RESTORING CREDIBILITY TO INTERNATIONAL LENDING

Jerry L. Jordan

Who Will Bear the Losses?

Part of the problem of restoring credibility to international lending boils down to resolving, and making it explicit and final, who has incurred the losses that already have occurred. Somebody has lost. Somebody is poorer. The debate over the IMF quotas was a matter of haggling over who was going to publicly confess that they made a mistake and that a loss has occurred. The big international lending institutions in the West have been resisting having to tell their shareholders that they made a mistake. The government officials in debtor countries have been resisting having to tell their citizens that they made a mistake. In many cases, the present management of the banks and the present government officials are not the same as the ones who got us into this mess. But that does not seem to help very much.

Getting from where we are today to a resolution of who is, in fact, going to bear the losses is the key to restoring credibility to international lending. In making this decision, there are three basic options:

1. Austerity measures could be imposed on debtor countries, possibly under IMF conditionality agreements. This would mean that present and future consumers in the debtor countries are going to be worse off than otherwise.
2. The debtor countries could overtly default; that is, they could repudiate their outstanding debt. This would mean that the stockholders of the lending institutions must recognize that they are worse off than otherwise.

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The author is Dean of the Anderson Schools of Management, University of New Mexico, Albuquerque, N.M. He is a former member of the President's Council of Economic Advisers.

3. In the event that less developed countries default on their external debts, the governments of creditor countries could devise ways to socialize the losses. This would mean that the taxpayers of the creditor nations (especially U.S. taxpayers) would be forced to bear the losses.

Aggregative Versus Distributive Effects

The prospect of an international financial crisis raises the possibility that everyone will be made worse off. To understand the issues and analyze the alternatives, we should separate the "aggregative effects"—the effects on economic growth—from the "distributive effects"—the effects on the distribution of real income. In a very basic way, aggregative issues are concerned with the size of the pie, or more precisely, with how rapidly the size increases over time, while distributive issues are concerned with who gets how big a piece of pie at any point in time. In the context of the international debt problem, the issue boils down to the following. Suppose we knew for certain that the total real output of all of the countries involved was going to increase at the same rate, regardless of the ultimate resolution of the international debt crisis. Then, whether or not the IMF quota was increased, whether or not there were defaults by some countries, or whether or not there were write-downs of the face value of international loans by the lending institutions, there would be no effect on real output.

If we knew that output was going to increase at the same rate, no matter what happened on the financial side of things, there would be no aggregative issues, but only distributive issues. In other words, we would be arguing over *shares* of the pie, not over the *size* of the pie. However, to the extent that the international debt problem could result in a financial crisis that caused a contraction in aggregate output of the countries involved, the standards of living of citizens of both developed industrialized countries and the less developed debtor countries could decline, something similar to the Great Depression of the 1930s. Many commentators have focused on the probability of an international financial crisis resulting in a contraction in world output. They also have discussed the types of policies that would be appropriate to prevent a debt crisis from lowering living standards in *both* creditor and debtor countries.

If we could insulate the growth of world output from any financial crisis, then we could focus on the pure distributive effects of different solutions to the current set of international debt problems. It should be abundantly clear that somebody has incurred a loss. From the time of the first oil shock in 1973 and 1974, it has been obvious that

there have been distributive effects of the relative price changes of internationally traded commodities. In the first instance, the quadrupling of oil prices in 1974 meant that the oil-importing and consuming countries were worse off, in a present-value sense, while the oil-producing and exporting countries were better off. In other words, there was a redistribution of wealth from some countries (or the citizens of some countries) in favor of other countries.

The Available Options

Once policy makers in the oil-importing and consuming countries recognized what was happening in 1974, they concluded that there were basically two choices available to them. They could either reduce their living standards *immediately* or they could borrow and reduce their living standards in the *future*, as they repaid the loans. Some countries, such as Korea, Taiwan, and Japan appear to have taken the first path and decided to tighten their belts. Other countries chose the second path and have decided to borrow heavily on the international financial markets in order to pay for oil and other imports in the short run. In doing so, they hope to maintain their current consumption levels as much as possible, or even increase them, and therefore to create a situation where the wealth loss is shifted into the future. In other words, the recycling of petrodollars has made it possible for governments of oil-importing and borrowing countries to shift part of the wealth loss implied by the first oil shock into the future.

