The Debt Crisis at a Turning Point

Q. Whatever happened to the Third World debt crisis? Is it over, or has the U.S. election campaign merely pushed substantive issues to the back burner? A. A lot of substantive issues are being pushed into the background. On the debt crisis, there is an air of complacency because part of the crisis is actually over. That’s the part that involves U.S. banks and the worry that some of our major banks might go under. While the creditor problem has receded, the other part of the crisis, the debtor problem, still looms large. In 1982, some of our banks did risk insolvency if the debtors had defaulted. Over the last few years two things happened to save the banks. One, the debtor countries continued to pay interest and service their debt. Two, for their part, the banks have not made new loans and have had time to rebuild their capital. Because of their much improved financial position relative to Third World debt, the banks are mostly out of the woods.

Q. What about the condition of the debtor countries? A. That has always been the second half of the creditor-debtor equation. The situation in many debtor countries is desperate. Their condition was never the central focus of the news accounts in the U.S. media. The media always focused on the banks. What we face today is a development crisis, not a banking crisis. It’s a regional crisis in Latin America. It involves new democracies and hundreds of millions of extremely poor people. That crisis is far from resolution. Actually, it’s worse today than it was several years ago.

Since there is no longer a great risk of a world financial crisis arising out of the debt problem, the administration and the public have grown complacent.

All of the major Latin American countries are fighting enormously high inflations that are tearing apart the social fabric. Mexican inflation has reached about

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180 percent over the past twelve months. Argentine inflation right now is running at about 350 percent, pushing that country to the brink of a real hyperinflation. Brazilian inflation, as of the last three or four months, is racing at an annualized rate of probably 600 or 700 percent. Peru is also speeding toward a hyperinflation with monthly inflation rates of 18 to 20 percent which annualizes to 600 to 700 percent and is rising very sharply. The central banks of Argentina, Brazil, Ecuador, Peru, and Bolivia are virtually out of cash.

Their fundamental economic crisis is as far from resolution as it was five or six years ago and is now getting even worse. These are countries that have already suffered enormous declines in living standards. That’s the part of the debt crisis that remains. It’s not talked about these days, and it’s very poorly understood by the American public.

Q. In your congressional testimony on this subject, you claimed that U.S. government policies have been misguided in managing this crisis. In what sense do you mean that?
A. American policies have been oriented toward one goal since 1982, and that’s to keep the debtor countries paying the full amount of interest due to American banks. U.S. policies have not only put enormous pressures on the countries themselves to continue paying, but have pressured the international financial institutions to set policy strategies aimed at uninterrupted debt servicing. It’s very hard for a country to get an IMF program, for instance, if it’s in arrears to the commercial banks. Public money has been encouraged to flow into the debtor countries, so they have the money to pay the commercial banks.

Q. Why has the United States pursued the narrower strategy?
A. That’s not too hard to understand, if you look back to late 1982. At that time we really did face the risk of a world financial crisis stemming from the LDC debt problem. When Brazil and Mexico were overwhelmed by the crisis at the end of 1982, several others soon joined them in falling domino fashion. As a result, major American money-center banks were left with loans to the Third World that amounted to 300 percent of their bank capital. Their exposure to Latin American countries, alone, was almost 200 percent of bank capital.

Q. That means that Latin American debt owed to American banks exceeded capital by a factor of two? A. That’s right. And as of late 1982, it became crystal clear that Latin American debtors did not have the money to service their debts promptly and according to existing contracts. Another thing wasn’t so clear: Did they have the will to try to pay what they could? At the time, it looked possible that all of this debt could all of a sudden just be wiped out, and that event could have brought down the major American banks with it. Such a possibility posed enormous risks to the U.S. banking system and, by extension, to the international banking system.

Q. But wasn’t that really a fiction? The Federal Reserve and the Treasury would have intervened to prevent most of the major banks from failing. Some desperate plan would have emerged to prevent a banking collapse.
A. No doubt some sort of plan to save the banks would have emerged, but it would have come at enormously high cost to American taxpayers and shattered confidence in the U.S. financial system. Actually, I agreed with the policymakers as of late ’82 that this was a serious crisis, one that couldn’t be resolved simply by a Federal Reserve bailout. I probably would have joined U.S. officials at that time, placing the very first priority on continued servicing of this debt by the debtor countries in order to stabilize the situation. Remember, the industrial world at that time was in a deep recession. Interest rates were very high, there were profound uncertainties. A collapse of the banking system, it was feared, could lead the entire world economy into a major depression. In retrospect, that may appear alarmist, but at the time it was rather sound analysis that resolution of the crisis required debtor countries to continue to service as much of their debt as they could.

