S. Hrg. 98-838

INTERNATIONAL DEBT

HEARING

BEFORE THE

SUBCOMMITTEE ON ECONOMIC GOALS AND INTERGOVERNMENTAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-EIGHTH CONGRESS

SECOND SESSION

MARCH 28, 1984

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
35-101 O WASHINGTON: 1984

JOINT ECONOMIC COMMITTEE

(Created pursuant to sec. 5(a) of Public Law 304, 79th Congress)

SENATE

ROGER W. JEPSEN, Iowa, *Chairman*
WILLIAM V. ROTH, JR., Delaware
JAMES ABDNOR, South Dakota
STEVEN D. SYMMS, Idaho
MACK MATTINGLY, Georgia
ALFONSE M. D'AMATO, New York
LLOYD BENTSEN, Texas
WILLIAM PROXMIRE, Wisconsin
EDWARD M. KENNEDY, Massachusetts
PAUL S. SARBANES, Maryland

HOUSE OF REPRESENTATIVES

LEE H. HAMILTON, Indiana, *Vice Chairman*
GILLIS W. LONG, Louisiana
PARREN J. MITCHELL, Maryland
AUGUSTUS F. HAWKINS, California
DAVID R. OBEY, Wisconsin
JAMES H. SCHEUER, New York
CHALMERS P. WYLIE, Ohio
MARJORIE S. HOLT, Maryland
DANIEL E. LUNGREN, California
OLYMPIA J. SNOWE, Maine

CHARLES H. BRADFORD, *Acting Executive Director*
JAMES K. GALBRAITH, *Deputy Director*

SUBCOMMITTEE ON ECONOMIC GOALS AND INTERGOVERNMENTAL POLICY

HOUSE OF REPRESENTATIVES

LEE H. HAMILTON, Indiana, *Chairman*
AUGUSTUS F. HAWKINS, California
OLYMPIA J. SNOWE, Maine

SENATE

LLOYD BENTSEN, Texas, *Vice Chairman*
ROGER W. JEPSEN, Iowa
ALFONSE M. D'AMATO, New York

CONTENTS

WITNESSES AND STATEMENTS

Wednesday, March 28, 1984

SUBMISSIONS FOR THE RECORD

Wednesday, March 28, 1984

INTERNATIONAL DEBT

WEDNESDAY, MARCH 28, 1984

CONGRESS OF THE UNITED STATES, SUBCOMMITTEE ON ECONOMIC GOALS AND INTERGOVERNMENTAL POLICY OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 340, Cannon House Office Building, Hon. Lee H. Hamilton (chairman of the subcommittee) presiding.

Present: Representative Hamilton.

Also present: James K. Galbraith, deputy director; and Sandra Masur and Robert R. Davis, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The Subcommittee on Economic Goals and Intergovernmental Policy will come to order.

Since August 1982 when the Mexican Government announced that it could not continue servicing its massive debt, the crisis atmosphere surrounding the international debt situation has abated. However, problems certainly remain, Argentina being the most immediate and obvious one, and there is a wide divergence of views concerning the current situation and the prospects for the future.

There are those who believe that we are on the right path to solving this critical problem, that the current set of ad hoc debt management policies, coupled with sustained industrial economic growth, will return us to a more normal situation. There are those observers who believe we are but in the eye of the storm, with major crises ahead, unless substantial policy changes are made now.

Regardless of one's perspective, it is indisputable that the international debt situation has had an enormous effect on the U.S. economy and will continue to do so for years to come. And it is no less true that our economic performance is a critical component in helping the debtor countries to get out from under their debt burden.

We are fortunate today to have with us two distinguished eminent economists who have done a great deal of work and commented frequently on the international debt situation: William Cline from the Institute for International Economics and Prof. Rudiger Dornbusch from MIT.

We look forward to your testimony and discussing with you the important issues in this area.

Both of you have rather extensive prepared statements. Those statements, of course, will be entered into the record in full. I would appreciate it very much if you would summarize those statements and not take the full time to read them so that we can turn soon to questions.

Mr. Cline, you are first, and we will begin with you.

STATEMENT OF WILLIAM R. CLINE, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, D.C.

Mr. CLINE. Thank you very much, Mr. Chairman.

The crucial question before us is whether the current strategy of dealing with the debt crisis is viable in the medium term. I will not dwell on causes of the debt crisis. They are relatively well-known. I will simply emphasize that oil price increases, and especially the global recession of 1981–82, had a major impact in causing the crisis. And by the same token, because oil prices are unlikely to experience another huge leap, and because we are now coming out of the recession of 1981–82, these pressures will be reversed.

I would also add that the internal policies that have contributed to the problem in terms of overevaluation of exchange rates and capital flight have largely been terminated. Countries such as Mexico, Venezuela, and Argentina are no longer allowing enormous capital flight, and that, too, should help the problem.

I will also not dwell on the vulnerability of the banking system to the debt problem. The public is generally aware of this problem. I will simply cite one figure. The nine largest U.S. banks have loans outstanding to developing countries and Eastern European countries that amount to 280 percent of their capital.

Let me turn to the current strategy. The strategy that we have employed so far has been based on the concept that the problem is one of temporary illiquidity, not fundamental insolvency. The strategy has therefore adopted appropriate policies of temporary lending to tide countries over the liquidity problem, rather than writeoffs of the debt. There has been continued debt servicing rather than extended and complete moratorium.

In earlier work last year published at the Institute, I prepared a projection model for the major debtor countries examining their prospective balance of payments and debt. This model concludes that under a scenario, which is basically the expected scenario, of 3-percent growth in the OEC countries in 1984–86, and with interest rates not surging once again to their extremely high levels of 1981–82, the debt problem should be manageable. The ratio of debt to exports for the 19 largest debtor countries declines from 190 percent to 160 percent. For the oil importing countries, again, by 1986 the improvement is even sharper, especially for the major debtors such as Mexico, Brazil, and Argentina.

I would add that other analyses along the same lines have come to the same conclusion. I would cite in particular the Federal Reserve Bank of New York in its model and Morgan Guaranty Bank in its model.

What evidence do we have to date on the performance according to this script?

I would submit that the evidence is quite favorable. We have seen overperformance rather than underperformance on external adjustments. Mexico, according to its plan with the IMF, was supposed to have a current account deficit of $3 billion in 1983. Mexico's actual current account performance was a surplus of $5.6 billion.

Venezuela was anticipated in my model to have a deficit of $4 billion in 1983. Instead, Venezuela had a surplus of $5 billion. Brazil's IMF program called for a deficit of $7.5 billion. Instead, Brazil actually had a somewhat smaller deficit, $6.5 billion.

For the seven largest debtor countries in my model, 1983 results showed less than half the magnitude of the external deficit that had been projected. So I would submit that the analysis I conducted last year, so far, is rather being overperformed than underperformed.

The main negative factor in this picture is a very severe recession in the debtor countries in 1983. Latin America had a decline in GNP of 3 percent. The external adjustment which was achieved was perhaps less robust than might have been desired because it was largely on the side of reducing imports rather than increasing exports. At this point the crucial requirement is for increased exports to finance increased imports that can support a recovery of domestic incomes.

What about the assumptions on international growth? International economic recovery is the keystone to the resolution of the debt problem. The typical forecast now calls for a growth of 3.5 to 4 percent for 1984. Through 1986, the average in most forecasts is expected to be on the order of 3 percent.

To just cite an example, the March 12 forecast of the LINK project of the University of Pennsylvania, an international project, calls for 4.3 percent growth in 1984, 2.9 percent in 1985, and 2.0 percent in 1986, with an average slightly above 3 percent for the period.

Interest rates, it is true, are edging up, but 1 percentage point on increased growth is worth about 5 to 7 percentage points on increased interest rate, and the somewhat higher than expected growth in 1984 should more than offset the edging up of interest rates that we are seeing in the markets now.

The strength of the dollar also plays a role. An unduly strong dollar, as we have had since 1980, means that the dollar prices of world-traded goods are depressed. That is, otherwise the real value of the commodities would actually be rising, if their dollar value remained unchanged. Since that does not happen, the dollar price goes down. We are starting to see a reversal of the overvaluation of the dollar, and it is not unrealistic to expect that in 1984 and 1985 the dollar might decline by perhaps 10 percent each year. So it seems to me the macroeconomic assumptions are coming on track.

What about the medium-term viability? It is true that even with the improvement that we are seeing so far, it may not be until 1986 or 1988 that some of the key debtor countries are back to more normal creditworthiness levels. What will keep the process moving until then?

It seems to me that the process of bank lending that we have seen so far offers encouragement. Banks are now lending under what I call a regime of involuntary lending. Now, under this mechanism, banks that are not currently exposed do not make new loans to countries in trouble. But the banks that are already exposed have an incentive to make additional modest new loans to shore up the quality of the outstanding loans. And, in fact, that is what we have seen. We have seen the mobilization of bank lending on order of 5 to 7 percent expansion of exposure in Mexico; again, Brazil recently received a $6.5 billion loan from abroad. So that process seems to be holding up.

The medium-term viability also depends on political response in the debtor countries. And here, again, we have seen a much better performance than many had feared. The Mexican political response to the lag of wages behind inflation, for example, has been mild. Even the Brazilian political situation, despite a formal call by the major opposition party last year for a moratorium on debt, has passed a critical watershed and in November voted a congressional compromise on the wage indexing law that permitted the renewal of IMF lending and bank lending.

The current crisis, of course, or semicrisis is the Argentine situation. In my view, the Argentine problem has been overplayed in the press in recent days. It seems to me that what we are seeing is essentially a technical deadline that may cause and is likely to cause at this point the bookkeeping reduction of some of the recorded interest on Argentine loans. But this process should be reversed within perhaps the next 2 months. It seems to me still likely that Argentina will reach an IMF agreement within the next two months or so and that that will make it possible for the banks to renew their lending and, therefore, for Argentina to pay its interest.

One must keep in mind that the Argentine Government is still within the 6-month deadline it set for itself to set its house in order on debt. And one must also keep in mind the U.S. banks only account for one-third of the bank lending to Argentina, and the Japanese and European banks do not face the same 90-day deadline that U.S. banks face.

In Brazil I would signal simply the fact that the major progress in reducing oil imports will make it possible for them to reduce their debt/export ratios over the next 2 or 3 years back to more normal levels, even without heroic assumptions about rapid export growth. And I might say I have new estimates which downsize to some extent the export forecast for Brazil and still come to the conclusion, because of declining oil imports, that their creditworthiness will recover.

My bottom line on this broad assessment, since I am running out of time, is that we have basically been following the proper public policy strategy on international debt, that it would be a serious mistake to adopt extreme measures, such as write-downs of the debt. Those who, for example, would advocate a 30-percent write-down of the debt either have a cataclysmic view of the world that I find unjustified or perhaps also are unaware of the implications. This would mean essentially casting the U.S. major banks into at least technical bankruptcy.

There are schemes that would say that a new international agency should buy up the debt and that it should be stretched out over many years and its interest rate reduced.

Such schemes ignore the fact that they would cut off the lending from the banks precisely because they would remove the incentive that banks have now to lend, let us say, to Brazil to shore up their old loans on Brazil, because the banks would no longer have any loans against Brazil.

There are also important policy implications on the positive side. It is essential that banks keep lending internationally at something like the $25 billion rate which is only half of the rate of, say, 1981. It is important that this threshold not be reduced further. It is essential that industrial countries, and especially the United States, keep their markets open for the exports of developing countries in debt. Otherwise, these countries will not have the foreign exchange to service the debt.

I would, however, point out that the markets remain relatively more open than one might suspect and that a lot of the protection of the last year or two has been north-north protection, say, against Japan rather than against the developing countries.

The banks can cut the spreads on their loans. Mexico is paying about $700 million a year extra because of the penalty spreads on rescheduling of the debt. This price is not really a market clearing price; it is a negotiated price. And there is room for the banks to reduce that price without taking significant losses as long as the interest rate spread above international interest rates stays at least at or slightly above the original terms of the loan.

For the United States it is also extremely important to resolve the budget deficit problem so that we can have a more balanced monetary and fiscal policy that will permit lower interest rates closer to historical real interest rate levels. With the very high interest rates that we currently have as the result of the pressure of huge fiscal deficits on the credit markets, we jeopardize the debt problem because we impose a heavy burden of interest payments on the debtor countries whose interest payments are linked to the international level of interest rates which are driven by our own interest rates.

Thank you very much.

[The prepared statement of Mr. Cline follows:]

35-101 0 - 84 - 2

PREPARED STATEMENT OF WILLIAM R. CLINE

MANAGING GLOBAL DEBT: AN INTERIM EVALUATION [1]

It has been more than eighteen months since Mexico temporarily suspended payment on its external debt of $80 billion, marking the onset of the first major crisis in international debt in the postwar period. Since that time more than 30 countries have encountered debt servicing disruptions, and approximately $100 billion in debt maturities has been rescheduled. It is an appropriate time to judge whether the worst of the crisis has been overcome, or whether instead even more severe breakdowns are in store for the future.

So far the international financial community has responded energetically to the debt crisis. Central banks, the U.S. Treasury, the International Monetary Fund, the Bank for International Settlements, national export credit agencies, and multilateral lending institutions have all contributed official funding to financial rescue packages. The private banks, with some exceptions, have done their part by jointly extending new credit rather than individually withdrawing. Most debtor

---

1. For specific estimates and elaboration of the analysis presented here, see William R. Cline, International Debt: Systemic Risk and Policy Response (Washington, DC: Institute for International Economics, 1984).

countries have carried out their role by adopting adjustment programs. Through this strategy, ad hoc though it may be, major defaults or write-downs have been avoided. The central question is whether the current strategy will continue to work in the future.

Origins and Systemic Risk

The causes of the debt problem are relatively well known. Both external shocks and domestic policies played a role. The oil price shocks of 1974 and 1980-81 added a cumulative total of $260 billion to the import costs of oil-importing countries from 1973 through 1982, above what would have been paid if oil prices had merely kept pace with general inflation. Largely as the result of mismatched monetary and fiscal policies in the United States, interest rates in 1981-82 were extraordinarily high, adding approximately $40 billion to the debt servicing costs of non-oil developing countries above the interest burden that could have been expected on the basis of historical real interest rates. The global recession of 1981-82, the most severe since the Great Depression, cost these countries an estimated $100 billion in foregone export earnings, through lower real prices and quantities for their exports. In all, additional external deficits of approximately $400 billion in 1973-82 were attributable to external shocks, amounting to the major portion of the $500 billion increase in the debt of non-oil developing countries over this period.

Through the 1970s growing debt was supported by growing temporary freezing up of new bank lending to countries in difficulty caused debt disruptions and the need for painful adjustment programs. But it also highlighted how vulnerable the industrial countries had become to developing country debt through the large exposure of Western banks. The nine largest U.S. banks had loans outstanding to East European and developing countries equal to 280 percent of bank capital. If more than a third of this debt were determined to be worthless and written off, the major banks would reach technical bankruptcy. Two of the largest U.S. banks had exposure in Brazil alone amounting to three-fourths of their capital. Even considering that write-downs would not be total (barring outright debt repudiation) and that the central banks would almost certainly act to moderate potentially drastic economic consequences of major defaults, the potential threat of the debt crisis to the Western financial structures and economies was severe. Thus, the write-off of one year's principal and interest from Argentina, Brazil, and Mexico would eliminate profits and one-third of capital for the nine largest U.S. banks. Declining capital would cause strong pressure to reduce total lending, including domestic, to remain within acceptable capital-loan ratios. While this effect would be recessionary, there could also be inflationary consequences if foreign defaults prompted central banks to inject funds into affected banks, potentially expanding the monetary base. Moreover, it is not just the largest banks that are involved: even excluding the top nine, other U.S. banks have loans outstanding to developing and East European countries equal to

114 percent of their capital.