The problems created by the initial world energy crisis in 1973–74 were serious enough, but the second oil shock in 1979 and 1980 further exacerbated the problems and ultimately created a condition in which very hard choices became inevitable. The wealth loss (in a present value or actuarial sense) that initially resulted from the quadrupling (and subsequent doubling) of international petroleum prices was very apparent. The recycling of the international flows of funds meant that a point would come in which political demagogues in the borrowing countries might find it useful to focus on the debt servicing problems of their countries and claim that it was the international lending institutions—the big banks of the developed countries in the West—that were exploiting the citizens of the lesser-developed borrowing countries. Even if politicians in the oil-importing debtor countries realized that higher energy prices meant a reduction of living standards, it was not obvious that it would be in their self-interest to blame OPEC. It has become much more convenient to claim that the large international lending institutions were the ones exploiting the less developed borrowing countries—demanding

interest on the outstanding debts of LDCs as well as repayment of principal, and requiring payments that were a rising share of the export earnings of those countries.

If the political leaders of the less developed borrowing countries were successful in creating the perception that it was the *lenders* who were exploiting them and causing the problem, then it would be more tempting to default on the loans and shift the losses to the shareholders of the international lending institutions. The big lending banks of the Western industrialized countries understand this very well and are working through their own governments and the IMF to try to impose policies on the less developed borrowing countries that would ensure that these losses are in fact borne by the citizens of the borrowing countries.

In domestic lending, everyone understands that if you borrow a lot of money and throw a big party, it might be fun in the short run. However, in the long run, it will mean a decrease in your real standard of living as the debts are paid off. If you are not able to pay your debt, then you declare bankruptcy and the lenders must bear a loss as a result of having made it possible for you to throw the party at an earlier time. Naturally though, the lending institutions are going to try to minimize their losses by attaching or acquiring all of your assets, and the borrower who has defaulted will find it very difficult to repeat the credit-financed party in the future.

In international lending, it does not work quite the same way. It is very difficult for lending institutions of foreign countries to put liens on or to acquire and possibly transport assets that they have repossessed from the borrowers. If the borrower can prevent the lender from repossessing the assets, then the loss incurred by the lender is going to be relatively greater, while the loss incurred by the borrower is going to be smaller, than in the case of domestic lending. Obviously, if it were made more difficult or impossible for a lending institution to repossess a car or a house when the borrower could not make his payments, the lenders would be less willing to make this kind of loan in the future. In effect, default by the governments of less developed borrowing countries would be very similar to a "debtors' holiday" in domestic lending where "the slates are wiped clean" at a point in time. Everyone promises not to do it again, but the action by government imposes the loss on the lenders rather than on the borrowers.

Methods of Paying Off the Debt

Let us take a look at some fundamental relationships. So long as the internal real growth rate of a borrowing country exceeds the

external real borrowing costs (that is, the real rate of interest on the currency being borrowed or in which the debt is denominated), then (theoretically) there is no limit to the amount of debt that can be serviced by the borrowing country. Relatively high internal rates of real growth mean that potential export earnings will always be sufficient to pay interest on and repay principal of externally borrowed funds. However, if the internal real rate of growth falls below the external real borrowing cost, then on a present-value or actuarial basis the outstanding amount of foreign debt cannot be repaid in full without reducing domestic consumption. If this situation persists, then there will be a continuous contraction in domestic standards of living.

There are essentially two ways to pay off outstanding debts. One is the "gradual, over-time" approach, and the second is the "all at once" settling of obligations. In the context of international debts, the first method amounts to remitting to international lenders the proceeds of export earnings over an extended period of time until the debt is finally eliminated. The second method amounts to turning the title to assets over to lenders, so they can earn what they can or can dispose of the assets on the market for whatever they can get. This second method of settling debts occurs in a domestic context only when bankruptcy is declared by the borrower. Lenders must make the judgment as to whether the present value of a loan is greatest if the original borrower continues to operate the enterprise, or if the lender takes over and manages the enterprise, or if the assets are acquired and sold on the market for whatever some third party thinks they are worth.