Q. Was the capacity to service their debt in 1982 greater than it is today?
A. In one sense, yes. Debtor governments still had optimism about their debt situations in 1982. Many economic analysts believed the debtor countries faced a short-term liquidity problem. If they would just squeeze their economies in standard austerity policies for a year or two, the crisis would pass. A leading American analyst of the debt crisis, William R. Cline, at the Institute for International Economics, outlined several influential scenarios of the recovery. The ratios of a Latin American country’s debt to its exports—an indicator of a debtor’s ability to service its foreign
debt—would, by past historical experience, fall back to lower, and more normal, levels by 1986. They would then be back in the world financial markets, borrowing once again.

Q. But Cline’s optimistic scenario rested on some important conditions, didn’t it?
A. Several conditions, in fact: The industrial world had to grow adequately—world interest rates had to come down three percentage points per year; commodities prices had to hold up reasonably well. He reasoned that short-term austerity in the Latin American economies would under those conditions produce recovery within two or three years. Events did not go that way, of course.

Q. Major Latin American countries did accept that strategy, didn’t they?
A. The remarkable fact of ’83 and ’84 was that the major debtor countries did squeeze enormously. They imposed tremendous and extremely painful austerity programs for the sake of servicing U.S. and other foreign bank debts. The current-account deficits of the major countries swung widely from large deficits, first into balance and then to surplus. Trade balances shifted from huge deficits to surpluses in a matter of a year or two. Imports were compressed quite brutally, with the inevitable consequences of higher domestic unemployment and lower GNP in the major Latin American countries.

Q. And the squeeze worked at first, didn’t it?
A. Their response defused the immediate crisis. The debtors kept up their payments in 1983-84, and the fear subsided of a generalized world financial collapse resulting in widespread default. You may remember a New York Times story in early 1985 that ran the now famous headlines, to the effect that the “Debt Crisis Is Over.” But that was only a half-truth. True, the banks were out of the woods in a fundamental sense; they were no longer at risk of their survival. But during all of this time, the goal had been to keep the interest payments coming in and the banks solvent, while no one looked to the steep and steady deterioration of the debtor countries. In 1983, Mexico suffered a minus 5 percent GNP growth, almost an 8 percent decline in per capita terms—an enormous depression in one year. Inflation was on the rise in several countries. In Argentina it soared to almost 1000 percent per year by 1985.

The debtor countries were squeezing enormously and willingly paying their debts, but their economies were crumbling. The U.S. administration and the U.S. press viewed the problem essentially as a banking crisis. They rejoiced on the "great progress we’ve made." Few people understood, and certainly the larger public was unaware, that you can’t make fundamental progress in this kind of crisis unless the debtor countries get better, as well.

Q. When did the morning light break, or has it yet?
A. In mid-1985, Alan Garcia, the newly elected president of Peru, confronted the world with the harsh reality. In his inaugural address, followed up by a speech to the United Nations, he announced that Peru’s debt really posed a problem to the survival of democracy in that country. It was a matter of honoring debt or democracy. He chose democracy and thereby limited debt payments to 10 percent of Peru’s exports. This was remarkable, because it was the first time a country had decided as a matter of policy that it was going to restrict debt payments, rather than run its cash reserves down to zero.

Q. Was that really the first time that Americans began to realize that focusing solely on saving the banks risked the collapse of democracy in major Latin American countries?
A. Garcia’s announcement forced some Americans to focus on the trade-off, but the Reagan Administration’s debt strategy didn’t fundamentally change after his announcement. Garcia did provoke a response from Treasury Secretary Baker, though. Baker unveiled the so-called Baker Plan at the IMF meetings in Seoul, Korea, in October 1985. As it turned out, the Baker Plan never became more than a speech. There was no change of U.S. policy after his speech, though maybe a change in tone. Yes, the Baker Plan in effect conceded the debt crisis could not really be considered to be over until the debtor countries also resumed their economic growth.

