Volcker's 'new' divide and conquer plan for the debtors

by David Goldman

Fed Chairman Volcker now argues that the trade surplus squeezed out of Ibero-America is large enough to prevent interest arrearages from piling up past the write-off point. These surpluses were won at the expense of total economic, social, and political dislocation. On paper, Volcker is right. If the countries accept this level of looting, there will be no Third World debt crisis until early 1985, when the economic systems of the affected countries give out from exhaustion.

Volcker's point concerning the debtors is right on paper, but not necessarily in the real world. Whether the political firestorm that must result from the current level of looting will break open at the September meeting of the debtors at Buenos Aires is impossible to predict in advance; the longer the debtor-countries submit to the current regime, the worse it will be.

Evidently, the fall in the yield curve (the difference between short- and medium-term borrowed funds), along with the much-touted rise of the stock and bond markets, is directly related to Volcker's ability to present the massive bailout of Continental Illinois Bank as the last big financial shock for a while. Eurodollar six-month interest rates are just over 12%; in July, they approached 13%. Although the base level of interest rates, measured by the unchanged Federal funds rate, has not fallen, the longer maturities have come in enough to make credible the current puff in the securities markets.

Divide and conquer

The name of Volcker's game is divide and conquer, in anticipation of the early September meeting of the South American debtors at Buenos Aires, and the late September annual meeting of the International Monetary Fund (IMF). Volcker told the Senate Foreign Affairs Committee Aug. 8 that the creditor nations should grant privileges on a "case-by-case" basis to the debtors, in order to prevent the emergence of a "sweeping re-organization" of Third World debt.

"I believe the stage has been set for a new phase in financing programs tailored to the progress and circumstances of individual countries," Volcker said. "As progress and performance justify it, it does seem to me critically important to move to a new phase in which individual borrowers will be able to refinance maturing debt for some period ahead at reasonable terms, permitting both borrowers and lenders to have a more certain and stable base of lending."

Volcker said that the so-called recovery in the U.S. economy has contributed to positive trade balances of "good boy" debtors such as Mexico and Venezuela to such an extent that it more than compensates for the effects of higher interest rates. "Notably, Brazil trade surpluses are significantly exceeding expectations."

Enough blood from a stone?

The American economy is, in fact, looting the Ibero-American debtors by importing huge volumes of goods at less than half their production cost, while forcing these countries to shut down their imports, including imports of essentials such as medicine. U.S. imports from the Third World are way up from last year. The latest published figures (through April) show American imports from developing countries to be $40.12 billion, compared to $29.35 billion last year, a rise of 37% in dollar terms. Since the Third World's currencies and commodity prices have fallen drastically over the past year, the actual increase is probably above 50%.

For example, Brazil is now projecting an $11-$12 billion trade surplus, which is roughly equivalent to their interest bill for this year. Mexico's trade surplus (rate of looting) is even higher, at $5.2 billion trade surplus for the first four months, or a $15.6 billion annual rate; at this rate, Mexico can repay principal.

Although Brazil's projected $12 billion trade surplus involves a certain measure of statistical fakery, it is nonetheless true that the biggest of the Ibero-American debtors has managed to bring its net exports into the range of its annual interest bill.

In Argentina, the means by which this has been accomplished is illustrated by the bloodbanks next to the suburban commuter train stations of Sao Paõlo; before payday, industrial workers will sell blood to raise their train fare to work. The blood is frozen, and exported to the United States.

Both Brazil and Argentina are now sitting on interest arrearages just short of the 90-day cutoff level, after which banks would be forced to write down the value of the debtor's paper on their books. Brazil's present level of exports is barely sufficient to prevent the arrearages from climbing over the danger point, but hardly sufficient to build them down, leaving the country's finances at cliff's edge.

Juggling interest rates

Volcker also said he has "sympathy" for the proposal to "cap" interest rates, i.e., reduce interest rates by some small margin for debtors on good behavior. The banks would capitalize the difference between market rates and the capped rate by adding it to the principal of the loan.

Volcker's scheme involves a continued murderous rate of looting of the debtors, combined with some concessions from the bankers (who cannot afford significant concessions without going bankrupt) and a certain margin of government subsidy for "good" debtors.

