in per capita income and consumption. While it is healthy to have moved away from the loose spending and planning stimulated by the relatively easy external bank financing of the seventies and early eighties, the present attitude is at the other extreme and is unlikely to be sustainable for long.

[10]This represents 13 percent multiplied by the decline in dollar terms of trade, in this case using a 1980 base.

Resource Flows and the Elements of Recovery

The present conundrum of high interest charges and reduced loan inflows has led since 1982 to a sharp resource transfer from Latin America to commercial banks, in comparison with positive flows from banks to debtors in earlier years.

The focus on resource transfer (essentially cash flow) can be criticized as one-sided, since it is the whole of the balance of payments that matters, rather than just one segment of it, and since it is true that banks as a whole are still increasing their net lending and exposure, albeit at a much lower pace than the breakneck one of 1979-81. However, the net flows from countries to the commercial banks have become the second largest item in the balance of payments, after the merchandise trade account, and—other things being equal—cannot be financed without a very large surplus in the latter, an unsustainable proposition if countries are to resume growth and import again at a more normal rate. Moreover, in a setting where the foreign exchange reserves are low (except for Venezuela, Colombia and Trinidad and Tobago), it is understandable that Treasury and central bank officials of debtor countries are focusing primarily on net foreign exchange cash flows rather than on the growth of the stock of debt outstanding.

To reinforce the above point, it is fairly clear that in the absence of offsetting capital flows, the negative transfer since 1982 is sustainable only so long as a large enough trade surplus can be maintained to finance the outflows. That is the reason many observers focus on the need for heavily indebted nations to maintain large trade surpluses. However, the emergence of such surpluses in 1983[11] is not a reliable sign of their continuation in the future, because they were achieved primarily as a result of massive import cuts, which were in turn both cause and effect of fairly drastic income and production declines. It is of course widely recognized that the approximately 40 percent decline in imports between 1981 and 1983—more than 50 percent in the case of Mexico—has brought them to a level which is unsustainable if economies are to grow again.

The difficulties of resuming orderly income and production growth should not obscure the continued need for financial discipline on the part of debtors. Several countries, notably Brazil, Chile, Ecuador, Peru, and especially Mexico, among others, have already made drastic adjustments. In general, there is still room for major sustained action in improving the finances of state enterprises—if that is indeed achievable for long—, in reducing subsidies, especially in energy prices—and in maintaining realistic exchange rate policies. Nevertheless, it is well to recall the words of the most recent annual report of the U.S. Council of Economic Advisers: "By far the greatest share of the burden [of adjustment] was borne by the debtors themselves. . . . Calls for solutions to the debt problem through adjustment by the debtor countries must acknowledge the fact that an enormous amount of adjustment is already taking place."[12]

[11]See Morgan Guaranty Trust Company, *World Financial Markets,* September 1983, p. 5.

[12]*Economic Report of the President,* Annual Report of the Council of Economic Advisers, U.S. Government Printing Office, February 1984, pp. 78-79.

Renewed growth will inevitably require rapid recovery of imports. For that to be feasible, a combination of three elements is necessary: a decline in market interest rates (in order to diminish the magnitude of the negative net transfer to banks), a sustained improvement in the access of developing country exports to the markets of industrialized countries as well as a strengthening in commodity prices (the latter in turn depends partly on the same decline in interest rates, at least for several major interest-sensitive commodities), and new resource flows. These requirements are well highlighted in the projections cited above and others, although few observers so far have paid enough attention to the increasing protectionism of several industrialized countries, a significant obstacle.

The projections for economic recovery may well come to pass, especially in the longer run. But for the transition period 1983-84, the probability looks quite uncertain, especially if domestic and international U.S. dollar interest rates continue at the levels of the end of 1983 for any length of time; more problematic still would be a continuation of the uptrend in U.S. interest rates which has occurred beginning in the second half of 1983. The "transition" could then stretch into 1985 and perhaps even beyond. The pace of interest rate increases of the spring of 1984 could—I almost say "would"—swiftly undo the careful progress made so far, if the increases continue.

Because refinancing arrangements have so far operated reasonably well, and because there is no simple and practical alternative to them, a feeling of optimism has arisen on the side of the lenders. This has been reinforced by Mexico's success in implementing a drastic stabilization program. Moreover, for Latin America as a whole, the social and economic sacrifices of stabilization programs have been surprisingly well accepted, so far. However, part of that acceptance probably stems from the rapid economic growth which preceded the period of adjustment. As that memory recedes, social stability may become difficult to maintain, unless renewed economic growth comes quickly. It is not safe for international policymakers to assume that a region of 370 million mostly urban inhabitants can calmly continue to withstand income declines such as those of the last three years for long, particularly when past population growth creates today a rapid increase in the labor force of almost 3 percent per year and there are high expectations in the predominantly young population.