The new catch phrase became growth-oriented adjustment programs for the debtor countries. The Plan promised modest new credits from the commercial banks that in fact did not materialize in a timely way. Yet, the Baker Plan demanded even further policy changes in debtor countries that threatened greater strains on the already shaky political systems in these countries. The debtors were told: Austerity isn’t enough; you also have to liberalize, privatize your industries, and open up your countries to foreign in-
vestment. Jump through several more hoops and you can get the IMF, World Bank, and Paris Club aid programs that you so desperately need to keep from total financial collapse.

Q. At that time, in 1985, what was actually happening to Third World exports? Were they beginning to recover?
A. The answer to that is an important point. In addition to Garcia's speech—even one of the events that prompted it—was the collapse in commodities prices in 1985. No one expected that, since the sharp U.S. economic recovery in 1983-84 and modest growth in other industrial countries would normally have pushed commodity prices higher, not lower.

Q. That was a result of the disinflation process, wasn't it?
A. Yes, the disinflation process had continued since the early 1980s. But there was a collapse in commodities prices in 1985—a brutal year for countries exporting commodities. That event was a major departure from the fairly optimistic scenario that Cline had outlined. Back in 1984, economists could not easily have foreseen that collapse. Looking at the economic fundamentals suggested that with the dollar starting its downtrend, interest rates coming down from very high levels, and fairly good growth in the industrial world, it was reasonable for economists to expect some rise in commodities prices.

Instead, an enormous glut of primary commodities had developed in world markets. That was because the debtor countries were pumping out so much volume in order to earn export revenues for servicing their debt and the glut of supply drove down world prices. Beyond that, the world went through some wrenching shifts in the structure of agricultural production and trade: China became self-sufficient in major grains, thereby depressing both world demand for agricultural products and agricultural prices in world markets. The unanticipated and steep declines in commodities prices had devastating impact on the ability of some debtor countries to meet their payments.

Q. The advanced countries were reviving very strongly, but the Third World developing countries were still going down?
A. The financial squeeze in the debtor countries became intense. Argentina, for example, was trying to stabilize its high inflation in a widely discussed program called the Austral Plan. It collapsed in 1986 because of inadequate foreign finance and falling commodities prices. After a one-year respite in its high inflation, Argentina all of a sudden saw inflation explode again by the end of 1986.

Q. Brazil also took an unhappy turn at this point, didn't it?
A. Yes, Brazil was the next big story in this sequence. The financial squeeze forced Brazil to declare a moratorium on debt service payments on February 20, 1987. In mid-'87 I had the pleasure of working with that country's Finance Minister—Bresser Pereira—who understood quite clearly that Baker's debt strategy was really a strategy for saving the banks, not the debtor countries. Bresser dramatically outlined the dismal deterioration of Latin American economies before the U.S. Congressional Summit held in Vienna last September. At that time, he noted, Latin America still had not recovered the per capita income level of 1980. He proposed a plan for swapping new securities for outstanding debt based on existing values in the secondary market.

From Vienna, he took the plan to Washington where Secretary Baker rejected it. As the debtor countries have found, whoever tries to draw the world's attention to their domestic economies ends up getting clobbered by the creditors in the international financial system. The creditor institutions act pretty much in unison in these matters, and they slammed the door on the Bresser plan. He was forced to resign early this year, and Brazil has, temporarily at least, flipped back to the alternative strategy ending its moratorium and borrowing more money to meet interest payments as they come due.

Q. In other words, the U.S. Treasury sufficiently twisted Brazil's arm so that it gave up any hope of a Bresser-style plan?
A. Not only the U.S. Treasury; the IMF, the World Bank, the official export credit agencies of the industrial world, the Paris Club—which refused to deal with Brazil until it went back to the IMF—and the commercial banks all played their hand in a very tough-minded fashion and forced Brazil's policy reversal.

Q. Can Brazil actually sustain this policy?
A. The reversal is only temporary, I believe, because Brazil simply doesn't have the cash to live up to the
A kind of agreement that these parties now seem to be aiming for. Brazil's moratorium did produce one good result: it did finally provoke a serious view of what was going on. The commercial banks, with Citicorp in the lead, took a step ahead of the Treasury and of the Federal Reserve, by making provisions for loan losses against LDC debt. That was important for one major reason: It proved conclusively that the banks can absorb substantial losses on these loans without any risk whatsoever to their continuing operations or solvency at this point. In fact, during the week after Citicorp made its $3 billion loan-loss provision, its share prices shot up 14 percent.