There are obvious complications in applying this analysis to international lending, especially when the borrower is a foreign government or state-owned enterprise. If a loan has been made to a government and is to be repaid by collecting taxes from that country's citizens, there is not much the foreign lender can do. The loan, representing a claim on foreign taxpayers, could be sold on the market for whatever it will bring, or the original lender can simply hold on to the claim and accept whatever payments are forthcoming.

It is interesting to note that when foreigners lend to the U.S. government (by buying Uncle Sam's bonds), the decline in the value of such loans as a result of adverse U.S. economic policies cannot be ignored. However, the loans by U.S. citizens or banks (or those of any other Western country) to a less developed country are not "marked to market" as it becomes apparent that the real economic value of such loans is declining.

I suspect that there were cases in the 1970s in which so-called special issues of nonmarketable U.S. government debt were held by foreign governments or central banks at "par" value even though the price of marketable U.S. government debt was declining significantly. The foreign government or central bank was reluctant to write down the value of an international reserve asset and acknowledge that a loss had been incurred. Failing to reduce the value of assets on the books, however, does not mean that a loss has not occurred.

Involuntary Lending

From the standpoint of restoring credibility to international lending, the most adverse development in the 1982–83 period is what is referred to as "involuntary lending." Such coercive use of the powers of government should be rejected on principle in a free society. U.S. Constitutional protection against the "taking of property" should mean that a financial institution cannot be forced by government to make loans to anyone or on terms contrary to the judgment of management.

The rationalization for involuntary lending is that there is some "market failure" and a "free-rider problem" in international lending. Several points need to be made. First, the burden of proof is on those who make such assertions. There is no evidence of a market failure or free-rider problem in international lending any more than in domestic lending. Syndicate leaders in international lending earn a fee for bearing a risk and "making a market," as do domestic security underwriters. Having underestimated the risk and set too low of a fee in the past does not justify the use of force to require others to continue lending.

The holders of the certificates of deposit (CDs) of a bank that gets into trouble—such as Franklin National Bank—cannot be forced to renew and add to their holdings of CDs, even if a free-rider problem is asserted. The holders of the commercial paper of a large corporation cannot be forced to continue to lend to a company that gets into financial difficulty. Forcing a relatively small regional bank to continue to lend to Argentina or Poland would be no different than forcing them to continue to lend to W. T. Grants, Penn Central, or Penn Square.

Furthermore, many banks felt they were incurring little risk in their international lending because the loans were all "short term." But the phenomenon of government-orchestrated involuntary lending has resulted in all those loans becoming long term even though they mature frequently. The original pricing of what were thought

to be short-term loans would have been different if the lenders had anticipated that they would be forced to make the loans on a long-term basis. A present-value loss has been imposed on the lenders. They will be less likely to make that mistake again in the future. The pricing of short-term loans in the future will reflect the possibility that the lender will be coerced into renewing or extending the loan.

Another development in the past two years that is to be regretted is the failure of banks to begin writing down international loans to their expected actual value. There is no justification for international loans to be treated differently than domestic loans in the provision of reserves against losses or the classification of the status of the loans. The banks' boards of directors have a responsibility to see that managements accurately and honestly report the status of all the banks' assets.

Credibility of Lending Means Credibility of Economic Policies

The credibility or viability of the underlying economic activity that is financed by debt determines the soundness of the loan. In domestic lending, credit risk means, Can the borrower pay us back? Banks do not lend to businesses that are expected to lose money. In lending to foreign governments or state-owned enterprises, however, there is no similar assessment of credit risk. The country's taxpayers, rather than company earnings, are viewed as the ultimate source of debt service.

Banks have financed the construction of state-owned or subsidized steel mills, automobile factories, and other projects, where there was no reason to believe the country had a natural comparative advantage. That means the banks were financing economic losers. Wherever the borrowing country distorts its exchange rate, or maintains different exchange rates for private, commercial, and financial transactions, it is likely that the foreign lenders are supporting an uneconomic use of the borrowing country's resources. Wherever there are market-distorting import-substitution policies, subsidies to exporters, onerous tariffs on imports, credit subsidies, or other interferences with the price and profit signals from international and domestic markets, a misallocation of resources is occurring. The resulting reduced growth or stagnation in the borrowing country means the taxpayers and consumers of that country are going to bear part of the burden of servicing the foreign debts.