Since progress has been made both by lenders and borrowers in coping with a very difficult problem, the initiatives of the governments of the industrialized countries, other than in supporting an expanded role for the International Monetary Fund, have been relatively mild. With some exceptions, primarily in the U.S. government role in the Mexico rescue package in the autumn of 1982, and most recently in the March 1984 emergency loan to permit Argentina to service part of its interest arrears, it has been business as usual.

The supply of long-term official finance has been limited. The net transfer of resources from the World Bank and the Interamerican Development Bank has been increasing, but at a modest rate in the light of needs. In 1983, for Latin America as a whole, the transfer from both multilateral banks combined was about U.S. $1.4 billion, equivalent to 7 percent of the current account deficit of the region. The World Bank in particular has been hamstrung by the lack of support from donor governments for the International Development Association, its concessional loan window for the poorest countries of Africa and Asia. Lack of resources for IDA draws away World Bank lending for Latin America. Many initiatives for additional lending have been discussed, notably to increase the flow of export credits from industrialized countries but they have so far remained on paper. Other than the increase in the quotas of the International Monetary Fund, important as it is, contingency planning appears to have been quite limited. If recovery does not take place as planned, mechanisms to foster additional resource flows and face emergencies will need to be put in place quickly. So far, such plans do not appear to exist, at least in a systematic fashion.

Lowering the Interest Burden

The problem of recovery is thus a long drawn-out one and it is therefore best tackled through fundamental measures rather than last-minute emergency loan packages. That does not mean, however, that action can be postponed. The rise in interest rates poses an urgent and immediate problem. Even though U.S. domestic economists have for some time foreseen such a rise, its implications for heavily indebted developing countries have not really been factored into the debt refinancings and the IMF programs and bank loan packages which accompany them. The room for maneuver is simply too limited.

In designing a comprehensive approach, we must recognize two realities of today:

a. Taxpayers in the United States, Europe, and Japan will simply not foot the bill.
b. Neither will bank stockholders. Their shares are already in many cases selling at a substantial discount below book value, especially in the United States, and in comparison with alternative investments.

There is, of course, some give in these positions, but it is probably quite limited. Sweeping schemes to refund debt at much lower rates for long maturities are therefore quite unlikely to get off the ground for now. Moreover, even if they were doable, one can question whether they are even desirable, since they would tend to reward imprudence in borrowing, and would create demands for similar treatment by many debtors, from the governments of some high-income countries to individual U.S. voters from the sometimes heavily indebted middle-class.

But these sweeping proposals do address themselves to a key issue: the heavy interest burden. Some way has to be found to reduce it during the present period of high interest rates. The difficulty is to reconcile this objective with the maintenance of net lending by commercial banks. In the end, it is conceivable that there is room for a significant reduction in interest charges, because the main motivation for the type of maintenance nonmarket lending being done today is not profitability but is an attempt to ensure the recovery of the interest on what has already been lent in the past. However, in order to be feasible, a reduction of interest charges below "market" levels has to be acceptable to bank supervisory and accounting authorities, so that they do not declare loans on which negotiated interest rate reductions take place—within predefined parameters—as nonperforming or substandard, as they would have to at present. The practice is already well accepted in the United States in the case of domestic reschedulings, as long as the borrower is not in danger of going bankrupt. Whether the same could occur for international loans, without additional legislation in various countries, is not entirely clear.

Choices exist, at least in theory, on whether to capitalize the deferred interest, and postpone it to the end of the refinancing period, or whether to simply reduce it. The former maintains the original earning asset of the banks, and thus would be preferable because it would make continued net lending less difficult. On the other hand, it would by definition continue to increase the exposure of the lenders, although without the problems of organizing large syndicates for nonmarket loans. In either case, depending on the size of the reduction of interest, lenders would get a more secure asset since the chances would be improved of collecting the remaining interest and leaving some margin to begin amortizing principal.

Several additional points should be made:

a. Such arrangements would need to be done under some kind of systematic pattern, with the IMF providing the balance of payments information and analysis to justify a given amount of interest relief. An IMF program would be a key ingredient for lenders to have some assurance that the relief would not simply be misdirected into unrealistic domestic monetary expansion.
b. Since interest rates are not predictable, arrangements would have to be for one period—say one year—at a time, subject to annual reassessment.
c. Negotiations would be bilateral, under the aegis of the IMF, rather than global.