Q. Why is that so significant?
A. It illustrates first that the stock market has long since discounted the stock prices of commercial banks that hold this debt, and has taken an accurate view of the fact that these debts are not worth their face value. Second, it showed that the market is very interested in banks resolving this crisis, even if it means announcing losses. So here we have the fantastic spectacle of Citicorp announcing, in an unanticipated way, a $3 billion loss in 1987 which was followed by a 14 percent rise in its share prices in the next week. The market is right on that.

Q. Did that signal a real turning point?
A. It began in the Summer and Fall of '87, when creditors gave far more attention to the need for a more realistic approach—with the one big exception of the U.S. government which remains absolutely committed to the old story. On the debtor side, more and more countries have decided, since this game is basically so unrealistic, that they have to take unilateral action, even if that means facing the opprobrium and punishment of the creditor world.

Look at the Latin American situation: Brazil is still in a partial moratorium to its creditors; Bolivia is in virtually complete moratorium; Costa Rica, the Dominican Republic, Ecuador, Honduras, and Peru are all in suspension of interest servicing on a unilateral basis; and possibly as many as a dozen African countries are in arrears as well, including the major debtors such as the Ivory Coast, Nigeria, Tanzania, Zaire, and Zambia. The system is simply breaking down slowly, because our policy is still based on the unrealistic preference given to the banks at the expense of conditions in the debtor countries. Particularly since the banks are now out of the woods, I believe we must necessarily and inevitably move toward a more balanced view of this crisis that recognizes the dire situation of the debtor countries.

Q. But don't the outstanding loans of U.S. banks to the major debtor countries still exceed their capital positions?
A. Generally they do. The exposure of a few of the major banks is still probably around 100 percent of bank capital, down from 200 percent—with respect to the major debtors. But it's clear now that the banks are not going to lose all of that. Most of the solutions to this crisis would involve taking a loss of perhaps 40 percent to 50 percent on those claims. We also know now that the stock market has already discounted for these losses in valuing Citicorp's share price—the assumption is that the bank has already lost 50 percent of its LDC loans. The great drama being played out now is about whether the debtor countries can be squeezed into paying their debts in full. If so, the prices of bank stocks will double! More important, a realistic solution offering the debtor countries some relief means that bank share prices don't even have to fall below their current levels.

Q. So in the past few years we have bought time to improve drastically the position of the banks?
A. Absolutely. It was an investment that was quite costly in terms of the economic conditions of the developing world. Now it's time to rectify the balance, and it's urgently needed. Most of the debtor countries are facing risks to their democratic societies, through hyperinflation and depression. Infant mortality is rising throughout much of the developing world. Millions of people are falling into conditions of absolute poverty and malnutrition in our own hemisphere. New democracies are in profound jeopardy. Remember, in most of the Latin American countries, the debt was incurred by military governments and is now being paid off by democratic governments. That is true for Argentina, Brazil, Bolivia, Peru, Ecuador, Uruguay, Honduras, and Guatemala. Ironically, it is now the U.S. government holding out in its demands—for 100 percent debt servicing—that threatens the very existence of democratic governments. This is not only dreadful from the Latin American perspective, but thoroughly misguided and potentially disastrous from the U.S. foreign policy perspective.
Q. Debt relief, in your view, is really a positive-sum game?
A. Though this may sound paradoxical, debt relief would bring benefit both to the creditors and to the debtors. This is a point that administration leaders don’t seem to grasp and it is far less understood in the larger public. But my position is based on broadly familiar principles of corporate reorganization in bankruptcy proceedings.

Q. Could you elaborate on that?
A. Chapter 11 provisions of the bankruptcy code, in particular, are based on the view that creditors are sometimes better off by reorganizing and reducing the debt of a firm, and then letting it function on a healthy financial basis, than they would be if they forced the firm into liquidation by picking its assets apart, piece by piece, and forcibly dragging it into dissolution. If the firm has positive present value based on the prospects of its future business operations, the creditors will benefit by some forbearance in letting the firm continue to operate. Creditors, too, will share in future benefits. A policy of equitably keeping all creditors at bay while the firm reorganizes will make creditors better off than they would be if each one tried to attack the firm to get its claims back on its own. In the case of the developing countries, we don’t have such a bankruptcy institution. Consequently, we have all the creditors to these countries desperately trying to get their money out, even though that means reducing the future economic prospects of these countries and also the overall value of the creditors’ claims.

