THE THIRD WORLD DEBT: A DANGEROUS GAME

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The basic contention of this article is that the external debt of the highly indebted countries or, more specifically, the interests on this debt cannot and, so, will not be paid in full, so that a solution to the debt problem will necessarily entail some form of reduction of the debt. The non-payment may take several forms. It may be the result of some kind of debt relief decided by the creditor countries or of a unilateral reduction of the debt overhang decided by the debtor countries. It may occur soon, or continue to be postponed as long as the *muddling through approach* to the debt continues to prevail and does not find effective resistance in the debtor countries. While this non-payment does not materialize, or – what is the same – while the debt problem does not find a long term solution, the harm caused to the debtor and to the creditor countries may vary in degree, but one thing is certain: the harmful consequences and the political risks involved in the debt problem only increase for both sides as time goes by.

The debt cannot be paid because it is too high, that is, because the paying capacity of the debtor countries measured by debt-export ratio only deteriorated after six years of debt management by the creditor countries. For each debtor country there was a given moment of time the debt became so high that its payment became incompatible with growth and price stability. Before this given moment, before this threshold was trespassed, an effective adjustment process would be able to solve the problem. But once this frontier was crossed and the debt became too high in relation to the country's production and exporting capacity to be paid, the direct consequences of the adjustment process required by the creditors are essentially negative. They would be extremely necessary if accompanied by a debt reduction, but, as they are not, they have as consequence further diminution of the saving, investing and long term exporting capacity of the debtor countries.

Since the external debt is today essentially a public debt, in each debtor country an "internal" fiscal crisis develops. The public sector in each debtor country is bankrupted.

Big public deficits, reduction of the saving capacity of the state, increase of the internal interest rate as the public sector competes in the internal financial markets for funds define this fiscal crisis. And, as the interest rate increases or as the local currency is devaluated as a consequence of the attempt to follow the rules and pay the debt, this fiscal crisis is deepened. Official multilateral agencies, creditor banks and an internal conservative business elite become aware of the fiscal crisis, but they equate it to a flow problem of public deficit, refusing to see that its basic cause is a stock problem: the external and also, increasingly, the internal debt. So they call for more severe internal adjustment measures, that – if adopted without the necessary concomitant reduction of the external debt– only aggravate the economic crisis: a crisis defined by stagnation of per capita income, very high rates of inflation, and a continuous deterioration of the paying capacity of the debtor country.

That this outcome is very bad for the debtor countries there is no doubt. What I intend to show, however, is that the *muddling through approach,* that leads to stagnation and inflation in the debtor countries, may have been functional for the creditor countries in the beginning, but recently is becoming economically harmful to them and may be politically disastrous. Actually the *muddling through approach* ceased to be a cautious device to protect the banks of the creditor countries and turned into a dangerous game.

Many proposals of debt relief – that I prefer to call debt reduction – have been made. I am not going to discuss them neither to propose another one. Everybody knows what basically has to be done. The proposals do not differ very much one from the other. The cost for the banks of these proposals in terms of debt reduction was already incurred. The reduction in the prices of their stocks and the reserves they created are the forms these costs assumed. And for the governments of the creditor countries the costs of giving a guaranty to the bonds that will be necessary for the reduction of the debt will be even smaller.

But among the creditor countries a decision has not yet been agreed. Why? Excess of caution? Need to protect the interests of the weaker banks? Shortsightness? Moral attitudes against relief? Sheer conservatism? It does not matter which is the cause. The fact is that this delay, this systematic postponement of a real decision, besides provoking stagnation and inflation in the debtor countries, is increasingly threatening their political stability.

In this paper I will discuss candidly this problem. The supporters of the *muddling through approach* believe they are defending the national interest of the creditor countries. I contend that this could be true in 1962, but in 1986 is definite false. The *muddling through approach,* the strategy of postponing a debt reduction to give time to the banks to reduce their exposure to the highly indebted countries, strengthening their capital ratios, turned today in just a costly game to debtor and creditor countries as well.

I will base my argument in the Brazilian experience because Brazil is the country I know better, because is the largest debtor, and because its paging capacity – as can be inferred by the discount in the secondary financial market – is not so bad as Bolivia's or even Argentina's, and not so good as Colombia's. The discount on Brazilian papers has averaged 50 per cent in the last year – and I would say that this is the average paying capacity of the debtor countries.