How much relief is needed? The case varies from country to country. Purely as an illustration, reductions in spreads and base rates down to the CD rate—as a proxy for the cost of money—would in the coming 12 months reduce the interest burden of Latin American countries and the Philippines by about U.S. $8 billion, a very substantial contribution indeed, equivalent to more than a third of the current account deficit of the group of countries. Undoubtedly, there would be an equivalent cash flow loss to the lenders. Since that reduction, however, is from a level of receipts which the lenders can probably not obtain without more strain and crises—which would further adversely affect the value of their stock and could well impair their ability to raise funds competitively—there is at least a basis for arguing that lenders would be no worse off and quite possibly better off. They would have more secure assets, although less profitable ones in the short term.

Is there a need for a special emergency lending facility, perhaps within the IMF, beyond such a scheme? We are constrained by the great difficulties of raising the money. It would be unrealistic to do so in 1984. The existence of such a facility might also indirectly encourage borrowers to defer payments beyond the already reduced levels and might lead lenders to let up on the efforts they are making for an orderly workout of individual country problems. Of course, if interest rates continue upward and no concerted effort is made to reduce the interest burden, at least temporarily, emergency facilities of one kind or another would undoubtedly become urgently needed. The sums involved, however, might by then have become unmanageably large.

The most effective way of establishing new emergency facilities would be through the IMF, since this would provide confidence that emergency lending would be used with care. However, it is also clear that such lending would have to be outside of the normal quota mechanism of the Fund, in the same way as the Oil Facility of the last decade.

How to fund an emergency facility is a matter of much discussion. Clearly, given the fiscal and political constraints in major industrialized economies, it would be very difficult to obtain additional budgetary funds. The simplest alternative would be IMF borrowing in the capital markets. However, this has been opposed by a number of major countries. One of the arguments has been that a world central bank should not be a borrower in the capital markets. This subject merits detailed discussion. It can perhaps be said here that the Fund is not a world central bank which can create money, and that in any case central banks do ''borrow'' through their open market operations. In practical terms the issue is whether such borrowing should be a limited short-term undertaking, in order to cope with a special situation, as it should be at this stage or whether it would be the start of a totally new and permanent mechanism, a far more complex undertaking.

There is no simple solution to the debt problem. As countries work towards a new set of policies—encouraging productive investment and efficiency—it is fundamental for lenders and for the international financial community, including the governments of the major industrialized market economies, to focus on the most immediate problem of the heavily indebted developing countries: the high and rising burden of interest payments at a time of limited capital inflows and still lagging export earnings. Otherwise, there is a risk, even a high risk, that the progress made so far towards an orderly workout of the debt problem would be set back significantly.

Appendix Table 1
Estimated Debt Burden of Some Major Developing Countries
(amounts in U.S. $ billion)

	Total External Debt, Including Undisbursed, at End 1982	Estimated 1983 F.O.B. Merchandise Exports	Ratio of Debt to Exports	Estimated Interest Due 1983 as % of Exports
Argentina	39	9	4.3	50
Brazil	86	22	3.9	46
Chile	17	4	4.2	50
Mexico	86	21	4.1	48
Venezuela	33	15	2.2	27
Total Latin America[1]	330	98	3.4	41
Algeria	15	12	1.3	14
Indonesia	22	21	1.1	19
Korea	37	24	1.5	18
Philippines	21	5	4.2	48
Nigeria	11	12	0.9	11
Total Other LDCs[2]	350	270	1.3	15

[1]Including Caribbean and other countries not listed.
[2]All other developing countries except centrally planned economies and Kuwait, Libya, Qatar, and the United Arab Emirates.

Source: *Foreign Affairs*, Fall 1983, *Latin American Debt: Act Two*, by the author. Derived by the author from Bank for International Settlements, *Maturity Distribution of International Bank Lending* (July 1983); Morgan Guaranty Trust Co., *World Financial Markets* (June 1983); International Monetary Fund, *International Financial Statistics*, various issues; and World Bank, various *Annual Reports*.

Note: These are estimates, subject to error, and should be used with care.

Discussion

Charles P. Kindleberger*

Pedro-Pablo Kuczynski limits his discussion to Latin America and the Philippines on the ground that existing arrangements among industrialized countries are adequate—except possibly for a sudden loss of confidence in the dollar—and that the East Asian debt problem, apart from the Philippines, is not serious. This perhaps glides over the troubles of Africa, Eastern Europe—especially Poland which has been in unrecognized default for years—and a potential problem in France with $40 billions of foreign debts, $30 billions of gold, but a psychological incapacity to sell the latter to bring down the former, plus a probable economic incapacity if major sales of gold by France were to knock the price down drastically. Even so, let us stick to Latin America.

