INTERNATIONAL DEBT: CRISIS AND CHALLENGE

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I. Introduction

Until the summer of 1982, the external debt problems of Eastern bloc and less developed countries (LDCs) were regarded as benign, or were ignored, by nearly all international financial and economic analysts and policy makers. Now, most observers share the conviction that these problems pose a current threat to the free world's financial and economic health and stability and must be dealt with quickly and forcefully. This study focuses on the present crisis. Longer term issues raised by the external indebtedness of Eastern bloc nations and LDCs will be dealt with in later studies.[1]

By all accounts, the external debts of Eastern bloc nations and LDCs are enormous. Government officials, financiers, economists, and the news media are urging that these countries be given help to cope. In opening hearings on "International Financial Markets and Related Problems" before the Committee on Banking, Finance, and Urban Affairs of the House of Representatives on 21 December 1982,

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Cato Journal, Vol. 4, No. 1 (Spring/Summer 1984). Copyright © Cato Institute. All rights reserved.

The author was Senior Economist for the Joint Economic Committee of Congress when this article was written. He alone is responsible for the analysis and conclusions of this study. Research assistance was provided by Rajni B. "Bonnie" Ohri.

The present paper is an edited version of the author's monograph, *International Debt: Crisis and Challenge*, Fairfax, Va.: George Mason University, Department of Economics, April 1983. The Cato Institute gratefully acknowledges the right to reprint the major part of the monograph in this conference volume.

Brackets are used to indicate additions to the author's original text and footnotes. The text has been left basically intact, except for several minor deletions. Several tables have been omitted, and these are noted in the footnotes. As a result, the numbering of footnotes and tables in the present paper does not conform to the original.—ED.

[1][The author intended the present study to be part one of a three-volume series on U.S. bank lending to LDCs and Eastern bloc nations. Part two of the series was published by George Mason University in August 1983, and entitled, *International Lending by U.S. Banks: Practices, Problems, and Policies*. Part three was never initiated.]

Chairman St. Germain referred to this call for help as the "conventional wisdom." He said, "These hearings . . . come against a backdrop of news reports about impending requests for an enormous new funding of the International Monetary Fund. The conventional wisdom suggests that the Congress should quickly and quietly vote the new funds, accept the Administration's and the Federal Reserve's rationale, and ask questions later—if at all." But, should the United States help these countries? If so, how? These are the current policy questions. My purpose is to clarify the issues involved and to provide guidance to the public and to policy makers who must resolve them.

From 1973 to 1982, Eastern bloc nations and LDCs and their residents greatly increased their borrowings from lenders in the United States and other developed free world countries. Few worried as the external debts of these countries and their residents mounted. Now, however, their debts are viewed ominously. They are regarded as serious threats to world trade, political moderation in LDCs, and to the financial and economic health and stability of the United States and other developed free world nations.

Concern is growing over whether some Eastern bloc nations and LDCs will be able to service their debts. Defaults have been avoided to date only because the United States and other developed free world countries and the Bank for International Settlements (BIS) have provided emergency "bridge" loans, private creditors have postponed scheduled loan repayments and extended new credits, and the International Monetary Fund (IMF) has granted timely longer-term loans.

Some analysts worry that smaller banks, which have gone along until now with postponing scheduled loan repayments and extending new credits, will soon balk, especially at extending new credits. In part, smaller banks do not want to assume additional risks. In addition, their access to dollar deposits, especially in the Eurodeposit market, has been constrained in recent months by depositors' "flight to quality." Thus, even smaller banks that want to participate in extending new credits to debtor nations and their residents are finding it difficult at the present time. This increases the pressure on large banks, and some of them are thought to be growing nervous about increasing their exposure to defaults by Eastern bloc nations and LDCs.

If there are widespread, major formal defaults, many fear that the U.S. banking system would collapse, world trade would fall precipitously, and the U.S. economy would plunge into a depression as terrible as the one experienced in the 1930s. There is added fear that if LDC defaults are avoided by pressuring LDCs into draconian

actions that decrease their imports and consumption, U.S. exports will be reduced and recovery from the 1981 to 1982 recession, which now appears to be under way, will be aborted. Such actions also could trigger widespread unrest in developing countries and political change—for example, the formation of a "debtors' cartel."

To some observers, the United States is caught in dangerous waters where, like the straits between Scylla and Charybdis, avoiding one disaster leads to another. If defaults and political change were the only dangers, we could steer a course between the two. But, in setting our policy course, it would be a mistake to assume that these are the only or even the greatest dangers we face. The greater peril may lie in the side effects of policies adopted to help debtor nations cope.

The remaining sections of this study examine the evolution and dimensions of the external debt problem confronting the Eastern bloc nations and LDCs (section II); the logic of the popular worst-case scenarios and the more likely sequence of events (section III); and solutions to the current Eastern bloc and LDC debt crisis (section IV).

II. Evolution and Size of the Problem

How Did It Happen?

The external debts of non-OPEC developing countries grew only moderately before the quadrupling of oil prices in late 1973 and early 1974. At the end of 1973, their medium- and long-term indebtedness was about $100 billion.[2] After 1973, as Chairman Willard C. Butcher of the Chase Manhattan Bank observed, "the pace of lending accelerated with the world's major banks playing the leading role." By the end of 1982, non-OPEC developing countries' medium- and long-term indebtedness was $520 billion.

The 1973 and 1974 increases in oil prices provided both financial resources and motive for a jump in external borrowing by non-OPEC developing countries. The increases in oil prices generated huge current account surpluses for OPEC members. Every year, billions of dollars were transferred to OPEC members from oil importing nations. The aggregate current account surplus of OPEC member nations rose from only $7 billion in 1973 to $68 billion in 1974.

[2]Estimates of indebtedness usually exclude short-term debt; that is, debt with an original maturity of less than one year. However, the magnitude of the problem is reasonably accurately measured by medium- and long-term debt alone because the short-term foreign financial liabilities of non-OPEC developing countries are not significantly larger than their short-term foreign financial assets.

In the mid-1970s, while planning what to import, Saudi Arabia and other OPEC members used their new surpluses to purchase deposits from free-world banks, thereby providing financial resources for expanded bank lending to non-OPEC developing countries. At the same time, higher oil prices caused non-OPEC developing countries greatly to increase their credit demands. Non-oil producing countries had to do so in order to finance the huge current account deficits they experienced as they sought to maintain physical oil imports at pre-1973 levels and to continue to provide for growth through capital imports. Oil producing countries outside OPEC, such as Mexico, did so in order to develop their oil resources and to provide for growth in other sectors of their economies.

The match was obvious. In the mid-1970s, banks recycled OPEC's surpluses to non-OPEC developing nations. If banks had not matched the new petro-deposits to the new credit demands of non-OPEC developing nations, if they had loaned the funds to other entities instead, some of these other entities or those to whom the funds were transferred, further down the line, would have done the recycling. Where arbitrage opportunities exist, there are certain to be arbitragers.

By 1978, the OPEC current account surpluses virtually disappeared as OPEC nations more closely matched imports to exports. They quickly reappeared as a result of the effects of the Iranian revolution on oil prices in 1979 and 1980. However, by 1982, they had dwindled once again.

