

A revised version appears as:

"Debt Forgiveness: Dangerous Trend or Absolute Necessity?" *World Link*, Vol. 4, No. 5
(September/October 1991), pp. 37-39.

Debt Forgiveness: Dangerous Trend or Absolute Necessity

Vinod K. Aggarwal
Department of Political Science
University of California at Berkeley
Berkeley, CA 94720

vinod@berkeley.edu

July 1991

As the debt crisis drags on into a second decade, debate rages over whether the banks should forgive part of the debt owed to them by debtor countries. Arguments are generally couched in terms of North versus South, or law-abiding bankers versus corrupt borrowing countries. But this characterization misrepresents the problem. The struggle is actually between extremely short-term minded banks versus almost all other interests. This latter group includes exporters, industrialists, consumers, creditor governments, taxpayers, and banks with longer-term perspectives in the developed world, and businesses, workers, and consumers in the developing world. Ironically, then, a small group of bankers has managed to define the agenda for everyone else to their own benefit and to the detriment of a wide host of other interests.

Who does this hurt? The most commonly discussed groups are those in the debtor countries. Estimates suggest a net outflow from the Third World of \$50 billion in 1989-1990. GNP has been declining in most debtor countries (Mexico's fell by 16% from 1982 to 1989), unemployment has skyrocketed, and consumers struggle with worsening poverty (Mexican real wages in 1990 are half of those of 1982). But in addition to these losers from the crisis, those in the developed economies suffer as well.

First, the crisis has severely hurt exporting interests. The adjustment strategy of many countries is to reduce imports to a bare minimum. Debtor countries' imports have thus plummeted over the last decade. For example, the U.S. surplus of \$3 billion with Latin America tumbled to a deficit of \$17 billion in 1985. The resulting contraction of markets for exports from firms in developed countries generates cut-throat competition among these businesses for market share. Workers have paid the price: job loss estimates due to the debt crisis are about 1 million EC workers in 1985 and 650,000 US workers in 1982-3.

Second, manufacturers in the developed countries now face a deluge of imports as debtors attempt to service their debts by sharply increasing exports. Because banks insist on complete servicing and repayment of outstanding loans, debtors attempt to export through all possible means, including subsidies, tax incentives, and other strategies that the GATT has been trying to eradicate as unfair trade policy. Recently, Mexico's largest cement producer paid the U.S. a \$10 million fine for dumping. This export drive has encouraged firms in the developed countries to cope with growing competition by reducing their work-force and seeking protection. In the short run, such protection has immediate costs for consumers; in the long run, protectionism creates inefficiencies of resource allocation. One need only recall the 1920s and 1930s when creditors insisted on the deadly policy of full repayment -- in a time of growing protectionism. The economic instability this provoked in Germany helped pave the way for fascism.

Third, consumers in developed countries now face the costs of bankers' renewed interest in

the "domestic market." Put differently, bankers are now devising schemes to extract fees and charges from consumers to finance their mistakes in lending to the developing and former East bloc countries. No doubt some of this revenue will also pay for domestic lending mistakes such as commercial real estate loans that have soured. But the debt problem continues to pressure banks to raise profits elsewhere as their international sources of profit dry up.

Fourth, taxpayers are now being asked to pay for the debt crisis. Banks have called upon creditor governments to absorb their losses and to provide tax benefits for loan-loss reserves. But what some people forget is that taxpayers will be the ones to finance their governments' bailout of the banks.

Fifth, migration worsens ethnic tensions in the United States, Europe, and even Japan as individuals facing poor job prospects in their heavily-indebted countries head north to economic opportunity. As Senator Bill Bradley of New Jersey has warned, continuing debt servicing costs will create an "enormous wave of illegal immigration" into the U.S. Although many developed countries try to distinguish between political and economic refugees, the debt crisis continues to swamp them with the latter.

Sixth, economic chaos causes political unrest in debtor countries. Such unrest threatens important foreign policy objectives of creditor governments. Many banks share the view of one Citicorp vice chairman -- "Who knows which political system works? The only test we care about is: can they pay their bills?" But governments have political concerns extending beyond debt servicing. Latin American and Eastern European countries have been moving to democratic systems, systems now threatened by economic crisis.