Debt Prospects

A fundamental question is whether the debt crisis represents a temporary problem of illiquidity or a problem of permanent insolvency. Although for a country as opposed to a firm the distinction is metaphorical rather than precise it is nonetheless essential to make. The country is insolvent if, under all plausible scenarios of trade performance and lending availability, there is no forseeable way it can service its debt. It is illiquid if adjustment measures and likely international developments should enable it to reduce foreign deficits to magnitudes manageable with plausible amounts of foreign financing. To this point, the central actors in the international financial system have treated the debt problem as one of illiquidity, not insolvency, and have extended additional lending to tide countries over problems judged to be temporary, rather than writing down or writing off their debts as would be appropriate under a diagnosis of fundamental insolvency.

In order to examine the issue of illiquidity versus insolvency, I have prepared an analytical model projecting the balance of payments and debt of the 19 largest debtor countries through 1986.[2] In this model export volumes rise by 3 percent for each additional percentage point of OECD growth (although because exports actually decline at zero OECD growth the average

---

2. Ibid.

elasticity, or degree of export responsiveness, is only 2 percent for each 1 percent OECD growth). Export prices also respond to international recovery, depending on the composition of each country's exports, as estimated on the basis of patterns during the past two decades. Imports respond to the country's own domestic growth, rising proportionately with GNP and in addition rising by 3 percent for a 1 percent rise in the growth rate over the previous year (because changes in imports respond more than proportionately to cyclical domestic growth). Non-oil imports decline by 0.6 percent from a 1 percent real devaluation, which causes exports to rise by 0.5 percent. Interest payments depend on international interest rates (LIBOR).

Prices of traded goods depend on OECD inflation, assumed to average 5 percent annually. In addition, the dollar prices of traded goods are assumed to rise by 1 percent for each 1 percent that the dollar depreciates relative to other major currencies. (Otherwise, the real price of commodities and manufactures in terms of international purchasing power would change just because of a change in the dollar-yen and dollar-Deutschemark rates, for example.)[3] The strength of the dollar has been a special problem in 1981-83, because the dollar's rise has contributed to declining dollar prices for commodities, thereby weakening the underpinning of dollar export earnings relative to dollar-

---

3. The dollar prices of internationally traded goods have confirmed this analysis in recent years, rising by about the same amount as dollar depreciation in 1979-80 and falling by approximately the amount of dollar appreciation in 1981-82.

denominated debt. Finally, values of oil trade depend on the price of oil.

The base-case assumptions of the estimates, conducted in mid-1983, were that OECD growth would average 1.5 percent in 1983 and 3 percent thereafter; LIBOR would decline to 8 percent by 1986; the price of oil would remain at $29 per barrel through 1985, and the dollar would depreciate by 5 percent in 1983 and another 10 percent in 1984. Domestic growth in debtor countries was assumed to trend upward from 2.5 percent to 4.5 percent over the period (with some important exceptions), and cases of major devaluations were taken into account. Under these assumptions, the ratio of net debt (deducting reserves) to exports improves from 190 percent in 1982 to 160 percent in 1986 for the 19 largest debtors as a group. For the oil importing countries, the improvement is sharper, from 194 percent to 128 percent. Because stagnant oil prices are assumed, oil exporters show a deterioration, but from a relatively favorable base.

For the most important debtors, the basic projections show major improvement, with the debt-export ratio declining from 380 percent in 1982 to 200 percent in 1986 for Brazil, from 275 percent to 230 percent for Mexico, and from 370 percent to 180 percent for Argentina. The only major cases of deterioration are for Venezuela and certain other oil exporters; but in the course of 1983 Venezuela in particular demonstrated an unexpected ability to cut imports severely, suggesting that its future balance of payments can be much more favorable than in the base-case projections. In addition to the debt-export ratio, the interest rate- export growth rate comparison is favorable, as the oil importing countries experience export growth averaging 16 percent through 1986 but face interest rates on the order of 10 percent (or lower, considering the official component of debt). Real export growth averages 6 percent, a reasonable rate if OECD recovery persists, considering past experience.

The basic conclusion of these projections is that the debt problem is indeed one of illiquidity rather than insolvency. International economic recovery boosts exports and improves the creditworthiness indicators for most of the major debtor countries. Accordingly, the strategy used in dealing with the problem to date -- temporary lending rather than more radical action such as major write-downs -- is appropriate. Other projection analyses have tended to come to the same conclusion.[4]

This favorable conclusion is sensitive to adequate performance of the international economy. If OECD growth averages 2 percent instead of 3 percent in 1984-86, there is no improvement in debtor country creditworthiness (although additional computations indicate that by a further 10 percent real devaluation the debtor countries could offset the adverse effects of a reduction in OECD growth by 1 percentage point). A

---

4. Morgan Guaranty bank in World Financial Markets, February 1983; and Ronald Leven and David L. Roberts, "Latin America's Prospects for Recovery," Federal Reserve Bank of New York Quarterly Review 8:3 (Autumn 1983). However, a more pessimistic conclusion, especially on debtor-country growth, is reached in Thomas O. Enders and Richard P. Mattione, "Latin America: The Crisis of Debt and Growth," Brookings Discussion Papers in International Economics, No. 9, December 1983.

surge in interest rates by 5 percentage points similarly would eliminate improvement in debt trends.

Performance to Date

The actual results on balance of payments and debt in 1983 are now history. Broadly, performance to date is even better than projected in the model described above. The most spectacular over-performance was in Mexico and Venezuela. The IMF program called for a current account (goods and services) deficit of $3 billion in Mexico; instead, Mexico recorded a current account surplus of $5.6 billion. The projection model called for a Venezuelan deficit of $4.4 billion; instead, Venezuela achieved a $5 billion surplus. In Brazil, the IMF-agreed target of a trade balance surplus of $6 billion was over-achieved, and the current account deficit was $6.5 billion rather than the official target of $7.7 billion. For the seven largest debtors, the actual current account deficits in 1983 totaled only 40 percent of the aggregate figure projected in the model described above. At least on the criterion of external balances, recovery from the debt crisis is ahead of schedule.

The success to date has come at a high cost. It has been achieved primarily through reductions in imports rather than increases in exports. Venezuela's imports fell by 60 percent in 1983, and Mexico's imports in 1983 were less than half their level in 1981. Import compression has come at the expense of lower domestic income. Gross domestic product declined by approximately 4 percent in both Mexico and Brazil in 1983. For default, thereby shoring up their previous loans to the country. In technical terms, banks find it attractive to extend new lending as long as the resulting reduction in the probability of default, multiplied by the amount of outstanding exposure (in other words, the expected benefit) exceeds the terminal probability of default multiplied by the amount of new lending (the expected cost of the new lending).

Although rational for banks as a group, modest new "involuntary" lending to safeguard old loans may not appeal to smaller banks. They tend not to recognize that their individual actions affect the default probabilities, although in the aggregate their actions matter. The smaller banks have a temptation to be "free riders," benefitting from the improved quality of all outstanding loans that occurs when the larger banks make additional new loans to enable the country to avoid default.

In 1982-83 various influences overcame the free-rider problem. In a historic departure, the IMF made its lending conditional on the provision of new money from the banks, thereby acting as a centralizing force to coalesce new lending from otherwise free-riding smaller banks. Central banks appear to have applied pressure in this direction as well, and large banks were relatively successful in making the case that all banks had to bear their fair share of the burden of new lending. Ultimately, official pressure was probably less important in circumventing the free-rider problem in involuntary lending than was the sheer realization that in the absence of coordinated action less favorable consequences could be expected, such as more unilateral moves by the debtor country to ignore payments or capitalize interest due.

In the process of involuntary lending, the banks have not been "digging themselves in deeper" as some critics contend. Because their new lending is considerably less than the interest they are receiving (with exposure expanding in the range of 5 percent to 7 percent while interest rates are in the range of 12 percent), in an economically meaningful sense the banks are reducing their exposure, not increasing it. That is, for the real present discounted value of their exposure to hold constant, they would have to be increasing exposure at the interest rate, or considerably faster than has actually occurred.

If interim financing can be secured on the supply side of the debt equation, what about the demand side? Will the debtor countries simply find it more attractive to default than to continue participating in financial packages with domestic adjustment as the price? In one sense the incentive to default has risen. In the 1970s, for every dollar of interest paid out there were three dollars of new lending entering the country. By 1982 this relationship had shifted to a net negative balance, with interest payments exceeding new borrowing (especially for some of the larger debtors). By a narrow calculation along these lines some countries might be tempted to default.

However, the stakes in default are much higher than the short-run comparison between interest paid and new loans received can convey. The major debtors have become integrated into the international economy as newly-industrialized countries, and they are unlikely to discard this hard-won status by cutting themselves off from the international financial system through default.

Even a close calculation of financial effects of default (or open-ended moratorium on interest and principal) would be likely to show a negative balance. Not only would new medium-term lending be cut off; in addition, short term trade credit usually rolled over would be likely to evaporate. In Brazil, for example, interest payments are approximately $11 billion. New private and official lending and direct investment are on the order of $8 billion for 1984. A moratorium at most would save $ 3 billion annually, and if even one-third of short-term trade credit were lost the net financial result would be zero or negative.

The broader risk of default or moratorium for the country is that it will be pushed toward autarky. Beyond financial isolation, there is the risk that foreign creditors would seize export shipments through legal action. These broader risks of unknown dimensions, in addition to the likely credit consequences, make default a risky and unattractive strategy in most circumstances. At the same time, the incentive of each country to preserve its own credit rating if future prospects appear favorable works against the formation of a debtors' cartel. Both this factor and the general risks of default have made a debtors' cartel unappealing to debtors so far, as illustrated by the mild outcomes of international meetings of debtor countries.

Although there is growing recognition that the current strategy of global debt management is succeeding, many question its medium-term viability on economic and political grounds. In the economic sphere they argue that the debt reschedulings to date have merely postponed the problem to the late 1980s when large maturity bunchings, especially for Mexico, will pose a new burden. However, fears concerning maturity bunchings fail to recognize that the treatment of amortization of past loans is a far different matter from the mobilization of new funds for the expansion of exposure. Most banks and official entities have no illusions that actual repayment of principal is a realistic option over the medium term. Their objective is not to receive net repayments of principal but to obtain orderly servicing of the interest on the debt owed, combined with rollover of the principal. Preferably this rollover will occur on a market, voluntary basis; but if necessary, it can be achieved through subsequent rounds of rescheduling. The non-receipt of net principal may be seen as less threatening if viewed in the light of normal corporate debt: the market does not expect General Motors to reduce its outstanding indebtedness over time, but it does expect to receive timely interest payments.

The eventual return to voluntary lending also remains uncertain. Even as creditworthiness indicators return to more normal levels, the transition to voluntary lending may be difficult. Logically this transition will require that at least the smaller banks be able to receive their amortization

35-101 O - 84 - 4

payments; otherwise lending will not yet be voluntary. However, calculations based on the projections described above indicate that by the late 1980s, the requirements for new lending should be sufficiently limited that plausible expansion of large-bank exposure (by those banks seeking to remain long-term lenders to the country), on the order of 7 to 12 percent annually, should be sufficient to cover external deficits in addition to modest amortization payments to the smaller banks accounting for up to 30 percent of total bank exposure, in the cases of the three largest debtor countries.

Political viability is more difficult to evaluate than economic viability. However, the evidence to date indicates that political tolerance to adjustment programs has been greater than many had feared. There has been minimal social disruption in Mexico, where the traditional ability of the official party to absorb dissent has been effective and where appearances of spreading the burden of adjustment evenly have been achieved through punishment of corruption among former officials as well as bank nationalization. The willingness of Mexican labor to accept temporary lags of wages behind inflation has contributed to stabilization.

In Brazil, social unrest has been more serious, as riots in Sao Paulo and food-store sackings in Rio de Janeiro and the Northeast have reflected the pressures of recession and a disastrous harvest caused by drought and floods. November 1983 was a watershed in the political viability of debt management. Earlier the major opposition party had called for a debt moratorium, and in October the opposition defeated the centerpiece of the IMF stabilization program, a bill limiting wage indexation to 80 percent of past inflation. However, in November a compromise indexation law paved the way for renewed IMF and bank lending, in turn undercutting the demands for moratorium. In Argentina, the resounding election of a new president augured well for the ability of the new democratic regime to achieve domestic support for an adjustment program. The new regime seems likely to honor the basic rules of the game in international debt, but may be expected to bargain hard on terms.

Through early 1984 the evidence on political viability of the current process of debt management was therefore relatively favorable. This emerging pattern was all the more impressive considering the extreme economic hardship being experienced in several of the debtor countries. Real per capita incomes have fallen by amounts ranging from 10 percent to 15 percent in the last three years in several Latin American countries, with natural disasters in Peru and elsewhere adding to the recessionary side-effects of adjustment.

In gauging political viability over the medium term, it is essential to recognize that adjustment to the external debt problem is unlikely to require many more years of recession. Many analysts appear to consider long-term domestic recession for the purpose of compressing imports to be a prerequisite of debt managment under the current strategy. Instead, the real prerequisite is the transfer of resources from non-tradables to activity in the tradables sector, producing exports and import substitutes. As new investment picks up in the tradables sector, economic recovery should resume. External adustment will then be continued through expansion of exports and increased imports, rather than through domestic recession and import contraction.

Policy Measures

Correct policy decisions by governments, international agencies, and the banks will be essential to successful management of international debt. An important policy improvement was achieved in 1983 when the U.S. Congress approved increases in the quota resources of the IMF and, in a significant new departure, the creation of special funding in an emergency borrowing facility (through the General Arrangements to Borrow, financed by major industrial countries). Congress finally acted despite intense criticism that the measure was a bail-out for irresponsible banks. In reality banks were being asked to contribute still more resources, not being bailed out; and a breakdown of international debt threatened to do far more damage than could be confined to bank share-holders (who have already taken substantial losses from falling stock prices). Moreover, the annual cost of higher IMF quotas was minimal, considering that most of the resources called upon would earn interest close to the market rate for official debt instruments.

An important area of bank strategy and policy is the level of interest rate spreads above LIBOR and special fees on the reschedulings and new lending for debtor countries. The initial pattern of reschedulings led to sharp increases in these costs. Mexico had paid a spread of approximately 0.9 percent above LIBOR in borrowings through 1981, but faced a spread of almost 3 percent above LIBOR on its rescheduled debt of nearly $35 billion in 1982-83. The additional costs to Mexico have been approximately $700 million annually, or 5 percent of a normal level of annual imports.

In major debt reschedulings, the interest rate is not a market clearing mechanism but a negotiated price, technically analogous to the determination of wages in a bilateral monopoly between a powerful labor union and large firms. The actual price can vary over a certain range, with the outcome depending on bargaining leverage. In these circumstances the concept of fairness takes on importance. For the banks, interest on rescheduled loans should be at least as high as on the original loans; otherwise there is a "moral hazard" or incentive to break the original contract. For the borrowing country, extreme increases in interest spreads will appear to be unfair.

There is room for reduction of spreads below the high levels associated with the major recent reschedulings. Indeed, in the new lending for Mexico in 1984, the spread has been reduced by approximately 1 percentage point from the level in the previous year's lending. This process, if pursued, should help secure political support in debtor countries for continued adherence to financial obligations and adjustment programs. However, if spreads are lowered too far it will be more and more difficult to mobilize new lending, especially from smaller banks. In addition, the magnitudes of the savings to the country from reducing spreads are inherently limited. Considering these factors, reduction of spreads to perhaps one-half percentage point above the spreads on the original loans would be a useful direction for bank reschedulings and new lending, especially if such reductions can be linked to demonstrated progress in country adjustment.

Bank regulation is an important area of public policy. The legislation to increase IMF quotas fortunately was passed stripped of numerous punitive amendments on bank regulation, such as required provisioning to loan loss reserves on all rescheduled loans. European banks appear to have set aside greater reserves on developing country debt than U.S. banks, in large part because of their greater incentive to do so under tax laws that encourage "hidden reserves" in the form of undervalued assets. U.S. banks may not take tax deductions for loss reserves in excess of 0.6 percent of total assets. Greater tax flexibility on U.S. reserves would be helpful. More generally, flexibility by regulators may be required in areas such as the classification of loans for reserving purposes -- especially if deadlines on interest have been missed (typically 6 months is the demarcation that tends to trigger loan-loss reserves, and a 3 month deadline applies to the milder measure of removal of interest accrual from reported earnings) but negotiations show promise for resumption. In extreme cases, interest capitalization may be required, as discussed below; if so, regulatory flexibility will be required to avoid classification of loans as requiring loss reserves.