The financing and adjustment or muddling through approach is the strategy adopted by the banks and the governments of the creditor countries. It says that the interest on the debt can be paid, provided an adequate combination of adjustment with financing. Financing by the banks is naturally very limited. In principle it should never go above 50 per cent of the interests due each year. The debtor is required to product large trade surpluses in order to pay the interests. This strategy started to be called the *muddling through approach* when it became evident that just financing and adjustment would not solve the debt problem, but, in spite of this evidence, banks and governments did not change it. It became clear that the creditors were just postponing a solution of the problem, muddling through the debt.

The partial financing of the interests is basic in this strategy. It is called "new money" by the bankers (they are specialists in semantics), although no real new money is involved. The debtor country does not receive net resources, there is no provision for new investments, just financing of no more than 50 per cent of the interests.

There is a logic in limiting to 50 per cent the financing of interests. Since the real interest rate is roughly 50 per cent of the nominal interest rate, the real total debt will be maintained constant. On the other hand the bankers try to limit at maximum financing interests. Given the present discount in the secondary financial markets of around 50 per cent, every time they make a new loan, this loan looses half of its real value at the same moment.

In 1985, given the evidence of stagnation and increased rates of inflation in the debtor countries, while its paying capacity did not improve, the U.S. Secretary of the Treasury, Mr. James Baker, presented the Baker Plan. To the word "adjustment" was added the expression "with growth", and to the word "financing" the expression "with structural reforms". It was an official recognition by the major creditor country of the failure of the financing and adjustment approach

Actually the Baker Plan did not change the basic tenet of the *muddling through approach:* there is no incompatibility between growth, price stability and the payment of the debt. It just said that the debtor countries need structural reforms, in addition to austerity programs that cut the public deficit and make the exchange rate realistic (adjustment), and that the financing of the interests should be large enough to guarantee growth. By "structural reforms" were understood those reforms that tend to limit state intervention, eliminating all kinds of subsidies and making the economy internationa1ly more competitive. No indication was given about how it would be possible to convince the banks to increase their supply of credit.

In 1987, during the annual IMF meeting, it became clear to everybody including the American authorities (see the speech of Mr. Baker and the communiqué of the Interim Committee) that the *muddling through approach* had failed, that the debt problem was more serious that was initially thought, and that new ideas were necessary.

The failure of the *muddling through* or of the finance and adjustment approach can be seen by several angles:

a) the debtor countries' income pet- capita did not grow since 1980, when the debt problem really appeared and the banks began to demand adjustment from the debtors; in the four initial years per capita income fell sharply due to severe adjustment programs;

since 1984 some growth indeed occurred due to the good export performance of the creditor countries in this year and also to the partial abandonment of the adjustment programs; but growth rates were c1ear1y unsatisfactory; since 1980 stagnation and inflation prevailed in all debtor countries, even that in different degrees; the Latin American income per capita fell 7.6 per cent between 1981 and 1986, the Brazilian increased only 4 per cent; in Brazil, after an artificial growth in 1985/86, the country was back to inflation and stagnation in 1987.

b) the debtors' countries paying capacity did not improve, on the contrary, it deteriorated; the basic objective of the adjustment programs was to increase this paging capacity through increased exports and reduced imports, but imports were reduced not only to the detriment of consumption but mainly due to reduction of investments, so that the exporting capacity of the debtors did not improve;

c) the debtors' paging capacity deterioration became evident in the debt ratios, specially in the debt/export ratio; economists and bankers agreed during the 70s' that such ratio should not surpass the 2 mark; in 1982 it was 2.6 for the ten major debtors, in 1987, 3.8 (see *World Financial Markets* June/July 1987); in Brazil this ratio changed from 3.4 in 1982 to 4.7 in 1987; a deterioration of 46 per cent for all the debtors and of 38 per cent for Brazil.

d) an increasing number of countries started recurring to total or partial moratories of the interests; only in Latin America, in 1987, nine countries were in this situation; no country gave the second unilateral step: to define a discount and/or to say how it would pay the interests; but this is a clear possibility, a quite probable next move.