In the past, there was a bias (at least on the part of mid-sized regional banks) toward lending to foreign governments or govern-

ment-owned enterprises, rather than to the foreign private sector. The rationale was that a country could not go broke. Such logic often meant that it was preferable to lend in countries where there was a strong authoritarian regime, rather than a democracy or a weak dictatorship. If the lender expects the borrowing country's consumers and taxpayers to ultimately bear any losses, a nondemocratic political system will be more attractive to the lender.

Perverse Policies of Lending Countries

Since the ability to pay interest and repay principal on foreign borrowing depends on the ability to export (unless foreign private equity capital inflows are used to pay debts), the major industrialized countries have a responsibility to preserve open markets for internationally traded goods. It is hypocrisy for the governments of the European Common Market, Japan, and North America to restrict imports from the less developed debtor countries while professing to search for a solution to the international debt problems. Some agencies of the U.S. government want to force banks to continue lending to Mexico while other agencies want to limit imports of Mexican lettuce, tomatoes, manufactured goods, and other products. The Common Market countries heavily subsidize their own agriculture while chastizing Latin American countries for not being able to earn more foreign currencies to pay their bills. If the Philippines could sell more bananas, pineapples, meat, and wood products to Japan, their debt burden would not be a problem.

Conclusion

The willingness of creditors to lend in the future and debtors to borrow in the future will be influenced by the ultimate resolution of the inherited international debt problems. Either the supply of international credit or the demand for it will be affected, unless the taxpayers of lending countries are forced to bear the losses. To the extent that present and/or future consumers of debtor countries bear the losses, international *borrowing* will not be so attractive in the future. To the extent that shareholders of lending institutions bear the losses, international *lending* will not be so attractive in the future. But to the extent that taxpayers in industrialized countries bear the losses, a new form of international welfare program will have emerged.

The rise in protectionist sentiment in the United States and other major industrialized countries is a threat to international trade and, therefore, to international lending. Misplaced emphasis on export promotion programs of industrialized countries in the mistaken belief

that such programs will "create jobs" is detrimental to the debtor countries. Past lending to inefficient state-owned or subsidized enterprises, or to government infrastructure projects where there is no revenue generated, imply that the borrowing country's taxpayers and consumers must pay the bill. Future lending should be based on the economic viability of the activity that is being financed. This is the only sure way of restoring credibility to international lending.

Finally, one other element of restoring confidence to the whole system of international lending should be mentioned. It would involve assuring everyone that the United States will not continue with its highly erratic stop-and-go monetary policies, and that it will begin to put its fiscal house in order. If we do not solve these problems, then the rest of the world has little chance of working out its problems.

"RESTORING CREDIBILITY TO INTERNATIONAL LENDING": A COMMENT

William R. Cline

The problem that Jerry Jordan (1984) deals with—restoring credibility to international lending—is of critical importance. Its most graphic illustration, perhaps, is in figures on the exposure of the banks to the developing countries, Eastern Europe, and some of the OPEC countries, which amounts to 280 percent of their capital. It does not take too much imagination to see the kinds of problems we can get into if that debt is seriously eroded or collapses. In my opinion, confidence in international lending and the financial system will be restored by the processes of international economic recovery which we are already witnessing.

Some Projections

In order to analyze the severity of the debt problem, I developed a projection model for the 19 largest debtor countries (Cline 1983). The model forecasts these debtor countries' exports, their balance of payments, and other key economic variables through 1986. Their exports are related to OECD growth, both in terms of volume and in terms of the prices of their exports, and to their own exchange rates. Their imports are determined by their own domestic growth rates and by their exchange rates. Interest is determined by the level of international interest rates, and dollar prices in world trade are determined by the dollar's strength. Under the model's basic assumptions, which are more or less being realized at the present time, one sees favorable projections for resolving our current world debt problems.

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The author is a Senior Fellow of the Institute for International Economics in Washington, D.C. This comment was delivered as part of a luncheon panel at the Cato Institute's conference on "World Debt and the Monetary Order," 20 January 1984.