Public policy toward resources for the multilateral development banks is also important. Expansion of capital for the World Bank and Inter-American Development Bank will be an active issue in the future. The experience of the early 1980s should be read as evidence of the risk of relying too heavily on private financial flows for development finance, given the vulnerability of these flows to sudden reversal, and decisions on multilateral development financing at near-market terms will be the occasion to begin reversing this trend toward greater risk in the system.

For their part, the private banks must continue to provide new lending at magnitudes at least comparable to the reduced levels of 1982-83. Net new bank lending to developing countries declined from approximately $50 billion in 1981 to $25 billion in 1982, and appears to have been at this level again or slightly lower in 1983. Yet the projections discussed above suggest that through 1986 annual capital flows of approximately $75-80 billion will be required to finance the external deficits of developing countries, even allowing for major progress toward external adjustment. It will be extremely difficult if not impossible to mobilize financing on this scale if private banks cut back their new lending still further.

Trade policy is an essential area of public policy for resolution of the debt problem. It will be impossible for debtor countries to service their debt if their efforts to increase exports are thwarted by new protectionist barriers in industrial countries. In the early 1980s export stagnation was driven primarily by global recession, not new protection.[3] However, protectionist pressures are high as the result of recent unemployment and, in the United States, a seriously overvalued dollar.

The seeming trend toward restriction of the steel market for imports from developing countries in early 1984 directly pitted sectoral interests against the broader financial objective of permitting Brazil and other debtors to earn their way out of the debt crisis. However, despite pressures for enforcement of unfair trade legislation and more directly protectionist efforts the markets remain relatively open to exports from debtor countries. The political power to obtain protection appears to be concentrated in a few sectors with large employment and voting power, especially textiles and apparel, steel, and automobiles. For a wide range of other products the markets should remain relatively open in the future, although political leadership will be necessary to ensure this result.[4]

There have been numerous proposals to address the debt problem through sweeping new reform schemes. Typically these mechanisms involve the transfer of debt to an international

---

3. C. Fred Bergsten and William R. Cline, "Trade Policy in the 1980s: An Overview," in William R. Cline editor, Trade Policy in the 1980s (Washington, D.C.: Institute for International Economics, 1983), pp. 72-75.

4. William R. Cline, Exports of Manufactures from Developing Countries: Performance and Prospects for Market Access (Washington, D.C.: Brookings Institution, forthcoming).

agency which would purchase it from the banks at some fraction of its face value, and in turn reduce the interest rates and stretch out the maturities facing the debtor countries. However, such proposals implicitly judge the problem to be one of insolvency, not illiquidity, and the analysis here suggests that such a diagnosis is inaccurate. New entities could require large public capital.

Mechanisms of this type would tend to cut off new capital flows from the most important source, the private banks, by terminating the incentive mechanism of involuntary lending: once banks held claims on a new international agency instead of on Brazil or Mexico, they could afford to cut off all new loans to such countries until future years when creditworthiness might be more clearly reestablished, because country default would no longer affect them. Finally, such proposals would be devastating to the capital of banks, because, as outlined earlier, significant writeoffs on sovereign lending would make deep cuts into the capital of the banks.

Contingency approaches may nonetheless be required. Especially if banker fatigue from repeated rounds of mobilizing involuntary bank lending causes a breakdown in this mechanism, it may be necessary to resort to other approaches. Increasingly interest capitalization, or interest rescheduling, is attracting attention as a contingency alternative. In this process, instead of raising new bank lending to pay part of interest due, some portion of interest would merely be added to the outstanding principal due. Normally failure to meet interest would occasion the setting aside of loan loss reserves, but a cooperative regulatory attitude, judging the arrangement not to jeopardize ultimate collectability of the loans, could probably be obtained under certain conditions.

If possible interest capitalization should be avoided. It tends to remove the last degree of voluntariness from the lending system. At present the country must present an adjustment package that convinces banks to make new loans. Interest capitalization would tend to lead to unilateral statement by the country of the interest it is rescheduling. Correspondingly, capitalization of interest would tend to increase total debt and imports in the debtor country, postponing the date when its debt burden could be back to levels associated with creditworthiness.

The sole attraction of interest capitalization is that it might be easier to obtain than new bank lending, considering that the free rider problem would disappear (banks would merely receive cables informing them of their interest capitalized, rather than requests for new money). If this advantage were to become indispensable, capitalization of interest could be a contingency mechanism that would avoid moratorium. If used, it would ideally involve IMF orientation and require IMF approval of a country's adjustment plan, as in the case of new lending.

Prospects for the Largest Debtors

Only a few countries are large enough to have system-wide consequences of a default. To complete this review of global debt management, it is useful to consider briefly the outlook for some of the largest debtor countries individually.

Brazil is the largest debtor country, with external debt of $92 billion at the end of 1983. There is heated controversy over the wisdom of its stabilization approach agreed with the IMF. Critics contend that further budget deficit cuts will only depress the economy further, because there is already excess capacity. Skeptics doubt that trade surplus targets ($9 billion in 1984) can be met, and suggest that Brazil's problem is intractable into the indefinite future.

Analysis subsequent to that in the general modeling effort reported above indicates that, ironically, for at least 1984 the external sector will no longer be the bottleneck to economic growth. Instead, domestic inflation of over 200 percent is the obstacle to growth. The external constraint will be eased because a rise in domestic oil and alcohol production will permit Brazil to reduce its oil imports by $2 billion in 1984, permitting a rise in non-oil imports on the order of one-third while remaining within the IMF-agreed target of $16 billion for total imports. An expansion of this magnitude is more than sufficient to accomodate domestic reactivation.

The problem lies with domestic inflation. The goverment intends to limit money supply growth to 50 percent and reduce the budget deficit from 2.7 percent of GNP to a surplus of 0.3 percent of GNP as the means of reducing inflation. Importantly, a large increase in agricultural production is expected to help reduce inflation (food price increases in the range of 400 percent spurred inflation in 1983). It would greatly ease inflationary pressure if the system of indexation could be relaxed so that automatic wage increases did not perpetuate inflation; but the political difficulty of deindexation has been demonstrated.

In these circumstances, there is little apparent alternative to the strategy adopted by the government under IMF auspices. It should also be noted that the policy need not be as recessionary as first appearances might suggest. True money supply should include highly liquid government bonds with indexed interest; so defined, money will be growing considerably faster than 50 percent. The contractionary effect of a 3 percent cut in the government deficit (the equivalent of about $7.5 billion) will be partially offset by a rise in demand from increased exports (on the order of $3 billion to $ 4 billion), and some "crowding in" of private borrowing and activity should occur as the government reduces its claims on the credit market. Zero or slightly negative growth in 1984 may be unavoidable, but the measures to reduce inflation should set the stage for a reactivation of the economy beginning in 1985. Importantly, new debt relief in 1984 would seem unlikely to provide room for economic expansion, because foreign debt is not currently the obstacle to growth.

Over the longer run, Brazil is well positioned to achieve substantial reductions in its external deficits. The projections for Brazil in the general model described above tended to indicate large export growth through 1986. Subsequent recalculations suggest somewhat slower export growth rates on the basis of a more detailed examination of export compostion -- at nominal rates of approximately 17 percent in 1984-85 and 11 percent thereafter.[5] However, even with a downscaling of projected export growth, the greater than anticipated savings on oil imports should permit a downward trend in external deficits, and the achievement of a debt-export ratio of approximately 200 percent by 1988 (somewhat later than in the earlier estimates described above), a level generally associated with satisfactory creditworthiness.

There remains the possibility that domestic political frustration with recession will cause a disruption of the debt management process adopted to date, despite the fact that the current limit to growth appears not to stem from external constraints but from domestic inflation. Nonetheless, existing evidence on the views of the principal candidates for election in November does not suggest a strong likelihood of sharp radicalization on the debt issue.

Mexico has shown the most effective short-run adjustment progress among the major debtor countries. As discussed earlier, its external adjustment in 1983 was particularly dramatic. Many analysts are concerned that over the medium term pressures on Mexico will be severe because of the bunching of maturities later

---

5. World inflation is assumed to add 5 percent annually to growth of export value. In addition, the higher rates in 1984-85 are associated with an 8 percent rise in dollar-prices each year assumed for a wide range of manufactured goods and some raw materials as the consequence of 10 percent annual dollar depreciation. Note that even in the face of dollar appreciation, Brazil's export value following the maxi-devaluation of February 1983 rose at an annual rate of 14 percent.

in the decade, with amortization coming due in amounts above $20 billion annually by 1987. However, excessive concern on these grounds appears unwarranted, because of the vital distinction between rolling over past debt (amortization) and mobilizing new lending, as discussed above. Indeed, in 1981 total borrowing by Mexico was considerably larger than that to be required in the late 1980s. With a return to more normal creditworthiness indicators, Mexico should be able to secure the refinancing of amortization coming due.

In the general projection model described above, there were indications of continuing deficits associated with the weakness in oil markets. Nonetheless, the remarkable reduction of imports in 1983 suggests that there was considerable scope for import substitution in an import bill that had soared in the late 1970s during the oil bonanza. With a slimmer import base, Mexico should be able to attain even smaller external deficits than those projected with the general model, which themselves indicated gradual improvement in creditworthiness.

Mexican authorities have made an important basic change in policy since the period before the debt crisis. Rather than trying to hold a relatively fixed exchange rate, they have established a realistic exchange rate and devalued it frequently to offset domestic inflation. As long as exchange rate realism is maintained, the prospects for external balance are favorable (barring a collapse in the price of oil). Moreover, the large external surplus of 1983 provides some scope for reactivation of the domestic economy in 1984. Finally, with cooperation of labor the government appears to be making progress in bringing inflation down relatively rapidly from the range of 90%.

The Argentine case is one of the most difficult to assess. Although its debt is large relative to exports, Argentina has relatively small external deficits and has achieved a sizeable trade surplus. Its underlying external economic position is less in question than the political atmosphere for its adherence to the current rules of the game. Self sufficient in oil and food, Argentina is the country best positioned to move toward autarky, and perhaps least vulnerable to adverse effects of default.

The domestic economy has suffered from chronic high inflation, in the range of 400% in 1983. The new regime is determined to advance real wages and achieve positive economic growth. It has stated its commitment to major reductions in budget deficits. Cuts in military spending may be one source of savings, and increased enforcement of tax collection another. Budget cuts may nonetheless be difficult with frequent readjustments of wages for real increases.

Early in 1984 Argentina was in an interim period of partial moratorium pending debt renegotiation by mid-year. To the concern of many, the government allowed interest to go unpaid on a significant portion of debt even while setting aside some external reserves. To some this pattern seemed to be preparation for possible default. Moreover, the likely failure to reinstate interest payments before the end of the first quarter meant that U.S. banks were likely to be forced to remove many Argentine loans from performing status, and to stop accruing the interest as part of reported earnings. While many press accounts portrayed this pending development in alarmist tones, banking experts appeared more calm about it, anticipating that the loans would be back to performing status by the second quarter of 1984 and reported earnings would rebound correspondingly.[6]

Despite the fears of some that Argentina could be adopting a highly confrontational approach, the greatest likelihood was that the delays were primarily associated with the time required for the new government to establish its economic program, and that while Argentina would seek favorable terms on interest rate spreads and maturities (including on former reschedulings not yet signed), the government would not seek a radical break such as unilateral limitation on interest payments.

Rather than extremist designs, pragmatic difficulties in achieving both reduction of inflation and the goals of growth and real wage increases seemed likely to dominate economic decision making. In this process, it remained to be seen at the end of the first quarter of 1984 whether Argentina could come to agreement with the IMF on its adjustment program.

Conclusion

The performance of global debt management to date may be read in different ways. Those who hold that the current strategy of managing debt will fail can point to severe domestic

6. Note also that US banks account for only one-third of bank loans to Argentina, and that European and Japanese banks do not face a 3 month deadline for accounting classification of loans as non-performing.

recessions in 1983 as evidence that the process is not working and will generate intolerable political strains, resulting in defaults. Yet a more balanced view would seem to be that the political fabric has held up relatively well under these strains, and that the stage has been set for recovery in the domestic economies either in 1984 or by 1985. In the external sector, the evidence is overwhelmingly in support of the feasibility of the current strategy. The most important component of the strategy has become a reality: substantial economic recovery in the industrial countries is underway. The dominant expectation is that growth on the order of 3% can continue into 1985. Although recession could occur thereafter, it would almost certainly be far milder than in 1981-82 in the absence of a new oil shock (and new calculations for Brazil indicate that the debt-export ratio could decline to 230% by 1988 even with OECD growth slowing down to 1.5% in 1986 and 2% in 1987).

Similarly, actual performance on external accounts by major debtor countries was either squarely on target or far ahead of schedule in 1983. Involuntary lending has also held up, as shown by the mobilization of $6.5 billion in bank lending to Brazil in early 1984.

For these reasons, it would be a mistake to change policy direction towards radical new departures at this time, when the early phase of global debt management has shown major progress. Although subsequent breakdown cannot be ruled out, especially from the standpoint of domestic political frustration not necessarily germane to real economic effects of the debt burden, the best course remains the one that has been adopted to date. This strategy relies on case by case debt management through the cooperative efforts of official agencies, banks, and debtor country governments. The broad strategy also relies fundamentally on global economic recovery, and for this purpose continued efforts at appropriate macroeconomic management in the industrial countries will be essential, including especially reduction of fiscal deficits and of pressure on interest rates in the United States. Finally, in light of the extremely painful adjustments that major debtor countries have already made, policymakers in industrial countries should continue to intensify their efforts at financial support (especially through multilateral agencies on a long-term basis) and at maintaining open trade regimes, in order that the process of international adjustment be sufficiently symmetrical to ensure the continued commitment of the major debtor countries to the current rules of the game in the international financial system.

Representative HAMILTON. Thank you very much, Mr. Cline.
Mr. Dornbusch, please proceed.

STATEMENT OF RUDIGER DORNBUSCH, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MASS.

Mr. DORNBUSCH. I appreciate the opportunity to state before this subcommittee my views on the foreign debt problem. I agree with many of the points of view Mr. Cline has already expressed, except I do not share his optimism, so I would like to give emphasis to where we differ.

I would like to make four points.

The first is that U.S. macropolicies continue to aggravate the debt problem.

Second, our commercial policies and the policies we insist on abroad make the debt servicing more difficult.

Third, in some countries IMF policies have actually delayed the adjustment process.

And, last, that it is not in our national interest to take an uncompromising stand on debt service at any cost to our own exports.

I would like to go briefly back and ask where the debt problem comes from. Probably the best time is to start in the 1930's. In the 1930's, most Latin American countries, with the exception of Argentina, defaulted on their external debts. The external debts were written down, and nothing much happened in terms of international capital until the early 1950's. The Latin American countries had defaulted on bonds, not on bank loans, so it was natural that after the war bonds were not in. The lending first took place in the form of international direct investment, and only in the early 1970's did bank lending take place on a large scale in Latin America.

We all know that over the 1970's the Latin American debt grew extremely, and we have to ask: What have we inherited from the 1970's? And it is certainly the case that a very good part of the debt does not represent financing of profitable investment, but rather in some countries large-scale imports of consumer durable goods as a consequence of disequilibrium in exchange rates; in other countries, budget deficits. In still other countries, the increase in debt more than entirely represents capital flight.

Certainly the lending was not sound. We have observed now for that reason is that it is very hard to service the debts because there is no productive capital sitting as a counterpart of those debts.

