U.S. MACROECONOMIC POLICY AND THIRD WORLD DEBT

Michael Mussa

Introduction

Since 1981 the world financial system has faced continuing crisis due to doubts about the ability and willingness of debtor nations in Asia, Africa, Latin America, and Eastern Europe to meet the debt service obligations on their extensive loans from the international banking system. As demonstrated by the widespread opposition to the recent increase in IMF quotas, the commonly held view is that this crisis was created primarily by excessive borrowing by developing countries and excessive lending by financial institutions, especially large international banks. An analysis of the investment projects financed by external borrowing in many developing countries, and an analysis of the lending practices and policies of many financial institutions, would no doubt lend support to this commonly held view. However, since the current international debt crisis affects such a wide range of countries and such a wide range of institutions engaged in international lending, it is relevant to ask whether there is some common cause for this crisis beyond the errors and excesses of particular borrowers and lenders.[1]

In this article, I shall argue that the economic policies pursued by the United States during the past decade played an important role in the evolution and severity of the problems besetting debtor nations and their creditors. Specifically, I shall discuss six mechanisms through

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[1]In cases where problems with external indebtedness affect only a single country, such as Zaire in the mid-1970s, it is reasonable to focus attention on the specific difficulties of that country and its lenders. Such a narrow focus does not seem entirely justified in the current crisis that affects such a wide range of countries and lenders.

which policies of the U.S. government contributed to difficulties currently besetting the international financial system:

1. In the mid-1970s, U.S. policy encouraged borrowing by developing countries by facilitating the development of an international banking system that would recycle the surpluses of the OPEC countries.
2. Between 1975 and 1980, the monetary policy that contributed to a generally declining foreign exchange value of the U.S. dollar and to a generally low level of nominal and real interest rates encouraged borrowing by developing countries, especially borrowing denominated in U.S. dollars.
3. The energy policies of the United States between 1974 and 1980 that contributed to a higher world price of oil stimulated borrowing both by oil-importing developing countries, like Brazil, that sought to finance part of their increased oil import costs and by some oil exporters, like Mexico and Venezuela, that borrowed in anticipation of increasing oil revenues.
4. The shift to a tighter U.S. monetary policy after 1980 increased the debt service burden of debtor nations by contributing to increased real and nominal interest rates and to the appreciation of the U.S. dollar.
5. The worldwide recession that was partly the consequence of the tightening of U.S. monetary policy in 1981 adversely affected the export earnings of many debtor countries and thereby contributed to doubts about their credit worthiness.
6. The continuing large deficit of the government of the United States crowds out other borrowing, including that of developing countries, and contributes to higher interest costs on the existing debt of these countries.

The Nature of the Current Crisis

Before examining these mechanisms through which U.S. economic policies have contributed to the crisis confronting debtor nations and the international financial system, it is important to analyze the key ingredients of this crisis. The basic problem is that for many debtor countries, net foreign income[2] is less than the interest and principal due on foreign loans. Furthermore, sufficient doubt exists about the capacity or willingness of these countries to meet their future debt service payments since they cannot easily refinance the excess of

[2]Net foreign income is the current-account balance less net interest paid on foreign loans. It measures income available to pay the interest and principal on foreign loans.

their current debt service requirements over their net foreign income. The nature of this problem and the circumstances that contribute to its existence are well illustrated by considering the case of Brazil, the developing country with the largest external debt.[3]

At the end of 1983, Brazil's external debt was approximately $100 billion. Since much of this debt is floating-rate debt with an interest rate that is linked to LIBOR (the London Interbank Offered Rate), interest due in 1984 will be sensitive to actual behavior of interest rates. Assuming that LIBOR will average 10 percent, that Brazil pays a premium of 1.5 percent over LIBOR, and that all of Brazil's debt is floating rate, it follows that interest due in 1984 will be $11.5 billion. Some of Brazil's external debt is long term (15 years or more), but much of it has a maturity of 4 to 10 years. Assuming an average maturity of 8 years, it follows that principal payments due in 1984 should be about $12.5 billion, implying a total debt service requirement for 1984 of $24 billion. Brazil's net foreign income for 1984 will obviously depend on economic developments during the year, but it is reasonable to assume a figure between $2 billion and $6 billion, with $4 billion as a point estimate. Recognizing that all of these figures are rough approximations, it is clear that Brazil's net foreign income will pay only a small fraction of the interest and principal due on its external debt, leaving $18 to $22 billion of debt service to be refinanced presumably through rescheduling arrangements with Brazil's creditors and loans from the IMF. If mutually satisfactory rescheduling arrangements cannot be worked out between Brazil and its creditors, then Brazil would presumably go into default on its international loans and this would precipitate a major international financial crisis.

It is tempting to think that the basic problem with respect to Brazil's international debt situation is simply that its debt is too large. This is not entirely correct. It is surely true that if Brazil's external debt were much smaller, say $50 billion, its required debt service payments would also be much smaller, say about $12 billion rather than $24 billion. The debt service requirements would still exceed Brazil's net foreign income by $6 to $10 billion, but it would be easier for Brazil to refinance this smaller sum because it is smaller and also because Brazil's creditors would have greater confidence in its ultimate capacity to meet its debt service obligations.