The argument in brief is that the debt problem of Latin America, a few countries apart, is unmanageable without some combination of reduced interest rates, improved commodity prices and exports, continued capital inflows and increased Latin austerity. The last has political limits which Brazilian and Argentine renegotiations in the last year have approached and threatened to exceed. While Mexico adopted a stiff enough program, it is not clear how long into the future it can be sustained politically. Increased export prices and export values depend on revival in Europe, Japan, and the United States. Kuczynski's timing led him to underestimate recovery in Europe and Japan; whether he is right that the U.S. recovery will be sustained is a subject on which I have no confident opinion, although I note the view that it may be topping off here because of deficits, high interest rates and a strong dollar. The present interest in protection in the industrial countries is something to worry about. It is probably countercyclical and will decline in Europe and Japan, perhaps intensify in the United States. The restrictions on U.S. imports of steel from Argentina and Brazil are not a good omen.

Continued capital flows into Latin America are not discussed at length. The IMF has been acting as a whipping boy, pushing the money market banks to continue lending. The money market banks in turn have been leaning on the regionals. The regionals seem to be a weak link in the chain. Britain was pushed off the gold standard in 1931 not by withdrawals by France and the United States, but by conversions into gold of Belgium, Holland, Switzerland—the same countries that later switched their dollars into gold overnight, this time followed by France. In the summer of 1971, again, it was the smaller countries, not Germany, Japan, or Britain, that applied the *coup de grace* to dollar convertibility. "Responsible" big banks can be held in line. The little ones feel no compulsion to defend the system when they are so small—the typical free-rider attitude.

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This leaves the reduction in interest rates, on which Dr. Kuczynski spends most of his time. The approach is an indirect, not a direct answer to the question—whether "Emergency Lending Facilities Are Adequate." On the whole, he chooses not to discuss this question on the ground that taxpayers in the industrialized countries are unwilling to make major contributions—which I interpret to mean that there is no possibility of further enlarging the IMF through the legislative process, even though contributions to the IMF lie outside the regular budget and are not paid for by taxes. The other part of this statement is that bank stockholders are unwilling to make a major contribution either. I should have thought the positions of taxpayers and bank stockholders were altogether different. The former can choose through the legislative process not to help. The latter may be called upon to contribute through default on the part of one or more debtor, and would certainly be affected by Kuczynski's proposal for an interest-rate reduction. The argument that bank stockholders won't assist because their shares are in many cases already below book value is not very compelling. If loans to the three major debtors were marked to market, book values would decline drastically. In any event they are locked in and as a group have little choice. A reduction of interest rates might be nominally at stockholder's expense, but could ultimately maintain the value of their shares above levels to which default would bring them.

It is not clear to me that all the bank loans to these countries were contracted on a floating-rate basis. Floating rates help the debtor, of course, so long as interest rates are falling, but are particularly painful now when they are rising. I am impressed by Henry Kaufman's criticism of the innovation of floating rates of the last two decades that it encouraged loose lending by banks because it eliminated the interest-rate risk—or rather eliminated it for the lender and assigned it to the debtor. This left the banks with only one major risk, the one they now face, of borrower default. No doubt the borrowers should have been more circumspect in borrowing at floating rates and taking on the added risk of an adverse movement of interest rates, which they now have to shoulder. But as I shall presently argue, one should perhaps adopt asymmetric standards for developing countries in finance as is done in trade, and I agree with Kuczynski that this may well be done by interest rate reduction.

"Purely by way of illustration" the paper suggests a reduction of interest rates, including spreads and base rates, to the CD rate which is taken to be the cost of money. This would eliminate the banks' profits on rolled-over loans, but in a period of rising interest rates it would not greatly help some of the borrowers on maturing old loans with fixed low rates, if there be any. I should like to refine Mr. Kuczynski's suggestion by adding the asymmetry that rolled-over loans for separate debtors, after IMF approval implying stern programs of austerity kept within the limits of political feasibility, be fixed in interest against increases, but flexible should interest rates decline. Such asymmetry is not entirely new in banking. Richard Sayers' history of the Bank of England records the troubles of the William Deacon's Bank in January 1929 when the Bank came to the rescue but Montagu Norman laid down the condition that the bank was not allowed to raise its dividend even though other banks were doing so, but was required to reduce it should any other bank take that action. The purpose, of course, was to hide the bank's condition from the world. The days of bank secrecy on the subject of bad loans, however, seem long forgotten.