Thus, the debt crisis does not merely concern debtor countries and their bankers. Instead, it is of great importance for a whole host of interests in developed, former East bloc, and developing nations.

Currently, many banks resist plans to reduce the amounts owed them unless creditor governments help to absorb losses. Moreover, banks argue that debt reduction will prevent debtor countries from obtaining future funding. As an alternative, banks have suggested a variety of "new" schemes to solve the debt crisis.

These two arguments are completely specious. During the 1970s, the banks were more than happy to make money from their profligate lending activities led by newly-minted MBAs. In a burst of creativity, banks even managed to profit handsomely from rescheduling arrangements in the early 1980s. At that time, banks had no desire to share their large profits with consumers and creditor governments; but now, faced with absorbing losses, they wish to share the "burden".

The second argument criticizing debt reduction reflects the banks' appalling lack of historical perspective. In an effort to counter suggestions for debt relief, the banks and many economists have developed several "original" ideas to resolve the current debt crisis. One need only turn to the

history of debt negotiations to see how unimaginative -- and unsuccessful -- these ideas really are. Over the 60 years from the 1820s to the 1880s, Mexico and its bondholders floated proposals of every sort. In the 1830s, Mexico's bankers agreed to issue new bonds to capitalize overdue interest. After servicing the new bonds for only a year, Mexico promptly defaulted on its debt. In a novel twist on debt-equity swaps, shortly after the Mexico-Texas war, the Mexican government sought to adjust its debt while securing support for its effort to regain and maintain its Northern territories. It proposed that British bondholders be given land in Texas, Sonora, the Californias and elsewhere. This proposal garnered little support among London bondholders: they were not interested in obtaining questionable territory, and were not eager to emigrate to Mexico. These and other such plans came to naught.

In fact, the debt crisis was only resolved when Mexico came to terms with its creditors in the 1880s. The bankers agreed to float new bonds (eventually redeemed at 60 cents on the dollar), and to receive interest at less than half the amount they were originally owed. Almost immediately, German bankers, flush with funds and left out of the earlier lending boom, began lending to Mexico in the late 1880s. And when Mexico discovered oil at the turn of the century, its credit rating soared. With respect to future borrowing potential, the aftermath of the 1930s also refutes the critics of debt reduction. In the 1930s, Argentina did not default on its debts; yet its future borrowing proved no easier than that of the many Latin American countries who did. More recently, countries who have received debt reduction, such as Mexico under the Brady Plan, are finding that they can at least raise some funds on the bond market. On the whole, then, history provides no evidence that debt reduction hurts countries' ability to borrow in the future, especially if reduction is achieved through negotiations.

In any case, despite bankers' claims of careful risk analysis, they have a strong herd instinct. Flush with funds in the 1970s from petro-dollar deposits, banks lent to almost anyone. Interest rate spreads did not reflect the differing risks that banks were taking when making loans. And in 1982, when Mexico began having problems, the banks retrenched en masse, cutting off funding to countries undertaking sound adjustment programs and throwing them into crisis. Today, when asked about their future plans, most bankers recoil from the notion of large-scale lending. They say they won't resume lending in their lifetime, under any circumstances.

The upshot is that prospects are dim for large transfers of capital to needy borrowers -- even those pursuing sound macroeconomic policies. Those who have been faithfully repaying their debts have not significantly benefitted: regardless of their diligence, they have not been able to raise much capital at favorable rates.

In sum, the notion that debt reduction is detrimental to the health of debtors is simply wrong. With little prospect for new lending in sight, a reasonable reduction of debt will ensure that debtors' economies will recover, and that banks will recoup at least a significant portion of their investments. In addition, the many other groups in developed and developing countries who suffer from the debt crisis will greatly benefit from its resolution.

At this point, a more aggressive Brady Plan seems to be the only solution. This would entail cutting back the principal that debtors owe by 50% or so, forcing banks to continue absorbing losses, and maintaining adjustment programs in debtor countries. In addition, bankers should be encouraged at a minimum to engage in trade financing, and banks with long-term vision should be encouraged to lend to reforming debtors.

Banks have been engaging in narrow calculations of interest for over two centuries. In the past, they have left economic disaster in their wake. At this point, the debt crisis is too important to be left to bankers.