This does not imply, however, that Brazil's debt exceeds a reasonable estimate of the debt that Brazil could afford to service in the

[3]All of the figures mentioned in this discussion are approximations used for illustrative purposes.

long run. Since Brazil is a country with a good record of economic growth over the past 20 years and reasonable prospects for future growth, and since Brazil is probably a country that can profitably invest more in its development than can be financed out of domestic savings, it is conservative to estimate Brazil's dept capacity as the amount of debt on which it could afford to pay the annual real interest cost out of net foreign income. This is a very conservative criterion because if Brazil did pay the annual real interest on its external debt, then the real value of this debt would remain constant over time. With Brazil's real income expanding at 5 percent per year, well below the average growth rate of the past 20 years, the ratio of Brazil's external debt to its national income would be rapidly declining.[4]

During the past 20 years, real interest rates on loans to countries regarded as good credit risks have ranged from minus 3 or 4 percent in the late 1970s to plus 6 or 7 percent in 1981 and 1982. As a long-run average, 4 percent per year is probably an upward biased estimate of the real interest rate that credit-worthy countries would have to pay on their external debts. It follows that for Brazil to meet the conservative criterion for credit-worthiness that it be able to pay the real interest on its external debt of $100 billion, Brazil would need to generate net foreign income of $4 billion, or about 2 percent of Brazil's national income. In my judgment, Brazil has the capacity to generate this amount of net foreign income in the longer run.[5] Hence, I conclude that the fundamental problem with respect to Brazil's external debt is not that the size of its debt is beyond a reasonable measure of the amount of debt it can afford to service. This same conclusion also holds for Mexico (the developing country with the second largest external debt) and for most other debtor countries. Only for a few smaller countries with very high ratios of external debt to national income is there a serious concern that the absolute

[4]Between 1960 and 1970, Brazil enjoyed a growth rate of national product of 5.4 percent per year. Between 1970 and 1981, this growth rate rose to 8.4 percent per year. A 5 percent average real growth rate for the next two decades, therefore, does not seem unreasonable. Such growth would reduce the ratio of Brazil's external debt to its national product to about one-third its current level if there was no growth in the absolute size of Brazil's external debt.

[5]Among all developing countries, Brazil has had one of the better records of economic growth during the past two decades. It is well endowed with natural resources (except oil) and has an expanding population. Even in the present extremely distressed state of the Brazilian economy, the country will probably manage to generate net foreign income of about $4 billion. As the economy grows over time and as general economic conditions improve in the world economy, Brazil should be able to generate adequate net foreign income to service its debts.

size of their external debt exceeds a reasonable estimate of their debt capacity.

The fundamental problem for most debtor countries is that their debt service, which must be paid to avoid default, frequently runs six or eight times the amount of the real interest payments that would keep the real value of their debt constant. Moreover, sufficient doubt exists about the ability and willingness of the governments of these debtor countries to meet their future debt service obligations. These countries cannot easily refinance the substantial fraction of current debt service that cannot be paid out of net foreign income.

Three factors contribute to the high ratio of debt service to debt outstanding. First, real interest rates charged on loans to developing countries have risen because of the general increase in real interest rates since 1980 and because fears of default have pushed up real interest rates for loans to developing countries. Second, the nominal interest rate charged on loans to developing countries, like all nominal interest rates, includes both the real interest rate on these loans and an inflation premium to compensate for the expected increase in the price level. During the past three years, the inflation premium on U.S. dollar-denominated loans has probably added between 4 and 12 percent to nominal interest rates. During the late 1970s, when real interest rates were generally negative, the inflation premium accounted for more than all of nominal interest charges. Third, since loans to developing countries tend to be of intermediate duration (8 to 12 years), principal repayments frequently run between 8 and 12 percent of outstanding loans. Altogether, debt service on loans to developing countries during the past three years has generally run between 15 and 25 percent of outstanding loans. This amount of debt service is very much greater than the 4 percent real interest that would keep (on average in the long run) the real value of the external debt from expanding.

Three factors have also contributed to increased doubts about the ability and willingness of the governments of debtor countries to meet their debt service obligations, in addition to the growth of these obligations. First, because of the world recession and the declines in the prices of many of the exports of the debtor countries (in terms of the currency of denomination of their external debt), export earnings of many debtor countries have declined and this has diminished the actual and perceived capacity of these countries to service their external debts out of their net foreign incomes. Second, because many debtor countries have experienced severe economic difficulties since 1980, governments in these countries are understandably reluctant to pursue more restrictive domestic policies that would

contribute to their capacities to meet their external obligations but at the expense of further declines in domestic output and employment.

Third, when doubt arises about the ability or willingness of a country to meet its debt service obligations in the longer term, potential lenders are reluctant to extend new credit and existing lenders are anxious to receive payment of all interest and principal. Even a creditor who has a favorable assessment of a country's ultimate capacity to service its debt may be very reluctant to make new loans or roll over existing loans because that creditor fears that a default may be forced by other creditors who do not share that favorable assessment. This might create a panic situation in which doubts about creditworthiness and fears of default become self-justifying. In fact, in negotiations of rescheduling arrangements, it is frequently the case that large banks which recognize the impossibility of collecting all of the interest and principal due on loans to a debtor country will not reschedule these payments unless similar banks agree to accept their "fair share" of rescheduling.

