

Konrad, Anton

Article — Digitized Version

Ways out of the debt crisis

Intereconomics

Suggested Citation: Konrad, Anton (1984) : Ways out of the debt crisis, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 19, Iss. 1, pp. 23-27, <http://dx.doi.org/10.1007/BF02928287>

This Version is available at:

<http://hdl.handle.net/10419/139897>

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those involved in this process. There is therefore no call for resignation at the present time.

The industrialised countries must give priority to creating the conditions for a non-inflationary upswing of the world economy and world trade. In addition, they will have to open up their markets further to products from developing countries. Private lenders must resist the temptation to withdraw from their commitments or to pass the buck of existing risks to the IMF, the central banks or individual governments.

It goes without saying that the main contribution towards overcoming existing problems must be made by the developing countries themselves. A first step in the right direction would be to stop passing on the responsibility for their problems to creditors alone. Developing countries will only be able to re-establish their creditworthiness if they appreciate that there is a direct link between inefficient economic and fiscal policies, inadequate growth and payments difficulties. An important move in this respect is to make up for the failure to adjust to the changed international economic setting as soon as possible. This can be achieved by finding a way back to market-conforming output price and factor price relationships and rectifying unrealistic exchange rates. In addition, developing countries should, in future, support paths to growth which harbour

less risk and are less capital-intensive, avoiding long gestation periods and circuitous routes of production. Assuming that industrialised countries cease to continue or even intensify their opposition to changes in the structure of the world economy, labour-intensive and export-oriented development strategies hold the key to long-term successes at a lower risk. A successful reorientation of economic policies would help many debtor-countries to regain access to the currently blocked capital markets and thus facilitate economic recovery.

However, the necessary economic consolidation represents a process which is in some cases socially painful and which is accompanied by substantial political risks for domestic policy-makers. It is still not clear whether the understanding of the debtor-countries and/or the pressure of creditors and the IMF will suffice for these countries to embark upon such a course. There is still a danger that individual debtor-countries or groups of debtor-countries with sufficient negotiating powers will try to take a more convenient (at least in the short run) path, namely that of "solving" their internal problems at the expense of (external) creditors. No-one would benefit from this in the long run, not even the developing countries. They would be cut off permanently from capital inflows and their internal problems would continue.

DEBT CRISIS

Ways Out of the Debt Crisis

by Anton Konrad, Munich*

Thanks to collaboration between creditor banks, western central banks and the IMF, the danger of the financial collapse of numerous developing countries and consequent chain reactions in the western banking system has been kept at bay for the present. However, a number of circumstances give cause to doubt the durability and strength of the solutions adopted so far:

□ The rescheduling agreements concluded so far relate only to debts falling due in 1983 and, for a small number of countries, 1984. It is to be feared that further debts will have to be renegotiated in the near future, given the hesitant recovery in the world economy.

□ The rescheduling agreements merely delay the due dates of the debts by six or eight years, creating the danger of another bunching of maturity dates in the second half of the eighties.

□ The burden of high interest rates, one of the main causes of the financial crisis, has not been alleviated by the rescheduling agreements but further increased, for interest premiums of more than 2 % and rescheduling fees of up to 3 % on the rescheduled loans have been agreed. This interest burden prevents a reduction in the balance of payments deficits and contributes to a further increase in indebtedness.

□ The banks reacted to the onset of the crisis by drastically reducing their lending to developing

* University of Munich.

countries from the record level recorded in 1981. The statistics on medium and long-term bank loans to developing countries do show a surprising stability at a somewhat reduced level – \$ 22.08 billion in the first three quarters of 1983 compared with \$ 26.28 billion in the same period of the previous year;¹ however, the flow of capital was not sustained spontaneously but only as a result of pressure in the rescheduling negotiations from the IMF, which made the provision of Fund resources conditional upon the granting of new bank loans. Besides, these new loans were largely eaten up by the increase in interest obligations and produced only a small transfer of resources to developing countries.

Common Underlying Idea

The realisation that the negotiations so far have merely produced a breathing-space has caused a range of proposals to be made for fundamental and long-term solutions. An idea common to most of them is to consolidate short and medium-term bank debts by converting them into bonds. If such conversion bonds were issued directly by debtor countries, however, there would be a danger that their quotations would fall to a very low level, which would not be exactly beneficial for the countries' future credit standing. This is particularly true of one version whereby these bonds would not have a fixed redemption schedule but would bear entitlement to a specified percentage of the debtor country's export earnings.²

There appears to be more logic in the proposal that conversion bonds issued by the developing countries should be given an international guarantee by the industrial countries before a secondary market in them is formed. If debtor countries became finally insolvent the developed countries would bear the losses. However, this proposal is open to the objection that taxpayers' money would have to be used to bail out the banks. In the past the banks have managed to offload the entire risk of interest rate changes onto the debtor countries by the technique of roll-over loans and they are now in the process of turning even rescheduling into a profitable deal. Such proposals would therefore be acceptable only if the banks continued to bear part of the risk of default.