The London *Financial Times* reported Aug. 9, "One major central bank [obviously the Bank of England] has a dossier of over 100 proposals for restructuring world debt." Bank profits will not be "protected" by the solution, and "normal market lending will never be resumed" until many years after the reorganization. Most of the cost of relief should be "put onto banks rather than creditor governments."

The formula of this particular distillation of the available proposals is: let the countries pay 4% "real interest rate" plus 6% "inflation adjustment," i.e., 10% interest; that corresponds to New York Fed President Anthony Solomon's interest rate "cap" proposal. Secondly, let the governments put up sufficient money via the IMF or the World Bank to absorb 2%; and let the banks write off 2%, which is all they dare "without risking their solvency," and you get 14%, which is what they are now paying.

Although there is nothing new in the *Financial Times'* version, it does make one point explicit that is often left out of focus, namely, that the interest which the debtor nations currently pay cannot rise much without bankrupting the debtors, and cannot fall much without bankrupting the creditors—unless the global cost of bank deposits were to fall.

However, the American requirement to bring in, net, over $100 billion of foreign capital each year in the process of financing a staggering trade deficit and budget deficit prevents the global cost of funds from falling. It is significant that, in recent weeks, the base cost of short-term dollar borrowing has not moved at all, despite the wild fluctuations of the yield curve as market participants decide that Armageddon will happen later or sooner.

Snags in negotiations

The divide-and-conquer operation is evident in the several sets of negotiations now under way with major debtors. The Swiss bankers' newspaper *Neue Zürcher Zeitung* (*NZZ*) reported Aug. 7 that the Argentine economics minister's current trip to Washington will likely produce an Argentine agreement with the International Monetary Fund, after nine months of cliffhanging. Both sides will reportedly make concessions. Contrary to earlier reports, economics minister Grinspun will stay in office, at least until the September IMF meeting, according to sources in Buenos Aires, which corroborate the *NZZ* account.

Argentine finance minister Bernardo Grinspun, reports of whose political death appear to have been exaggerated, met with the International Monetary Fund Aug. 10 in Washington, but there are no reports concerning the outcome.

Mexico, meanwhile, received a $500 million loan from the World Bank on Aug. 9, following a series of similar official credits to Brazil.

It is not at all clear that the setup will proceed as smoothly as Volcker intends; European banks may not accept the squeeze, and objected furiously to proposed interest-rate concessions for Mexico, the test case for the Volcker "case-by-case" plan. Anticipating Volcker, or perhaps with his blessing, the Mexicans told the commercial banks that they wanted a fixed level of interest rates under the rate they are currently paying, and the banks objected furiously.

Venezuelan officials, meanwhile, began a round of talks with bank creditors in New York Aug. 9 on issues that touch directly on Volcker's intentions.

In late July, Venezuela met with the IMF for its annual "Surveillance" consultations, and was given "a clean bill of health by the IMF," according to administration sources.

Venezuela, thus far unsuccessfully, has proposed to reschedule its $22 billion public sector debt due through the end of 1985, into fixed annual payments of $4.2 billion a year, at rates of 7/8% over the London interbank rate (the benchmark for banks' own cost of funds). The banks have rejected the Venezuelan proposal thus far, on the grounds that too little principal would be included in the repayment.

'Banks want to hang someone out to dry'

The following interview with an administration source close to Henry Kissinger's Bipartisan Commission on Central America was conducted on Aug. 9.

Q: What's behind the declaration of default by the banks on Bolivia?
A: They want to pick on someone they can pick on and hang them out to dry. Make an example of Bolivia. Try to show the other countries what happens when you start getting your assets attached.

Q: But what about the bigger debtors like Mexico?
A: The other debtors are being cleared up. Mexico is getting a multiple-year rescheduling, which will result in Mexico not needing any new flows of credit in the next year and still be able to pay their debt.

In that case, the big news is that Mexico may be able to get out of their IMF program. They won't need bank loans and they won't need any more money from the IMF. So they will be out of IMF conditions.