In summary, the fundamental source of the current crisis in the international financial system is not simply that the debts of most developing countries are too large relative to a reasonable estimate of their long-run debt service capacities. Rather, the problem is that annual debt service requirements have grown very large due both to the growth of outstanding debt and the high ratio of debt service to outstanding debt. This growth of debt service requirements has occurred at a time when low export earnings have reduced current debt service capacities and when severe economic difficulties have raised serious doubts about the ability and willingness of the governments of debtor countries to meet their external debt obligations. In this environment of doubt, creditors have become reluctant to extend new loans or roll over existing loans, thereby contributing to the possibility and fear of default even by a country that might have the long-run capacity to meet its debt service obligations.

The Origins of the Crisis in the 1970s

Having examined the nature of the difficulties currently besetting the international financial system, it is appropriate to turn attention to the role of U.S. economic policy in creating these difficulties. The seeds of the current crisis were sown in the middle and late 1970s. As shown in Table 1, if we go back before this period to 1970, we find that ratios of external debt to national income and of debt service to export earnings for middle-income developing countries were typically lower than in 1981, when the debt problems of these countries

TABLE 1

THE EXTERNAL DEBT AND DEBT SERVICE RATIOS OF DEVELOPING COUNTRIES

	External Debt as a Percentage of GNP		Debt Service as a Percentage of Export Earnings	
	1970	1981	1970	1981
Low Income Countries	17.5	18.6	12.0	8.8
Middle-Income Oil Importing Countries	13.4	19.1	9.3	13.9
Middle-Income Oil Exporting Countries	13.7	20.3	10.3	15.2
Lower Middle-Income Countries	15.5	23.2	9.2	12.5
Upper Middle-Income Countries	12.4	17.8	10.1	15.4
All Middle-Income Countries	13.5	19.6	9.6	14.4

SOURCE: *World Development Report*, 1983, pp. 178–79.

first become a matter of general concern. Looking in more detail at events between 1970 and 1981, we find that the external debts of non-OPEC developing countries grew more rapidly than their national incomes after 1973, but that the ratio of debt service to export earnings grew only gradually until the alarming increases in 1981 and 1982.[6] In assessing the role of U.S. economic policy in the development of the international debt crisis, therefore, it is useful to consider separately the period from 1973 to 1980 and the period since 1980.

The fourfold increase in the price of crude oil that occurred in late 1973 and early 1974 was widely believed to be an important factor contributing to the world recession of 1974–75. In the Keynesian framework of macroeconomic analysis that dominated official thinking and policy making at that time, the oil price increase was seen as contributing to the recession because the OPEC countries were running huge payments surpluses which represented substantial increases in world savings (at a given level of world income). If not offset by a

[6]The *World Development Report 1983*, pages 20 and 21, indicates that for all developing countries the debt service ratio rose from 9 percent to 13 percent between 1974 and 1980 and then rose to 21 percent in 1982. For the middle-income oil importers, the debt service ratio was at 14.9 percent in 1980 versus 14.0 percent in 1970. By 1982, the debt service ratio for middle-income oil importers had risen to 23.0 percent.

corresponding increase in spending somewhere else in the world, then (the argument concluded) there would be a reduction in world aggregate demand and in world output. The policy prescription, therefore, was for the governments of the major industrial nations, especially in the United States, to run budget deficits to offset the OPEC surplus. In addition, the world financial system was called upon to assist in recycling the OPEC surplus from the OPEC countries that wished to save to countries that wished to borrow and spend. Given this policy objective, governments and regulatory authorities in the United States and other industrial countries generally looked with favor on developments in the international banking system that facilitated increased borrowing by developing countries. Concern was occasionally expressed about excessive borrowing by one or two developing countries, but lending by the international banking system to most developing countries was not discouraged, controlled, or even monitored. Indeed, I recall that at a conference I attended on the subject in 1975, one speaker commented that the problem was not that countries would borrow too much from the international banking system, but rather that there was no country to serve as "the borrower of last resort."

My point here is not that recycling of OPEC surpluses through the international banking system to developing countries was undesirable. On the contrary, the relatively good growth performance of many developing countries that did borrow substantial sums suggests that the resources that were borrowed were put to productive use. The point is that it was the policy of the United States and other industrial countries to facilitate the development of the international banking system that allowed for and encouraged much of this borrowing. To the extent that this system permitted the world economy to function better than it otherwise would have during the 1970s, these policies deserve some of the credit. To the extent that this system has developed serious problems since 1981, these policies deserve some of the blame.