Q. Why do you suppose knowledgeable bankers, to say nothing of U.S. policymakers, take such a position when they see the inevitable dangers of potential economic collapse and political and social chaos in some of these countries? That couldn’t be in the interest of the banks or of U.S. foreign policy.
A. I can only explain it as a failure of leadership right now on the part of the U.S. government. It’s easy to understand why a particular bank fights to get its money out as fast as possible. It’s in business to make a profit, not to save Brazil.

Fundamentally, we face here the so-called collective action problem: each individual bank sees its self-interest in getting the best terms possible, while it would be in the collective interest of all banks to moderate the terms. It’s very hard to maintain the collective interest in this world when nobody is managing the overall strategy properly. The manager would have to be the U.S. government together with other creditor governments. The current situation is even more complex since banks are not the only creditors. There are bilateral official credit agencies, such as the U.S. Ex-Im Bank, the Japan Ex-Im Bank, and thousands of independent, private suppliers who have loaned money to these countries over the years. There are the official institutions, such as the World Bank, the IMF, and the multilateral development banks. Each of these different creditors would like to see someone else pay the bill.

Q. How can we solve the collective action problem?  
A. It will take strong and wise political leadership. We don’t have, nor do we need, a world bankruptcy institution to do it. Unfortunately, we just haven’t had that kind of political leadership, and I think it’s a missed opportunity. People like James Baker have so much invested in the old strategy of protecting the U.S. banks and their interest payments. Besides, they are unwilling to invest in a new strategy, because their opponents would say: We’ve told you all along that your strategy isn’t working. The government has persevered in a strategy that made sense for a few years in order to protect the U.S. banking system, but it’s very hard to get off that track now.

Q. Aren’t the banks themselves calling for change?
A. Yes, reflecting a new consciousness. For example, the American Express Bank announced just a few weeks ago a plan that calls for massive debt write-offs by the commercial banks and relief for the debtor countries. This is a major breakthrough. Other regional banks in this country have endorsed it, but major banks still seem reticent. Many of the creditor governments support the plan: the Japanese government properly understands that the current strategy makes no sense, but has held back and allowed the U.S. government to take the policy lead.

Q. How much would be the write-off? What rough order of magnitude are they talking about?
A. The American Express plan only sets in motion a process, without giving final numbers. The banks would sell off their Third World debt to an international facility at something like the current discounted market price. That implies an average write-off of something on the order of 50 percent right now, if all of
the debts were sold off. That discounted valuation is determined by quoted prices on transactions of seasoned debts that are sold by one bank to another private holder in the secondary market.

Q. Isn’t this really a market solution that emerges from the current reality?
A. The American Express proposal underscores that the current hardnosed strategy up to now has given the banks enough time to get their own houses in order, but pushing it farther is actually going to hurt them. The American Express Bank would rather get out now at 50 cents on the dollar, because it believes if you push too hard on the debtors, their ability to pay will continue to deteriorate and the value of bank-held debt will plummet even further to 25 cents, or 20 cents on the dollar. The remarkable experience in the last two years bears that out: In 1985, the secondary market prices on these debts stood at about 70 cents; in 1986 they were about 60 cents; in 1987 they were about 50 cents; in 1988 they’re about 45 cents. And, in the case of Argentina, it’s gone from 70 cents to something like 27 or 28 cents on the dollar at present. The creditors are losing their claims, because the current strategy is not getting the debtor governments and their countries back to economic health.

Q. Don’t you really have to bring together all the banks in some concerted organization in order to enforce a plan of collective action?
A. It’s a myth to believe that the market can do this on its own. If an individual banker learns that everyone else is going to write off 50 percent of their Third World loans, that individual banker would say publicly: “Wonderful, great idea, absolutely realistic.” While all the other guys join the bandwagon, he would hold out on all his loans and then, when the debtor country has such a reduced burden that it can pay everything on remaining debt, the hold-out banker plans to collect in full. That’s the essence of the collective-action problem. A successful plan will have to get all the bankers together to face the facts and to absorb the write-down, without letting any individual creditor play strategically against the group.

