Comment on "Economic Reform and Debt Relief in Eastern Europe: Lessons from the 1980s Debt Crisis," by John Williamson

Richard Portes

I do agree very much with the basic truth of John Williamson's analysis. Nevertheless, I think there are some things to add.

The primary lesson of the 1980s for the creditors, as Williamson puts it, is that there are more important things in life than continuing to have debt serviced on the basis of the original contractual terms. I would regard that as a primary lesson for the debtors as well.

I quite agree with his analysis of why the initial debt strategy was wrong, with a few nuances. First, he says that the basis of the initial debt strategy was in part an exaggerated perception of financial fragility. On this issue of financial fragility, I would add that the Chairman of the Federal Reserve might have been concerned to avoid being labelled for his restrictive monetary policies as the architect of a new great crash (as well as a wish on the part of the Managing Director of the IMF to find a new role for that institution in the 1980s). To sort out ex-post what was happening in 1982-1983, we need much more archival evidence than is currently available.

Second, I would stress, even more than John Williamson did, the failure in the *initial* analysis of the debt crisis to allow for the internal transfer problem of the debtors: the domestic fiscal burden of debt service and the consequent pressures on prices and interest rates. There is a very good analysis of that, for example, in Cohen (1987). I think this is very relevant to the Hungarian case, to which I shall return.

The third point is on the history, the ignorance of which on the part of most participants is a theme in Williamson's paper. The historical lessons were in fact reasonably well understood, and several of us were trying to spread the message. Barry Eichengreen and I studied the full set of loans made in the 1920s, and in one of our papers arising from this work, we wrote: "Observers familiar with the history of international lending approached the debt crisis of the 1980s with a sense of *déjà vu* (Eichengreen and Portes, 1986). It was indeed *déjà vu* all over again. The first paper I wrote in this area was on East European debt, five years before the debt crisis began (Portes 1977), and I relied significantly on previous studies of the way in which creditors have dealt with debt problems over the decades, indeed the centuries. This was not totally unknown territory.

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The historically *normal* resolution of debt servicing problems has taken the form of a restructuring agreed between creditors and debtors, with some significant debt relief element and subsequent restoration of normal access to the capital market. Eichengreen and I found that the countries that did default in the inter-war period did not have inferior access to capital markets in the post-war period, relative to those countries that did not default.

My next point is on the "debt Laffer curver". I think that this analysis overemphasises the search for a Pareto superior solution, or resolution. If that is the way your mind is conditioned to go, you ask whether the country is on the wrong side of the debt Laffer curve; if so, a reduction in the nominal stock of debt will make both the debtor and creditor better off. In a paper by Daniel Cohen and myself (1990), we come to the conclusion that there are very few countries that are on the wrong side of the debt Laffer curve. So this is a relative weak case for debt relief. But that is taking for granted the basic hypothesis that you are looking for a Pareto superior solution.

The question is, Pareto superior relative to what? Relative to one hundred per cent debt service? Complete fulfilment of the initial contractual obligations? No, that doesn't seem to me to be the right way to approach the problem. Instead we should be contemplating solutions that involve some pressure by creditor country governments on the creditors, in particular the banks, to arrive at solutions that are *not* Pareto superior, but rather require the banks to take some loss. If one says Pareto superior relative to the valuation of debt on the secondary market, that is a different story, and than there is something to talk about.

Let us go on to the lessons of all this for Eastern Europe. Whatever one may have written about Eastern Europe debt long ago or recently, it has had no effect on policy, certainly not on the banks. If you look, for example, at what happened in the mid-1980s, the appropriate title of some part of this section ought to be not 'the lessons for Eastern Europe' but 'the lessons for the banks'. Because yet again, having seen Poland, Hungary and Romania get into trouble in the early 1980s, the banks contrived from 1985 to 1989 to raise Bulgarian debt from 4.1 billion to 10.7 billion. And spreads went down from about 100 basis points in 1983 on average for Eastern Europe to about 25 basis point in 1987. The rush to lend prevailed again, they had to get back at it. They didn't learn anything!