E) in 1986 a discount appeared in the international financial markets; this discount increased during 1987 reaching a rough average of 50 per cent; it was said correctly that this market was small, and, incorrectly, that it was not significantly; if it is not significant why the big creditors do not buy the credits that are been sold?

f) as Sachs and Huizinga (1987) demonstrated the losses in the value of the stocks of the creditor banks are closely related to their credits against the debtor countries; and, as the authors remembered, this is not a small market.

g) following the move of Citibank, American and British banks started in 1987 to do what European banks have been doing since 1983: to create reserves against sovereign risk.

While the discount in the secondary market and the losses of the banks' stockholders were informal recognitions by the market that the muddling through approach had failed and that the debt could not be fully paid, the creation of reserves was a formal one. So, it was becoming clear to everybody in the middle of 1987 that new ideas are necessary in order to cope with the debt problem. New ideas and new strategies. Because the conflict of interests is so deep, it is nonsense just to emphasize common interests. They exist, but are overcome by the conflicting interests. Before examining some ideas and strategies to cope with the debt problem, however, let examine more carefully the case of Brazil.

Brazil, in the beginning of the 80s, was considered one of the wonders of the world. Growth was very rapid from the 30s' through the 70s. A solid industrial basis was established. More than fifty per cent of Brazilian exports were now of industrial goods, demonstrating the technological development and the international competitiveness of the industrial sector. A large working class, a strong middle or technobureaucratic class and a competent entrepreneurial class were established. In the other highly indebted countries a similar process of growth took place in the 70s', but Brazil and also Korea were the two countries where a clear and successful development strategy was adopted.

It is true that this growth suffered of a basic flaw. While the central countries, after the 1973 oil crisis, engaged in an adjustment process, Brazil decided to go ahead with its import substitution strategy through external indebtment. According to the Second PND (National Development Plan), the state would respond for the basic industries (steel, oil, electric power), the private sector for the capital goods industry and for cellulose production, and a combination of private and public sector, for the non-ferrous metals industry and for petrochemicals.

The cost of this strategy was very clear: public deficit through external indebtment. The justifications for this strategy, compelling: (a) the new liquidity of the international financial market made possible for the commercial banks to lend large sums of money to the developing countries; (b) the cost of theses loans was low (real interest rates below two per cent), and certainly considerably lower than the average rate of return on investment in Brazil, which could be particularly high given the high concentration of income; (c) Brazil had a project of national development – the Second PND – that legitimate if not urged large investments; (d) Brazilian exports increased rapidly during the 70s, suggesting that the indebtment and public deficit strategy was correct – that the country would be able to pay back its loans.

In 1979 this picture changes dramatically due to three new facts that occurred in the creditor countries, particularly in the U.S.: (a) the second oil shock; (b) a sharp increase in the nominal and real interest rates; (c) recession. The causes behind these new facts were, among others, the exhaustion of the deficit oriented Keynesian economic policy and the adoption of monetarist policies in accordance with the conservative wave that took hold of the central countries.

In this moment, in 1979, there was no other alternative for Brazil except adjustment. Korea, that was in that moment in a similar situation, understood that and decided to adjust. In Brazil the Finance Minister that saw clearly the need to adjust – Mario Henrique Simonsen – did not find support in society and resigned. And the new Finance Minister, that took office in August 1979, decided to go ahead and grow, trying to repeat the successful economic policy of 1968 in 1979. It was a terrible mistake. The economic conditions were entirely different. The growth rates of Brazil in 1979 and 1980 are the result of irresponsible indebtment. Brazil would only start adjustment by the end of 1980. But all indications were that then it was too late. That in spite of the strong adjustment in 1981 and 1983, in spite of the stagnation of the income per capita between 1981 and 1987, Brazil's paying capacity only deteriorated, so that Brazil had become unable to pay its debt.

The reason for that is very simple: in the second semester of 1980 the Brazilian external debt was already too high to be paid. Given an external debt around 60 billion and exports of 20 billion dollars the compatibility of growth, price stability and the payment of the interest on the debt no more prevailed. The debt/export ratio was well above the maximum ratio normally accepted: two.