The credit appetites of non-OPEC developing nations did not decline as the current account surpluses of OPEC members fell in 1978 and again after 1980. As David P. Dod of the Federal Reserve Board's Division of International Finance pointed out (*Federal Reserve Bulletin*, September 1981): "An increase in public-sector and private borrowing combined has been necessary in view of economic policies in developing countries that have contributed to higher, sustained deficits in the current account of their balance of payments." The underlying policies were extremely rapid money growth and huge budget deficits continuing year after year. These policies produced inflation. With exchange rates fixed or at least sticky, inflation reduced exports and increased imports, and thus acted to increase current account deficits.

Non-OPEC developing countries had to borrow to finance their current account deficits or else abandon the policies that were perpetuating the deficits. Not all of them perpetuated inflationary policies. Some, especially in Asia, reduced money growth in the early 1980s. But some Latin American nations pursued inflationary policies

throughout the late 1970s and early 1980s. These countries had to borrow.

Banks in the United States and other developed free world countries were eager to lend to Eastern bloc nations and LDCs in the late 1970s and early 1980s in part because they underestimated the risks, but also because lending opportunities in their own markets were squeezed. Their own market opportunities were squeezed because real wages increased unsustainably, especially in Western Europe. European trade unions were able to raise nominal wage rates faster than prices were rising. The ratio of wages to Gross Domestic Product in most major Western European countries increased substantially in the late 1970s. As a result, the demand for loans by businesses in Western Europe was dampened, and U.S. and other multinational banks limited their lending activities in Western Europe and expanded them in the United States and Eastern bloc nations and LDCs. And because the increased competition from multinational banks in U.S. markets left many primarily domestically oriented U.S. banks with fewer loan customers in the United States, many of these banks were impelled to begin or to step up their lending to Eastern bloc nations and LDCs.

The Organization for Economic Cooperation and Development (OECD), in its *External Debt of Developing Countries 1982 Survey* [hereafter, *1982 Survey*], estimates that bank medium- and long-term loans to non-OPEC developing countries increased from $69 billion at year-end 1977 to $182 billion at year-end 1982, an increase of $113 billion. Other private lending to borrowers in these countries increased from $20 billion to $46 billion. These loans do not include credits to finance exports to these countries, which jumped from $45 billion to $105 billion during the same period.

Export credits aside, the new private credits to non-OPEC developing country borrowers were used to finance private business investments and government construction and development plans, including delivery of extended and upgraded education services. However, some of the new credits were used to finance increased consumption. Not all of the investments that were made with the new loans were sound, nor were all of the construction and development plans sensible. Further, parts of some loans were dissipated in corruption. By the second half of 1982, it was clear that there were problems.

Referring to the massive debt structure built up in recent years, Wall Street financial analyst Henry Kaufman said (*Washington Post*, 19 September 1982): "It has financed . . . not a large amount of economic efficiency, but for a long while a large amount of inflation. But

now we have it, it is there, it has a maturity schedule and it has an interest payment." A comprehensive analysis of what went wrong would not help us to clarify whether the United States should help debtor nations to cope, and, if so, how; nor would it provide guidance to the public and to policy makers, who must resolve the issues. To most analysts, however, it is clear that lenders as well as borrowers are to blame for the abuses and excesses that occurred.

The OECD put it this way in its *1982 Survey:* "It appears in retrospect that certain developing countries have borrowed unwisely (as indeed have some other borrowers), using some of the resources to finance consumption and investments of dubious value, rather than to strengthen their productive potential." They were able to do so because creditors, primarily banks, did not constrain their lending by adhering to normal prudent standards. Rather, "overeagerness by banks to lend has sometimes allowed borrowing governments to delay necessary adjustments."

Some would absolve banks from blame. They argue that banks would have been less eager to lend to developing countries if they had had reliable, current information about the total indebtedness of the countries to whom they were lending. Through 1982, each bank had timely information only on its own loans. However, the argument is not persuasive. One large regional bank, the National Bank of Detroit, as reported by Sanford Rose of the *American Banker,* stopped lending to Mexico by the end of 1981 based on an in-house analysis of the risk involved. Furthermore, all banks should have understood the risk of operating without full information and tempered their eagerness to lend to developing countries accordingly. As it was, some banks made loans in excess of their capital to countries that are now having trouble meeting their debt-service obligations.

Regardless of how much blame should be assigned to borrowers and how much to lenders, by the summer of 1982 it was clear that some LDCs and Eastern bloc nations were having trouble servicing their debts, that their bankers were becoming concerned and reluctant to extend new credits and in some cases to renew maturing credits, and that some banks, including some in the United States, had made loans to these countries in excess of their capital, sometimes in disregard of the advice of in-house specialists on sovereign risk. These elements define the current crisis.

Those who look for proximate causes will tie the emergence of the present debt crisis to the 1981 to 1982 disinflation and recession. During recessions, especially when accompanied by substantial disinflation (to build a springboard for sustainable growth), as in 1982, debts are not easily serviced by debtors, nor are they automatically

renewed by lenders. This view of the emergence of the debt problem has been popularized by the press. The *New York Times*, for example, wrote on 9 January 1983, that "what has really gone wrong in the third world can be traced to the weak world economy rather than to an overextension of credit by greedy commercial bankers or extravagant borrowing by imprudent leaders of developing nations." The *Washington Post* wrote on the same day, "The recession has sent to the brink of bankruptcy countries once thought to be impeccable credit risks . . . [depressing] demand prices for commodities that are the mainstay of the developing world."

However, disinflation and recession in the 1981 to 1982 period did not occur in an historical vacuum but followed a wave of inflation that began in 1977. The debt crisis can be tied to that inflationary surge. Advocates of this view need not dispute that the debt buildup financed "a large amount of inflation," as Kaufman pointed out, or that initially the inflation was associated with robust growth figures. Early on, the chain of causation definitely runs from debt accumulation and money creation to inflation and growth. Later on, however, the chain of causation runs the other way—from inflation to debt accumulation and recession. Inflation undermines household, business, and government balance sheets. It creates an atmosphere in which debtors flourish and become eager to borrow, often without regard to risk, while lenders downgrade risks. As a result, careless practices creep into the lending process and indebtedness increases dangerously. At the same time, even if it is periodically ratcheted upward, inflation inevitably produces recessions. Since, as balance sheets deteriorate, production and spending fall, especially capital formation and investment spending.

The inflationary surge of the late 1970s to 1981 is legitimately viewed as the underlying cause of the present debt crisis. The 1981 to 1982 recession period was the trigger event. The recession suppressed demands for goods and services generally, and because commodity and raw materials markets are relatively competitive, commodity and raw materials prices declined relatively more than the prices of intermediate and finished goods. In fact, the latter continued to increase on average.

On balance, non-OPEC developing countries export commodities and raw materials and import intermediate and finished goods. Thus, the 1981 to 1982 recession raised their trade and current account deficits. At the same time, at least until recently, high interest rates raised the costs of financing current account deficits and refinancing maturing debt. As a result, many non-OPEC developing countries

have found it difficult—and sometimes impossible—to meet their debt service obligations.

High interest rates, which resulted primarily from the inflationary surge that preceded the 1981 to 1982 recession, had an even more devastating impact on the ability of some LDCs to meet their debt-service obligations. During the inflationary surge of the late 1970s, the interest rates at which Eastern bloc nations and LDCs borrowed were generally below the U.S. inflation rate. As a result, the real cost of carrying external debts was negative during this period. However, market interest rates rose dramatically in the 1979 to 1981 period, only recently have they dropped below 1979 levels. As short-term market interest rates rose, loan rates also rose both on new and maturing loans and on debt subject to variable or floating interest rates. In 1981 and the first half of 1982, the interest rates paid on debt subject to floating interest rates averaged substantially higher than the U.S. inflation rate. For nations with a large part of their debt consisting of floating-rate loans, the consequences were deadly.