Establishment of a Rescheduling Fund

The proposal for an international guarantee to cover conversion bonds issued by debtor countries is but a

step away from the plan first put forward by F. Rohatyn whereby bonds would be issued not by the debtor countries themselves but by an international body, such as a subsidiary of the IMF or of the World Bank; this solution would also meet the need for an international guarantee.³ The conversion bonds would be offered to the banks in exchange for their short-term claims against the developing countries. The rescheduling fund would in turn convert the short-term claims acquired in this way into long-term claims. According to Rohatyn, the conversion bonds should bear interest at a lower rate than the original loans. The banks would therefore suffer a loss of income from interest, but would be more than compensated by the restored quality of their assets. A variant of this plan devised by R. S. Weinert goes so far as to propose only a variable interest rate that should be based on the debtor country's ability to pay, which in turn would be measured according to export volume and terms of trade. Here too, the rescheduling fund would guarantee a minimum rate of interest. On the other hand, the banks would have to retain 20 % of their debt claims so that they continued to bear part of the risks.⁴

These proposals undoubtedly deserve to be described as global solutions, for they largely eliminate the problem of individual country risks. However, difficulties would be encountered raising the necessary guarantee capital for the new conversion fund. Even the agreed increase in the normal IMF quotas under the Eighth Review of Quotas was implemented only with difficulty owing to opposition in the US Congress! Peter Kenen seeks to solve the problem by proposing that the fund acquire the banks' claims at only 90 % of their face value; for that reason he calls the rescheduling fund the "International Debt Discount Corporation".⁵ This would also meet the need for the banks to bear some of the loss. Nevertheless, there is a danger that the fund's losses would far exceed 10 % of the acquired claims.

A Solution Advantageous to the Banks

The solution that would go furthest towards meeting the banks' interests would entail the conversion fund issuing its bonds on the capital market direct and using the proceeds to purchase the banks' claims on developing countries. Apart from the fact that this would scarcely be an equitable sharing of the burden between

¹ O E C D : Financial Statistics Monthly, No. 11, 1983, pp. 17 ff.

² N. A. Bailey, R. D. Luft, R. H. Robinson: Exchange Participation Notes: An Approach to the International Financial Crisis, in: The International Financial Crisis: An Opportunity for Constructive Action, Georgetown University, Washington, D.C., 1983.

³ F. Rohatyn: A Plan for Stretching out Global Debt, in: Business Week, 28th February 1983.

⁴ R. S. Weinert: Banks and Bankruptcy, in: Foreign Policy, No. 50, 1983.

⁵ P. Kenen: A Bailout Plan for the Banks, in: The New York Times, 6th March 1983.

debtor countries, banks and taxpayers, such a comprehensive plan would probably be defeated by the sheer scale of the operation; the developing countries' debts towards the banks amount to more than \$ 300 billion, whereas the maximum that the IMF can grant in loans in its present form is \$ 12 billion a year.

Finally, the central banks of creditor countries are suggested as institutions that should take over the doubtful claims of the commercial banks. Under the plan put forward by Peter Leslie, the central banks would establish a rediscount facility for this purpose so that banks could grant new loans in place of their frozen claims. However, the latter would continue to be treated as contingent liabilities and would be written off by the banks in the event of the debtors' inability to pay.⁶ Even those proposals that provide for an international organisation to take over bank claims, such as the schemes mentioned above, recommend the rediscounting of its bonds by the central banks as a supporting measure.⁷ However, it is very doubtful how far the central banks could reconcile such rediscounting of LDC debt with their money supply policies. The crisis

would probably have to deepen dramatically before considerations of this nature were overridden.

Safeguarding a continuous flow of new credit to developing countries is more important for the revival of the world economy than consolidating existing debt. The funding schemes described above also serve this aim to some extent in that they improve the banks' liquidity and secure their assets, but it has to be asked whether they would sufficiently overcome the reticence of the banks, for the decisive obstacle is probably the risk attached to new loans. It has therefore been proposed that the exchange of bank claims for funding bonds be made conditional on the granting of new loans by the banks.⁸ However, measures to encourage new loans directly would probably be more effective. A common feature of the plans presented below is the proposition that in future the banking system cannot bear as large a share of development financing as in the past, so that the lead must again be taken by the international organisations. This raises two questions, which relate first to the adequacy of the world institutions' financial resources and secondly to the terms for access to credit.