Another mechanism through which U.S. economic policy contributed to increased borrowing by developing countries during the 1970s and thus to the current problems of the international financial system was by contributing to a generally low level of real interest rates for U.S. dollar-denominated loans and to a general decline in the foreign exchange value of the U.S. dollar between 1976 and 1980. Econometric studies have generally found it difficult to establish a clear link between monetary or fiscal policy and the level of real interest rates or the behavior of exchange rates. Despite this lack of clear-cut econometric evidence, I believe that U.S. macroeconomic

policy, especially monetary policy, did have the effect of keeping real interest rates in the United States lower than would otherwise have been the case, and lower than real interest rates were in most other industrial countries. It was certainly a key objective of monetary policy for the first three years of the Carter administration to facilitate growth of output and employment by supplying adequate liquidity to the economy. I also believe that the general perception that the Federal Reserve was pursuing a loose monetary policy between 1976 and late 1979 and again during the summer and fall of 1980 contributed substantially to the weakness of the U.S. dollar in foreign exchange markets. The quantitative effect of low real interest rates in the United States and of the declining foreign exchange value of the U.S. dollar on the extent of borrowing by developing countries between 1976 and 1980 is not known. The *direction* of the effects, however, is clear. When real borrowing costs are expected to be low, there is a greater incentive to borrow than when real borrowing costs are expected to be high. When year after year a country finds that the value of its debt declines relative to the value of its exports because its debt is denominated in U.S. dollars and export prices reflect a weighted average of the values of national currencies, then borrowing is also likely to be encouraged.

The third mechanism through which U.S. economic policy contributed to the growth of borrowing by developing countries in the 1970s was by assisting in maintaining a high world price of crude oil. The overall effect of the energy policies adopted by the U.S. government between 1974 and 1980 was to discourage domestic production of oil and other energy sources by keeping prices to producers artificially low, to encourage domestic consumption by keeping prices of energy to consumers artificially low, and to encourage oil imports through the allocation scheme for low-priced domestic crude oil. All of these effects contributed to a higher world demand for OPEC oil and thus to a higher world price of oil. Between 1976 and 1979, the declining foreign exchange value of the U.S. dollar reduced the price of OPEC oil (which was priced in U.S. dollars) for countries whose currencies appreciated against the U.S. dollar. This decline in oil prices for other countries, however, stimulated their demand for oil during this period and made the world oil market so tight by 1979 that the supply disruptions associated with the Iranian revolution could not be absorbed without another massive increase in the world oil price.

The high world price of oil contributed to the growth of borrowing by developing countries in different ways for oil importers like Brazil than for oil exporters like Mexico. For oil importers, the increase in

the world oil price in 1973 and again in 1979 meant a substantial increase in import costs. This increase in import costs could be absorbed either by reducing other imports and increasing exports or by increased borrowing. With real interest rates very low, especially for U.S. dollar-denominated loans, many oil importers decided to borrow to finance at least part of the increased cost of oil imports. For oil exporters, higher world oil prices meant increased export revenues. For some of these exporters like Kuwait and Saudi Arabia, increased revenues were so large that they became substantial net lenders. Other oil exporters with greater domestic absorptive capacities borrowed on the expectation of future oil revenues to finance ambitious development programs whose costs exceeded current revenues from net exports. The outstanding example of a country that pursued such a program is Mexico, which has accumulated the second largest external debt of any developing country.

In summary, by the end of the decade of the 1970s, the external debt of oil-importing developing countries and of some important oil exporters had grown substantially relative to the national incomes of these countries, but debt service requirements had risen only modestly relative to export earnings. Much of the debt of these countries was denominated in U.S. dollars and was owed to the international banking system. The growth of such debt was encouraged by policies of the United States and other industrial countries that facilitated the development of the international banking system as a mechanism for recycling OPEC surpluses. It was also encouraged by the low level of real interest rates on U.S. dollar-denominated loans and by the declining foreign exchange value of the U.S. dollar, both of which were at least partly the consequence of U.S. monetary policy. U.S. energy policies which affected the world price of oil also contributed to the growth of external debt of oil-importing developing countries and some oil exporters.

The Development of the Crisis since 1980

The current crisis of the international financial system began in 1981 and intensified in 1982 and 1983 because of serious and growing concern about the willingness and ability of many developing countries to meet their external debt service obligations. The proximate causes for this concern were the sharp increase in debt service requirements of many developing countries, the sudden and substantial declines in their export earnings, and the growing doubt about the willingness of the governments of some developing countries to pursue tighter monetary and fiscal policies in the face of declining domestic output

and employment. The economic policy pursued by the United States, especially its monetary and fiscal policy, contributed directly to all of these developments.

To understand the role of U.S. economic policy in this regard, it is useful to summarize briefly the recent history of U.S. macroeconomic policy. In an effort to slow a rapidly accelerating inflation rate, the Federal Reserve tightened monetary policy in late 1979 and early 1980. The consequence of this tightening and of rising inflationary expectations was to force nominal interest rates upward until March of 1980. The tightening of monetary policy and the rise in interest rates, along with other factors, pushed the U.S. economy into sharp but short recession in the spring of 1980. As output declined and inflationary expectations abated, nominal interest rates fell precipitously between April and June of 1980. Concern with recession (and perhaps also with the presidential election) led the Federal Reserve to shift to an easier monetary policy between June and November of 1980. As the economy recovered and inflation accelerated, nominal interest rates began to rise in the summer of 1980. To combat resurging inflation, the Federal Reserve moved to a tighter monetary policy starting late in 1980 or early in 1981.[7] As a consequence of monetary restraint and still-rising inflationary expectation, nominal interest rates rose above their peaks of March of 1980 by year-end and continued to rise to even higher levels during the first half of 1981. During this period, real interest rates rose substantially from the negative levels experienced during the late 1970s to positive levels of 4 to 8 percent per year.