This is the basic reason why creditors decide to refuse new credits to Brazil in this year. The continuous increase of the Brazilian debt at a higher rate than the rate of increase of exports made new loans to Brazil increasingly risky. They only changed their minds when the Brazilian Government admitted changing its internal economic policy and started an adjustment process, in the end of 1980. In 1981 and in 1982 up to August they continued to make voluntary loans to Brazil, but only to finance partially the interests. Real new money, in order to finance new investments, Brazil did not receive since 1979. In August 1982, with the moratorium of Mexico, voluntary lending is definitely closed for Brazil.

In spite of the suspension of voluntary lending to Brazil, neither creditors nor the debtor acknowledged that this debt was too high and so that its interests could not be paid. The creditors proposed and the Brazilian authorities accepted the financing and adjustment approach, hoping that in this way the paying capacity of the country would be reestablished. Actually, they took a structural disequilibrium for a conjunctural one, they confused a stock problem (an external debt too high) with a flow problem (a balance of payments deficit). In consequence the paying capacity of Brazil did not increase in the subsequent years up to now; it deteriorated; while the debt/export ratio grew above the 4 mark and income per capita stagnated.

There is no doubt that up to now the financing and adjustment approach failed. And I am suggesting that this happened and continue to happen in all highly indebted countries because their debt is too high to be paid. The sheer dimension of the debt makes inconsistent the payment of the interests with growth and price stability. Experience is demonstrating that this is true, but this proposition requires more discussion. The simple affirmation that the debt/export ratio should not go above two is not enough.

The external debt of a country becomes “too high”, that is, inconsistent with growth and price stability, when the payment of the respective interests, provided a reasonable rate of interests financing, requires a given level of trade surplus and so a given increase of exports that the country is unable to achieve. The required trade surplus may be achieved through reduction of imports, but in this case the investment capacity – and so, the growth and export capacity of the country – will be reduced, defeating the final objectives of the adjustment process: the increase of the paying capacity of the country and the resumption of its economic growth through the increase of its saving and investment capacity.

In the case of Brazil – and I suggest that the same is true to most highly indebted countries – its external debt became too high to be paid around 1981: the year that Brazil finally starts its adjustment process. At the end of 1980 the Brazilian external debt reached 60 billion dollars, and exports and imports were around 20 billion dollars. Given the assumption that Brazil could reduce imports in 10 per cent without hurting its investment capacity – only reducing internal consumption – and that the maximum rate of financing of interests the banks would provide would be 50 per cent, Brazil should increase 30 per cent its exports during the adjustment period in order to achieve the required trade surplus of 8 billion dollars.

Actually these targets proved not to be feasible. After three years of adjustment the required trade surplus was obtained, but the export and import objectives have been reversed: exports only increased 9 per cent while imports decreased 33 per cent. As a consequence of such net transference of real resources, the saving and investment capacity of the country that was around 22 per cent of GDP was reduced to 16 per cent. Thus the growth and export capacity of the Brazilian economy was seriously hurt.

The big reduction of imports, that is typical of all adjustment processes monitored by IMF and the creditor banks, was made not only at expenses of consumption but also of investment, as can be seen by the reduction of the rate of investment. It was 22.4 per cent in 1980 and in 1983-84 was down to 16 per cent. In the same period the transference of real resources to creditors (identified with the surplus of real transactions), went from 2.5 per cent negative in 1980 to 5.4 per cent positive of GDP in 1984. In the last sears this transference averaged 3 per cent of GDP.

If the transference of real resources is explained by increased exports there is no harm to investment, but if its basic cause is the reduction of imports, the correlation between this transference and the reduction of the rate of investment is direct. It was what happened in Brazil and more generally in Latin America. In 1983 the targeted 8 billion dollars of trade surplus was almost achieved but at expenses of a reduction of the rate of investment, and with sacrifice of the rate of growth. Since 1964 trade surpluses for Brazil averaged 11 billion dollars, but it is quite clear that this was only possible with the reduction of the rate of growth of GDP and of the rate of investment.

The increase of exports can be explained by the real devaluation of the cruzado and by the utilization of idle capacity. However, given the decrease of the rate of investment, the rate of increase of production capacity was reduced. Additionally, given a modest but effective rate of increase of internal demand, the exporting capacity of the country was also reduced. In 1986, with the great increase of internal demand, idle capacity was exhausted. In 1987 this became very clear: exports increased 4 billion dollars, but this was only possible due to the deceleration of the economy.