The proposal to make a new distribution of Special Drawing Rights would solve both problems; the

⁶ P. Leslie: Techniques of Rescheduling: The Latest Lessons, in: *The Banker*, April 1983, pp. 29 ff.

⁷ S. A. Yohai: How the World Bank might Recycle Assets, in: *Euro money*, January 1983, pp. 46 ff.

⁸ C. Bogdanowicz-Bindert: Debt: Beyond the quick fix, in: *Third World Quarterly*, October 1983, p. 837.

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Großoktav, 480 Seiten, 1983, Preis brosch. DM 76,-

ISBN 3-87895-231-7

VERLAG WELTARCHIV GMBH - HAMBURG

question of finance would be resolved by the fact that the SDRs would be created from nothing and that of access terms would be solved on account of this being unconditional liquidity. However, even SDR allocations have a cost, as they must bear a market-related interest rate once they have been issued. Unlike other IMF balance of payments assistance, however, they do not have to be repaid. Of course, they would have their greatest impact if allocation were made in the form of the "Link", in other words if the new SDRs were issued solely to developing countries. As such a change in the method of allocation would require reform of the Fund's Articles, a general allocation would appear to be easier to obtain. Nonetheless, under this arrangement the developing countries would benefit only in proportion to their respective IMF quotas. At the Annual Meeting of the IMF in September 1983 agreement could not be reached on a new allocation of SDRs, although the question is to be examined further. The advocates of such action pointed out that world currency reserves declined for the first time in 1982 and that the inflationary dangers of creating SDRs were slight in view of the world-wide overcapacity. On the other hand, only a massive allocation of SDRs – the figure of 15 billion a year for the next four years was mentioned – would bring the debtor countries tangible relief.

Those industrial countries that up to now have clung to moderate money supply targets in spite of underemployment would certainly find the potential creation of money on this scale difficult to accept. Advocates of the plan are seeking to make a new allocation more palatable by proposing a new variant of SDRs that would be repayable over the long term and subject to conditionality.⁹

Measures Already Decided

One measure that has already been decided is to increase IMF quotas by 47.5 % to SDR 90 billion. The coming into force of the increase was delayed by opposition in the US Congress to raising the American subscription. American consent was finally given and the quota increase will come into force in 1984, but it has already proved insufficient to cover existing IMF lending commitments. This is understandable, if one considers that at most half of the resources to be subscribed to the IMF will consist of usable currencies, so that the IMF's liquidity will rise by only about \$ 15 billion. A further review of quotas will take at least three years. Hence it

was suggested by the Indian delegation that quotas should be adjusted automatically in step with the growth in world trade; the present ratification procedure would apply only to increases in quotas over and above this.

The World Bank has already adapted to the new situation as far as it is able. The flow of capital to the developing countries is to be maintained by means of new forms of co-financing that offer private lenders greater security as a result of the World Bank's participation. For example, the new co-financing arrangements provide that the World Bank's share of loans will be redeemed only after the private creditors have been repaid, that the World Bank will guarantee later redemption instalments or that fixed-rate annuities are made possible in spite of fluctuations in interest rates. However, these measures cannot be expected to make more than a modest contribution to crisis management, first because the World Bank is restricted to project loans and cannot grant general balance of payments assistance and secondly because its volume of lending is too small to be able to offset a withdrawal by the commercial banks.

International Credit Insurance

The idea of an international guarantee has been proposed not only in connection with the settlement of existing debt but also for new lending.¹⁰ A comprehensive plan along these lines has been put forward by Johannes Witteveen, the former Managing Director of the IMF, whereby an insurance facility for bank lending to developing countries would be established under the auspices of the IMF.¹¹ As the risk cannot be calculated in actuarial terms, the scheme would have to be financed from public funds in the same way as national export credit insurance. However, the insurance would only cover 75 % of the loan so that the banks would continue to have an interest in making their own provisions for contingencies. In Witteveen's opinion, the necessary political support for this plan would be forthcoming only if the banks avoided the excessive lending in which they indulged in recent years. The offshore money markets would have to be more strictly controlled, and in particular made subject to minimum reserve requirements. As reform of this kind is time-consuming and the introduction of the insurance facility is a matter of urgency, control over the Euro-markets would have to be replaced temporarily by co-operation among the central banks to this end.

⁹ D. Avramovic: The Debt Problem of Developing Countries at End-1982, in: Außenwirtschaft, Vol. 38, 1983, pp. 65 ff.