The OECD *1982 Survey* estimates that for Argentina, Brazil, Mexico, and their residents, "about three-quarters of their total [gross] debt was due to private markets at variable interest rates and without official support from OECD governments [compared with under 20 percent for most developing countries]." A 1 percentage point increase in the London Interbank Offered Rate (LIBOR) means an increase in yearly net interest payments, calculated on 1982 indebtedness, of $593 million for Mexico, $455 million for Brazil, and $205 million for Argentina. It is easy to see how higher interest rates in the 1981 to 1982 period greatly strained the abilities of these nations to meet their debt service obligations.

The "debt-bomb" can be disarmed. Economic recovery is under way in the United States and other developed countries. That will increase developing countries' capacities to service their external debts. Interest rates are down. That will reduce the burden of their debts. But even though the bomb need not go off, and in my view won't, it might. The merchandise trade surpluses of developing nations will not increase automatically in future years. Investment income will not necessarily grow. Loan interest rates, which have fallen substantially since the spring and summer of 1981, might rise again. If the trade and investment accounts of developing nations do not improve, or if they worsen, and if interest rates rise again, then in the absence of generous loan reschedulings or heroic official aid, widespread, major formal defaults are inevitable. It is important, therefore, to understand how widespread, major debt repudiation

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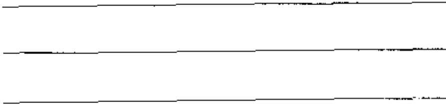

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would affect the U.S. banking and monetary systems and how it would affect U.S. exports, GNP, and employment. Whether we should help developing nations cope with their debts depends crucially on the analyses of these issues. Before analyzing these issues, however, it is useful to discuss the dimensions of the external debts of Eastern bloc and less developed countries, the exposure of U.S. banks, the abilities of individual countries where U.S. bank loans are concentrated to meet their debt service obligations, and whether our banks have enough capital to absorb defaults.

The External Indebtedness of Developing Countries

How much do Eastern bloc nations and LDCs owe in total? Hobart Rowan wrote (*Washington Post,* 19 October 1982): "No one really knows." But he reported that "a high-level World Bank official said that if everything were known about the super-secret world of banking, the real global total would probably add up to something close to $750 billion." Official estimates are somewhat lower.

The World Bank estimates that at year-end 1981 the medium- and long-term debts of 98 developing countries totaled $462 billion. The International Monetary Fund estimates that the medium- and long-term external debts of non-oil developing countries totaled $437 billion at year-end 1981 and rose to $502 billion at year-end 1982. The OECD estimates that the outstanding disbursed medium- and long-term external debts of non-OPEC developing countries, including Eastern bloc nations, totaled $445 billion at year-end 1981 and increased to $520 billion at year-end 1982. Including members of OPEC, the medium- and long-term indebtedness of the world's developing countries is estimated to have been $530 billion at year-end 1981 and to have increased to $626 billion at year-end 1982.

Official estimates exclude short-term debt; that is, debt with an original maturity of less than one year. The 1982 gross short-term external indebtedness of developing countries exceeded $120 billion for non-OPEC developing countries and may have been as much as $175 billion for all developing countries. However, the short-term foreign assets of developing countries, including non-OPEC developing countries, are about the same as their short-term foreign debts. Thus, it is appropriate to ignore short-term debt in estimating the total external indebtedness of developing countries. In contrast, the medium- and long-term foreign assets of developing countries fall far short of their total external medium- and long-term debts.

The OECD data show that U.S. and other free world bank medium- and long-term loans other than export credits were $182 billion,[3] or 35 percent of the grand total, and that more than 20 percent of all loans were at "concessional" rates and terms.[4] From an analytical standpoint, the importance of the first fact is that exposure of the free world's banking system to defaults by Eastern bloc nations and LDCs is much less than their total indebtedness; excluding export credits, it was $182 billion at year-end 1982. The importance of the second fact is that the burden of the external debts of developing countries cannot be gauged by looking only at the size of their debts.

The total medium- and long-term debt of Eastern bloc nations and LDCs and the bank subtotal are dramatic statistics, but they are not meaningful ones, since they differ depending on what nations are aggregated in estimating them, and the bank debt subtotal also depends on whether export credits are included. Moreover, the fact is that there is no aggregate Third World debt problem. Banks are exposed significantly in some developing countries and hardly at all in others. Further, different countries have different capacities to handle debt, and their capacities will be affected differently by the same event; for example, by a change in the price of oil or in interest rates. Debt, as the OECD points out, is "a phenomenon which manifests itself at the level of individual countries, rather than in aggregates and averages." Country specific data on the exposure of U.S. banks and the ability of LDCs to service their external debts are discussed in the sections that follow.

Exposure of U.S. Banks

In its *1982 Survey*, the OECD estimated that if all borrowers, sovereign and private, in all non-OPEC developing countries in Eastern Europe, Latin America, the Caribbean, Asia, and Africa repudiated their year-end 1982 external debts, U.S. and other free world banks would face balance sheet write-offs of $159 billion. The OECD, in its tabulation of data on "Lending and 'Exposure' of Banks to Non-OPEC Developing Countries," provided the following estimates of outstanding disbursed amounts at year-end 1982:

[3]In testimony before the House Banking Committee on 2 February 1983, Federal Reserve Board Chairman Paul A. Volcker stated that non-OPEC developing countries owed banks here and abroad $268 billion and their total debt was $550 billion in mid-1982. However, the Federal Reserve's $268 billion subtotal includes certain export credits that are not included in the OECD's $182 billion subtotal. This accounts for the major part of the difference between the two figures.

[4][See Table 1, p. 13, in *Crisis and Challenge*, 1983.]

Bank Credits and Exposure		$ Billion
1. Short-term credits		134
2. Medium- and long-term credit		231
A. Officially guaranteed export credits	49	
B. Financial loans and credits	182	
3. Total outstanding (1+2)		365
4. Deposits with BIS banks		157
5. Total net bank "exposure" (3–4)		208
6. Net bank "exposure" excluding guaranteed export credits (5–2A)		159

The 1982 exposure of U.S. banks was less. Data from the Federal Reserve Board's June 1982 *Country Exposure Lending Survey* show that, as of June 1982, adjusted for guarantees, U.S. banks were owed $343.6 billion by foreign borrowers.[5] However, $196.7 billion of this total was owed by borrowers in developed countries. With the exception of Spain, the risk of default by borrowers in developed countries is trivial. Borrowers in non-OPEC developing countries in Eastern Europe, Latin America, the Caribbean, Asia, and Africa owed $108.2 billion to U.S. banks at mid-year 1982. Of this amount, $69.6 billion was owed by borrowers in Latin American and Caribbean countries and $27.7 billion by borrowers in Asian countries.

The Federal Reserve Board data also show that the nine largest U.S. banks were owed $65.6 billion by borrowers in non-OPEC developing countries. The next fifteen largest banks were owed $21.7 billion, and all other banks were owed $21.1 billion by borrowers in these countries. Loans to borrowers in Eastern Europe, Latin America, the Caribbean, Asia, and Africa comprised 32 percent of all foreign loans made by the nine largest banks, 33 percent made by the next fifteen largest banks, and 29 percent made by all other banks.