When Antonio Barros de Castro (1984) emphasized the importance of the Second PND, he was correct, but when he concluded that the investments of the 70s produced a structural trade surplus that would allow Brazil to pay its debt, he was clearly influenced by the growth of exports of 1984 made possible by a particularly good year for the economies of the central countries and by the possibility of Brazil using idle capacity.

But, if the basic problem is the reduction of investment capacity provoked by the diminution of imports or – what is the same – by the transference of real resources to the creditor countries, wouldn't it be possible to increase compensatorily the internal saving capacity of the country? Theoretically this is possible. It is the strategy proposed in the Macroeconomic Control Plan of July 1987. But we should not mix Political Economy – our science – with some kind of social engineering or a sort of mechanical Economics. In order to compensate the excess transference of real resources caused by the excessive dimension of the debt, it would be necessary to reduce substantially internal consumption, well below the historic levels of the average Brazilian propensity to consume. There is no doubt that a great internal effort must be made in this direction. The priority of the Macroeconomic Control Plan was the reduction of the public deficit and so the recuperation of the saving capacity of the public sector. But the limitations of this strategy are quite obvious. The disequilibrium of the public sector is not only a flow disequilibrium, it is also a stock disequilibrium. The problem is not only the public deficit, but also the public debt, especially the external public debt. Total public debt represents more than 50 per cent of GDP and its respective interests cost 3.5 per cent of GDP; only the external public debt represent more than 30 per cent of GDP and their interests, 2.3 per cent of GDP. Therefore there is a structural or stock dimension of the public deficit that will only be solved through a reduction of the public debt, particularly the external public debt. To try to compensate entirely this gap, this insufficiency of internal savings through reduction of internal consumption is not realistic.

On the other hand, it is convenient to remember that a reduction in consumption, if not correctly managed, may have perverse results: instead of increasing the savings capacity, it may reduce it. If the reduction of consumption is abrupt, as it was in 1983, the contraction of internal demand will lead to a diminution of investments and consequently of savings. In order to avoid such distortion it would be necessary to compensate the reduction of internal consumption with an increase of exports and of export oriented investments. But this is not a change that can be easily achieved.

The conclusion, that probably can be extended to most highly indebted countries, is very simple: the Brazilian external debt was already too high in the end of 1980, when the financing and adjustment approach begun to be implemented; in 1988 it is still higher, while the country's exporting capacity was relatively reduced as the rate of transference of real resources to the creditors was sharply increased and the rate of investment according1y reduced. If in the beginning of the decade we already faced with a basic incompatibility between growth and the payment of the interest on the external debt, presently this inconsistency is still more evident.

The idea that debt relief – or, as I prefer to say, debt reduction – is the only realistic way out of the debt crisis begun to become evident in 1987. Before that many economists and politicians and some bankers were already speaking about debt relief. But the turning point happened during the September 1987 IMF/World Bank Annual Meeting in Washington. As Finance Minister I had been the first finance minister in debtor or creditor countries to propose officially a reduction on the debt – through the securitization of the old debt – taking advantage of the discount existing in the secondary markets. I had made this proposal two weeks before in Wien, in the US Congressional Summit. The reaction of the large American banks and of the Secretary of the Treasury was initially very negative. But Japans finance minister supportive comments and an increasing interest of the international financial market changed the picture. When, two weeks later, the IMF/World Bank meeting begun, the attitude towards securitization had changed favorably. In the Communiqué of the Interim Committee, and in the speech of Secretary of the Treasury of the United States the idea appeared clearly. The finance ministers of the creditor countries co-opted the proposal of securitization, including it in the so called menu approach, as one of the market alternatives to cope with the debt problem. In this way the securitization of the debt would have the same status, for instance, of the debt/equity conversion.

The Brazilian formal proposal of September 25, 1987, included the proposal of voluntary securitization of part of the debt. The new bonds would have seignority and, additionally, a limited guaranty for the payment of two years interests began to be negotiated with the World Bank. In November the Mexicans, with the support of Morgan Guaranty, made the first effective move in direction of securitization, giving to the banks as a guarantee for the payment of the principal a zero cupon bond. They tried also a guarantee for the interests from the World Bank, but, as in the case of Brazil, the Mexicans did not succeed in obtaining it due to the opposition of the American government.