After a strong first quarter in 1981, the U.S. economy began to slide into recession. The recession deepened through the first half of 1982 and recovery did not begin in earnest until 1983. Monetary policy remained quite tight until the summer of 1982, when the Federal Reserve shifted to a substantially easier policy. Nominal interest rates moved slightly and erratically downward between mid-1981 and mid-1982, but real interest rates increased slightly due to the significant decline in the inflation rate. With the easing of monetary policy in mid-1982, nominal interest rates declined more substantially, but real interest rates remained very high by historical standards. With evidence of strong recovery by mid-1983 and perhaps

[7]If monetary policy is measured by growth rates of money, then monetary policy remained fairly loose through the first quarter of 1981. Interest rate behavior, however, indicates significant tightening of monetary policy starting late in 1980. Continued growth of the money supply during the first quarter of 1981 was probably a response to the strong real growth of the economy during that quarter, and this monetary growth was actively resisted by the Federal Reserve.

because of concern with future inflation, the Federal Reserve apparently shifted to a somewhat tighter monetary policy. In late 1983, nominal interest rates were generally running 1 to 1.5 percent above their year-earlier levels, and with the continuation of low inflation, real interest rates remained quite high.

Fiscal policy since 1979 has shifted in the direction of greater ease due partly to the continued growth of federal spending (especially for national defense) and partly to President Reagan's tax reduction program. It is arguable that the large actual and prospective fiscal deficits associated with this policy have contributed to higher real interest rates by increasing the actual and prospective real demand for loanable funds and perhaps also to higher nominal interest rates by increasing fears of future monetization of deficits.[8] With respect to the effect on real interest rates through the demand for loanable funds, however, it is probably relevant to look not only at the U.S. government deficit but also at the deficits of the governments of other industrial nations and at the OPEC surplus. Comparing the period 1977–79 with the period 1981–83, there has been a dramatic increase in the fiscal deficits of governments of the industrial countries from about 1 percent of their national incomes to about 5 percent of their national incomes. Comparing these same periods, the OPEC countries moved from substantial payments surpluses to actual payments deficits. These developments imply a massive increase in the net demand for loanable funds by the combination of the governments of the industrial countries and the OPEC countries. In light of this development, it is perhaps not so surprising that the level of real interest rates has moved from minus 2 or 3 percent in 1977–79 to plus 4 or 6 percent in 1981–83.

The other major development that is related to the situation of debtor countries and to U.S. economic policy since 1979 is the strong appreciation of the U.S. dollar. In nominal terms, the U.S. dollar has appreciated about 25 percent in terms of a trade-weighted basket of the currencies of the other industrial countries. Corrected for movements in national price levels, the real appreciation of the U.S. dollar relative to a trade-weighted basket of these currencies has been even greater. In my judgment, a substantial fraction of this real appreciation can be attributed to the change in the actual and perceived stance of monetary policy in the United States. In the late 1970s, it was

[8]Historical evidence does not suggest a strong, or even a positive, correlation between deficits and real or nominal interest rates. Such evidence, however, may not be relevant to the present case of a large structural deficit, in contrast to a deficit that is primarily cyclical.

widely believed that the Federal Reserve was pursuing a relatively loose monetary policy and was tolerant of a high inflation rate. This belief led to a low value of the U.S. dollar in the foreign exchange markets and to the expectation that the value of the dollar would continue to decline. Since 1981, beliefs about the Federal Reserve's policy have changed. The Federal Reserve is now perceived as quite concerned about inflation—a concern that was demonstrated by its willingness to tolerate a long and deep recession and a prolonged period of very high nominal and real interest rates. This changed perception of the Federal Reserve's basic attitude toward inflation should have increased the attractiveness of holding dollars relative to other national currencies and thereby have strengthened the foreign exchange value of the U.S. dollar. In addition, it may be that the higher level of real interest rates in the United States made necessary by the government deficit has attracted foreign capital to the United States (to finance part of this deficit) and has thereby contributed to the strength of the U.S. dollar in foreign exchange markets.

These developments in U.S. economic policy since 1979 have adversely affected the situation faced by developing countries with substantial amounts of foreign debt. First, the high level of nominal and real interest rates since 1981 has increased substantially the amount of interest that these countries must pay on their external debts. Indeed, since nominal interest rates in the United States in 1981–82 were about double the level of 1978–79, the interest component of dollar-denominated loans was approximately doubled between these two periods. In addition, the much higher level of real interest rates means that the amount of real interest that a debtor country must pay to keep the real value of its debt constant has risen from a negative level to 4 percent to 6 percent per year on its outstanding dollar-denominated debt. This has meant a significant deterioration of the apparent credit-worthiness of many developing countries according to the conservative standard of being able to pay at least the real interest that is due on their outstanding debt.