I would slightly disagree with Williamson on the analysis of which countries are in trouble. He wrongly omits Albania, whose debt export ratio, even in 1990, was almost 300 per cent and is now 500, 600, 700. Albanian exports are sufficiently close to zero that even a marginal variation affects the ratio considerably. On the other hand, one should not include, as far as I can tell, all the successor states of Yugoslavia, because both Croatia and Slovenia appear to have relatively manageable debt burdens.

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John Williamson's comments on the Polish deal reached with the Paris Club suggest that it was a great success. I would not be that positive. Firstly, why did it take so long? Why not before March 1991? The stabilisation programme was introduced at the beginning of 1990. Second, why have the banks not followed? Poland is still locked in negotiations with the banks. Why haven't the creditor countries put a lot more pressure on the banks to strike a deal on the same (or comparable) terms as the Paris Club? Third, to what extent did the deal really give the IMF such strong leverage as Williamson suggests in the Polish context? Even to the extent that it did, there are limits to this: the Polish government has just fallen. The political strains produced by all of this pressure have been considerable.

And then we get the Hungarian case. Williamson says the successful deal that Poland arrived at with his creditors didn't seduce Hungary. This suggests that he believes that Hungary definitely should not have followed that road, and I am not at all convinced.

It seems to me that Hungary was about as close an analogy with Mexico as you could get in Eastern Europe: extensive reforms already in place; a government that was certainly committed to further reform; and a very heavy debt burden. The Hungarian debt burden is not and was not moderate. Cohen (1991) shows that on all measures – what he calls 'debt per effective capita', growth-adjusted debt, econometric analysis of the secondary market prices – on all those criteria, Hungary was and still is one of the most indebted countries in the world. As Cohen puts it, Hungary was similar to Argentina, Brazil and Côte d'Ivoire, as opposed to Poland, which ranks similarly to Turkey and the Philippines.

The domestic fiscal consequences of maintaining full debt service can be crippling. In the Hungarian case, you are talking about 5 per cent of GDP in interest payments. And that has resulted in a great squeeze on investment, both public investment and also (with high real interest rates) private investment.

On Bulgaria and Russia, I couldn't agree more with the policy suggestions in the paper. Bulgaria now: it should have been earlier, but certainly now. Russia later. In terms of striking a comprehensive debt relief agreement, there is a major difference that is not pointed out in the paper: the Bulgarian debt is mainly to the banks, and the Russian debt is mainly to governments.

A penultimate point on the content of needed reforms. Williamson sets out the Washington consensus, and he tends to endorse Latin American solutions for Eastern Europe, with a few provisos. It doesn't really fit well in certain places. For example, the East Europeans do not really need to allocate more to education, and they certainly do not need to cut marginal tax rates, because there has not ever been a personal income tax in many countries. Moreover, that consensus omits anything about recapitalising the banks and dealing with enterprise debts and the debt overhang internally. All those, I think, are essential points.

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The main distortion, however, from looking at Eastern Europe through Latin American eyes, is to overemphasise macroeconomic issues. Thus Williamson comes out approving a relatively narrow version of conditionality, a macro version along traditional lines, and characterises the advice that has been given to these countries as broadly appropriate.

I think this gives the wrong emphasis. In particular, it endorses the predominant role of the International Monetary Fund vis-à-vis the World Bank. The Bank has considerable expertise in structural conditionality, in micro level conditionality, and it seems to me that that is where the emphasis should have been from the beginning.

The output decline that we have witnessed in Eastern Europe, Williamson says, could not have been avoided with less restrictive macroeconomic policies. I tend to agree with that, but most of us do criticise the policies and the conditionality that has been followed. I am not arguing so much for a more expansionary *macro*economic environment, as for more stress on the basic *micro*economic issues: for example, the financial restructuring which is necessary to create the capital market, which really has not been done successfully anywhere yet in Europe.

I finish simply by endorsing the final point of the paper: "debt restructuring is an effective way of helping to finance a programme of economic reform". Indeed, I was pushing that three years ago (Portes, 1991), partly on the grounds that in thinking about how one could get reasonable sums of aid to Eastern Europe, it seemed to me that politically for the Western governments, that was the most likely way to find significant amounts – through debt relief, rather than out of new allocations. I still believe that to be the case, and it is certainly overdue already for Bulgaria.

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