The limited success of the Mexican initiative left clear that the reduction of the debt cannot be entirely voluntary; it must be based on the market, but it cannot depend exclusively on market forces. To take advantage of the discount existing in the financial secondary market is indeed a self-defeating strategy if it is only a market operation the resulting increased demand for debt/new bonds conversion will necessarily reduce the discount in the secondary market.

Actually the debt problem will only be solved if there is a reduction in the debt. This reduction should be based on the discount on the secondary market, should be a process of securitization, that is, of debt/new bonds conversion. The new bonds either will have a reduced face value or a reduced, sub-market, rate of interest. And should have a strong guarantee in order to stimulate the banks to swap the old debt for new bonds with a discount.

There are several proposals in this direction. The first one that gained world attention was Senator Bill Bradley's proposal. The American Congress already passed debt relief resolutions proposing – unsuccessfully – that the American government give guarantee to the securitization of the Third World's debt. Last year Mr. Okita, Jayawardena and Sengupta led a WIDER study group that made proposals in this direction taking in consideration the potentiality of the Japanese surplus for world economic development (1987). In the beginning of 1988 the representative of India in the Executive Board of IMF, Mrs. Arjun K. Sengupta (1988), and the chairman of American Express Bank, Mr. James D. Robinson III (1986), presented very similar proposals leading to the securitization of the debt. According to Sengupta's proposal, the IMF should buy the debt from the banks, exchanging it for its own bonds; according to American Express' proposal, a new debt facility, the Institute of International Debt and Development, should be create to perform the same role. The last proposal was quite detailed, demonstrating that the securitization of around 250 billion dollars – the total long and medium term debt of the highly indebted countries to commercial banks – is feasible. The capital that the new institution – or a fund in IMF or in the World Bank – will need to guarantee the whole operation will be around 20 billion dollars – an amount quite small to such a big problem that would be solved in this was. More recently, in the last summit of the G-7, in Toronto, the finance minister of Japan, Mr. Miyasawa, made a similar proposal. According to all accounts the basic resistance to a move in this direction comes from the American government, which is not secure about its consequences on the finances of a few of its weaker banks.

If the creditor countries do not reach an agreement about that, the only alternative to debtor countries will be some kind of debt repudiation. In the end of 1987 year Brazil and Argentina were practically decided to take unilateral measures in this direction. The problem is not only of declaring a moratorium, but of defining how much will be paid and in what conditions. Brazil, for instance, would suspend its moratoria only to the banks that agreed in swapping the old debt for new bonds with the same face value but a sub-market interest rate involving a 40 per cent discount. Supervenient facts, however, led Brazil to a conventional negotiation of its debt, which pleased very much the banks, but is internally only consistent with stagnation and inflation.

A multilateral strategy of debt reduction, as the ones described above, is certainly more desirable than unilateral decisions by the debtor countries. But a unilateral decision will be the only alternative left if the multilateral alternative does not materialize. What is certain is that the large majority of the highly indebted countries will not pay their debt, and that the finance and adjustment approach, the strategy do lending "new money" to countries whose debt is already too high, is absurd. As said John K. Galbraith recently**:**

> "I always thought that the loans to the Third World – particularly to Latin America – will not be paid. We should eliminate them from our books and finish with this unbelievable business of lending extra money so that you (debtors) pay the interests on the old loans' (1988).

But, besides the conviction that the debt will not be paid, there is another problem to condemn the highly indebted countries to stagnation and inflation is not only unjust to the millions and millions that live in theses countries, it is also dangerous. In many of these countries the debt was contracted by authoritarian regimes.

The economic crises brought by the debt problem in the first half of the 80s' was a major factor to support the transition to democracy in these countries. However, as the new democratic and reformist regimes are not being able to solve the same economic crises, it is the turn of the new democracies to be menaced. In Argentina, in Mexico, in Brazil, in the Philippines we have almost the same pattern. In the 70s' capitalism seemed consolidated in these countries, but we had an authoritarian capitalism. Now we have democracy, but neither democracy nor capitalism are safe anymore, giving the dangerous and unjust game the major creditor countries are playing.

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