When we look at the debts now we have to ask: Where is the situation going? Should we expect that there will be large-scale defaults with perhaps very serious implications for the world financial system? Or will the debt problems evaporate sheerly with the passage of time?

In the last 2 years the international financial system, with the active collaboration of governments, has shown itself able to cope with the debt problem by the rolling-over approach. Debts have been rescheduled, and in conjunction with IMF programs the world financial system has avoided a very severe crisis. We have learned how to keep countries on the machine almost indefinitely. Now it is time to stand back and see whether that is a sensible approach or whether the current methods of rescheduling with IMF conditionality are actually not promising recovery in the debtor countries consistent with their servicing their debts.

There are four questions we have to ask when we want to know where the debt problem is taking us.

One is whether there is an expectation of frivolous default either because a populist nationalist government finds it in its interest or because some regional bank becomes adventurous.

Second, whether the debtor countries can afford to continue the tight policies under which they are now.

Third, whether our U.S. monetary fiscal policy makes the debt service impossible.

And, last, whether our trade policies stand in the way of a solution to the debt problem.

I want to answer those questions.

I do not believe there will be a frivolous default. Most countries are not in a position to default because they depend on the current trade credit for this month's and next month's imports. They literally could not afford to walk away from the banks because their bank credit would be frozen and they could not import the oil for next week's economy. It is clear that that happened in the case of Chile, and within 3 hours of being threatened with the freezing of credit lines Chile had taken over private debts.

There would, however, be the possibility that some countries, for example, Argentina, because of their strong position in terms of reserves, trade surpluses, ability to sell wheat to Russia, can in fact play games with the banks, hold out for better terms. It is quite obvious that Argentina now is in a much better position than the banks to whom she owes the debts. Argentina can wait 6 weeks for a solution and the banks 3 days. We will expect that that is reasonable bargaining, and that Argentina, in the interests of domestic stability, would take advantage of it.

So I do not believe there will be a frivolous default, but I do believe there will be some excitement.

The second question is whether the LDC's can afford to continue on the current adjustment path. And here it is very important to bear in mind the differences between countries. As Mr. Cline has already pointed out, Mexico on one side with a very costly but very successful adjustment program, and on the other hand Brazil, the other large debtor, with a less effective adjustment program.

The figures in my prepared statement show what has been happening to growth and trade in Latin America and asks what does the adjustment mean? So far the adjustment has actually not taken place in any country other than Mexico. Adjustment has meant extremely tight monetary and fiscal policies that have reduced growth to negative levels and through that channel have cut imports vastly, freeing foreign exchange to pay part of the interest.

That is in no way an adjustment. It is a depression. It is only an adjustment if at the same time policies are undertaken that mobilize the resources, freed by the budget cuts, and translate them into increased exports or into import substitution.

In Mexico that has taken place in the most successful way and, in fact, the adjustment was contemplated long before the debt default. In Brazil the opposite has occurred. Figure 2 of my prepared statement shows that in Brazil export profitability now is 10 percent below the average of the last 10 years.

I believe that is an extremely important point to recognize. When we talk about adjustment, we are asking: How will countries be able to service their debts and yet have reasonable employment levels? We cannot expect that Brazil, over the next 10 years, will service her debts with growing unemployment and with falling per capita income. It is socially unacceptable, and sooner or later will lead to the radicalization we have seen in other Latin American countries.

So if those countries have to have reasonable employment levels, even if they have low incomes, then somehow the people have to be employed, and the only place they can be employed, if budget-cutting takes place on a large scale, is in the production of export and the production of import substitutes. The only way that will take place is if exports become more profitable, and that means the exchange rate has to be depreciated or money wages have to be cut. The cutting of money wages seems impossible. That means depreciation would have to be the answer.

In Brazil the IMF has very strongly resisted policies that promote export profitability and has instead, and mistakenly, insisted on budget cutting. The point I want to make is the followng: The IMF has urged Brazil, or forced Brazil, to cut subsidies on food, on oil, on a number of commodities. As a consequence of those budget subsidy cuts, the inflation-adjusted budget is now actually in surplus. Adjusting the budget cyclically, Brazil has a 3 percent budget surplus. So Brazil is in an extraordinary fiscal position on that account.

But what have the subsidy cuts meant? Real wages now are lower. But they are not lower because people have become more competitive in foreign trade. They are lower because the budgets have been cut. So nothing has been done so far to make Brazil in the long run more fully employed and more capable to service the debt through exports. But because the real wage has already been lowered so much it becomes almost impossible now to undertake the step to promote export profitability through devaluation. So the IMF policies have actually made it virtually impossible to take the sensible steps. Why the IMF has followed this poor course, I do not know.

I see in the adjustment problem of the LDC's, particularly in Brazil and Chile, the difficulty that export profitability is not there; that therefore there is no predictable strong source of growth in the economy. Of course, per capita incomes have fallen very much, more than 15 percent in Brazil. They will stop falling and there will be some turnaround. But if we ask: Is it possible that by 1990 Brazil will be back where she was in 1980, we would have to have 5 percent growth per capita per year, and very few people would predict that starting right now that is possible for Brazil.

I want to turn next to the U.S. macropolicies and ask whether they are likely to support the smooth servicing of the debt. As Mr. Cline has pointed out, the external macroeconomic environment is extremely important because it sets the interest rates on the external debts; it sets the growth rate of exports and therefore export earnings of the debtor countries; and it affects the real prices of commodities.

There is a sharp discrepancy between what happened in the early 1970's when interest rates were low and inflation was high and growth was high and all the LDC's became good debtors and the late 1970's when the debt problem started. That happened in 1979 to 1982 when interest rates were high, inflation by no means as high, because the dollar appreciated in world trade, and growth disappeared. Now we have to ask: In the next 3 years, which of those scenarios should we expect? The early 1970's, which is a debtor's paradise, or the late 1970's, which is not the creditor's paradise?

I show in table 3 of my prepared statement two commercial forecasts from Data Resources and from Lehman Bros. They say there will be very strong growth in the U.S. economy this year, coming down to somewhat under 3 percent over the next 3 years, and interest rates would be roughly at the current levels. Those are the central forecasts.

What do they say for the debt problem? Well, they say that interest rates will not, as was predicted last year, come down to 8 percent. The prime rate is forecast to be 11.5 percent, not 8 percent, and that means the debt servicing difficulties on the interest rate side will not disappear as was thought last year.

On the growth side we do have in the United States a strong recovery. We did not know that last year, we do have it now, and we can look forward to more, but we do not have the same growth in Europe, and we do not have it in Japan, either. So for the world economy at large, there is growth but perhaps slightly less optimistic than last year; interest rates certainly considerably more pessimistic than last year.

But I see a major difficulty in looking just at the central forecasts. They are quite plausible scenarios for the U.S. economy, but things could turn out very differently. If we have a clash between monetary policy and inflation, if the cyclical recovery of inflation forces the Federal Reserve to tighten money, then it is quite possible that interest rates in the United States should rise 200 to 300 basis points and that economic activity next year should slow down significantly.

The debtor countries are highly sensitive to our interest rates. For Brazil an extra point on the interest rate means $750 million. I said it is possible we will have a 3-percent increase in interest rates. That is more than $2 billion extra in debt service. If that is accompanied by a reduction in export earnings, the debt problem becomes suddenly much worse, perhaps not as extreme as in 1981–82, but certainly the implications will be exactly the same. I find it very unlikely that with Brazil having a $4 or $5 billion in its current account deficit, it should all come out of increased lending by the banks. The banks will insist on cutting imports some more, and I find that a very plausible outlook.

So our macroeconomic policies, and particularly our overly expansion long-term fiscal policy, contribute to the debt problem because they create the scenario of high interest rates combined with a slowdown in growth.

I come next to our trade policies, and here I want to briefly say that the United States has a trade policy inconsistent with the servicing of debt. We erect trade barriers to all the commodities in which LDC's can easily solve their debt problems—sugar, orange juice, shoes, meat, steel, copper, leather footwear, rubber footwear—all these things have great restrictions or are being lobbied very actively for increased restrictions. In an election year no doubt we are going to get substantially more problems on the trade side.

I would also object to our policy forcing LDC's under IMF programs to abolish export subsidies. An export subsidy may be the most efficient way in which an LDC can gain increased exports without giving up macroeconomic stability. The common argument is that a country cannot devalue because it is very inflationary, because with a devaluation all import prices rise. But an export subsidy concentrates the trade initiatives on a very narrow range of goods in which a country has a highly sensitive foreign demand, so that is the optimum way of achieving extra growth in export earnings with which to service the debt. But we are very dogmatically opposed to that, and therefore it makes the adjustment problems much more difficult for the LDC's.

In my prepared statement I present a quote from Mr. McNamar who is Deputy Secretary of the Treasury. His remark is outright extraordinary. Mr. McNamar stated that LDC's cannot solve their debt problems by creating unemployment in the United States. Well, I appreciate that he takes the view of U.S. employment, but if the LDC's cannot export, then they cannot earn the foreign exchange with which to service the debt. And I think that points very clearly to the problem. If we want debt service, then we have to take their goods. Of course, we might say, "No, they do not export more and they service the debt," but that means they import less, and that is still higher unemployment here.

We are really sitting on the fence where we have to choose: Do we want to export to them, in which case we have to allow them to export more to us in order to earn the foreign exchange to pay for our exports and for the debt, or do we not want the debt service, in which case we do not lose employment? Our policy so far has been to stick our head deep in the sand and not worry about that problem. And I think in the next 3 years that is going to be the No. 1 issue in the debt context.

I want to conclude by saying that the foreign servicing of the debts is not in our national interest. We have significant interest in exporting of manufactures. If we want more debt service, that means LDC's will import less from us and we lose employment in manufacturing. We have all the interests in getting cheap imports that raise our standard of living, and we certainly do not have an interest in promoting regulatory devices that make the debt problem into a great strategic game. The U.S. regulatory authorities, by not forcing banks to hold reserves, have made it likely that should a country default we will have a collapse of the U.S. financial system. Regulatory authorities abroad have insisted that reserves be set aside. In Germany and in Switzerland the debt problem is not a problem. The reserves are held by the banks, and the banks will make the losses on the bad loans they have.

In the United States, banks have enjoyed the support of the administration. They have not set reserves aside. Therefore, they are extremely vulnerable to the debt, and that is a policy-created dilemma. I think it is high time to recognize this and move policy away from the protection of the debt to a more balanced concept that looks also at our manufacturing.

Thank you.

[The prepared statement of Mr. Dornbusch follows:]

Prepared Statement of Rudiger Dornbusch

THE INTERNATIONAL DEBT PROBLEM*

Growing debt service arrears and pervasive rescheduling of LDC debts have become a common fact in the last two years. At the same time IMF conditionality and the "muddling-through" strategy have been shown effective in avoiding a collapse or even major crisis of the world financial system. The question now is whether this strategy will also be successful as a medium-term approach to restoring growth in the LDCs while at the same time improving these countries' position as debtors. On these points I do not share the common optimism, while recognizing that the position of individual countries differ significantly.

I will argue the following: First that U.S. regulatory and macroeconomic policies continue to aggravate the debt problems. Second, that U.S. commercial policies and our criticism of debtor countries' trade policies are entirely inconsistent with a satisfactory solution to the debt problem. Third, that IMF policies in some countries, specificially in the case of Brazil, have been poor and have moved the country into deeper economic problems and further away from a medium term ability to service the debt under conditions of social and economic stability. Fourth, that it is

*Testimony before the Subcommittee on Economic Goals and Intergovernmental Policy, Joint Economic Committee, U.S. Congress, March 28, 1984.

not in our national interest to seek the full payments of bank debt at any cost to our own trade and to economic and social stability in the debtor countries.

The Present Situation

In August 1982 Mexico declared her inability to meet debt obligations, and in short order Brazil and a long list of other countries followed. During the fall of that year the international financial system was acutely threatened by collapse in the event that one of the parties should, by design or inadvertancy, allow a default to occur. But crisis management did work very effectively, and half a year later scenarios were designed in which the debt problem would evaporate; they relied on a setting of strong world recovery, falling interest rates, a lower dollar.

These scenarios, no doubt, played a part in institutionalizing the process of forced lending that now is underway. The LDC debts, of course, cannot be paid off -- "debt does not get paid, debt gets rolled" Brazil's Delfim Neto reminds us -- nor can the full interest bill be met out of dollars earned from trade surplusses. At present some of interest is paid from trade surplusses, some by borrowing from official agencies and a large part by increased borrowing from the banks. Looking ahead a few years, should we expect the debt problem to shrink to insignificance or is it being rolled into something of quite unmanageable proportions?

Table 1 shows the external debt of the main Latin American debtors as well as a breakdown of the liabilities to banks. The claims on U.S. banks appear small when judged as a fraction of total assets of these institutions -- only 4.4%. But the problem, of course is the large concentration of these debts in the hands of the major banks for whom they represent about 200% of capital. Four major banks alone hold more than a third of these debts and are particularly vulnerable.

Table 1: The Latin American Debts
(Billion $ U.S., June 1983)

	Total Debt	Debt to Banks: All Banks	Debt to Banks: U.S. Banks
Argentina	37.5	25.5	11.2
Brazil	89.5	62.8	23.3
Chile	18.0	10.9	5.2
Mexico	85.6	65.5	32.3
Venezuela	31.9	26.8	10.8
Total	263.3	191.5	82.8

Source: Bank for International Settlements, Morgan Guaranty and Board of Governors of the Federal Reserve.

In 1983 the view was that the debt problem might disappear by the end of the 1980s. Today a lot more scepticism is being voiced and the difference in the position of various countries receives emphasis. The outcome will depend largely on the answer to the following questions:

• Although unlikely but not inconceivable, will there be a frivolous default initiated by a populist-nationalist government or a gung-ho regional bank?

• Will the debtor countries be willing and able to stick to the tight adjustment programs that at present restrain their imports and thus create trade surplusses that make some downpayment toward solving the debt problem?

• Will the monetary-fiscal mix in the industrial countries allow sustained, reasonable growth along with declining real interest rates and a lower international value of the dollar?

• Will we allow debtor LDCs to service their debts by increasing their exports of steel, copper, textiles, shoes, frozen orange juice, sugar, meat automobiles and parts, etc. or will there be growing restraints on imports?

An outright default or repudiation apears quite unlikely. The advances made since the 1930s in private and public survival techniques assure that a debtor can be kept on the machine almost indefinitely. Creditors are well organized to avoid accidental default and international institutions and governments take an active interest in keeping the debts in a semi-performing status. In the meantime the U.S. Treasury has made clear the consequences of default:

"A second obligation of the LDC debtors is to work with their creditors within the international financial system to bring about orderly rescheduling of their debt service burdens...A repudiation takes place when a borrower unilaterally renounces responsibility for some or all of his debt obligations. Under such circumstances, the foreign assets of a country would be attached by creditors throughout the world; its exports would be seized by creditors at each dock where they landed; its national airlines unable to operate; and its sources of desperately needed capital goods and spare parts virtually eliminated. In many countries, even food imports would be curtailed. Hardly a pleasant scenario."[1]

Even though plain default is unlikely, there may be considerable posturing by particular countries whose trade surplusses, export structure and reserves put them in a strong bargaining position. These countries -- Argentina and Venezuela come to mind -- will hold out for improved terms (fewer strings, longer maturities, small or spreads and fees) and in the course of the bargaining may offer excitement. But few countries are in a position to cast off the short leash of trade credit with which banks effectively enforce the debtor discipline. The question then is whether the debt problem will be solved by continuing adjustment and restraint on the part of debtors in conjunction with a favorable world economic environment, or whether we must expect some adjustments on the principal or interest of the debts. The latter may well be desirable in some cases. It assuredly is

---

[1] Address by R.T. McNamar, Deputy Secretary of the Treasury, before the International Forum U.S. Chamber of Commerce, Washington, October 12, 1983, pp. 3-4.

not the case that our national interest calls for an uncompromising stand on the question of debt service.