Second, the strong real appreciation of the U.S. dollar has sharply increased the real value of the outstanding debt of developing countries, most of which is denominated in U.S. dollars. Thus, the real debt service that must be paid to keep the real value of debt from expanding has risen both because of a higher real interest rate and because this real interest rate is applied to a higher real value of outstanding debt. In addition, the real appreciation of the U.S. dollar has meant a decline in the real value of the exports of many developing countries to the industrial countries. This is so because many

developing countries sell their goods not only to the United States but also to other industrial countries, and the decline in the real foreign exchange value of the currencies of these other industrial countries has been associated with a decline in the real dollar value of the exports of developing countries to these industrial countries.

Third, the export earnings of developing countries have fallen since the late 1970s as a consequence of the deep recession that has afflicted the industrial nations. This decline in export earnings has contributed directly to concerns about the credit-worthiness of developing countries with large external debts because export earnings represent the foreign income that might be available to service these debts. In addition, the decline in exports of developing countries has contributed to the general decline in output and employment in these countries, which has made it more difficult for their governments to pursue restrictive monetary and fiscal policies that would increase the net foreign income available to service external debts. To the extent that tighter monetary policy in the United States has contributed to recession in this country and elsewhere in the industrialized countries, therefore, it has contributed through these mechanisms to the problems faced by developing countries and the international financial system with respect to the external debts of developing countries.

Fourth, for reasons already discussed, higher real interest rates have contributed to the debt problems of developing countries. To the extent that large actual and prospective deficits of the U.S. government have contributed to a higher level of real interest rates, therefore, they have contributed to these problems and hence to the crisis in the international financial system. In effect, one could argue that the large fiscal deficit of the U.S. government and the governments of the other industrial countries has crowded developing countries out of the world credit market and has forced up interest rates on their already outstanding loans.

Conclusion

The preceding discussion has emphasized the role of U.S. economic policy in the evolution of international debt problems of the developing countries during the 1970s and in the culmination of these problems in the crisis that has beset the international financial system since 1981. Rather than reviewing the main points of that discussion, it is appropriate to conclude this paper by mentioning some important qualifications. The problems currently confronting debtor countries and the international financial system are certainly

not the sole responsibility of the U.S. government. Excessive borrowing by some developing countries and imprudent lending by some financial institutions have also played important roles. So too have changes in economic conditions affecting output and employment levels, trade volumes, interest rates, and prices that were the consequences of policies of other governments or were beyond the influence of any government policy. Moreover, while there has been a tendency in this country to disregard the role of U.S. government policy in contributing to the current crisis of the international system, our policy has generally not contributed to this crisis because of a calculated attempt to improve the economic position of the United States at the expense of other countries. On the contrary, the United States suffers harm from the current disarray in the international financial system and would suffer greater harm if there were a general breakdown in this system that might occur in the event of an outright default by one or a number of developing countries with substantial external debts. We also suffer significant economic harm from depressed levels of economic activity in many debtor countries, and we would almost certainly benefit from any development that would allow these countries to meet their external obligations without such serious sacrifices of output and employment. Finally, it should be emphasized that the policy developments in the United States that contributed most seriously to the current problems of debtor countries and of the international financial system were generally errors of policy conduct from the standpoint of purely domestic economic objectives. The relatively easy monetary policy of the United States in the late 1970s which contributed to the growth of borrowing by developing countries was harmful to the United States by fueling an acceleration of inflation. This policy and the flip-flop in monetary policy that occurred in 1980 were also harmful because they made it necessary for the Federal Reserve to pursue a tight monetary policy for a long time in 1981–82 in order to reduce inflation and restore the credibility of the monetary authority. Thus, the record shows that a macroeconomic policy that adversely affects the U.S. economy is also likely to be bad for the rest of the world. Conversely, I believe that a more stable and predictable macroeconomic policy in the United States would serve our interests while serving the interest of the rest of the world.

RESOLVING THE DEBT PROBLEM: SOME POLICY CONSIDERATIONS

Karl Brunner

Introduction

The debt problem examined by Michael Mussa (1984) attracted the attention of the Shadow Open Market Committee during the summer of 1982.[1] I had an opportunity at the time to discuss the international debt problem in detail with my friends at the Swiss National Bank. These discussions alerted me to the deep concern about international financial developments among central bankers. The emerging situation clearly demanded careful attention. A systematic clarification of what proper policies should or should not do became quite urgent at the time. A sudden crisis was widely expected to threaten the world with a deflationary collapse. Fears of such economic collapse motivated proposals for monetary reflation or schemes to bail out creditor banks or debtor nations. Economic collapse was certainly possible, but would require remarkable mismanagement by policy makers. Neither inflation nor bail-out policies were moreover required to exorcise the threat of a depression triggered by a financial crisis.

A successful policy should thus be designed to avoid deflation on the one side and also avoid renewed inflation or bail-out schemes on the other. The longer-run dangers associated especially with the latter schemes seemed to be essentially neglected in public discussions. Bail-out schemes only postponed the adjustments needed in the balance sheets of creditor banks and the policies pursued by debtor nations. Most important, neither bail-outs nor renewed inflation are necessary to prevent worldwide economic disaster.

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[1]See the Shadow's *Policy Statement and Position Papers*, September 1982.