I actually had experience with this when I helped set in motion the current Bolivian government’s buy-back procedure. It’s a so-called voluntary, market-based solution in which each individual bank decides whether to tender its Bolivian debt for purchase by donor governments. The Bolivian government has negotiated an agreement in which the tender price is 11 cents on the dollar for Bolivian loans—a fairly accurate assessment of their value, given that debtor’s desperate economic situation. Bank of America was one of the leading organizers of the plan, helping to sell it to the rest of the banking industry. But Bank of America has rather cynically held back in putting most of its own claims on Bolivia into the pot. The Bank of America actually sent a vice president to testify in Congress in March on how good the Bolivian deal was and how realistic and necessary it was for a country like Bolivia to get its debt written off. And then in the end, they tendered only about $10 million out of $60 million of Bolivian debt on their books. They are hoping the other $50 million will go up in value, once all the other banks get out.

Q. Was that brought out in the congressional hearing?
A. No. It wasn’t, of course, because not everyone is a Bolivian expert. This case exposes very nicely the myth that we can have a purely voluntary, market-oriented write-down. Financial distress requires collective action by the creditors and debtors to overcome the strong incentive to act strategically and individually to let the other guys give the relief, while you hold out for full payment from the debtor.

Q. Has there been much support for the other refinancing proposals?
A. As of last week, the Indian executive director of the International Monetary Fund, Arjun K. Sengupta, unveiled a plan for a financial facility within the IMF to repurchase developing country debt and give relief to the debtor countries. The fact that his plan has a lot of support from inside the International Monetary Fund shows that people in official institutions are beginning to reach the same conclusions that some bankers and academicians share.

Q. Now exactly how would such a transfer be made? What resources would the IMF use to buy the bank debt?
A. All of the programs apply the same basic mechanism. I should mention at least, besides the American Express and the Sengupta plans, there have been similar proposals put forward in recent years by Felix Rohatyn, Peter Kenen at Princeton, and by Representatives John J. LaFalce (D-N.Y.) and Bruce A. Morrison (D-Conn.). The commercial banks would trade their debts to an international financial institution in return for bonds issued by that institution, an IMF
facility, for example. The IMF would give to Citicorp 50 cents in the form of a bond in exchange for $1 of Brazilian bank debt that Citicorp now holds. The IMF would issue these bonds in exchange for bank debt owed by a Third World country, only for a debtor that participates in adjustment programs and economic reform under the supervision of the international creditor community. Conditionality is essential. Finally, the IMF would then turn around and say: "Well, since I've given a 50 cent bond to the commercial banks in return for the dollar claim on Brazil, I can reduce the dollar that Brazil now owes me down to 50 cents and break even."

Q. Then Brazil would continue to service its reduced debt, but now make interest payments to the IMF?
A. Brazil would pay to the IMF; the IMF would use the money to pay to the commercial banks; and the IMF would break even and be the intermediary in this process. The claims that the banks would get would be IMF claims that, formally speaking, would be safe, no matter what Brazil did. So the IMF would bear the residual risk. And this is a sticking point in these programs, because bearing the residual risk means, of course, that the taxpayers in all of the creditor countries would ultimately bear the residual risk, because they are the shareholders of the IMF.

Q. How big would that residual risk be?
A. In my view, the whole idea that we can't go forward because of the residual risks is silly. When you come down to it, what it says is: "We can't afford to write down Brazil's bank debt from $70 billion to $35 billion, because maybe they can't afford to pay $35 billion. And since we don't know whether they can pay $35 billion, we have to keep $70 billion on the books and keep demanding $70 billion." If Brazil is at some risk of not being able to pay even $35 billion, it seems to me foolish to hold out on a strategy in which we press Brazil relentlessly to pay up $70 billion.

To answer your question, the risk would be extremely small. The debtor countries could pay the amount represented by their current market prices. Brazil could service half its debts on time. It can't service all of them, but it could service half. And that's why its claims sell for 50 percent in the secondary market. Even if the IMF were to lose some fraction because it turned out, say, that Brazil could service 40 percent of its current debt, not 50 percent, the amounts of losses we're talking about turn out to be very small, because the IMF would distribute them not just to the United States, but to all member creditor countries around the world.

If you assume a worst-case scenario, my calculations show the United States might have to appropriate half a billion dollars a year, or a billion dollars a year at most, over a period of several years in order to make good on the IMF repurchases. And when you consider that our foreign-aid budget is on the order of $16 billion, what we're talking about is using 6 percent of the foreign-aid budget to solve the debt crisis. Debt problems now afflict about 40 major developing countries in the world for which we have pressing foreign-policy concerns.