Our regulatory policies have aggravated the international debt problem by ensuring a continuing threat to the financial system from possible write-downs or failure of debtors to make timely interest payments. If banks had been forced to set aside appropriate loan loss reserves to meet these risks, as has been the case in Europe, then threats to the financial system at large would be unlikely to arise; debt problems would be merely threats to the banks' stockholders. Accordingly, there would also be no justification at all for government intervention in the relations between debtors and banks. The failure to promote timely reserve accumulation, even today, means that the financial system at large remains vulnerable. But this is clearly done as a matter of strategy by the banks: the strategy is to assure severe vulnerability of the financial system as a forceful deterrent against any attempt by the LDCs to weaken on debt service.[1]

The present debt problems are not an extraordinary, entirely unpredictable and unprecedented fact. Latin American performance as a debtor is notorious (see the appendix). The late 1970s and early 1980s were a repetition of the debt problems of the 1930s: loans had been pushed to finance current account deficits which, in the late 1970s, had no significant counterpart in increased productive investment. On the contrary, a large share of these loans financed budget deficits, capital flight and accumulation of consumer durables under the incentive of disequilibrium exchange rates.[2] In the case of Argentina, for example, the increase in

---

[1]On such strategies see T. Schelling, Microincentives and Macrobehavior, Norton, 1978.

[2]See R. Dornbusch "External Debt, Budget Deficits and Disequilibrium Exchange Rates." Unpublished manuscript, MIT, 1984.

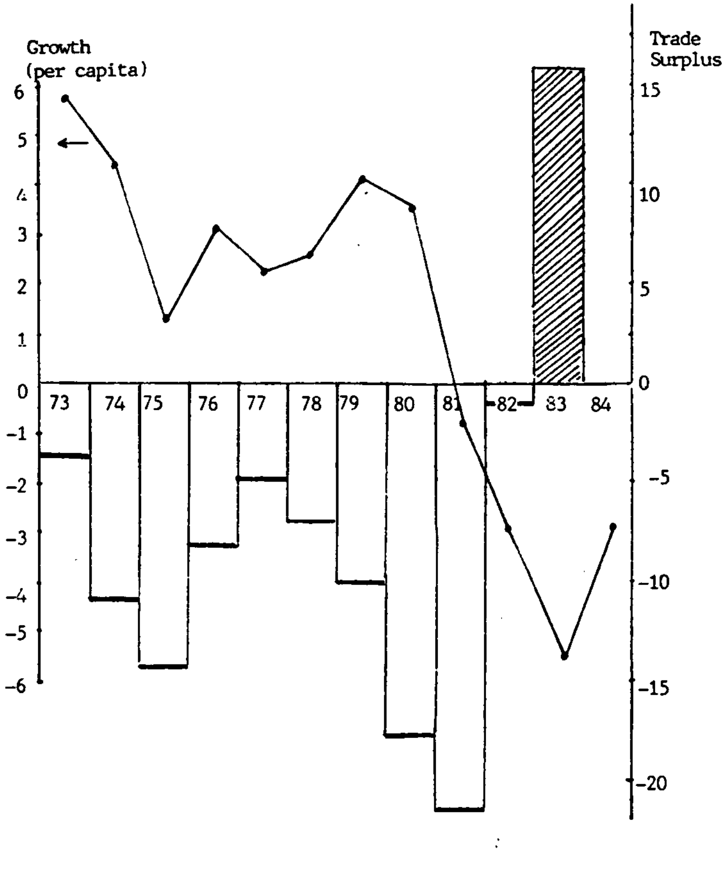
gross external debt in the period 1978 to 1982 has no counterpart in current account deficits; the counterpart is a flight by private capital into real estate abroad and financial assets in the U.S. and other countries. Financing that process certainly cannot be defended as sound lending.

The lending (and borrowing) may have been unsound in the first place but it certainly became so when our monetary-fiscal policy mix increased interest rates sharply and caused the dollar to appreciate and commodity prices to decline. The combination of these three shocks on exporting dollar-debtors is, of course, devastating. There is no question that the debt crisis today is in good measure due to our own failure to pursue sound fiscal policies. It is therefore absurd and, indeed, outright cynical that our Treasury officials should travel to the debtor countries to preach belt tightening.

The debtor countries have since 1981/82 undergone a dramatic adjustment. Figure 1 shows for Latin America growth and the trade balance. Growth has been negative since 1981 and is expected to contine being negative even in 1984. By that time per capita income will be fifteen percent and perhaps more below the 1980 level. Considering the poverty and inequality in these countries, this represents a dramatic rolling back of social progress that is essential to political stability in the region.

The sharp cut back in demand is reflected in an elminiation of trade deficits in 1981, reversing the normal pattern for Latin American countries, and a nearly 16 billion surplus in the four quarters ending September 1983. Even a larger trade surplus is expected for 1984. It is worth noting that the trade surplus represents primarily a cut in economic activity and imports, not export growth. Exports of Latin America in 1983 were still far below the levels of 1980 or 1981, while imports of the region had been cut by nearly 40% from their 1980-81 level. The size of that decline is comparable

FIGURE 1 LATIN AMERICAN GROWTH AND TRADE BALANCE



Source: International Financial Statistics and Cepal, "Balance Preliminar de la Economia Latinoamericana Durante 1983".

to the devastation that LDCs experienced during the Great Depression. The cut in imports is required by the fact that resource transfers toward Latin America have been reversed. Now recession policies are required to generate the foreign exchange with which to assure at least a partial debt service. This reverses the earlier trend where fresh loans covered not only the full interest bill but also further net imports of goods and services.

The Macroeconomic Outlook

Latin America's ability to service debts and at the same time return to positive growth, though more moderate than the post-war average, depends critically on sustained growth in the world, high real prices for commodities, a low dollar and a low real rate of interest. These countries have debts largely denominated in dollars and therefore benefit when dollar prices in world trade rise rapidly relative to dollar interest rates. Table 2 shows the dramatic difference between two key episodes.

A common benchmark for evaluating the development of a debt problem is to look at a country's debt/export ratio. Growth in world trade and price inflation raise export revenue and therefore lower the debt export ratio, thus improving the position of the debtor. But this is mitigated by the fact that higher interest rates mean increased debt service and, for given domestic restraint, increased current account deficits and hence increasing debt. The relevant variables to judge the external influence on a debtor country are interest rates, the growth rate in the world and the inflation rate of prices in world trade.[1]

Table 2: Prime Rate, World Growth and Price Inflation in World Trade (Average Annual Percentage Rate)

	Prime Rate	Inflation Rate	Growth
1970-73	6.7	12.4	4.7
1979-82	15.5	4.4	1.1

Source: International Financial Statistics and Economic Report of the President 1984.

Can we expect a return of the 1970-73 pattern where real interest rates are negative while at the same time growth in the world economy, and hence growth for LDC exports of primary commodities and manufactures is strong? Or is the world economy going to look as it did in the 1979-83 period? The outlook for growth today is satisfactory, but by no means very strong. Real interest rates will definitely remain positive and will quite possibly rise. The dollar, finally, still has to make its long-predicted dive.

Table 3 shows commercial forecasts of interest rates and growth for the U.S. economy over the 1984-86 period. The Table presents three different forecasts. The first row (A) shows the basic forecast of DRI that is assigned a probability of 60%, while the second row (B) presents a scenario that is particularly harmful and is assigned a probability of occurring equal

[1] This approach has been developed in a number of debt studies. Note in particular William Cline's fine and controversial report International Debt and the Stability of the World Economy, Institute for International Economics, Washington, D.C. 1983, and Michael Dooley, et. al., "An Analysis of External Debt Positions of Eight Developing Countries through 1990." Board of Governors of the Federal Reserve, August 1983.

to 20%. The third row (C) reports the central Lehman Bros. forecast that is assigned a 70% probability.

Table 3: The U.S. Macroeconomic Outlook

	Growth			Prime Rate		
	1984	1985	1986	1984	1985	1986
A. (60%)*	5.5	3.2	2.6	11.0	11.6	10.8
B. (20%)*	6.3	1.7	0.1	11.5	13.6	13.9
C. (70%)**	5.4	2.9	2.7	11.3	12.0	11.2

*Data Resources, Inc., ** Lehman Bros., Kuhn, Loeb.

We note that the chances for continued growth in the U.S economy are certainly high and that the undoubtedly strong 1984 growth is certain to come in above 3%. That is unquestionably good news for the debt problem. But it is also the case that interest rates do not come down, they go up relative to 1983 and quite possibly a lot. Moreover these interest rate increases represent increased real rates, thus aggravating the debt problem. Faced with this ambiguity we could try to judge the relative importance of growth and increased interest rates. An extra point growth in the world economy -- through increased export volumn and higher real prices of commodities -- might raise export revenue by as much as 3%. But an extra point on the interest rate will increase debt service in proportion to the debt.

Consider for concreteness the case of Brazil: exports are $23 billion so that an extra 3% export growth yields $690 million in revenue. An extra point on the prime rate is estimated to raise debt service by 750 million.

The trade-off therefore is close. If extra growth brings with it higher interest rates, then there may be no significant net benefit. Of course whether there is a benefit or not depends on the exact growth-interest rate combination and that means it depends on the source of growth. A great easing of money in the industrial countries would be a blessing to the debtors, but it would destroy the progress made on disinflation and therefore must be ruled out. If fiscal expansion is the source of growth, then higher interest rates are inevitable and likewise if the dollar should depreciate. Given the U.S. policy mix the most likely scenario thus suggests that on balance the macroeconomy is favorable, but because of increased interest rates the gains will remain limited. Whatever optimism the basic outlook offers, it does not imply that the debt problem will simply go away. At best it suggest that debt/export ratios will have a modest, steady downward trend.

The discussion here has focused on developments in the U.S. economy, neglecting other industrial countries. We note here that the growth outlook for Europe is far below that of the U.S. and that Japan, too, cannot be counted on to raise significantly world growth. The growth rate for the major industrial countries over the next three years is expected to stay below 3% and perhaps as low as 2%.

But there are also scenarios where monetary policy comes to a clash with a cyclical upsurge of inflation. In that case interest rates will rise sharply -- three percentage points or more -- and as a result growth will slow down. This possibility is a reenactment of 1981, though on a more moderate scale. For the debt problem though, it may be the decisive blow because the combined effect of lower growth and much higher interest rates opens a seemingly unmanageable gap between export earnings and debt service requirements. This possibility is one of the two reasons to believe that the debt problem in the next year will get more serious. The other reason is the enormous social cost involved in depressing economies to deliver debt service dollars.

Adjustment in the Debtor Countries

The adjustment effort and the success at stabilization differs vastly among countries. They all have been very costly in terms of cutbacks in demand and employment and in terms of direct reductions of real wages through the elimination of subsidies to food and public sector prices. But they differ sharply in the success: At one extreme is Mexico where adjustment now appears to be successful. At the other extreme is Brazil, or Chile, where the economy has been derailed into counterproductive destruction of economic activity. The IMF with its narrow-minded inflation and budget deficit fixation, and lack of serious attention for employment issues, must take the blame for condoning, and indeed encouraging, the grave policy errors in the Brazilian and Chilean experience.

The general idea of adjustment in a country with budget deficits and external deficits is the following: Public sector spending must be cut or taxes raised and subsidies reduced. The resources freed by the public sector, in order not to remain idle, must be transferred to the foreign trade sector. They should be employed producing extra exports or goods to replace imports. To achieve this reallocation of resources, and thus sustain employment in the face of budget cuts, a real depreciation is necessary. Wages must fall in dollar terms thus making it profitable to increase production of internationally traded goods. A real depreciation can occur as deep recession and high unemployment slow down wage increases below the rate of price inflation of traded goods. But that process is immensely slow and does involve sustained, high unemployment. The recommended solution, therefore, is to depreciate the currency and use incomes policy to prevent the spreading of increases in traded goods prices to wages and other costs which otherwise would wipe out the gain in export profitability. Even with this strategy short-run unemployment cannot be avoided, but at least it buys long-run prospects of growth.

In Mexico this adjustment was brought about by an immediate, dramatic and highly successful devaluation combined with incomes policy. The expertise of the Mexican team and, above all, the undeniable advantage of a new, strong government must be credited with the success. It is particularly gratifying that this progress has been made without damage to democratic institutions in Mexico. Exports now have started growing in a significant way and employment, after the deep slump is now on the rise. The government has successfully locked in the real depreciation and may now be about to harvest the longer-term advantages in terms of export and employment growth. Many argue that the Mexican adjustment remains precarious and that the real wage reductions may not be safely locked. But that would make us even more pessimistic about the scope for adjustment because at least Mexico has done most things right.

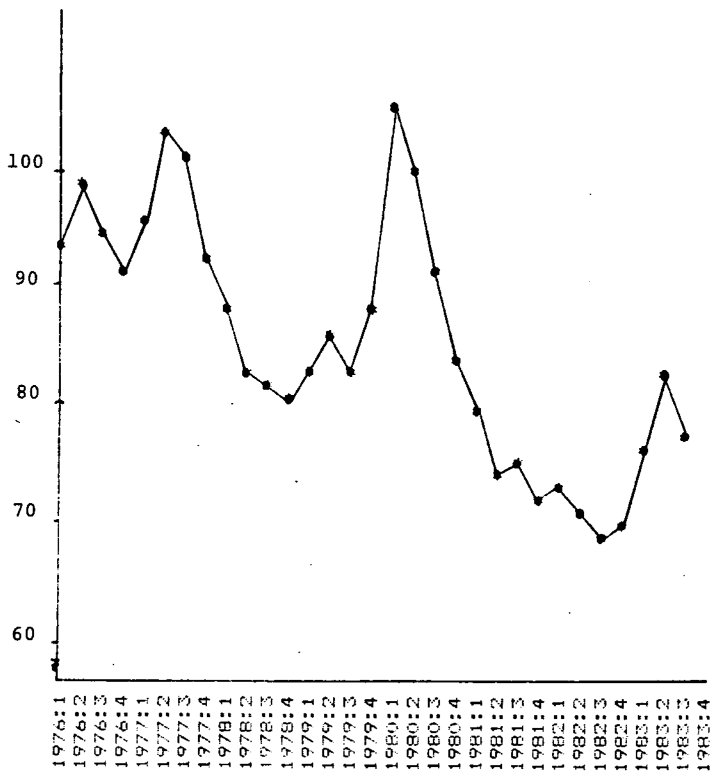
In Brazil the emphasis has been on cutting the budget deficit by removing aggressively a vast array of subsidies. Real wages have declined and, with the decline, income and employment have fallen by more than 15% since 1981. A very tight monetary policy has reinforced the effects of budget cutting. But how can one take issue with budget cutting in a country where public sector deficits reach 15% of GNP and inflation is rampant? My disagreement is with the timing and magnitude of policies. The preferred policy, as in the case of Mexico, is to place a lot of emphasis on securing a real depreciation that ultimately brings in employment and export growth. That does require a cut in real wages and therefore is politically troublesome. But it is much more troublesome if real wages have already been cut significantly as a consequence of removing subsidies. When further real wage reductions are proposed to gain external competitiveness, with real wages low and unemployment pervasive, there is no will and enthusiasm left. This is the case of Brazil where the budget (adjusted for inflation) has been brought literally to a surplus, where unemployment is at a record high for this century, and where absolutely no gain in export profitability has been achieved.

Figure 2 shows an index of Brazilian export prices compared to domestic prices. A rise in the index, such as in 1979:4 at the time of the maxi devaluation, signals a gain in export profitability. It is apparent that by 1983:3 export profitability was more than 10% below the average of the last ten years. But that means the export sector will not make a striking contribution toward recovery and growth and that is why IMF policies in Brazil have barked up the wrong tree.

After four years of deteriorating economic activity, Brazil is in no better position than she was when the debt crisis started, while Mexico, by comparison, is poised for a prospect of longterm growth and stability. The adjustment costs in both countries have been comparable except that Mexico did achieve something while Brazil has a budget surplus and a depression, but no light at the end of the tunnel.