The uncertain drift in policy motivated me to assemble some friends to form the Ad Hoc Committee on International Debt. We met in January 1983 in Washington, D.C., and issued a statement presenting three guidelines for policy makers: Policy needs to be aimed at avoiding deflation, inflation, and any bail-out.[2] Our statement discussed in some detail the nature of the policies required. It elaborated in particular the importance of the "lender of last resort" function and differentiated this function from bail-out schemes. A liquidity crisis can be effectively handled by the "lender of last resort" without operating a bail-out; that is, assuming the losses of bad credits initiated by creditor banks. We also emphasized that technical insolvency would not justify the closure of a bank. It should be encouraged to continue as an operating unit, possibly under a new management, and its earnings should be used over time to write off the losses on credit accounts.

Explaining the Debt Problem: Two Hypotheses

In choosing suitable policies to cope with the debt problem, we need to recognize the conditions responsible for the problem. An examination of these conditions forms the basis of Mussa's paper. Two major and conflicting hypotheses emerge in discussions of the origins of the debt problem. One hypothesis attributes the current debt problem to general and worldwide economic conditions. These conditions, however, are not systematically connected with special patterns of debtor nations. The alternative hypothesis addresses an array of specific arrangements and conditions characterizing *some* debtor nations. Among these conditions the political structure and its operation loom with particular force. The monetary and fiscal policies, the exchange rate and trade policies, and the evolution of the government's police powers in economic matters form the core of the relevant specific conditions.

I wish to make clear at the outset that the first hypothesis is quite erroneous in spite of its frequent occurrence in the public arena. It fails to explain some crucial facts about the noteworthy variation in the economic fate observed among debtor or creditor nations. We encounter a similar issue in the context of the inflation problem. The rate of inflation expressed by the movement of the general price level informs us about the location, or position, of the distribution of price changes. It reflects the common element contained in all price changes dominantly attributable to monetary evolution. But this information

[2]See Brunner et al. (1983).

cannot tell us what items exhibit price changes in the upper tail of the distribution. The items placed under the upper or the lower tail experience specific allocation effects independent of the common strand. The typical occurrence of a substantial variance of the pattern of price changes implies therefore that specific characteristics of items appearing in the upper or lower tail cannot be explained in terms of the general or common strand. Information is required about specific market conditions, about allocative factors shaping the real conditions affecting one market relative to other markets.

The general conditions adduced under the first hypothesis are the OPEC oil-price shock and the worldwide simultaneous shift from inflationary to disinflationary policies. But the common experience of two OPEC price shocks affected some debtor nations very differently. Mexico and Venezuela gained, whereas Taiwan, Brazil, and Argentina lost as a result of these events. Some debtor nations also gained at the cost of creditor nations. The OPEC shock did not systematically discriminate against debtor nations in favor of creditor nations. Similarly, the shift in policy from inflation to disinflation initiated around 1980 cannot explain the difference between Mexico, Brazil, and Argentina on the one side and Korea, Taiwan, Singapore, and Malaysia on the other. An unexpected change from inflation to disinflation does impair the economic position of debtors. It tends to raise the real burden of their debt service to the extent that they are locked into long-term debt at high nominal rates of interest which are not adjustable to new market situations. But the significant variance in the experience of debtor nations, independent of the comparative magnitude of their foreign indebtedness, remains a decisive fact incompatible with the first hypothesis.

This fact compels us to look beyond the common strand. We need to examine the specific situation of individual debtor nations. The large differences observed in the economic fate of debtor nations seems moreover not to depend on the relative magnitude of their indebtedness. The variation observed needs to be associated with national differences in economic arrangements, policy institutions, and domestic policies.

Mussa correctly emphasizes that our financial policies contributed little to alleviate the international debt problem. The policy of uncertainty and drift prevented the return to single-digit interest rates, lowering the debt service burden of debtor nations. But other nations, debtors and Western developed nations, could modify the consequences with suitable strategies for their own policies. Some nations, however, chose "to dig even bigger holes" of their own and pro-

ceeded on a somewhat reckless financial course, possibly encouraged by shortsighted foreign loan officers at some Western banks.

Policy Considerations

What are the policy conclusions derived from a recognition of the crucial significance attributable to domestic policies and internal institutional arrangements? I return for my answer to the statement of the Ad Hoc Committee on International Debt. The U.S. government needs first and foremost to replace the erratic and unpredictable course of monetary policy making with a stable and predictably noninflationary arrangement. The budget should be contained and balanced in order to avoid the remarkable spectacle of the richest nation tapping world savings in order to finance its budget deficits.

We also surely need to exorcise any threat of a deflationary collapse. This does not require that we bail out the creditor banks. Central banks should acknowledge and understand their role as lenders of last resort. This function could of course be misused and be converted into a hidden bail-out. It is therefore important that the lender of last resort does not absorb the losses of the creditor banks. These losses, however, should still be treated with some circumspection. The losses suffered on bad loans do not justify the closure of banks. They should be given an opportunity to generate a stream of earnings into the future. These earnings of an operating unit provide the basis for a gradual write-off of affected loans. A bail-out of creditor banks would create incentives among bankers to neglect careful evaluations of risk and systematically shift the risk to "government." This pattern would eventually encourage a "creeping nationalization" of the financial industry. A bail-out also imposes arbitrary and distorted standards on regulatory agencies. Once introduced for a particular purpose, political temptations will induce a wider application also to domestic affairs. Under the circumstances, the loan business would be increasingly guided by political criteria.