Q. Relative to our overall foreign-policy objectives, the risk in terms of tax dollars is small?
A. Remarkably small when weighed against the heavy concerns that the United States has in our foreign relations with Mexico, Brazil, Argentina, Peru, and Bolivia which are trying to fight cocaine exports. In Asia, we have the Philippines, which is fighting a communist insurgency, and there are other similar cases. U.S. leadership is simply not facing up to the inevitable facts surrounding the debt crisis and their great significance in our strategic foreign policy. The United States is terribly wrong to view this as a banker's problem and not as a foreign-policy and developing-country problem.

Q. If the bankers are changing their tune, and the IMF is coming around, where is all the opposition?
A. The idea could be readily sold to the public by a president who had some interest in it. The banks would be prepared to sell off a substantial portion of their claims on terms such as these. The banks, though, are still hoping for a big, official bailout: The World Bank is now asking for another $75 billion toward a general capital increase this year. Unfortunately, no one in the U.S. government is saying that the banks should accept some losses before that goes through. If there is no write-down of existing debt, the new capital funds will just get recycled to pay interest to the commercial banks. In short, the commercial banks are looking for a miracle, so they won't take the lead in asking for a write-down, but they would accept one if it were part of a coherent official strategy.

Every road leads back to the U.S. leadership problem. Only political leadership can correct the strategic and collective-action problems that prevent debt relief from going forward on a voluntary basis. I blame this
administration for that: James Baker at the Treasury views this as a banker’s problem; Paul Volcker viewed this as a banker’s problem and represented the U.S. banks; regrettably, George Schultz, as our secretary of state, has hardly gotten involved in this issue. Understandably, he’s involved in more important U.S.-Soviet relations, which probably do take precedence if you had to choose only one policy area. But the State Department has been almost completely outside of the debt crisis, even though these problems are raising some of the most fundamental foreign-policy questions that this country is facing.

Q. Does Paul Volcker still see it as a banker’s problem?
A. From conversations that I’ve recently had with him, Paul Volcker still views it as too dangerous to start recognizing the fact that this debt isn’t worth full value. He believes there is a slippery slope: if one starts acknowledging that the debt may be worth only 50 cents, then the countries won’t even pay the 50; they’ll say, “we’ll only pay 10 cents on it.”

Q. Well, is there something to that argument, isn’t there?
A. It is vastly overrated on historical grounds, if nothing else. The long history of debt crises shows a substantial write-down in the value of claims is part of the solution. Debtor countries have rarely been able to catch up on their financial arrears and fully capitalize their obligations. Missed payments almost always got cancelled and new loan programs were designed with much lower interest rates than the original loans. The historical record shows that with real relief, debtor countries work very hard to honor those lower debt levels.

In fact, the experience of the past five years is astonishing, when you see how awfully hard the debtors have tried to pay their obligations, even to the point of turning their economies upside down, risking hyperinflations, and political and social instability. We don’t see countries recklessly and irresponsibly refusing to pay their debts. In fact, they are virtually breaking the backs of their economies to pay them. Let me add, debt relief is a major way to enhance the credibility of reformist governments and to help stabilize the political situations in these emerging democratic countries. If we tell debtors to take the risk of coming to the IMF, they will actually get debt relief along with a stabilization program. At present, if they come to the Fund, they can expect to be squeezed nearly to death. Their hapless finance ministers go home to face an uproar from their constituencies.

Q. But doesn’t this really mean a substantial shift in the austerity approach that the IMF has traditionally taken?
A. There are basic elements in IMF programs that are properly oriented toward getting countries to reduce budget deficits, open up their economies, reform how the government sector operates. While I respect and support the fundamental design of these programs, they go wrong in trying to make sure that the countries also honor their interest payments to the commercial banks, dollar for dollar. They end up undermining the very government officials who are trying to achieve the goals that the IMF wants.

Argentina has just signed its 4th agreement with the IMF, promising fiscal austerity. From the outset, the economic targets in the new agreement are nearly impossible to achieve—a drastic narrowing of the budget deficit by the end of this year to a level of some 2 to 3 percent of GNP, down from 6 or 7 percent. That is a preposterous target. Second, even if it could be achieved, it would simply cause the government to be booted out in short order. That policy restraint would involve an intolerable squeeze on the population.