It is important to have an idea about prospects in Brazil. Clearly growth will return because the decline in activity has been immense. But the recovery will be slow and it will take quite a few years of growth to get

FIGURE 2 BRAZILIAN EXPORT PROFITABILITY
(Index 1975=100)



Note: Non-Coffee export prices relative to the domestic price level.

Source: Data Resources, Inc.

back to where the economy was in 1980. To reach the 1980 level of per capita income by 1990 Brazil would have to grow over the next six years at 5% per year, starting right now. Few people would make that prediction with great confidence. The reason is simply this: the public sector will not be a source of growth because budget discipline is the rule. Investment is immensely depressed because of tight money and capacity utilization of less than 50% in some sectors. Consumers will not lead a growth spree because the budget cutting has cut their means. That leaves export growth as the only driving force in the economy. Exports will grow, as we saw above. But suppose they grew, adjusted for inflation, by 10% per year. Since exports account for only 10% of GNP, export growth at that rate will yield an extra one percent growth in income. Even doubling export growth will not bring us anywhere close to the 5% growth required to restore the 1980 income levels by 1990. The calculation suggests that Brazil faces a very difficult situation for the years to come unless ways are found to raise the share of exports in income by some five percentage points via a complete restructuring of the stabilization policies. The IMF has failed to give any weight to these considerations, claiming instead some magic crowding-in associated with budget cutting.

The U.S. has given strong support to IMF-led stabilization programs. These programs have emphasized primarily monetary and fiscal tightening, not taking into account economic institutions such as indexation that will frustrate the disinflation and turn tightening into depression. It is true that the IMF sought a sharp change in indexation. But having failed to get anything but a token change the macro policies were inevitably severely depressive and without any advantage from a point of view of external competitiveness. It is time therefore to reconsider the stabilization programs and turn them toward growth-through-exports and place a central emphasis on incomes policy. The business community has already understood these points even if they have not come to be shared by U.S. policy makers.

The Trade Policy Issue

Latin American debt defaults of the 1930s occurred in good part as a consequence of commercial policies that denied debtor countries the possibility to service their debts by exports. (See appendix). Today trade restrictions are minor by comparison, but the tendency toward protection has clearly been growing and has not left out the goods in which debtor countries could muster strong export growth. From the point of view of the debtors this raises sharply the cost of debt service: not only have our unbalanced fiscal policies raised real interest rates vastly, in addition we place obstacles in the way of debtors earning easy export revenue. We therefore force them to service their debts by contracting their imports through domestic depression, barring the alternative of growth in employment in the export sector. This, of course, hurts not only them but also us. Our exports to Latin America in 1983 were only half of their 1980-81 levels, having declined by more than $20 billion.

There are two specific issues in the area of trade policy. One is U.S. restrictions on exports from debtor LDCs, the other is our dogmatic attitude toward foreign export subsidies. The import restriction issue is well understood: The U.S. has placed quantitative restrictions and voluntary export restrictions on a broad range of products and is actively discouraging LDC export growth in such key areas. Far from preparing to accept debt service by an expansion in our imports, we are trying to limit imports, thus responding to our own adjustment difficulties without giving any weight to the difficulties we create abroad. That is shortsighted because we cannot have it both ways: we cannot call on LDCs to service their debts and, at the same time, make it extra difficult for them to earn debt service dollars. That strategy creates resentment and depression abroad and ultimately defeats our interests because it promotes political instability and radicalism on our doorsteps. But most fundamentally, every extra dollar of imports we accept from LDCs either comes back to us as debt service or it gives us extra employment as the revenue is spent on our own exports.

Our lack of understanding, or our unwillingness to face up to the issue, is particularly clear in our response to foreign export subsidies (for example alleged Brazilian steel subsidies). Here is how the U.S. Treasury presents the issue:

"A second important action that developing countries should take is to eliminate export subsidies. Such subsidies are self-defeating... In an interdependent world, exporting developing countries cannot pursue "beggar-thy-neighbor" policies and expect continued financing by importing countries with the highest unemployment in over a generation."[1]

The statement is extraordinary in that it fails to recognize the trade-off between increased financing and increased exports. It also is extraordinary, given the burdens we are already imposing via our fiscal policies, in suggesting that debtor-LDCs should not seek to solve their problem through aggressive export growth. If it is not via increased exports how are these countries supposed to recover and service their debts. It may be inconvenient to address the issue in an election year, but there is no question that our policy stance is entirely indefensible and, in addition,

---

[1]Remarks by R.T. McNamar "The International Debt Problem: Recent Progress and Future Ideas." before the Davos Symposium, Davos, Switzerland, January 30, 1984.

inconsistent.[1]

From the point of view of U.S. income and employment it cannot make much difference whether debtor-LDCs earn their debt service dollars by cutting down on imports from the U.S., whether they earn them by promoting exports through a real depreciation or whether they promote particular exports through selective export subsidies. In each of the cases there will be a loss of U.S. jobs, be it in our manufacturing export sector that is affected by reduced foreign imports or in our import competing industries that have to face up to increased competition from abroad. Indeed, other things equal we should favor the adjustment that makes it least costly for the debtors, assuring that they are more likely to service their debts while maintaining political and social stability. Dogmatic opposition to foreign export subsidies is good election politics but it does not serve the debtor countries interests. Moreover, it may not be in our interest once we recognize the damage we inflict indirectly on our own exports but also abroad.

The trade policy issue brings out clearly that we have a quite diffuse national interest in the debt issue: export and import competing manufacturing should prefer to see the debts written off so as to protect U.S. jobs, exporting firms should wish a foreign boom and import competing firms should wish a foreign depression in preference to an export drive. Lenders should wish to see foreign trade-oriented adjustment. The public at large must take into account that debt losses are partially written off the tax bill, just as increased unemployment caused by adjustment abroad promotes instability that has severe long-run costs. The public at large therefore

---

[1] In this connection see the excellent treatment in Economic Report of the President, 1984, Chapter 2.

should not emphasize too strongly the debt service and should take a more complacent view of debt write-downs. There is no overriding national interest in insisting on timely, complete debt service and the insistence of our policy makers in this direction represents a knee-jerk reaction rather than a consistent pursuit of our national interest. There is no suggestion here to encourage a general writing off of debts, but we do have to do make a choice whether and how best to take delivery on the debt service.

Concluding Remarks

U.S. policy in the debt question has favored the "muddling-through" strategy of rescheduling loans shortterm at considerable spreads. The argument is that the spreads are required to maintain the involuntary lending by banks. At the same time the U.S. has endorsed stabilization programs under the auspices of the IMF that in several Latin American countries have had devastating effects on economic activity without setting a clear path for an improvement, Mexico as noted being the exception. The adjustment rhetoric has been to promote budget cutting, thereby freeing resources to earn debt service dollars in the traded goods sector. But our public policy has been quite different in that we have gone out of our way not to remove obstacles to foreign goods. On the contrary, as Mr. McNamar's beggar-thy-neighbor slip suggests, we do not want to see LDC goods, certainly not while U.S. jobs are scarce. We don't even want to see them if they come extra cheap, making U.S. consumers better off. In sum our policy has been to try and do the impossible: be good neighbors, protect the banks' bad loans and protect domestic employment. We cannot achieve all of these targets at the same time. The collapse of the world financial system is no longer a threat and we can cooly reexamine why some banks should not have to suffer the consequences of their poor investments rather than forcing extra unemployment on U.S. export industries.

Bankers and policy makers have discouraged thinking about global solutions and the taxpayer is certainly not agreeable to foot the bill for a grand scheme. Muddling-through is poor policy because it does not, in the near-term, return the debtor economies to reasonably functioning market economies, poorer but with employment and hope. Muddling through has, for all intents and purposes, created siege economies.

The only constructive alternative I see is to work on a double front: in the developed countries, governments must remove import barriers must be removed and bankers have to write down some debts (on interest or principal), in exchange for stabilization programs that have as performance criterian not budget cutting but real exchange rates and export growth.

That direction is essential because there is no prospect in the next five years or ten that there should be a resumption of private resource transfers -- lending over and above the interest bill -- toward LDCs. Banks will want to reduce their exposure which means that they surely will not lend over and above the interest bill. The bond market remembers the bad loans of the 1930s. That leaves only direct investment as a source of resource transfers. But the experience of the 1950s and early 1960s, when countries had to rely on direct investment and official transfers for their financing, shows the limited scope of that source. Any significant growth these countries can achieve while servicing debts, must therefore come from export growth and import subsitution. U.S. policy should be now to promote a more realistic settlement, recognizing that the banks have no privileged claim to public support and that our long-run interest is best served by liberalizing imports and promoting trade-oriented conditionality.

APPENDIX

THE LATIN AMERICAN DEBT PROBLEM IN HISTORICAL PERSPECTIVE

"The experience of lending to South America has from the beginning been marked by numerous disasters....Waves of intense optimism, during which almost any properly engraved certificate could be sold at a high price, have alternated with troughs of profound pessimism, in which export of capital stopped completely. Every South American state has been in default at least twice and still it has always, after a greater or lesser delay, been possible for these states to secure funds."
American Economic Review, May 1935.

"The history of investment in South America throughout the last century has been one of confidence followed by disillusionment, of borrowing cycles followed by widespread defaults, and of a series of alternating repudiations and recognitions of external debts... The ability of the most credit-worthy governments to avoid default must necessarily be impaired if any considerable part of the nominal value of loans has not, in fact, been put to the use for which it was intended."
Royal Institute of International Affairs, 1937.

"When the great creditor countries reduce their exports of capital...all their debtors must meet their obligations either in goods or in gold, instead of by fresh borrowing. Before this extraordinary situation had fully developed, however, a further check was imposed upon the capacity of the debtor countries to pay their external obligations. The increased export surpluses which they placed upon world markets caused concern in the importing creditor countries, which thereupon imposed higher tariffs and supplemented them by additional restrictions on imports. There ensued in consequence an enormous shrinkage in world trade, and the logical consequence of this shrinkage has been a series of moratoria, suspensions of payment, and standstill agreements, as a result of which the credit of many debtor countries has been gravely impaired."
League of Nations, World Economic Survey, 1932.

Representative HAMILTON. Thank you, Mr. Dornbusch.

Before we turn to the Argentine situation, I want to get clear in my mind the differences between you.

Mr. Dornbusch, you began by saying you agreed with Mr. Cline but I really did not find too many areas where you did agree with him as you went through your testimony. And there is a tremendous difference, it seems to me, in your general assessment of the problem.

Mr. Cline, you are quite upbeat and optimistic. You said, I think, that we are following the proper public policy strategy, that we ought not to write down the debts. Mr. Dornbusch, on the other hand, appeared to me to be quite pessimistic about the whole matter. He seems critical, I think, of the IMF adjustment programs, particularly with regard to Brazil, critical about U.S. trade policy, how we are raising barriers this year in a lot of areas, and critical, I guess, generally, of the kind of ad hoc, muddling-through policy that we have been pursuing, and suggesting a number of changes.

Now, I think the question, beyond the difference in attitude between Mr. Cline's optimism and Mr. Dornbusch's pessimism, is: Where really are the substantive differences between you?

Is it fair to say, Mr. Cline, that you look at this whole debt crisis as essentially a liquidity and a cash-flow problem, and Mr. Dornbusch looks at it as a problem in insolvency? Is that the fundamental difference?

Mr. CLINE. Let me try to say what I think are the major differences, and perhaps Mr. Dornbusch could do the same, and that might answer this question.

The answer to your particular question is I do view this as a problem of illiquidity. I am not sure that Mr. Dornbusch would say that he views it primarily as a problem of insolvency.

But let me touch on some of the major differences between us.

I found myself agreeing with much of the basic setting forth of what Mr. Dornbusch was saying. We tend to agree on the structure of the problem, and the question is: How will the various influences within that structure go? Will we have a large run-up in interest rates or will we not? Will we have a robust recovery or will we not? But we both agree if there is a robust recovery and interest rates do not have a large run-up, then the chances for debt management are infinitely better than if the reverse occurs.

On the policy conclusion that Mr. Dornbusch suggested at the end, I find myself in considerable disagreement. He said it is not wise for the United States to insist on and seek full servicing of the debt.

You see, I do not think we are at a situation yet where the major debtor countries cannot and should not service a debt. Obviously, they need new bank lending to be able to service the debt, but the banks are prepared to provide that money, as long as there is an economic program in place, as long as the IMF and the official entities are behind that program.

That leads us to the question of whether the IMF is simply going in the wrong direction. I have some different figures than Mr. Dornbusch on Brazil's real incentive to exports. I am not sure how he gets such a sharp deterioration in the incentive to exports. If you look at the real index of the exchange rate as calculated by the Foundation for External Trade in Rio de Janeiro, that index has shown a

20-percent rise in the real incentive to exports and disincentive to imports because of real devaluation from a so-called maxidevaluation in February 1983. There was a 30-percent maxidevaluation. It has been eroded somewhat, but it is still a 20-percent increase.

So there is a technical difference between us. I am not sure how much one wants to focus on highly detailed technical questions on Brazil, but I do not at all read the IMF's posture on Brazil as saying, "Do not devalue. Do not give an incentive to exports." Quite the contrary, the last agreement between IMF and Brazil said explicitly that devaluation has to keep up with domestic inflation. So in a sense they were tightening the screws.

I completely agree with Professor Dornbusch that the principal source of activity, reactivation of these economies, is going to be the shift of activity in the direction of exports and production of import substitutes.

Now, Professor Dornbusch also left out an important piece of information in his description of Brazil, given the time constraints, and that is that inflation is running over 200 percent a year. Now, it seems to me that that kind of context means that it is very difficult to avoid the kind of austerity measures the Government is adopting and the IMF is supporting, especially when it is politically impossible to get a favorable break on inflation by deindexing wages. We saw the whole program almost collapse last year because Congress would not permit a deindexation of wages that had a lot of teeth in it.

As for where else we differ, on the regulations, I am not sure that it is accurate to say that we have set ourselves up because we have not been provisioning, like the Europeans. We could make some positive changes. We could be more lenient in our tax treatment. We only allow tax deductibility for 0.6 percent of asset in loan loss reserves. One of the main reasons Europeans have put aside more reserves is they have very lenient tax treatment. In fact, the German banks like to do what they call hiding reserves; they like to understate the value of their assets. But I do not think it is quite accurate to give the impression that the quality of the debt is so low and that we are so rigid in our regulations that we are headed for a disaster.

As for our other differences, it seems to me that what Professor Dornbusch is saying is that there are risks that we may not have enough international recovery, that we may have higher interest rates.

In my mind, the kind of action that might be inferred from the suggestions of Professor Dornbusch and some other academics would be a preemptive strike of, "OK, let us today write down the debt by such and such." That would cause more damage than the security it was supposed to be buying.

I do not see that the international debt situation warrants that kind of a preemptive strike. I think it could be highly destabilizing.

Representative HAMILTON. Professor Dornbusch, would you talk a little bit about these differences, and then we will go on to some of the other questions.

Mr. DORNBUSCH. In my earlier remarks I said that I agreed with much of what Mr. Cline said, except to share his optimism, and that is really where our differences are.

The common view now is that adjustment is underway, and when problems come we deal with them as they come. I see that to be very much Mr. Cline's approach, and I find that troublesome. I do not think that adjustment is underway.

Representative HAMILTON. Are you dealing in the Brazilian case with a situation of insolvency?

Mr. DORNBUSCH. No, Brazil is certainly not insolvent. Under the right policies, Brazil has insignificant problems in servicing the debt in the long run.

Representative HAMILTON. Do you agree generally that the whole debt crisis problem is essentially a liquidity problem or illiquidity problem?

Mr. DORNBUSCH. To a significant extent a liquidity problem unless we make the adjustment somehow and so much in the wrong direction that in the end we cannot service the debt because we have created depressions without creating an opportunity for export revenue.

Representative HAMILTON. Are we approaching that point now?

Mr. DORNBUSCH. I can see in Brazil with the high interest rates we could well get there in the next year, yes, indeed.