Using the Federal Reserve Board's survey data, a country-by-country examination of U.S. banks' foreign loans show concentrations to borrowers in seven non-OPEC developing countries: Argentina, Brazil, Chile, and Mexico in Latin America, and Korea, the Philippines, and Taiwan in Asia. The exposure of U.S. banks to defaults by borrowers in these seven countries was $79.5 billion in mid-1982. Nearly 75 percent of all U.S. bank lending to non-OPEC developing nations was to these seven countries: $25.2 billion was to Mexico, $20.5 billion to Brazil, $8.8 billion to Argentina, $6.1 billion to Chile, $9.2 billion to South Korea, $5.3 billion to the Philippines, and $4.4 billion to Taiwan.

[5][See Table 2, p. 15, in *Crisis and Challenge*, 1983.]

It appears, then, that among non-OPEC developing countries, U.S. banks would be highly exposed if Mexico and Brazil repudiated their debts, and exposed to a significant extent if South Korea, Argentina, Chile, the Philippines, and Taiwan defaulted. This is not to say that formal defaults by borrowers in other nations would not prove troublesome. Among OPEC nations, however, the exposure of U.S. banks in June 1982 was significant (over $3 billion) only in Venezuela, where U.S. banks were owed $10.7 billion. Among developed nations, exposure was substantial in all G-10 [Group of Ten] countries,[6] plus Switzerland, Australia, Denmark, Norway, South Africa, and Spain. Of these countries, however, the risk of default is considered trivial except in the case of Spain, where it is considered low but nontrivial. U.S. banks were owed $6.7 billion by borrowers in Spain at midyear 1982.

Ability of LDCs to Meet Debt Service Obligations

The OECD *1982 Survey* estimates that debt service payments of developing countries on their medium- and long-term external debts reached $131 billion during 1982, with interest payments accounting for $60 billion and amortization for $71 billion. For non-OPEC developing countries, interest payments were $50 billion and amortization $49 billion. Debt service payments by these countries to banks totalled $48 billion.

The OECD data on medium- and long-term indebtedness show that in 1982, 51 percent of the aggregate external debts of non-OPEC developing countries ($266 billion divided by $520 billion), 64 percent of their total debt-service payments ($63.3 billion divided by $93.8 billion), and 67 percent of their interest payments ($33.2 billion divided by $49.7 billion) was held and paid by borrowers in newly industrializing countries (NICs).[7] NICs—the most advanced and developed LDCs—paid more interest relative to their indebtedness than other non-OPEC developing countries. The data also indicate that both interest payments and total debt service (interest plus amortization) were somewhat higher percentages of both exports and GNP for NICs than for low income countries (LICs), middle income countries (MICs), and OPEC members.

The ratios of interest payments and total debt service payments to exports and GNP for NICs as a group are not crisis numbers. For example, 15 percent of aggregate NIC export earnings and 3.3 percent

[6][G-10 countries here are Belgium-Luxembourg, Canada, France, West Germany, Italy, Japan, Netherlands, Sweden, and the United Kingdom.]

[7][See Table 3, p. 17, in *Crisis and Challenge*, 1983.]

of GNP would fully cover the interest payments on NIC medium- and long-term external debts. However, it is not the group totals and ratios that matter. As the OECD notes, "Especially within the group of the NICs, there are enormous differences in the debt-service ratios of individual countries."

Country specific data show that nearly 45 percent of the total $131 billion debt-service payments made by developing countries in 1982 were made by Mexico, Brazil, Argentina, Chile, Venezuela, South Korea, the Philippines, and Taiwan—the developing countries where the exposure of U.S. banks to debt repudiation is significant. Debt service payments by these countries, plus Spain, in 1982, and the amounts they owed to U.S. banks at midyear 1982 are given in Table 1. Spain is a developed country, but since some analysts consider the risk that it will default to be nontrivial, it is listed here.[8]

TABLE 1

DEBT SERVICE PAYMENTS BY DEVELOPING COUNTRIES
(Billions of Dollars)

Country	Estimated Debt Service Payments in 1982	Amount Owed U.S. Banks at Midyear 1982
Mexico	18.5	25.2
Brazil	15.2	20.5
Venezuela	7.8	10.7
Spain	5.7	6.6
Argentina	4.9	8.8
South Korea	4.8	9.2
Chile	3.3	6.1
Philippines	2.1	5.3
Taiwan	2.0[a]	4.4
Total	64.3	96.8

[a]A precise estimate for Taiwan is not available. The figure given is a maximum.

SOURCES: OECD and Federal Reserve Board.

Traditionally, the ability of a nation to service its medium- and long-term external debts is measured by comparing its total debt-service charges (interest plus amortization) to its exports and its GNP, taking into account its reserves. These data are available only with a lag, however. Data for 1981 and 1982 are now available (see Table 2),[9] but they indicate only what was true, not what is now true. Conditions

[8][In the original monograph, Table 4.]

[9][In the original monograph, Table 5.]

TABLE 2

ESTIMATED MEDIUM- AND LONG-TERM DEBT SERVICE PAYMENTS, RESERVES, EXPORTS, AND GNP FOR COUNTRIES WHERE THERE IS A NONTRIVIAL CHANCE OF DEFAULT AND U.S. BANKS ARE SIGNIFICANTLY EXPOSED, 1981 AND 1982
(Billions of Dollars)

Country	Debt Service Payments 1982	Reserves 1981	Exports 1982	GNP 1981	Ratio of Debt Service to Exports	
					Exports	GNP
Mexico	18.5	4.2	26.3	230.7	.70	.080
Brazil	15.2	6.7	27.0[a]	274.2	.56	.063
Argentina	4.9	3.4	12.0	152.1[b]	.41	.024
Chile	3.3	3.3	6.1[a]	31.4	.54	.099
Venezuela	7.8	8.7	24.5[a]	67.0	.32	.090
South Korea	4.8	2.7	27.6[a]	63.4	.17	.063
Philippines	2.1	2.3	8.5[a]	39.7	.25	.040
Taiwan[c]	2.0	—	—	—	—	—
Spain	5.7	11.4	20.5[a]	—	.28	—

[a]1981.
[b]1980.
[c]Data are not available for Taiwan as it is not a member of the IMF.

SOURCES: World Bank, OECD, IMF.

now, early in 1983, are very different from what they were in 1981 and 1982; and they are almost certain to change as time passes. As conditions change, the debt-burden ratios change. In addition, traditional comparisons sometimes are distorted. For example, a financially strained country might shorten the maturity of its debt, reducing its payments to service its medium- and long-term debts. Thereby, its medium- and long-term debt-service ratios would be improved, even though its problems had worsened.

Because of the inevitability of change and the possibility of data distortions, the data for 1981 and 1982 must be used with utmost caution. With this caveat in mind, the data assembled in Table 2 show that the debt-service ratios of South Korea, the Philippines, and Spain were below or close to 1982 averages for all non-OPEC countries and that Venezuela's debt service to exports ratio was only moderately above the average.[10] Further, Spain and Venezuela had

[10][The debt service to exports ratio for all non-OPEC countries in 1982 was .24, and the debt service to GNP ratio was .056. See Table 3, p. 17, in *Crisis and Challenge*, 1983.]

large reserves at the end of 1981, although there are reports that they fell in 1982. In short, South Korea, the Philippines, Spain, and Venezuela were well able to service their debts in the 1981 to 1982 period, while Mexico, Brazil, Argentina, and Chile had difficulties. Brazil and Mexico were the most financially strained.

