

FRIEDBERG'S

LDC DEBT COMMENTS

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Again, deflate the debt, please

The international debt problem has been with us since the summer of 1982, when Mexico, followed by others, announced that it could no longer pay the interest and principal on its international debts. At the time, most experts thought that the crisis represented a short-term liquidity problem. This wasn't our view. We published a piece entitled "Deflate the debt, please" in December 1983 (copies are available on request). Given that most debtors employed interventionist, anti-growth policies, we argued that the debt crisis represented a long-run solvency problem.

Since most debtors have retained their anti-growth policies, the responses to the debt crisis have unfortunately been incorrect because they have been geared toward solving a liquidity, rather than a solvency, problem. For example, the first policy response (1982 to 1985) focused on an IMF austerity strategy, which was designed to squeeze as much interest out of the debtors as possible.

By 1985, it was clear that the IMF austerity approach wasn't working. Hence, James A. Baker III, then Secretary of the Treasury, announced a plan for the 15 most heavily indebted countries. The so-called Baker Plan, by encouraging more new lending to the debtors, was intended to shift the policy from austerity to growth. This strategy has also been less than successful.

The official strategy suffers from two fundamental problems. First, it forces countries that have borrowed too much to borrow more, and to transfer scarce domestic resources to service old debts that are not generating new income. Second, it forces commercial banks and multinational lending institutions that are already overexposed to further increase their exposure with new loans that may not generate future earnings.

In consequence, the official strategy — by failing to recognize that the international debt crisis is a solvency, not a liquidity, problem — is siphoning debtor's resources from productive uses and recycling good new money to service bad old money (see Chart 1). The strategy only postpones and compounds the eventual settlement of losses from past overborrowing and overlending, because the debtors and creditors are forced to do more of what they did to create the debt crisis in the first place.

Official failure

Not surprisingly, the official strategy has failed to promote either growth or creditworthiness. That the markets are skeptical about whether the debts will ever be paid or fully serviced is an understatement. After all, the value of most LDC debt (with the exception of Chile) has been falling in value and is typically worth less than 50 cents on the dollar.

Hence, each dollar in new loans is typically worth less than 50 cents as soon as it is made. It is no wonder that since 1985, most of the net new lending has been done by governments and multinational organizations. This is a significant change from previous practice, when most loans were from private sources.

The data in Chart 2 paint a bleak picture about the success of official policies in promoting growth and creditworthiness. Three points deserve mention.

- The macroeconomic performance of the debtor countries has been dismal: Per capita income has failed to recover; investment has remained depressed; and inflation has soared.
- Largely as the result of import compression, rather than export expansion, the debtors have generated large trade surpluses, so that they can service their debts and transfer resources abroad.
- The level of debt and cost of servicing it (measured by the debt/export and interest/export ratios, respectively) remain at excessively burdensome levels.

Steps in the right direction

On March 10, 1989, Nicholas F. Brady, Secretary of the Treasury, made a speech in which he signaled that the Bush Administration might shift the US position on the international debt issue. Although rather short on specifics, Mr. Brady recognized that insolvency is the problem facing the debtors, and that debt should be reduced. This shift is an important step in the right direction. However, the next step (the precise means to reduce the debt) is perhaps as important as the first.

In his speech, Mr. Brady implied that US taxpayer money would be used (via more World Bank and IMF loans and guarantees) to assist the creditors and debtors in their quest

to reduce outstanding debts. The use of taxpayer money would be unjustified because the losses arising from over-lending and overborrowing should be shared by the original parties to the loans.

Why should the taxpayers, who weren't parties to the loans, be asked to bear part of the losses? In addition, the involvement of taxpayer money creates counterproductive incentives. Specifically, a moral hazard problem is created because the creditors and debtors will have an incentive not to move until they have successfully extracted the maximum amount of "loss sharing" from the taxpayers.

Four propositions

As the debate about the means to solve the debt crisis picks up steam once again, we offer our views. (Note that we presented these ideas in testimony before the Subcommittee on International Finance and Monetary Policy of the US Congress on Feb. 8, 1989.) We begin with the following propositions:

(1) Given that most debtor countries employ interventionist, anti-growth policies, the debt crisis is an insolvency problem.

(2) Furthermore, the debtor countries' *economic problems* are caused by interventionist-socialist economic policies. That these policies retard economic progress has recently been reported by Professor Gerald W. Scully in an important study published in *The Journal of Political Economy*. In studying 115 countries over the period 1960 to 1980, Professor Scully found that nations with the greatest degree of economic freedom grew three times faster than did those in which freedoms were abridged.

(3) Hence, even if the insolvency problem is solved, the debtors will still be left with economic problems, unless they adopt free-market, laissez-faire policies.

(4) Like a domestic insolvency problem (a bankruptcy problem), it should be worked out between the debtors and creditors.

Voluntary approach

To solve the debt and economic problems of the debtor countries, we propose a voluntary approach to debt reduction that is linked to free-market economic reforms. In consequence, our voluntary, private proposal will simultaneously solve these nations' insolvency problems and promote economic growth.