On the write-downs of debts, I certainly do not believe we should go out and write down the debts across the board. For one, the banks would not agree to do it. But I do believe we have pursued a strategy where our banks hold low reserves and therefore are in a very poor situation to entertain even the discussion of writing down the debts. Now, that is a strategic decision, but surely you cannot turn around and say, "Because the banks have chosen that strategic posture, we certainly must turn our eyes away from any consideration of that course of action."

I do want to point out that U.S. exports to Latin America today are 50 percent of what they were in 1981. Surely we have lost a lot of jobs, and some significance must be attached to that. Certainly we must be able to think of a way to separate the stockholders of the bank that made the bad loans from the ongoing payment system that would not be impaired by some write-down of debts, in some cases negotiated with banks and debtor countries, guaranteed by strong export conditionality contrary to the current IMF practice.

Representative HAMILTON. Let me turn your attention to the Argentine situation for a moment. As I understand it, they have made it clear that they are not going to make good on the interest that Argentina owes, I guess by the end of this week. And by doing that, they trigger accounting procedures here, I suppose, that are set in the banking regulations, which will indicate for some of the banks substantial losses during the first quarter.

Now, how serious a problem is that? Mr. Cline, I seem to remember you saying that we are confronted with a technical deadline here, that the whole thing has been overplayed a good bit in our media. And I certainly got the impression from your observations that there really is not much to worry about with regard to the Argentine situation specifically.

I guess the real question is whether a failure by Argentina to pay the interest might possibly trigger some kind of a wider, deeper crisis in the entire international banking system.

Mr. CLINE. Long-term failure of Argentina to pay the interest would cause a very serious——

Representative HAMILTON. Is your microphone working?

Mr. Cline. Sometimes is seems to be; other times not.

Representative Hamilton. I am sorry about that.

Mr. Cline. Certainly if Argentina, over a long period of time, were not to pay the interest, that would be a very serious blow to the international economy.

But let me put this in perspective.

First of all, the 90-day limit, the 3-month limit, applies to whether the banks can continue to accrue the interest that they actually are not receiving, but accrue it on their books as if they were receiving it, and therefore incorporate it in earnings.

Now, the regulatory practice is that after 90 days of interest arrears, it can no longer be accrued. That is a less serious deadline than the 6-month limit, which is the deadline at which the loans are defined as being problem loans that require setting aside special reserves.

Now, if that deadline were to be passed——

Representative Hamilton. We are not facing that deadline now?

Mr. Cline. We would be in 3 months. We are not facing it now, no, we are not. But if we face that deadline in 3 months and the situation is still in limbo, then unless there were some regulatory waiver, it would be necessary to set aside reserves against those loans. Reserves would typically have to be 10 or 15 percent of the face value of the loans.

Now, as it stands, if nothing were to happen, if you sort of have a possibility of no adverse effect, which I think is the more likely event, or very substantial adverse effect, in the first case if Argentina and the IMF worked out an agreement in the next 2 months or so, which I think is likely, and if the banks then resume their lending, Argentina will then be able to become current in all its interest payments, and you will simply see that the profits reported in the first quarter, which went down, will blip up again, and it will be a temporary wash.

Just to put the things in perspective, the interest payments that have been missed over the last 5 months amount to about 3 percent of the annual earnings. So we are not talking about an atom bomb.

Now, if instead we go through June and the situation is not resolved and the loans have to be reserved against, then the cost is considerably higher.

Representative Hamilton. To the banks?

Mr. Cline. To the banks. In particular, the cost is about 25 percent.

Representative Hamilton. Twenty-five percent of what?

Mr. Cline. Of the profits of the banks, the nine largest banks, for the year. That is, if you miss all the interest in 1984 on Argentine loans, and if you have set aside 10 percent provisioning, say, against the capital, then that hit amounts to about one-quarter of the banks' profits.

Representative Hamilton. I do not want to distract you from your comments, but one thing I want to get clear is the liability of the U.S. Government in all of this. At what point does the taxpayer have to shell out something?

Mr. Cline. Well, it is not a direct liability of the taxpayer. Even in an extreme event—first of all, if what we are talking about would happen, in the first instance that would be a reduction of earnings—and I would like to say the bank stocks are already discounting a lot of this. Bank stock has declined by about 30 percent in the last few months. So they might have already discounted a lot of this and might not fall off a lot further, depending on how severe the situation was.

But the U.S. taxpayer, to the extent that he eventually pays in the event of a debt crisis, does so indirectly, because the Federal Reserve would step in. Its actions could conceivably—there would be the depositor insurance, the FDIC. The indirect effect also could occur if the Fed pumped a lot of monetary base into the banks and that caused an inflationary expansion of money supply, so that the taxpayer indirectly might wind up paying through an inflation tax.

Representative HAMILTON. There is not any direct liability that you can foresee of the American taxpayer in the event of defaults on these loans?

Mr. CLINE. I would have to check into the mechanics of the FDIC as to whether they have a contingent claim on the budget if their reserves are exhausted. But that would be the principal vehicle that I would see.

But let me just, if I may, finish the basics on Argentina.

The first point is that the more serious deadline really is the 6-month deadline. And that is also true because that is the time that Argentina itself has said it intends to have programs.

The more basic question is whether the Argentine Government will have a sufficiently coherent economic policy that the International Monetary Fund in good conscience can approve that program and that the banks can begin lending once again and get the interest current once again.

It is hopeful that the government has a budget deficit objective which is quite consistent with IMF views. They want to cut the budget deficit from 14 percent of GNP to 8 percent of GNP. They are less clear about how they can effectively do this. There is good reason to believe that they can substantially increase the collection of taxes. Tax collections went way down in the last quarter of last year with the change in government. Also, they are cutting military expenditures.

But there are other areas that could be a source of contention between the International Monetary Fund and Argentina, and in particular the Government wants to raise real wages by 5 percent a year. And although the IMF agreed to that last year, with inflation running over 400 percent, it would be more doubtful that they would be prepared to do so this year.

But I see the stakes of all the parties in this process being very high for getting an IMF agreement and getting Argentina back on track. And I do not interpret what's been happening in Argentina as a sinister phase in an aggressive default strategy.

Representative HAMILTON. Professor Dornbusch, do you want to tackle that?

Mr. DORNBUSCH. I am in disagreement.

Representative HAMILTON. You are in disagreement.

Mr. DORNBUSCH. Yes, I am. I believe Argentina has not paid interest since the end of October, so the 6-month debt time would actually come next month. The 3 months only came now.

Representative HAMILTON. That means the end of April?

Mr. DORNBUSCH. Yes. The 3 months is associated with the end-of-quarter statements. That is why we have it now.

The U.S. taxpayer would come in, because if the banks do not have earnings, then people have reduced income and therefore pay less income taxes. I believe, with Mr. Cline, that capital losses have already been written off the taxes. The FDIC, I do not believe, will become an issue because even if Argentina did not pay interest, it is not going to force the banking system into trouble.

Representative HAMILTON. Do you see this deadline that we are confronted with by the end of the week as a technical deadline, a bookkeeping deal of some kind, rather than a serious deadline?

Mr. DORNBUSCH. Well, the trouble for the financial system is not as serious, but the banks will have to retroactively write off interest payments that they have not received. But it is not a threat to the banking system. But I do believe one has to think of Argentina pursuing a strategy of going for better terms and doing it over the next half a year. The new Argentinian administration, when it came in, clearly indicated that that would be their policy. And I cannot see why being able to pursue the strategy, because they are in a very strong position, they should not do it.

Representative HAMILTON. The Secretary of the Treasury yesterday suggested that we relax our regulations requiring that American banks reduce their reported earnings to reflect their interest payments. Is that a good move?

Mr. DORNBUSCH. I think it is a very bad move. I think it is time the banks talked to the debtors and agree on terms they can all live with.

Representative HAMILTON. Could you comment on this American taxpayer liability for me, Mr. Dornbusch. I want to get clear on that.

Mr. DORNBUSCH. The only problem for taxpayers is if the banks do not collect interest and their earnings on this, and therefore there will be less income tax collection. I do not believe from the Argentine problem there is any multibillion loss through the FDIC or otherwise.

Representative HAMILTON. And you agree with Mr. Cline's observation that the impact would be indirect, whatever that may mean?

Mr. DORNBUSCH. Yes; it would certainly be through taxes that are not being paid.

Representative HAMILTON. And by "indirect," I presume you mean the impact on money policy of the Fed. Is that basically right, Mr. Cline?

Mr. CLINE. Let me clarify my response to your previous question. I was stating what the impact on the taxpayer would be in the event of a much, much wider debt crisis.

Representative HAMILTON. All right.

Mr. CLINE. And I agree completely with Professor Dornbusch that that is not at stake in the current Argentine situation, but in a much wider crisis it would be through such things as inflationary monetary base and indirect inflation costs. No, the only direct immediate tax consequence is simply the fact the banks will not be making as large profits if this is not simply reversed in the next couple of months, so they are not paying as high tax as they might. I might add, however, they have not paid particularly high taxes in the past.

Representative HAMILTON. Your reference to the FDIC—if you really had a wide-ranging debt problem here and crisis, they are certainly not going to have the kind of resources necessary to cover the losses, are they?

Mr. CLINE. Well, the losses are essentially a major write-down of this debt. You are talking about billions of dollars. And it is my impression that the FDIC does not have reserves that exceed perhaps something like $20 billion. I am not exactly on top of the FDIC reserves.

Representative HAMILTON. Yes.

Mr. CLINE. But potentially in a real debt cataclysm the FDIC funds would be insufficient.

Mr. DORNBUSCH. I cannot see that the FDIC problem would emerge because the FDIC guarantees small deposits; they do not guarantee large CD's. So, after the reserves and the capital and the large CD holders have made their losses, most certainly 90 percent of the banking system's assets are good and only 10 percent are bad debts. So I cannot see that the taxpayers, through the FDIC, would ever come to see that problem.

Representative HAMILTON. What happens now in this situation that we confront with Argentina to the climate for further lending by the banks to the Latin American countries?

Mr. CLINE. Well, it certainly does not help. What may happen in Argentina is that the process of involuntary lending, which has worked so far, which involves the mobilization of new commitments from a broad range of banks, including smaller banks, will be more difficult to carry out. The small bank, which would have been prepared to do its share of, say, expanding its exposure in Argentina by 7 percent before what has already happened or is going to happen within a few days, is going to be more reluctant to do so. It remains to be seen whether it will still be possible to mobilize sufficient funding.

Representative HAMILTON. Are we already seeing a sharp drop in lending by the banks to Latin America?

Mr. CLINE. Well, the figures on that question are ambiguous. It is not as sharp a drop as one might think. As I say, new bank lending to the developing countries declined from $50 billion globally in 1981 to $25 billion in 1982. The data come in with a 6-month lag so we do not know exactly what 1983 was, but the probability is it was somewhere in the order of $20 billion. The amounts of new lending have been significant.

But, you see, if the process does erode and a large range of banks are no longer willing to put in these modest amounts of new money, then I think the situation goes to the strategy of so-called capitalization of interest. In fact, the Argentines seem to be asking for that approach. And that approach means that instead of getting new loans from the banks, the banks are informed that, say, half of the interest that is due will simply be added to the bill to be capitalized. And in a deteriorated situation, that would be the only vehicle to insure the participation——

Representative HAMILTON. Do you think it is likely that we are going to come to that?

Mr. CLINE. In the Argentine case, it is becoming increasingly likely. In other cases it can still be avoided, and I think should be avoided.

Representative HAMILTON. Do you agree with that, Mr. Dornbusch?

Mr. DORNBUSCH. I believe in the Argentine case it is quite likely. I would also say there is not any lending in the sense we understand is taking place. The banks lend half the interest bill. There are no resource transfers and there is no way the banks can get out in the aggregate. The only problem is that the small banks can get out and the big ones do not want to let them. But the banks cannot get paid. There is no question about that.

Representative HAMILTON. There seemed to be a difference between you a moment ago on when the banks would have to set aside reserves. I thought, Mr. Cline, you said 6 months; Mr. Dornbusch said a month or something of that sort.

Mr. DORNBUSCH. It is 6 months, but they stopped paying at the end of October. So the 6 months is not June but it is coming next month.

Representative HAMILTON. I see. Is that correct, Mr. Cline?

Mr. CLINE. That may well be. I do not know whether the regulatory practice uses the end of the quarter for the 6-month demarcation or not. It is quite possible it would go back to the original. However, it is not true there has been a uniform nonpayment of interest for this whole period. One press report today said that only about 35 percent of the loans were not being paid.

First of all, the Argentines are paying interest on the really vital credit, the short-term trade credit. It also should be clarified that the classification of loans not performing for purposes of setting aside reserves is not a mechanical process. The 6 month is one of the influences that is taken into account. If the regulators thought that in good conscience there were serious negotiations going on, that an IMF program was in store, I think it is unlikely that if the 6-month period came on April 15 they would suddenly say, "OK, these loans have to have reserves set aside against them." It would be inappropriate for them to do so.

Representative HAMILTON. Do you think that an accommodation will be reached between Argentina and the bankers? Are both of you optimistic about that?

Mr. CLINE. I think that it will be, primarily because the stakes on all sides are very high to do so. I think it will involve some improvement on the terms in Argentina's——

Representative HAMILTON. So you have a better deal for the Argentines; is that right?

Mr. CLINE. Yes, a squeezing down of these spreads. I mentioned in my initial statement that the penalty spreads on reschedulings had been overdone, and that those spreads can be squeezed down somewhat. I think that is what we will see in Argentina.

Representative HAMILTON. What kind of IMF adjustment program for Argentina would be appropriate? They do not now have a program, do they?

Mr. CLINE. They do not. They essentially had a program last year and did not meet all of the performance requirements and the program was suspended.

The Government's own program of reducing budget deficits, I would say, is a crucial element. The maintenance of a realistic exchange rate, as Professor Dornbusch, has emphasized, is an important part of the right kind of package. The Argentine Government is more likely to emphasize continued wage indexation than probably would be desirable in the context of an inflation of over 400 percent.

But it seems to me that as long as the Government can credibly put together a program which carries out its side of the external obligations, in other words, which achieves—they are likely to have a $3.5 million trade surplus this year, for example. If it can maintain satisfactory external performance, then in some sense the banks and the international community have a less direct claim on insisting that Argentina's internal policies be particularly of this type or that type, that they have no controls of one sort or another. I think that the Government can put together a program which will achieve its external performance.

Mr. DORNBUSCH. I would emphasize in the stabilization program that the priority must go to locking in the real exchange rate that reactivates the economy, and that means the real wage promises that have been made are quite unrealistic. On the fiscal policy side, I believe a wealth tax would be much better than to try in a massive way to use subsidy removals because that would just increase inflation and in the long run comes back into the budget.

Representative HAMILTON. Let me ask a few questions with regard to the performance of the American banks in the situation. How do you assess their performance generally, since this so-called crisis developed? Would you characterize their actions as very responsible? And, if not, why not?

Mr. CLINE. Well, it seems to me that broadly they have been responsible. The mechanism that has been put in place involves a coordinated action among virtually all the significant banks, with all of them expanding their exposure by, say, something like 7 percent, under the umbrella of IMF guidance, indicating that the country has a coherent program.

Indeed, the IMF has conditioned its lending on the provision of new funds from the banks. So it is not a question of official money coming in the top and leaking out to the private recipients at the bottom.

The process seems to me to have held together rather better than many have feared. The performance, viewed in a larger basis, does highlight the vulnerability for relying on bank lending so heavily for development finance, because it is vulnerable to a reversal in the opinion of the bankers, so that you can get something as extreme as, I say, this $50 billion, to $25 billion cut in the flows. That, in turn, means an adjustment has to be very concentrated in a short period of time. That can be very costly. We have seen that in the reduction of domestic income.

But it seems to me that, basically, the banks by successfully mobilizing—for example, the $6.5 billion to Brazil has just been completed—have continued to take up their part of the burden.

Representative HAMILTON. Mr. Dornbusch, what is your impression of the banks and their performance?