Economic conditions have changed in recent months. On the whole, it appears that it will be easier for all of the nations listed in Tables 1 and 2, excepting possibly Mexico and Venezuela, to service their debts in 1983 than it was in 1981 and 1982. First, it now seems clear that interest rates will be much lower, on average, in 1983 than in 1981 and 1982. As a result, all debtor nations will find it somewhat easier to service their debts in 1983 than in 1981 and 1982, especially nations with high proportions of their total debt in floating interest rate loans. A 1 percentage point decrease in LIBOR decreases Mexico's annual debt service payments by $593 million, Brazil's by $455 million, and Argentina's by $205 million. The calculations, which are based on 1982 indebtedness, assume constant spreads between floating loan rates and LIBOR. These are significant reductions. For Mexico, debt service payments are reduced by 3.2 percent for each percentage point reduction in loan rates; for Brazil, by 3 percent; and for Argentina, by 4.2 percent. LIBOR has fallen about 7 percentage points since mid-1982.[11] Even though spreads have increased somewhat, it is clear that in 1983, Mexico, Brazil, and Argentina will find it much easier to service their external debts than they did in 1981 and 1982.

Second, we are likely to see lower oil prices in 1983. A fall in the price of oil will decrease Mexico's and Venezuela's export earnings, decreasing their ability to service their debts. At the same time, lower oil prices will increase the ability of the other seven nations to service their debts, since their expenditures on imports will decrease. Interest rates could also decline further, helping even Mexico and Venezuela meet their debt service charges, although perhaps not enough to offset the loss of export earnings. Finally, partly as a result of the fall in the world price of oil, a stronger recovery from the recession that has afflicted developed countries is now expected. For most nations, this too will enhance their ability to service their debts.

Based on conditions as they now appear (early 1983), only Mexico and possibly Venezuela among countries where U.S. bank loans are concentrated and there is a nontrivial chance of default will have

[11][The six-month LIBOR decreased from 15.625 percent in June 1982 to 9.44 percent in April 1983. Since April 1983 the rate has *increased* to an estimated 12.50 percent in June 1984. (Data from the Federal Reserve Bank of New York.)].

difficulty meeting their debt service obligations in the foreseeable future. Even these countries have improved prospects compared to the 1981 to 1982 period in some respects.

Ability of U.S. Banks to Absorb Defaults

The ability of a bank to absorb debt repudiation depends critically on its capital. At midyear 1982, the total capital of U.S. banks was $66.2 billion: $27.1 billion represented the equity of the nine largest banks, $12.7 billion the equity of the next fifteen largest banks, and $26.4 billion the equity of all other banks. Loans to all developing countries at midyear 1982 were $131 billion, or about twice total capital. Loans to non-OPEC developing countries were $108 billion, or 1.6 times capital.

Country specific data on the dollar volume of loans by U.S. banks in the aggregate, classified by size, at midyear 1982 by the nine countries where debt problems significantly threaten U.S. banks show that if all nine countries repudiated their external debts and loans to them had to be written down to zero, the loss would represent 150 percent of the capital of our largest banks.[12] Defaults by Mexico and Brazil alone would wipe out 95 percent of the capital of the nine largest U.S. banks and 74 percent of the capital of the next fifteen largest banks.

In considering the possibility of formal defaults, however, it should be kept in mind that immediate write-downs of loans in default would neither be necessary nor desirable. The regulators can allow banks time to write down defaulted loans, and it would be disruptive for them not to do so. Sudden, sharp net worth reduction from writing down defaulted loans all at once could force some banks to close and others to be merged into stronger institutions, and would require many banks to liquidate loans in order to rebuild their capital to loan ratios. Although total lending (by all financial institutions) would not fall as a result, assuming responsible Federal Reserve behavior, significant local adjustments could be required. Nothing would be gained by this. Defaulted loans can be written off slowly, since bank capital tends to increase over time. Paul A. Volcker, Chairman of the Federal Reserve Board, stressed the latter point in a 30 November 1982, letter to Senator William Proxmire. Over the long run, he wrote, "it is reasonable to expect that the capital of the lending banks will increase at a rate of about 10 percent per annum."

In the event of defaults, given adequate time, banks collectively can absorb the losses involved. Banks that made the loans in default

[12][See Table 6, p. 22, in *Crisis and Challenge*, 1983.]

would have to reduce dividend payments as their defaulted loans were written down and most of them will find their profits reduced, but as long as there were profits the defaulted loans could be written down in time.

III. Worst-Case and More Likely Scenarios

On 12 September 1982, Leonard Silk *(New York Times)*, reporting on the Toronto meetings of the International Monetary Fund and World Bank, wrote,

> . . . the mood was more anxious and the warnings more dire than at any such gathering in memory.
>
> Just before the sessions began, Denis Healey, the British Labor Party's shadow Foreign Secretary and former Chancellor of the Exchequer saw the Toronto meeting of the I.M.F. as the "last chance to save the world from a catastrophe even greater than the slump of the 1930s."
>
> Countries such as Mexico, Poland and Argentina, he warned, found it impossible to pay their existing debts, let alone raise the capital to stay afloat. Many third-world countries, he said, face the prospect of economic collapse, political anarchy and starvation, adding: "The risk of a major default triggering a chain reaction is growing every day."

How seriously should such nightmare scenarios be taken? What actually would happen if one, several, or many Eastern bloc nations or LDCs repudiated their external debts? Suppose that some LDCs with large debts announce that they cannot or will not reschedule them, that they are not interested in renegotiating more favorable loan rates, even if lenders are willing to do so. Rather, they announce that they are not going to pay back their external debts, nor are they going to pay the interest on the loans.[13] Would U.S. banks "fall like ninepins?"[14] Would trade between these and even other LDCs and developed free world creditor nations stop? Would the U.S. economy plunge or sink into a 1930s depression?

Will Our Banking System Collapse?

Fear of widespread bank failures, banks falling "like ninepins," has made Eastern bloc and LDC external debt problems a major

[13]The analysis that follows and the conclusions that are drawn from it would be substantially or substantively changed if formal defaults by Eastern bloc nations were used to trigger events.

[14][The expression, "fall like ninepins" was used in the *Wall Street Journal's* 10 November 1982, scenario of the debt crisis. This scenario was described in *Crisis and Challenge*, pp. 24–25.]

news story in recent months. The *New York Times*, for example, reported on 10 October 1982, that "it is even conceivable that, in desperation, Mexico might join together with other countries and declare a unilateral moratorium on their debt repayments. . . . That, of course, could be disastrous for the world banking system and could cause the collapse that many people have been speculating about."

However, under analysis, the threat of widespread bank failures, of the collapse of our banking system, is found to be imaginary. Although some banks might fail, there is no reason why banks should "fall like ninepins," provided that the Federal Reserve "furnish[es] an elastic currency," as it is charged under law to do, and that bank regulators use common sense in dealing with the loss of bank capital from LDC defaults. These are the only safety nets required to keep our banking system functioning.