A bail-out of creditor nations, on the other hand, involves a continued supply of new and additional credits to debtor nations. The flow of new credits should ensure the continued servicing of the old debt. This amounts to a Ponzi scheme on a truly vast scale, and like all Ponzi schemes it will eventually collapse, involving much larger losses and more serious adjustment problems than currently required. An immediate initiation of necessary adjustments on the part of both debtor nations and creditor banks imposes over the longer horizon smaller costs on all parties involved. This process of adjustment is to some extent under way but should be systematically encouraged by

our regulatory agencies and our government. The gradual adjustments in balance sheets and the associated negotiations concerning outstanding loans will have all the appearances of a "muddling through," reflecting the groping toward unavoidable adjustment.

The moral hazard posed by the Ponzi scheme to "solve the debt problem" seems rarely recognized. Such schemes essentially encourage the debtor nations in troubled positions to continue their bad policies which contributed so effectively to the "debt crisis." We also hear that it is necessary to maintain exports of major industrial nations. In the absence of new credits to debtor nations, our exports would shrink by a large magnitude. The decline of exports would trigger a collapse of the world economy. This picture of doom is vastly exaggerated. Exports of industrial nations would probably suffer. But suitable domestic macro policies would effectively prevent any contractive spillover from export industries to the rest of the economy. The experience of Sweden and Switzerland in the early 1930s illustrates this point with remarkable force.

Is There an Insolvency Problem?

One particular aspect of debtor nations' positions needs our attention. We usually encounter references to their "insolvency problem." This phrase, however, obscures the real situation. These nations possess large quantities of real resources owned by the government. The government could raise funds to repay debt or service debt by selling its real assets or converting some debt into equity claims on domestic real resources owned by the government. We will be confronted, of course, with the objection that this is not politically feasible. This objection, however, establishes the crucial point. We do not face an insolvency problem but an *unwillingness* to service the accumulated debt once a history of misconceived policies produces a serious debt problem. We learn from this experience that the specific risks associated with individual private borrowers are a minor problem compared with the sovereignty risk posed by the behavior of national governments. There exist established procedures for the case of individual insolvency and these procedures provide some protection for the creditor. No such procedures exist for the context of sovereignty risks: International relations are not embedded in a legal system with an enforcement apparatus. International relations are best understood from the vantage point of an anarchy model. Such a model provides the background for a proper appreciation of the sovereignty risk.

Some Concluding Remarks

Let us now consider the role of macro-policies pursued by creditor nations. Mussa especially emphasizes interest rates, the dollar exchange rate, and the recession. He notes in particular that the recent recession was the largest since the 1930s. This is not the case for the United States in spite of assertions made to this effect in the media. But Mussa is right with respect to West Germany and probably also the OECD group as a whole. The recession certainly aggravated the debtor nations' debt burden. The shift from an inflationary policy to a disinflationary policy also created problems for domestic debtors in the industrial nations. But once more this recession cannot explain adequately the severity of the Argentinian, Brazilian, Mexican, or Venezuelan difficulties as contrasted with those of the other debtor nations. The point is that macro-policies did impose a burden on *all* debtors, but some pursued policies better designed to cope with a difficult situation while others chose to aggravate their problem with poorly conceived policies.

The interest rate problem also deserves some careful attention. At times Mussa appears to fall into the trap of attributing a higher level of interest rates to a restrictive monetary policy. It is a well-established fact, however, that while a restrictive monetary policy may initially raise short-term interest rates, it will eventually *lower* nominal rates. The trend of interest rates in the United States was actually downwards from 1981 to the spring of 1983.

My point, however, does not absolve the United States together with other industrial nations from responsibility for the high level of interest rates. A rising ratio of real debt to real income increased the basic real rate somewhat above the level prevailing in the 1960s. A policy of permanent inflation embedded a substantial inflation premium into nominal rates of interest. In addition, the uncertain course of financial policies generated a risk premium that became incorporated in the gross real rate of interest. This premium reflects the purchasing power risk attached to government bonds free of default risk. Lastly, our financial policies confronted the debtor nations with an additional risk. The foreign debt is usually denominated in the creditor nation's currency. Erratic financial policies raise the variability of exchange rates and thus amplify the debtors' risk associated with the debt service.

These aspects indicate that my initial emphasis on the role of debtor nations' domestic policies cannot excuse our own bad policies—a conclusion supported by Mussa. The United States is burdened with a particular responsibility in this respect. The failure to

discharge this responsibility affects all nations, debtor and creditor, including the United States. We need to develop some basic "rules of the game" bearing on the budget, monetary, and trade policy. These rules should offer a stable framework yielding stable expectations bearing on predictable patterns. An "institutionalization" of such policies discussed in the *Economic Report* for 1982 prepared by the President's Council of Economic Advisers would actually contribute to a major alleviation of problems imposed on the world by the U.S. government's uncertain drift.

The necessity of this redirection of U.S. policy, however, does not establish its sufficiency with respect to the resolution of the debtor nations' problem. The debtor nations ultimately need to attend to their own "house cleaning." Their own foolish policies and poorly conceived domestic institutions would create some debt problem even in the context of much wiser U.S. financial policies.

References

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