Q. Your point is even more starkly outlined if you consider the domestic economies of these countries. What, for example, has happened to their standards of living over these years?
A. Since the debt crisis started to develop around 1981, per capita GNP for a typical Latin American country has dropped about 20 percent. Basically, the real income of these countries has fallen back to the levels of the early 1970s—15 to 20 years of lost economic development! Bolivia is in even far worse straits—per-capita GNP there has declined by almost 40 percent in the last eight years. There has been a horrifying rise in absolute poverty and malnutrition in Bolivia and in areas of other countries in the region. In Mexico, the drop in per-capita income is now on the order of 15 to 20 percent. In Argentina and Venezuela, the drop exceeds 20 percent. In Peru and Ecuador, it’s probably higher. Economic development has been lost to an entire generation, with few signs of sustained economic recovery in prospect.

Q. Since national income is typically so badly skewed in favor of upper-income groups, don’t these numbers
imply an even more drastic decline in the living standards of the masses of Latin Americans?

A. In Latin America, the real minimum wage, or the real average wage, for a day laborer is right now typically down some 30 to 40 percent from the start of this decade. A number of the higher-income groups have been able to protect themselves through capital flight, sending their money abroad. The income distribution has surely worsened significantly in the course of the 1980s, and the poor have been hit very hard by this, of course. It will take years and years to rectify the growing economic misery in large segments of these societies. Since the debt problem lies mostly in the public sector, governments have had to squeeze their budgets in order to service their debts. This has forced drastic cuts in desperately needed social expenditures and on health care.

Q. What about capital formation?

A. Most of these governments have very sharply cut the public investment budget in efforts to protect some baseline of current consumption levels. That decline in investment, continuing now for seven or eight years, will come back to haunt these countries severely in the 1990s. We’ve taken away the capital base for the export recovery that is supposed to provide new sources of growth. Bolivia, for example, has struggled to restore a modicum of stability only to realize that since there has been no investment in the country for ten years, there’s no basis for strong economic growth now. All we have is the hope of enough stability to get the beginnings of economic growth in the next few years when Bolivia may start to restore living standards once again.

In Argentina, real net private fixed investment has been negative in the last five years. That country’s capital stock is not only deteriorating, but is not even being replaced. The real economic base for Argentina’s future is crumbling. They are on the verge of hyperinflation with a crumbling infrastructure and no private-sector investment. Yet ironically, we read in the newspapers in recent weeks that Argentina will resume its debt service payments this year, for which the creditor community expresses deep gratitude.

Q. Do you see any of our current presidential candidates giving knowledgeable consideration to the Third World debt and development crisis?

A. Some Democratic candidates have spoken out on the need to do something different: Senator Albert Gore has made knowledgeable and thoughtful statements, for instance, that show he recognizes the links between the political and economic instability in Latin America and our foreign policy interests. From the Republican side, I haven’t heard a word about it. Besides, I believe Vice President Bush would carry on the same policies as the Reagan Administration, and they are quite harmful for Latin America.

Q. How high a priority should the next President, Republican or Democrat, give to the Latin American development problem?

A. The Latin American crisis is of the utmost significance; it involves hundreds of millions of people. One of the most populous countries—Mexico—is on our border. Our legitimate interests in Latin America go far beyond Nicaragua and its three million people, for example, where we’ve focused enormous attention. Virtually every country in Latin America, democratic or not, is deeply affected by this crisis, as are our trade and financial relations. The crisis poses great risks to democracy in the hemisphere—the fact that several countries are being destabilized by Communist insurgencies, as in Peru, should prompt urgent U.S. attention. I have observed at first hand how economic collapse has pushed Bolivians, for example, into the illegal economy, growing the cocoa leaf, processing it in Colombia and Peru, and exporting cocaine to the United States. This illustrates only one of the profound consequences of the economic crisis on the political and social systems of these countries.

Q. Apart from the leadership vacuum that needs to be filled, what concrete steps might we take?

A. As I testified on Capitol Hill in February, the U.S. Congress should convey a clear message to the World Bank that the American people support debt relief for Third World countries. Congress should support a multilateral, general increase in the World Bank’s capital base, so that it could initiate debt writedowns by commercial banks and relief for debtor countries. This would mean a U.S. paid-in contribution of less than $1 billion, with callable capital of some multiple of that amount. And to that the contributions of the other World Bank members, and that $1 billion U.S. contribution can almost surely be translated into debt reductions by the commercial banks on the order of $100 billion on a global scale. That would put no small dent into the problem.