Given the basic assumptions of 3 percent growth in the OECD countries from 1983 through 1986, a LIBOR (London Interbank Offered Rate) on the order of 10 percent in this period, oil prices more or less constant at $29 per barrel, and a depreciation of the dollar by 15 percent, the model leads to the following projections. The current account deficits of the 19 largest debtor countries will decline from 24 percent of their exports to 14 percent. Their overall ratio of debt to exports will decline from 190 percent to about 160 percent. Some of the trends for some of the key debtor countries are even more impressive. The debt-export ratio for Brazil can come down from 380 to 200 percent; for Mexico, from 275 to 230 percent; and for Argentina, from 370 to 180 percent. The projections find serious deterioration only in some of the oil-exporting countries, because of stagnant oil prices. Even in some of these countries, however, there have already been some sharp adjustments. For example, in 1983 Venezuela had a strong current account surplus, although that obviously involved sharp import restrictions.

An Illiquidity Problem

These projections indicate that the debt problem is one of illiquidity, not one of insolvency; that we will see a recovery through the normal processes of international economic recovery; and that we will see exports growing faster than the interest rate. This analysis is not unique; there is a similar analysis for Latin America published in the autumn 1983 issue of the Federal Reserve Bank of New York's *Quarterly Review*. And similar analyses appear elsewhere. On the basis of this kind of analysis, it seems to me that Jerry Jordan's premise that there will be massive losses and that the only question is how they will be divided, is very doubtful. In particular, this type of analysis indicates that the current strategy is the right one and that it is correctly premised on an illiquidity diagnosis of the world debt problem. Our model does imply that we have to achieve a certain rate of international economic recovery. If we go to lower levels of international growth, say, 2 percent for the 1983–86 period, or if interest rates escalate once again to 15 percent, then one does not see the improvement, and we are much closer to an insolvency problem.

Economic performance in 1983 has been favorable to the model's assumptions. In the case of my own projections, the actual current account deficits of the 19 debtor countries were only about half as large as I projected for 1983, so performance is ahead of schedule. In Mexico, which had a $12 million deficit in 1981, the deficit was

supposed to be $3 billion in 1983; instead, Mexico had a current account surplus of $5.5 billion. This overperformance obviously came at the expense of a sharp cut in imports and a serious decline in Mexico's growth rate. Argentina, Brazil, and Mexico together have shifted from a trade deficit of $3 billion in 1981 to a combined trade surplus of over $20 billion in 1983. We are seeing adjustment, but the dynamics of the adjustment process take time, so we should not expect these countries to instantaneously return to credit-worthiness. Statistical analysis of debt indicators suggest that even with these kinds of improvements it will be 1986 before we see the kinds of returns to credit-worthiness that would permit a return to voluntary lending.

The Adjustment Mechanisms

In my opinion, the adjustment mechanisms that would take us from here to there, would be very much the mechanisms we have seen in place so far. They involve official cooperation and what I call "involuntary lending." Involuntary lending, I would submit, would happen even without the IMF, the Federal Reserve, and the Bank of England. It would happen because the banking system has its own incentive to make these loans. The incentive works as follows. The moderate amount of increased exposure is sufficient to avoid default; therefore by making these moderate expansions of exposure, the banks are securing the large exposure that they have outstanding already. The problem of free-riders and the involuntary aspects that Jordan was referring to, have to do with the fact that the small banks, when they make their calculations, think that their own actions cannot affect the probability of default, even though in the aggregate they can. Consequently, there is a role for a unifying agent, such as the IMF, to help coordinate the actions of individual banks across countries. Even if the existing official international lending agencies were dissolved tomorrow, the banks would find it in their cooperative interest to have an institution like the IMF.

The existing system of international cooperation has been much more robust than many people anticipated. Even one year after the Brazilian crisis, we have seen the almost complete success in the mobilization of its second jumbo loan (of $6.5 billion) from the banks. This would not have occurred if the only incentive in the whole process had been Paul Volcker talking to the regional banks. I disagree that involuntary lending is an unacceptable intrusion by the state into private affairs. I think it is a matter of self-interest for the

banks, and I see it as being a fairly robust mechanism that will continue the lending until the point where we get to voluntary lending.

What about voluntary lending? My calculations indicate that deficits should come down sufficiently by 1986–87, so that it would be possible even for plausible amounts of expansion of exposure for the large banks to finance not only the deficits but in addition the orderly withdrawal on an amortization basis of some of the small banks accounting for up to 30 percent of the exposure. So I think we can envision a return to voluntary lending.