¹⁰ See C. Grant: Those Debt Proposals: Radical or just wrong?, in: Euromoney, July 1983, pp. 53 ff.

¹¹ IMF Survey, 10th October 1983, pp. 319 f.

The IMF as a Credit Intermediary

The same international guarantee effect occurs, of course, if the IMF itself acts as a credit intermediary. Hitherto the IMF has raised funds mainly through the General Arrangements to Borrow and the financing of certain special facilities; in each case this has consisted in borrowing from central banks. As a final alternative, however, consideration was given to tapping the private credit markets as early as 1981.¹² Admittedly, this course was regarded as no more than a transitional solution until the next general increase in quotas, but the debt crisis makes IMF borrowing in the credit markets appear as a genuine complement to declining direct loans from commercial banks to developing countries.¹³

IMF recourse to private money and capital markets would have an advantage over the proposed general international guarantee in that only the loans intermediated by the IMF would have to be secured in this way. A further advantage would lie in the flexibility of this method; it is argued that the IMF could adjust the scale of its borrowing to match the gap between the developing countries' overall requirement and the loans that the banks continued to provide and that it could withdraw completely from the private financial markets if the direct flow of bank lending to developing countries returned to normal. A further point advanced in favour of such an expansion in the activities of the IMF is that it would give the developing countries greater independence and would strengthen their negotiating position, for example in debt rescheduling negotiations or in securing the sorely needed fall in interest rates.¹⁴ Here then is an opportunity to influence the servicing of existing debt by making new loans easier to obtain.

There is continued strong opposition to this course of action, however, from such as the Deutsche Bundesbank.¹⁵ The main objection to IMF borrowing in the private capital market is that the IMF would be downgraded to the status of a Euro-bank of sorts and that it would induce the commercial banks to withdraw from high-risk direct lending to developing countries.

An Easing of Conditionality

A third group of reform proposals relates to the conditions for access to IMF credit. The most frequent accusation against the IMF is that it grants its conditional credit on such restrictive terms that it either places an inapposite curb on development efforts or imposes an intolerable burden on the population. Critics

point in particular to the one-sided emphasis on the monetary approach of balance of payments theory and demand instead that the objectives of growth and equity be accorded the same importance as balance of payments equilibrium. On the other hand, it can be held that the IMF conditions include measures that would be necessary in any case, even if the present crisis had not imbued them with added urgency. Measures such as curbing runaway inflation, restoring international competitiveness by means of currency devaluation, reducing budget deficits financed in an inflationary way and encouraging food production by setting prices that cover costs, benefit not only the balance of payments but also growth and employment. Nevertheless, the conditions must be so arranged that the social and political system is not disrupted.

There must in any case be serious doubt whether the external stabilisation objectives can be achieved before the world economy recovers, for a reduction in inflation and devaluation of the currency will initially only improve supply conditions. An upturn in the demand for export goods is also required if these measures are to have their full impact. Furthermore, the external effects of a stabilisation programme will always be impaired if it must be used simultaneously by a large number of countries, because it is then more difficult to achieve an improvement in the competitive position of an individual country. This would seem to indicate that external performance criteria should be viewed over a longer time span.

A specific measure that has been proposed in order to improve access to IMF resources is to allot a greater role to the compensatory financing facility. In future it should be able to offset not only fluctuations in export earnings but also fluctuations in the terms of trade and interest rate changes.¹⁶ The risk of interest rate changes will be particularly significant in the near future, as all the painstakingly negotiated debt rescheduling agreements could come undone if the imminent upturn in economic activity and the high budget deficits in industrial countries cause a further rise in interest rates.

All of the proposed solutions depend upon more or less radical institutional reforms, which would probably be achieved only under pressure from a lasting crisis. We can only hope that our institutions do not react too sluggishly to the pressure of circumstances!

¹² Cf. A. K o n r a d : Should the IMF Resort to Private Credit Markets for Refinancing?, in: INTERECONOMICS, No. 2 (March/April), 17th Year 1982, pp. 71 ff

¹³ Cf. M. F r a t i a n n i : International Debt Crisis: Policy Issues, in The Banker, August 1983, p. 42; IMF Survey, 10th October 1983, p. 298.

¹⁴ "The IMF is clearly attempting to play a new role, particularly as an instrument of pressure upon the banks." C. G. L a n g o n i : The Way out of the Country Debt Crisis, in: Euromoney, October 1983, p. 26.

¹⁵ Geschäftsbericht der Deutschen Bundesbank für das Jahr 1982, p. 65

¹⁶ Group of 24 Communiqué, IMF Survey, 10th October 1983, p. 298.