The banks have also decided to do a multi-year rescheduling for Venezuela. The banks have seen the real world on this. The news is that the IMF went in and looked at Venezuela during their Article 4 Consultation [every country, whether it has an IMF program or not, does an annual nonconditional consultation with IMF under the Article 4 "Surveillance" clause—ed.]
told them "your're moving in the right direction."

So Venezuela may be next after Mexico to get a bank deal even without the IMF.

Q: What happened to the debtors' cartel?
A: It's still a danger . . . especially if the prime rate moves up. But if we get Argentina dealt with, and the new guy coming in to replace Grinspun may be a bit more in the direction of what the IMF wants, then they'll reach a compromise.

Q: What about Mexico and Brazil and the cartel?
A: Mexico will wait to see what they get from the banks. If they like the deal, they are certainly not going to join a debtors' cartel. Neither will Brazil. I don't see them getting together.

'Which debtors will we have to triage?'

The following interview with a highly placed congressional source was conducted Aug. 9.

Q: Is Volcker telling the banks to stretch out their debt?
A: Yes, and Volcker is getting a lot of support on the Hill for this. Fed has been saying banks ought to take a longer-term perspective on the debt problem and, in particular, come to an accommodation which might last more than a quarter at a time with those countries which are in a position to get on to a long-term solution—like Mexico—so that we could whittle down the problem to the countries which you could write off—where you really do have to build up reserves and write them off.

Q: You mean, don't write off Mexico?
A: No, negotiate it out with Mexico so that you could then have an example of what can be done with a country, of what can be done with an IMF adjustment policy. In other cases, Bolivia, the banks are already writing down the Bolivian debt, and when you've done that, you've already got some sort of a *triage* process you can implement. There's a lot of sympathy for that approach on the Hill.

Q: Who else should be triaged?
A: I don't know, it's a question of negotiations.

Q: What about Argentina?
A: Argentina is the case that will remain as a tough case.

Q: Why not just treat it like Bolivia?
A: It's bigger, a lot wealthier with its trade surplus; it's a special case because it's a democracy undergoing a process of de-Nazification and the government in power is not the one which contracted the debt. . . .

Q: But all of this is talk about what to do with the principal. Volcker wants the banks to take the principal due over 3 years and stretch it out over 10 or 15 years, right?
A: Right.

Q: But none of these countries are paying principal anyway. What are they going to do about the real problem, paying the interest bill? The question remains, how does a country like Mexico pay its interest bill? What people have been scrambling about every quarter to get under the 90-day deadline is how do they pay their interest bill?
A: This has to be worked out between the debtors and the creditors.

Q: Isn't this a tempest in the teapot until you deal with the interest . . . the real sticking point? What does Volcker want to do about the interest?
A: What I've heard of is re-writing the loans at fixed rates.

Q: As part of the renegotiation package that Volcker's talking about? That's part of what he's asking the banks to do with Mexico?
A: Yes.

Q: How high a fixed rate, market rates?
A: That's a matter for negotiation with the creditors. But I've certainly heard sentiment for fixed-rate loans, not Volcker say-so officially, but staff.

Q: Fed staff?
A: Yes.

Q: You're going to fix them at market rates. Market rates are 13%. Thirteen percent of 100 billion is a $13 billion interest bill a year, $3.25 billion a quarter.
A: I understand, but there is no need that the market rates are the rates that have to be charged.

Q: So you mean there's talk of possibly fixing the rates on the new packages at below market rates?
A: Well, there is talk between the creditors and the debtors. . . . The question is whether the banks are going to have to absorb the reduction in their earnings.

Q: Is that being discussed at all?
A: Yes, I don't know how much and with whom. Sure that's being discussed, that's the question! But whose responsibility is that? This is up to the debtor-creditor negotiations and whatever comes out of that, i.e., the government should not subsidize the banks' losses. . . .

Q: There's been an incredible amount of criticism in Congress of the Conti bailout. Is this part of what Congress is getting at, that they want these banks to take some of these losses now, before getting into worse trouble later?
A: Yeah, yeah, I think that's a fair statement—that Congress does not like the idea of piling up, of lending to pay interest, and piling up the debt to a larger amount. That a prudent policy of reserving against these loans would be pretty welcome.