Mr. Kuczynski does not mention the dollar exchange rate, except as the possible cause of a crisis in the event of industrial countries' expectations turning negative. I should like to add to his list of conditions that are necessary for the world to inch its way back from the precipice of default—i.e., reduced interest rates, improved commodity prices and exports, continued capital inflows, and increased austerity—a decline of the dollar from its present overvalued position. The matter is subject to some controversy, but I take the position along with many others that reduced interest rates in general depend on the government deficit, and a reduction in U.S. interest rates would slow down the capital inflow, perhaps lead to some returns, and bring down the dollar. It is a consummation devoutly to be wished for many other reasons as well. If the reduction in interest rates were limited to those on rolled-over Latin loans, separately negotiated, however, without a general reduction leading to a decline in the dollar, one important element in the puzzle would be missing.

Finally, let me return to the question posed by the title of Mr. Kuczynski's paper: "Are international emergency lending facilities adequate?" One aspect of adequacy is amounts. Kuczynski thinks those under the control of the IMF cannot be increased, and he is probably right. I worry further that the IMF moves so slowly in decision-making. The swap network can be put into effect in hours; the IMF takes weeks to make its decisions. For small sums, bridging loans can be marshalled—the $100 million for Hungary in the summer of 1982 from the Bank for International Settlements, $300 million of the $500 million for Argentina scraped up from Latin American countries. The U.S. Treasury in August 1982 dug up $1 billion to buy Mexican oil in advance, and the Federal Reserve Bank of New York in 1983 made a $1 billion bridging loan for Brazil. These look *ad hoc*, and some of them threaten to bring rescue operations to forestall a worldwide crisis into the political arena, as happened with loans to Austria, Germany, and Britain in May, June, and August 1931 respectively. But I take comfort in the words of Sir Robert Peel writing to Parliament about the Bank Bill on June 4, 1844:

> My Confidence is unshaken that we have taken all the Precautions which legislation can prudently take against the Recurrence of a pecuniary Crisis. It may occur in spite of our Precautions; and if it may be necessary to assume a grave Responsibility, I dare say Men will be found willing to assume such a Responsibility.

Planning and rules are necessary up to a point; beyond that we must rely on "Men."

General Discussion

Barend de Vries drew attention to the country-by-country approach that appears to have been taken toward coping with the debt crisis. In many developing countries—such as India, Indonesia and South Korea—this approach includes both short-term and medium-term economic strategies. In these countries, long-term capital inflows are limited to priority projects. Most Latin American nations have neglected the development of medium-term strategies; only Colombia has demonstrated a willingness to adjust foreign capital inflows to a medium-term plan. Colombia is one of the few Latin American countries with no apparent debt problem. Accordingly, medium-term economic strategies deserve greater attention in designing a long-run solution to the debt problem.

David Holland added that the commercial banking system should also focus on a medium-term strategy as a precondition to designing international emergency lending measures. Without some structure, banks will bounce from one crisis to another.

Andre de Lattre rejoined that the IMF has outlined a medium-term strategy for the capital-importing developing countries. While one could judge the IMF's assumptions as too optimistic, its strategy does have meaning.

Robert Solomon commented on the economics of capping. According to Solomon, the typical interest rate capping scheme is fully equivalent to the alternative of increasing loans to the debtor countries. Capping involves adding interest payments beyond some ceiling to the principal on the loans. This would likely lower the debtors' ratios of current interest payments to export earnings, providing some semblance of improved creditworthiness.

Arthur Meehan raised two issues. First, in Far Eastern countries one often finds that capital markets are not free. He suspected that certain Latin American nations' debt problems might be quickly resolved if their capital markets were opened up. He suggested that this might be a less extreme solution for the debt problem than interest rate capping. Second, if capping was adopted, commercial banks—the likely losers under such a program—might reduce their lending.

Pedro-Pablo Kuczynski agreed that Latin American capital markets should be opened, especially to direct foreign investment. During the past 20 years, Latin American governments have adhered to the philosophy that loans from abroad are good but direct investments of foreigners are bad—for reasons of sovereignty. If direct foreign investment had been a larger component of these capital inflows in the late 1970s, the debt problem would likely have been significantly smaller; when economic activity declined in the debtor countries, dividend remittances to foreigners on such investments would have fallen. Instead, these countries face larger interest payments, as U.S. interest rates and the foreign exchange value of the dollar rise.

Kuczynski stressed that interest rate capping would address the immediate debt problem. He estimated that Mexico and Brazil will be devoting roughly 60 percent of their export earnings to debt service in 1984. A reduction in that burden would help such countries to meet future interest payments.