Heroic actions by policymakers are not needed to install the safety nets. The chairman and members of the First Federal Reserve Board, the chairman and directors of the Federal Deposit Insurance Corporation, and the Comptroller of the Currency need only give banks that hold defaulted loans on their books time to write them off. And the Federal Reserve, acting in its capacity as the nation's monetary authority, need only perform its long assigned "lender of last resort" role in a timely fashion. In essence, the Federal Reserve must keep the nation's money supply from contracting in the event of a run on banks.

Because the banking system collapsed in the early 1930s, some believe that it could happen again. As William R. Cline wrote in a 1982 essay for the Joint Economic Committee, "Most analysts consider such a scenario to be remote, although there is a historical precedent from the 1930s." However, what happened in the 1930s could have been prevented if the Federal Reserve had kept the money supply from contracting, as it could have done.

In the early 1930s, fear of bank failures drove depositors to demand payment in currency in massive measure. Banks liquidated other assets to replenish the currency they paid out. They called in demand loans, did not renew maturing term loans, and did not make new loans. As a result, the money stock, M1, fell by 27 percent, from $26.1 billion to $19.2 billion, between June 1929 and June 1933. The contraction of the money supply greatly exacerbated the economic contraction of 1929 to 1933.

The Federal Reserve could have supplied banks with reserves by making open market purchases or reducing the discount rate to encourage discounting on whatever scales were required to prevent a fall in M1. There was no statutory or logical reason for it not to have

done so. If it had, the fall in M1 would have been prevented and the decline in economic activity would have been small.

Discussing why the Federal Reserve failed to carry out its responsibilities in the early 1930s would take us too far afield. The crucial point is that the Federal Reserve still has the power to prevent monetary contractions in the event of runs on banks.

A run on banks today definitely is possible in the event of LDC defaults. Deposits in banks with substantial loans to LDCs or Eastern bloc nations, especially those holding defaulted loans, might be drawn down by worried depositors, and that would threaten the survival of those banks. However, such withdrawals would not threaten the banking system as a whole with an epidemic of failures, nor the economy with depression, unless worried depositors withdrew their money in currency. In that event, the continued functioning of the banking system would be threatened only if the Federal Reserve did not replenish the reserves lost because of the currency drain. Federal Reserve failure to act would compel banks to contract their deposit liabilities by reducing their loans and loan commitments. However, the Federal Reserve could easily replenish any lost reserves by purchasing U.S. Treasury securities on the open market or discounting eligible bank loans.

Assume that worried depositors demanded payment on their checkable deposits, saving accounts, and matured and maturing time deposits. Some would do so by transferring their deposits directly to other banks, others by writing checks to nonbank third parties, and others by demanding payment in currency. To the extent that depositors transfer their money from one bank to another, the banking system's consolidated deposit and reserve accounts would be unaffected, ignoring changes that could arise from the redistribution of deposits and reserves across deposit types and reserve classifications. What some banks might lose, other banks would gain. A zero-sum switch would also hold in the case of deposits that were withdrawn from problem banks by depositors writing checks to third parties. Whether those checks were written to purchase stocks, bonds, goods and services, or to paydown debts, payees' banks would gain the reserves and, directly or as a corollary, the deposits that payers' banks had lost. Systemwide accounts also would not be affected if some banks drew down their deposits in other banks. Neither the banking system's consolidated reserves nor its systemwide deposit liabilities are changed when interbank deposits are drawn down.

Even if depositors of problem banks insisted on payment in currency, there would be no difficulty if the currency were redeposited in other banks. It does not matter whether the redepositing is done

by former depositors of banks with defaulted loans or by persons and businesses who carry out transactions with them. If the currency were retained by the public, however, if the fear that motivated depositors to demand currency from certain banks spread to include the safety of deposits at all banks, there could be a systemwide problem. If the public's preferences for holding currency vis-à-vis deposits were permanently increased by the LDC defaults because of fears about the continued functioning of the banking system, a contraction of the money supply would ensue unless the Federal Reserve took preventive actions. However, the Federal Reserve can take preventive actions easily enough.

Assuming responsible Federal Reserve behavior, there will be no drop in the nation's money supply in the wake of LDC defaults. This means that banks will not "fall like ninepins." The nightmare case assumes that concerns about the safety of deposits in some banks are contagious. As a reult, deposits are converted to currency on a massive scale leading to multiple contractions of loans, deposits, and the money supply. It is further assumed that the process cannot be contained. The case is weak. The first assumption, that worries about the safety of deposits in banks with problem foreign loans will spread to cover the safety of deposits in other banks, is dubious and, moreover, is not sufficient to make the case. The second assumption, that the process cannot be contained, is definitely unwarranted. Even if worried depositors withdrew their deposits in currency from both problem banks and unexposed banks, the process could be contained by appropriate Federal Reserve open market purchases or discounting. These actions would prevent the money supply from contracting and the banking system from collapsing.

Widespread defaults by LDCs would not lead to the collapse of U.S. banking and money systems. They could lead to (1) a change in the composition of the money supply because the public may want to hold more currency relative to deposits, and (2) redistribution of deposits and reserves from banks with defaulted and exposed loans to other banks. Neither of these changes would have major perverse repercussions on the banking system (or the macroeconomy). To the extent that the public's preferences for currency increased, the banking system would be trimmed down by LDC defaults but hardly collapsed, and the money supply need not be affected. Some would even regard the trim-down of the banking system favorably. To the extent that deposits and reserves are redistributed, banks that had been least mindful of the risks involved in extending loans to LDCs and Eastern bloc nations would lose market shares to their more

prudent competitors. Many also would view this development favorably.

Data on bank capital and loans to LDCs and Eastern bloc nations show that for some U.S. banks, these loans exceed their capital (see section II). That means they could be declared bankrupt by the bank regulators in the event of widespread, major LDC defaults. It would be both unrealistic and foolish, however, for the bank regulators to close a bank or merge it for this reason.

It would be unrealistic to require that defaulted loans be written down to zero immediately after the default is announced. Placing a value of zero on repudiated loans assumes that the defaults will be permanent and never corrected and also that there will be no market price above zero for the loans. More important, it would be foolish for the regulators to require full and immediate write-offs of defaulted loans even if there were no nonzero prices for them and no reasonable prospect of payment. Defaulted loans should be written off over a period of years, and there is no reason why banks should not be given the time.

Even if they are given the time to write off defaulted LDC loans, some banks could find that they have to restrict or even contract loans to U.S. borrowers in order to bring their capital to loan ratios up to standard. That could cause painful local adjustments, which, however, would be minimal compared to what would be required if they were not given adequate time. Moreover, to the extent that some banks contract U.S. loans, other banks and nonbank financial institutions (savings and loan and other nonbank depositories, insurance companies, factors, etc.) will increase their lending, provided that the Federal Reserve supplies sufficient reserves to prevent a money supply contraction. The Federal Reserve may have to supply more reserves to maintain the same level of money, M1, and banks with resulting capital adequacy problems may have to call in or constrain U.S. loans; but total loans from all financial institutions to all U.S. borrowers need not fall.

Given commonsense behavior by bank regulators and appropriate actions by the Federal Reserve, the collapse of our money and banking systems can be ruled out even in the event of widespread defaults by LDCs. The U.S. banking system might be trimmed down, some banks could fail even if given time to write off LDC loan losses, and some painful local adjustment could be required. But the monetary and banking systems will continue to function, nonbank financial institutions will make up any falloff in bank lending, and our macroeconomic performance will sustain no blows that cannot be dealt with.