What about policy? There are many areas of policy. We have just focused on some that are of special concern. In this whole process of adjusting to the debt crisis, we have seen a tremendous amount of emphasis on the issue of whether the government ought to be involved; in particular, whether there should be IMF activity. In my opinion, the decision to increase the IMF quotas last year (in 1983) was the right decision. Failure to do so would have prompted countries to lean further in the direction of default. It is interesting that already the calculus of default has shifted in favor of default because, whereas the new borrowing used to be three times as large as the interest being paid, it is now true that the interest being paid exceeds the new borrowing. Jordan, no doubt, would push the calculus even further in the direction of default. The IMF has been pushing banks to lend more. Was it the banks' irresponsibility that caused the problem? If you look at the numbers from 1973 to 1982, the debt owed by non-oil developing countries rose by $500 billion. You can account for $400 billion of that through international economic shocks: Higher oil prices, above the general rate of inflation, accounted for about $260 billion; about $40 billion can be attributed to real interest rates above their historic averages in 1981 and 1982; about $80 billion to terms of trade loss; and the remainder to other shocks.

What about the question of whether the whole strategy is "digging us in deeper?" I have heard some economists say that the strategy now is making the prospective losses worse by digging us in deeper, and that the IMF, in particular, encourages banks to lend more, and that this is dangerous. I think what is being missed here is that the banks are digging themselves out, not digging themselves in. Because they are expanding their exposure at less than the interest rate, the real present discounted value of their exposure is declining, not rising. How about the IMF subsidies? Is it not awful that the IMF is subsidizing loans to developing countries? The subsidy involved in the IMF quota increase is $200 million a year. I would submit that this amount of investment in international financial security is well spent. This seems especially true in light of the fact that the amount

of damage done to developing countries' economies by distorted U.S. macro policies, in particular the mismatch between loose fiscal and tight monetary policy in 1981–82, is many many times that magnitude.

There is the issue of bank regulations: Is it not time to "mark to market?" Let us carry these loans at what they are worth. The difficulty, of course, it that it is a little hard to tell what they are worth. The market is pretty thin. The principle that you do not revalue what is on the banks' books every week if the market fluctuates, or even every year, has been with us since the 1930s. If we did, then the 8 percent bonds that mature in the year 2000 would have to be written down very severely. It is not my perception that there is a different treatment between international and domestic loans in this regard. To suddenly force marking to market in the midst of a period of financial stress would be destabilizing rather than productive. I would suggest that what we do need is a more liberal tax treatment of provisioning. We see that the German banks in particular have set aside much larger reserves than the U.S. banks, and this is driven primarily because of the liberal tax treatment in Germany which encourages the use of so-called hidden reserves. Our tax treatment limits the amount of provisioning that can be deducted to 0.6 percent of assets.

What about the attitude that the government should keep its hands off all of this. If the big banks collapse—Citibank, Morgan Guaranty—no problem. If it came to that, we could probably survive. But what is misleading is the implication that because this might be a possibility, it would be a wise thing to follow policies that increase the probability of Citibank and Morgan Guaranty becoming insolvent. An interesting figure is that the nine largest banks have about $200 billion in uninsured deposits. That is a lot of money to suddenly be lost. Institutionally, even the staunchest advocates of free markets would accept the presence of adjustment lags. If you one day have a collapse of a major bank, or shall we say the 10 largest banks, you do not the next day suddenly have institutions which replace them.

Conclusion

One should be very careful about what kind of a price one is prepared to pay for the ideological appeal of absolute nonintervention. Broader policy concerns do turn on the appropriate macro policy. The debt problem is being seriously aggravated by high international interest rates and by a strong dollar which reduces the dollar prices of traded goods relative to the debt denominated in dollars. U.S. policies have to change in order to reduce these strains. We

need a lower budget deficit to reduce interest rates and to bring the dollar back to a more realistic level.

The basic strategy on debt so far has been working. It has involved adjustments and efforts on the part of all of the key players. It is not the time to go to a new international agency, which would buy up the debt with public monies. Nor is it the time to declare that all public institutions must keep their hands off completely, that there should be no insurance in the system, and that the big banks should be allowed to fail. Instead, it seems to me, that with international recovery we will see confidence and credibility restored to the international financial system.

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