Our program would work in the following manner. The banks and the debtors would voluntarily agree to be bound by the decisions of a private Debt Relief Committee. The Committee would comprise "impartial" experts who would be agreed on in advance by the banks and debtors.

The Committee would play much the same role as a judge in a bankruptcy proceeding. Specifically, the Committee would determine whether a debtor could be made economically viable through the adoption of pro-growth, laissez-faire policies, such as those employed in Chile. If this determination were favorable, then a work-out of the overindebtedness between creditors and the debtors would proceed.

The criteria for growth

The Committee would function in the following manner. In each review period (perhaps one year), the Committee would determine whether the debtor was progressing or regressing. Progress or regression would be measured against the following criteria that must be met if economic growth is to be sustained:

1. Budget deficits and government spending must be kept under adequate control. Although budgets need not be balanced at all times, there are severe limits to the budget deficits that can be incurred with relative impunity. Governments and politicians must learn to say no to spending requests, so that public spending, as a share of the economy, is kept at modest levels and so that large budget deficits aren't realized on a regular basis.

2. Inflationary pressures must be kept under reasonable control. To encourage their economic development, small countries' inflation rates should not exceed that realized in the world economy.

3. The advantage of open international trade must be exploited. Liberal trade policies facilitate the efficient allocation of resources and stimulate economic growth. This is particularly true in small economies, where real competition can be obtained only through liberal trade policies that allow foreign producers to compete freely in domestic markets.

4. Excessive tax rates must be avoided. Excessive tax levels and rates distort behavior and create large disincentives to economic activity, while yielding little revenue.

5. Excessive subsidies and tax incentives for private industry must be avoided. Subsidies and tax incentives, which are designed to achieve particular objectives, may or may not actually assist in obtaining those goals. However, one thing is certain: They distort economic choices and resource allocation, and they retard economic growth.

6. The manipulation and repression of private capital markets must be avoided. The manipulation and repression of private capital markets distort and retard the savings-investment process. Hence, they should be avoided because they act as a drag on economic growth.

7. Undue union power must be avoided. State-created monopoly privileges for unions — such as exclusive representation and compulsory union membership — should be avoided. These monopoly privileges distort labor markets and create an artificial and unfair advantage over other non-union interests in democratic processes. In consequence, monopoly privileges for labor unions act as a drag on economic growth.

8. Price controls must be avoided. Price controls can't be justified on economic grounds. They tend to vitiate the signalling role that prices should play. Hence, price controls impede the movement of resources from lower-valued to higher-valued uses, and result in resource misallocation and slower economic growth.

9. Market interventions and restrictions on competition must be avoided. Market intervention and restrictions on competition result in inefficient enterprises, resources

misallocation, and slow economic growth.

10. State-owned enterprises must be eliminated. State-owned enterprises are inefficient and act as drags on an economy. For example, sales, adjusted profits, and productivity per employee are lower for nationalized enterprises than for private firms. Also, taxes paid per employee are lower; sales per dollar of investment are lower; profits per dollar of assets are lower; per dollar of sales, wages plus operating costs are higher; sales grow at a slower rate; and, with few exceptions, state-owned enterprises, where accounts are presented properly, typically generate accounting losses.

11. Unclear boundaries between public and private activity must be avoided. When boundaries between the public and private sector are unclear, it is symptomatic of poorly defined property rights. Ill-defined property rights distort resource allocation and retard economic growth. Government bailouts of bankrupt private firms are but one example of unclear boundaries between public and private activity.

Interest-rate carrot

If the Committee determined that there was progress in a review period, interest rates on outstanding debt would be reduced in the next period. Good performances could result in relief that would, at the extreme, eliminate interest obligations. If there were no progress in the review period, rates would not be changed for the next period. If regression were recorded in the review period, rates would be increased, with the upper limit being the original contracted level.

It is important to emphasize that this proposed program is in sharp contrast to IMF conditionality in two important respects. First, it would be based on a pro-growth set of performance criteria, rather than IMF-austerity criteria. Second, actual performance would be monitored, and relief would be subject to real performance. This would eliminate the need for letters of intent and other promises that, in any case, are hardly worth the paper that they are written on.

Multiple benefits

The benefits from such a linked, debt relief, pro-growth policy would be significant.

• Debtors benefit in three ways:

1) Most importantly, the program would give debtors incentive (debt relief) to adopt economic policies that would stimulate economic growth. Politicians in debtor countries would no longer be able to argue that sound economic policies couldn't be implemented because of excessive external debt. Indeed, politicians who didn't adopt sound economic policies would have to pay a cost: the debt relief that their countries passed up because sound policies weren't adopted.

2) In consequence of pro-growth policies, investor confidence would return, capital flight would stop, and capital would begin to flow to promising investment projects.

3) With the debt relief, economic growth, and new capital inflows, the principal on outstanding loans could be repaid on a sustained basis, without undue burdens.

• Bank benefits.