Will Defaults Depress World Trade?

World trade depends strategically on the continued availability of finance. As stated in OECD's *1982 Survey*, "In most DAC [Developed Assistance Committee] countries, a substantial part of bank credits to LDCs is related to export financing." The *Survey* estimates that export credits extended by the United States and other DAC countries[15] to non-OPEC developing countries totaled more than $100 billion at year-end 1982. DAC export credits were 20 percent of the total medium- and long-term external indebtedness of non-OPEC developing countries. These credits define the rock-bottom estimate of the importance of finance to trade between developed and non-OPEC developing countries.[16] In a more fundamental sense, however, nearly all of the external credit provided to non-OPEC developing nations and their residents is used to finance imports, reflecting the consideration that current account deficits have to be financed by borrowing or direct investment. If the required financing is not forthcoming, imports are likely to have to be cut to close the gap.

Debt repudiation by some non-OPEC developing countries would decrease lending by current creditors to the countries that defaulted. Creditors as yet not involved in lending to these countries could become emboldened to start lending to them, since their slates would now be free and clear of burdensome loans. But it is unlikely that new creditors would fully take up the slack. Formal defaults also would reduce unguaranteed lending by private creditors in developed countries to solvent developing countries and their residents. Default risks might even be revised upwards for loans to developed countries and their residents, which would reduce lending to those borrowers. It is almost a certainty, then, that if there are widespread, major formal defaults, there will be less private unguaranteed finance to lubricate the engines of international trade.

To some extent, less finance would be needed because the current account deficits of nations in default would be reduced since they will not be paying interest. However, it seems unlikely that some shortfall in export finance will not emerge. Unless the gap is filled by guaranteed loans, official aid, multilateral assistance, or loans from

[15][See Table 1, p. 13, in the original monograph.]

[16]The OECD notes that in addition to medium- and long-term export credits, "banks are providing considerable amounts of short-term credits with an original maturity of under one year (for both trade and roll-over purposes)." OECD external debt statistics do not include credits with an *original* maturity under one year. This omission is not serious, however, because for non-OPEC developing countries as a group, their short-term foreign assets are about the same as their short-term foreign liabilities.

CMEA countries (an improbable outcome), imports would have to be cut by most nations, especially developing nations. As a corollary, exporters would have to retrench, especially in developed countries.

Dr. Otto Emminger, former president of the German Federal Bank, told the Fifth Quadrangular Conference of the Center for Strategic Studies in September 1982 that

> a general move toward underlending would have on major effect. It would deprive a great number of developing countries of an essential source of balance-of-payments financing. . . . Last year the banks provided, on a net basis, $35 billion for the financing of developing countries. That is about one-half of the total net borrowing of these countries in this year. Now if there is too abrupt a cessation, or decline, in this lending, there may be a financing gap that cannot easily be filled by other institutions. And this might force a number of deficit countries to restrict their imports very sharply.

It is clear that the effects of formal debt repudiation on international financial flows and thereby on export and import industries throughout the free world would not be pleasant. But it is easy to overstate the case.[17] Another Great Depression can be ruled out.

Will Defaults Lead to Another Great Depression?

Discussions of the debt problems of Eastern bloc nations and LDCs are haunted by the specter of the 1930s. If the problems are not solved, so the story goes, if some of the nations are compelled (or impelled) to repudiate their external debts, the end result will be another Great Depression, an economic contraction on the order of magnitude suffered in the 1930s.

How could this happen? In the most popular nightmare scenario, the chain of causation leads from defaults to the collapse of the U.S. banking and monetary systems to the collapse of economic activity. But, as discussed earlier, this hypothesis assumes perverse actions by the bank regulators and irresponsible behavior by the monetary authorities.

[17]For example, in a front page *Washington Post* story on the Mexican debt crisis, 30 January 1983, Don Oberdorfer wrote, "Today about 20 percent of U.S. industrial output is for export involving one of every six U.S. production workers." Some readers might infer that if we don't resolve the Mexican and LDC debt crises, one of every six U.S. production workers will become unemployed. That inference is not warranted. Not all of our exports are sold to Mexico and other LDCs. We export industrial output to Japan, England, and other developed countries. According to *Time* magazine (10 January 1983), only one in every twenty manufacturing workers is employed producing goods for export to developing countries.

The analytical road from defaults by LDCs to another Great Depression does not have to pass through the collapse of our banking and monetary systems. A very different chain of causation has been hypothesized. It passes through the collapse of international trade.

Time magazine, in its 10 January 1983, cover story "The Debt-Bomb Threat," reported:

> The nations that buy many of the industrialized world's goods are the same ones that have borrowed so heavily. Any economic contraction on their part would boomerang back in the form of less demand by them for imports. The resulting deepening recession, so the theory goes, would further hurt the poorer countries, and so on and on. Once started, the process would be difficult to stop. The development dreams of the third world would come to a halt, stock markets would tumble, unemployment would soar, and world economic conditions would rival those of the 1930s.

To demonstrate that a lot is at stake, *Time* noted that:

> More than 40 percent of U.S. exports of commodities and services and one American manufacturing job in 20 hinge on sales to developing countries.

There is an element of truth in *Time's* scenario, but its conclusion is much too dismal. No doubt economic contraction in LDCs would compel a very painful adjustment in the United States. It would not, however, lead to an unending downward spiral of economic activity. Trade with developing nations would not cease if some repudiated their external debts. Even if it did, the effects on U.S. production and employment and unemployment would be far from cataclysmic.

The figures presented by *Time* cannot be used as is in evaluating the magnitude of the effects decreased exports to the developing world would have on total U.S. output and employment. Stating that 40 percent of U.S. commodity and service exports and one out of every twenty manufacturing jobs "hinge on sales to developing countries" can be misleading.

First, the term "developing countries" is too broad. It includes OPEC members, countries that do not find it difficult to service their debts, and countries whose external debts are largely to international agencies and other official lenders, often at low concessional interest rates. On average, OPEC members are creditor nations, and it is difficult to believe that those non-OPEC countries that can service their debts or that receive loans at concessional rates will repudiate them. At most, trade with these countries will fall only marginally, even if there are widespread loan defaults by other developing nations.

Second, it is difficult to believe that trade with nations that repudiate their external debts will be reduced to zero. At least some trade-related financial arrangements will be continued. Some new ones, with creditors as yet not involved, could be started; the slates of debtor nations will be wiped clean by their defaults and thus it will be relatively less risky to lend to them now. Alternatively, nations that default can use the money they get from exporting to finance imports on a cash basis; they will no longer be paying interest. There also will be barter and so-called countertrade arrangements where exporters accept goods from cash-short countries that can be exchanged for dollars or for other goods.

Third, although one in twenty U.S. manufacturing jobs and 40 percent of U.S. exports may "hinge on sales to developing countries," today only one job in five in the United States is a manufacturing job and exports are only 12 percent of GNP. Thus, only one in every hundred jobs and 4.8 percent of GNP "hinge on sales to developing countries" (where $.01 = .05 \times .20$ and $.048 = .40 \times .12$).

Finally, it must be understood that in market economies contractions of some sectors are eventually compensated for by expansions of other sectors. If trade declines, some of the resources previously employed in export industries will relocate in industries that produce goods and services previously imported, or close substitutes for them. There is an equilibrating mechanism at work, even though it does not work instantly or painlessly.