Mr. DORNBUSCH. Since the problems have started, the banks have been doing very well. Of course, one has to ask why it is that the problem occurred, why the banks never read the books from the 1930's? But I would think now would be the time for the banks to find out about alternatives that get most of the debts paid in time, and I think they are playing a bit too hard trying to get service under the initial terms of everything, and may with that get less in the end.

Representative HAMILTON. Do you agree with Mr. Cline's earlier comment that they ought to cut their spreads?

Mr. DORNBUSCH. They should indeed cut their spreads, but the cutting of spreads, while heavily advertised, really has not been large. Brazil has gotten a cut of one-eighth of 1 percent on a 3-percent spread, so it certainly has not been large. You add the front-end fees and the commissions and the interest rates that are being paid are very high indeed, and that means the debts are growing very fast relative to exports. The debt problem in that sense is getting worse.

Representative HAMILTON. Are the larger spreads necessary in order to keep the smaller banks involved?

Mr. DORNBUSCH. That is an issue between the large banks and the small banks. I think it would be very hard to keep the small banks in the loan market, and the higher spreads cannot possibly compensate a small bank for all the time and effort that is being spent. Banks do not lend a risky loan at 30 percent and a safe one at 12. They do not knowingly make risky loans. All the banks want to get out.

Representative HAMILTON. If the smaller banks do drop out, what is the impact of that? Can the larger banks pick up the slack?

Mr. DORNBUSCH. I do not believe so, no. I think the way to keep the small banks in is to have a program where you are more likely to get your money. That is, the terms and adjustment programs have to make that likely.

Representative HAMILTON. Most of our rescheduling agreements have been for a year at a time, have they not? Would it be wise to go to multiyear rescheduling?

Mr. CLINE. There have been some 2-year reschedulings, as in the case of Mexico. Brazil was 1 year at a time.

Yes. I think trying to set up a rescheduling package over a 2-year or even a 3-year horizon would make a lot of sense. Much longer than that, it seems to me, removes the discipline in the system for ongoing performance and also could be inappropriate given changing international economic circumstances. One does not really know 3 years in advance exactly what the current account deficits are going to look like or what amount of rescheduling is necessary.

Representative HAMILTON. It strikes me that the banks simply are not going to be able to lend in the same way that they did in the 1970's and in the 1980's. If they can not, then the question arises: Where are the resources going to come from to help these countries with their debt problems?

What is your response to that?

Mr. DORNBUSCH. I believe one has to be extremely pessimistic about the next 10 years for the LDC's. As you have pointed out, the banks will lend at least part of the interest, certainly not net resources for the LDC's to use for the development. Private investment will, just as in the 1950's, play an important role, but it has always been minor. Official agencies with our budget tightness as it is will not play a large role. There will simply not be large transfers to LDC's. The next 10 years for LDC's will be a very bad scene, even under the best conditions.

Mr. CLINE. May I just add that I think it is right that the resource inflows are going to be considerably lower. It is not clear to me that that automatically translates into radically lower growth. If the real incentives for exports and import substitutes can be increased and maintained, then there will be new sources of activity in the economies. And looking at the first year's performance in 1983, there have been rather sharp cuts in the requirements on capital flows. And Mexico and Venezuela alone represent a turnaround in the capital requirement of several billions of dollars. And those economies, it seems to me, need not be paralyzed by lack of resource flows. In some sense they had a bloated import bill because they had overvalued exchange rates associated with the oil bonanza.

So while I agree that the magnitude of net capital flows to developing countries will be considerably smaller in the next few years, and banks, of course, will be smaller—instead of growing at 20 percent their exposure will grow at something more like 7 percent—I do not conclude from that that developing country growth will experience permanent recession. It seems to me that it may be lower than it was in the 1970's, but I certainly would not expect it to be negative, as we have seen in the initial year of the adjustment, 1983, or that significant growth is just going to be impossible.

Representative HAMILTON. Let us talk a moment about the U.S. economy and its impact on this debt problem. Obviously, our economic growth and outlook has a very major impact on the Third World and on the debt situation.

Given the debt servicing problems that we have been talking about, what kind of leeway, what kind of flexibility, does the Fed have to raise interest rates?

Mr. CLINE. Well, as long as the international recovery is moving along well and ahead of schedule—there is a trade-off. As I say, in my calculations, a 1-percentage point improvement in GNP growth in the industrial countries is about five to seven times as powerful as a 1-percentage point change in the interest rate.

Now, if 1984 comes on strong, at perhaps even 4 percent or over 4 percent OECD growth, then there is a bit of leeway in there for interest rates to edge up to 10.5 or 11 percent.

Representative HAMILTON. Is that the projected level, 4.5 percent?

Mr. CLINE. As I said, in this project LINK exercise, which involves several countries, their projection for 1984 is 4.3 percent. I think 3.5 to 4 percent is a fairly normal range for 1984.

But if interest rates were to surge, say, to 17 or 18 percent on an international basis, as they were in 1981 and early 1982, then essentially this forward-looking analysis of an improvement in the debt situation would no longer apply. The debt indicators would tend to be frozen at a very unfavorable rate, although in theory they might be partially compensated by still further real devaluations in the debtor countries. But those are awfully hard to carry out.

Representative HAMILTON. Mr. Dornbusch, could you comment on that question generally, about the flexibility the Fed has to raise interest rates?

Mr. DORNBUSCH. I see less flexibility for the Fed than Mr. Cline does because I do not believe the growth-interest rate trade-off is as favorable. I look at Brazil and almost 10 percent growth in exports means $2 billion, but would an extra percent growth in the world economy translate into 10 percent? Most certainly not. Perhaps half, 5 percent. Five percent growth in exports is the same as 1 percent on the interest rate. So if we have strong recovery, and the interest rates rise, the debt situation would improve a bit. If inflation is the cause of higher interest rates, then the debt situation will get worse.

I do not conclude, though, that the Fed should be expanding the money supply more rapidly to solve the debt problem. If anything, we should tighten fiscal policy to lower long-term interest rates and that way secure continued growth. We should not work on the short-term interest rate.

Representative HAMILTON. The action to increase the prime rate this past week—is that a matter of concern in this debt problem?

Mr. DORNBUSCH. Yes.

Representative HAMILTON. How is that viewed as it affects the debt problem?

Mr. DORNBUSCH. The increase in the prime rate is exactly the kind of thing I look at in the adverse scenario in my statement, that we must look ahead for the next year to the possibility that the Federal Reserve will say, "We have the inflation down. Now in the recovery we have to keep it down. And the only way to keep it down is to tighten monetary policy as growth continues."

Interest rates in that setting can rise very strongly. If the dollar goes down, the impact on the price level would be such that interest rates would certainly rise 200 basis points. With those increases in interest rates, the debt problem looks much, much greater than it is now, and that is an entirely plausible situation.

Representative HAMILTON. Both of you have emphasized the importance of growth in the U.S. economy as well as the world economy. We are now in the 18th or 19th month of recovery, and the recovery has been unusually strong. Are we seeing any impact in the LDC's in terms of increased exports to the United States because of the American recovery? And if we are not, why not?

Mr. DORNBUSCH. The export growth from LDC's really has not been extraordinary. If I take the Brazilian numbers, it has been 8.6 percent in 1983, taking advantage of the growth in the world economy. But half of that is inflation. So the growth record has really not been strong. But we cannot pinpoint isolated restrictions because it so happens that steel and orange juice have been doing extremely well in the past 2 months.

So I think the pessimism must be that the growth in the world economy really does not in fact translate in a very strong immediate way into LDC export growth. The empirical results that we have from the 1970's are really very much distorted by a few oil producers spending $100 billion quickly. And they are really not the results that are supported if you look more closely at a few of those episodes.

That is what makes me more pessimistic about the potential of growth. Certainly the commodity price explosion that regressions would suggest is associated with recovery has not at all occurred, even though our recovery is very strong indeed.

Mr. CLINE. May I come in on that?

Representative HAMILTON. Surely.

Mr. CLINE. There are lags in this process. In other words, the growth increase in part of 1983 does not instantaneously generate the extra exports. We have seen Brazil's exports growing more like 13 percent after the first quarter when they had their maxidevaluation in 1983. And if one looks at Mexico's nonoil exports in 1983, one does see a rather rapid expansion.

So I think it is a little bit too early to conclude that exports are not going to respond this time around to the international recovery. And even on raw materials prices we have seen some firming of at least some of the prices. Copper is perhaps the biggest disappointment, because we expect copper to be very sensitive to the cycle, and it has not performed. But the undue strength of the dollar plays a very large role in the relatively low nominal dollar price commodities. As the dollar reverses, it seems to me that more normal cyclical relationships in commodity prices will take place.

Representative HAMILTON. Is a weaker dollar better for them?

Mr. CLINE. Yes; I would say unambiguously that a weaker dollar will help the debt problem because it will tend to raise the number of dollars per ton of coffee or ton of copper.

Representative HAMILTON. It makes their exports more competitive.

Mr. CLINE. It makes their exports worth more. It makes them able to command more norminal units of dollars, and that therefore gives them a better export base to the dollar-denominated debt that they have.

Representative HAMILTON. May I get you to express your opinion generally on the administration's role on the international debt problem? How would you assess their performance on the debt issue?

Mr. CLINE. My view is that they have done a good job of managing what could have become a crisis out of control. They acted rather forcefully in the initial phases of the crisis. Within a matter of days they had a credible package put together for the Mexican crisis. There has been a lot of very short-term support which perhaps gave a larger visual impact than the true magnitude of support amounted to, considering that they had to be repaid fairly quickly.

But the U.S. Government, it seems to me, has played an important role in keeping the debt crisis within manageable bounds.

In a longer term sense, there are shortcomings in the Government's performance on the real side. The erosion on the trade side and the creeping protectionism has set some traps for the future that should be kept in mind when evaluating the prompt financial response. The principal failure, of course, remains the more indirect policy of U.S. budgetary deficits, and the need to bring them down and relax pressure on the interest rate.

But in terms of short-run crisis management, it seems to me one has to give the administration high marks.

Representative HAMILTON. Mr. Dornbusch.

Mr. DORNBUSCH. I would agree that on the rescue operations the administration has been extremely effective, particularly the Federal Reserve. The trade issue is extremely serious because that is the only way that the debt problem can be solved in everybody's interest, and our fiscal policies certainly have gotten the LDC's very largely into trouble by raising the interest rates.

So when we say they should tighten their belts, probably we should instead.

Representative HAMILTON. You have hit upon the IMF adjustment programs, but I want to have you go into that a little more specifically, if you would, and comment on the criticisms made of the IMF programs.

Has the IMF tailored its programs to reflect the fact that a number of countries have to adjust at the same time? What kind of adjustments were made in the IMF programs to reflect that fact? And I really want to get your general assessment of how you think the IMF has performed here.

I might say we have a meeting tomorrow with the managing director of the IMF and I want, to use some of your comments for our discussion.

Mr. Cline. On this subject, I think you will find considerable difference between my view and that of Professor Dornbusch. There is the frequent criticism that the IMF's packages do not add up because when it tells 20 countries to contract at the same time, that causes global recession.

I think that critique is disproportionate in terms of the magnitudes. The change in the external balance that has to be carried out is this $25 billion swing in reduced bank lending. Relative to, say, OECD imports of $1.5 trillion, that is not of global macro magnitude. It is a case in which the effect in theory might be relevant but in magnitude it is kind of nongermane.

It seems to me the more fundamental point is that the IMF packages have been designed with a realistic limitation of resources available in mind. And when they have been criticized for too much adjustment too fast, too much austerity, the critics have not really drawn the conclusion that they should, that more IMF resources ought to be available to permit more gradual adjustment.

It seems to me that given the plausible amount of external resources that could be mobilized, both by the IMF and by the banks and by official agencies, the IMF packages do hold together in terms of their internal logic.

I do not have the same impression as Professor Dornbusch that the Fund has not been tough enough on external adjustment through real exchange rate devaluation. We have some differences of view on Brazil. I think the Fund more often is criticized, at least in Latin America, as being too hard-nosed in requiring devaluation and not realizing that devaluation does not work because trade does not respond, so the argument goes. So it is a little difficult to criticize the Fund much for not having paid enough attention to real exchange rate incentives.

It seems to me that the policies on domestic budget and monetary restraint, which is the normal Fund package, are often unavoidable, given very high domestic inflation rates.

If there were an easy, technical alternative to the packages the fund has been suggesting, it seems to me they would have been adopted by now. The whole area on stabilization theory as to what are the right instruments to use is one of even a greater disagreement than macroeconomic theory for the United States.

So it seems to me there is no simple alternative to the basic strategy the Fund has been pursuing. And in view of that, it seems to me that the Fund has been acquitting itself relatively well.

It did make one major important decision, and that was its historic decision to tell the banks there would be no IMF money if the banks did not put in money of their own.

Representative HAMILTON. Professor Dornbusch.

Mr. DORNBUSCH. Mr. Cline is very right to point out that the IMF helped very effectively by causing the banks to lend part of the interest.

In my comments on the IMF, I want to be certain not to be polemic, but I do think one has to criticize the Fund. If in this country we pursued policies that cost an extra 3-percent loss in GNP, we would think that is quite disastrous.

When we look at what the Fund does in Latin America, we say adjustment is essential. Now, I ask: Is it conceivable that if different policies had been followed that GNP would only have fallen 10 percent instead of 15 percent? In this country we would think that is a big difference and really worth thinking about.

Somehow it appears in Latin America that is not worth thinking about because I do not see that the IMF does think enough about it. The technical expertise that has gone into the Brazilian program is really vanishingly small. I have studied all of the IMF documents on the Brazilian case, and the sophistication is extremely low. The word "inflation" and "budget deficit" appears so often you can count them, but unemployment or recession do not appear.

That is a very serious problem. That is certainly not how we think of the economy in this country. Why is it that in Latin America it does not make any difference? And I wish that question was raised with the Fund.

It is the case that Brazil did have to adjust. They had a huge budget deficit and they did not have anything to pay the imports with. So adjustment was essential. But it is not my sense that the adjustment that was undertaken prepares Brazil for the next 10 lean years we can anticipate for lack of financing by giving them a reasonable export growth with which they can have 2, 3, or 4 percent growth per year. They are very far away from it. All the emphasis has been on stopping inflation which now is double the rate that it was before the IMF came, and on cutting the budget.

Representative HAMILTON. Is your criticism directed toward Brazil or the Brazilian experience, or is the criticism directed kind of across the board?

Mr. DORNBUSCH. No, certainly not. It is a very specific criticism. Mr. Cline rightly said the IMF had a tradition of emphasizing export-led stabilization programs. And somehow in the case of Chile and Brazil, because it was inconvenient in the discussions with those countries, it was given up, and instead subsidies were cut which raises inflation and creates unemployment, and there is no sense of where the economy is going to get reasonable growth as far as the eye can see.

But those are specific cases, and I am not sufficiently acquainted with many others except the Mexican one.

Representative HAMILTON. You hear some comments on the Hill here that the result of the IMF adjustment programs is to harm U.S. exports because we are asking them to curb imports. What do you think of that?

Mr. DORNBUSCH. I believe that is certainly true.

Mr. CLINE. It is true, but the basic point is there has to be a rise in the trade surplus of the countries. It would be nicer to see that rise carried out by larger exports from them so that the cut in imports from the United States can be avoided. But I ask you: Would the political pressure be greater under what has happened or under the alternative? A surge in exports to this country causes political pressures with a different set of clients, namely, the import-sensitive industries.

The basic point is there is an unavoidable rise in the trade surplus of the debtor countries that is caused essentially by the sharp cutback in financing, and the decline in U.S. exports to Latin America has been a necessary price of the adjustment.

Representative HAMILTON. Gentlemen, thank you very much for your statements and your responses. You have helped us understand a difficult problem better and we are grateful to you.

The subcommittee stands adjourned.

[Whereupon, at 11:40 a.m., the subcommittee adjourned, subject to the call of the Chair.]

O