Very simply, banks' assets (loans) would increase in value. To appreciate this, one must realize that with pro-growth policies and debt relief, debtors would be able to amortize their loans. Let's assume that a debtor, at the extreme, progressed so well that the Debt Relief Committee eliminated all interest obligations on outstanding loans. Then, what would the value of a bank's assets be worth? If a debtor amortized a loan over 10 years and a bank's discount rate were 10%, then the present value of the loan would be about 68 cents on the dollar. If the amortization period were stretched to 20 years, the loan's present value would be about 47 cents on the dollar. These values *exceed* the current market values for most LDC debt.

• International benefits.

The international economy would benefit because global economic activity and trade would increase.

• US taxpayer benefits.

The US taxpayers would benefit because they will not be liable for loss sharing on the outstanding loans to LDC nations.

Getting back to business basics

The indebted LDC nations are much like an insolvent enterprise that suffers from poor business practices and policies. In the case of an enterprise, the solution is clear enough: The enterprise and its creditors would work out the firm's insolvency problem in a bankruptcy court, and the enterprise's business practices and policies would also be altered. After these two objectives are accomplished, the enterprise would be ready to conduct business as usual again, with new credit lines, etc.

We have outlined a plan that would do much the same for debtor nations. Through a strong linkage, our proposal would first require the debtor nations to implement sound economic policies. If these were forthcoming, debt relief would be awarded. We are confident that our approach would solve both the insolvency and economic problems that plague most LDC countries.

If adopted, our program would provide the leverage to turn a potential tragedy into an opportunity of a lifetime: The transformation of Latin America into a high-growth region that could challenge the Asian Tigers.

Albert D. Friedberg **Dr. Steve H. Hanke**

Friedberg Capital Markets

Friedberg Capital Markets, a division of Friedberg Mercantile Group, is a market-maker in various LDC debt issues and loans. These instruments are offered, from time to time, to our clients accompanied by specific written recommendations (see *LDC Debt Comments* March 10, June 13, and Nov. 7, 1988). Friedberg Mercantile Group believes that LDC debt *can* be a rewarding investment depending on price and economic circumstances.

Chart 1
Latin America and the Caribbean
net inflows and resource transfers

(in billions of \$)

| <u>Year</u> | <u>Net Capital inflows</u> | <u>Net interest & profit payments</u> | <u>Resource transfers</u> |
|-------------|----------------------------|---|---------------------------|
| 1980 | 29.7 | 18.1 | 11.6 |
| 1981 | 37.6 | 27.2 | 10.4 |
| 1982 | 20.2 | 38.8 | 18.6 |
| 1983 | 2.9 | 34.4 | 31.5 |
| 1984 | 10.3 | 37.0 | 26.7 |
| 1985 | 2.2 | 35.0 | 32.8 |
| 1986 | 8.3 | 31.9 | 23.6 |
| 1987 | 13.9 | 30.5 | 16.6 |
| 1988 | 4.3 | 33.2 | 28.9 |

Source: *United Nations' Economic Commission for Latin America and the Caribbean*

Chart 2
Economic Performance and Debt Burden in 15 Problem Debtor Countries: 1980-1988
(in percent, unless otherwise specified)

| | Reference 1970-79¹ | Toward crisis | | | IMF-led austerity | | | Baker-led growth? | | |
|--|--|----------------------|-------------|-------------|--------------------------|-------------|-------------|--------------------------|-----------------|-------------------------|
| | | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988² |
| Macroeconomic performance | | | | | | | | | | |
| Per capita real GDP growth | 3.3 | 2.4 | -1.9 | -2.8 | -4.9 | -0.2 | 0.5 | 1.2 | -0.3 | 0.0 |
| CPI inflation rate | 32 | 47 | 54 | 56 | 92 | 118 | 121 | 77 | 116 | 157 |
| Gross capital formation (percent of GDP) | 25 | 25 | 25 | 22 | 18 | 17 | 17 | 18 | 17 | 18 |
| Arithmetic of debt service | | | | | | | | | | |
| Debt/export ratio ³ | — | 168 | 202 | 268 | 289 | 269 | 287 | 344 | 329 | 319 |
| Interest/export ratio ³ | — | 16 | 23 | 31 | 29 | 29 | 29 | 28 | 28 ⁴ | 27 |
| Terms of trade growth | 5 | 13 | -3 | -4 | -4 | 3 | -3 | -18 | 2 | -3 |
| Merchandise trade balance ⁵ | — | 6 | -7 | 4 | 28 | 42 | 41 | 21 | 28 | 27 |
| Exports ⁵ | — | 128 | 127 | 112 | 111 | 123 | 119 | 100 | 112 | 119 |
| Imports ⁵ | — | 122 | 134 | 108 | 83 | 82 | 78 | 79 | 85 | 91 |

NOTE: The countries are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

¹Compound annual rate of change.

²IMF Forecast.

³Export represents exports of goods and services

⁴Includes interest incurred, but not paid (arrears).

⁵Billions of US dollars.

Source: *World Economic Outlook*, IMF, April 1988.

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