Taking these several factors into consideration, the effects of the falloff in U.S. exports that could be expected to result from major and widespread debt repudiation by developing countries would not be large enough to create another 1930s depression. Given the state of the art, it is impossible to say by how much U.S. real GNP would fall and unemployment would rise in the event of widespread, major defaults; but, all things considered, the fall in GNP is unlikely to exceed 1.5 percent and the rise in unemployment is unlikely to exceed 0.5 percent. These estimates are set forth as benchmarks for putting the debt crisis in perspective and helping to evaluate proposed solutions. I make no claim about their accuracy other than that they do not appear unreasonable.

What is Likely to Happen?

Even though permanent default is not in the long-run interests of debtor nations, their short-run interests might be served by debt repudiation. Former Secretary of State Henry Kissinger has warned (*Newsweek*, 24 January 1983):

> Because the debtors can never escape their plight unless they receive additional credits, the comforting view has developed that no debtor country would dare default and wreck its creditworthiness. Unfortunately political leaders march to a different drummer than financial experts. They see the political interests of their country through the prism of their own survival. If pushed into a corner, a political leader may well seek to rally populist resentment against foreign "exploiters." This will surely occur if the so-called rescue operation concentrates primarily on the repayment of interest. A blow-up is certain sooner or later if debtor countries are asked to accept prolonged austerity simply to protect the balance sheets of foreign banks.

William Ogden, vice president of the Chase Manhattan Bank, recognized—as did Kissinger—that if permanent defaults are to be avoided, debtors must be "economically capable of servicing debt over the long run [and] not so committed to ideological objectives as to give little if any weight to achieving reasonable long-run performance. . . ." He told the Manhattan Institute for Policy Research (22 October 1982) that if these conditions were satisfied,

> there is a *negligible* risk of permanent default or debt denial in sovereign lending because sovereign borrowers cannot cease to exist. Permanent default implies both a long-term loss of access to international private capital markets and a sharply reduced ability to utilize the international financial service network that is essential to the ordinary conduct of foreign trade. It implies that the great bulk of the international trade of a country in permanent default must be carried out on a government-to-government barter basis. Such restrictions would enormously circumscribe the pace of economic development for a country so affected. The negligible risk of permanent default arises out of the borrowing countries' perceptions of self-interest.

One need not agree with Ogden that nations that repudiate their debts will lose access to international private capital markets. By eliminating their debts to current creditors, these nations become A-1 risks to new creditors. Nonetheless, his conclusion, that debtor nations would rather not default and will not do so unless "pushed into a corner," is reasonably assumed. Financially strained debtor nations will take measures that involve reasonable costs and risks to avoid default, particularly if their creditors will "work with them."

The risk of formal debt repudiations also depends on the behavior of creditors. Formal defaults are not in their best interests, so the threat of default is likely to trigger offers by creditors that debtors will find difficult to refuse, or suggestions by debtors that creditors will find agreeable. Specifically, creditors faced with impending defaults will offer to or agree to delay scheduled loan principal

payments and even interest payments. The September 1982 IMF/World Bank "Special Study" *(Institutional Investor,* September 1982) noted that "the number of borrowers tottering on the edge of default or bankruptcy, hence, the amounts involved, is simply staggering. So bankers have been forced increasingly to turn to one device to avoid such calamities: rescheduling."

Rescheduling can be one-sided, but it is more likely to involve concessions by both banks and debtors. In two-sided arrangements, banks stretch out scheduled loan payments by as much as ten years and often allow up to five years grace on any repayment. They also extend new credits. In return, debtors may agree to pay interest rates higher than prevailing market rates but conceivably below the interest rates on the original loans. There is also usually a rescheduling fee of 1 percentage point on rescheduled loans and 1.25 percentage points on new loans. Finally, but perhaps most important, debtor nations adopt policies that promise to increase their exports and improve their trade and current account balances. Such policies are likely to be unpopular in the short run but constructive in the long run.

Through rescheduling, banks are able to avoid or at least delay having to write off or even write down loans that are in jeopardy. In addition, banks benefit from any rescheduling fee and higher than market loan rate on rescheduled and new loans. Finally, to the extent that debtors are perceived to be improving their trade and current account balances, banks benefit by being able to raise deposits at lower interest rates than they otherwise could. That alone can be incentive enough to reschedule.

Debtor nations benefit from rescheduling not only because they avoid default, but because it reduces their short- and near-term debt-service payments by postponing principal repayments, and sometimes their interest payments, and can provide them with additional, new loan capital. Austerity measures and any rescheduling fee and higher than market interest rate that they might have to pay can be well worth those gains. If they are not, debtors will balk and still easier terms will be negotiated, though in some cases the process might break down.

What it comes down to is this: When debtor nations do not have the money to meet their debt-service obligations, their debts can be rescheduled and their debt-service payments adjusted by their creditors. That is the alternative to default. Rescheduling produces basic benefits for both banks and debtors. Banks do not have to write down problem loans. Debtor nations avoid the onus of default. Rescheduling is more attractive to creditors if debtors take hard steps to

improve their trade and current account balances and agree to rescheduling fees and to higher than market interest rates on rescheduled loans and any new loans. It is more attractive to debtors if banks agree to long stretch-outs of existing loans and extend new credits. The alternative to reaching an agreement is usually dismal to one or both parties. Thus, rescheduling, not repudiation, is the likely event in the present Eastern bloc and LDC external debt crisis.

The initiative in the rescheduling process is sometimes taken by debtor governments, sometimes by creditor banks, and sometimes by governments acting unilaterally or in concert with international lending agencies. In recent months, short-term "bridge" loans have been granted to debtor nations on the brink of default by the Federal Reserve and the Exchange Stabilization Fund of the Treasury and by other countries' monetary authorities acting alone and through the Bank for International Settlements. Usually, these bridging loans have been made for 60 to 90 days on the condition that the borrowing nations seek long-term loans from the IMF. The IMF, in turn, has made its loans conditional on (1) debtor nations taking steps to increase exports and investment and decrease imports and consumption, and (2) bank creditors restructuring existing loans and extending new credits.

Recent developments confirm that debt repudiation is unlikely and that rescheduling will be the probable response when loans are in danger of default. In recent months, bank loans have been rescheduled and new private and IMF long-term credits have been extended to a number of Eastern bloc nations and LDCs, including Argentina, Brazil, and Mexico.

Even if there are no defaults, there will be changes, some of them unwelcome, as a result of the debt crisis. First, rescheduling signals that the quality of bank loan portfolios is less than was assumed when the loans were made. As a result, other factors the same, banks that made loans to Eastern bloc countries and LDCs will have to pay higher interest rates than their competitors to attract and hold deposits, and spreads on loans to Eastern bloc nations and LDCs will increase. However, rescheduling will reduce the size of these effects if debtor nations are perceived to be improving their trade and current account balances. The resulting net changes in relative deposit interest rates will be unfavorable to banks that made risky foreign loans. But these changes should not be viewed as unwelcome. In a market system, banks that make risky loans should have to pay higher deposit rates to ensure even reasonable prudence in lending practices and risky borrowers should have to pay higher loan rates.

Second, debtor nations have to improve their trade and current account balances in order to meet the new debt-service payments schedules. The Council of Economic Advisers (CEA) points out in its *1983 Economic Study to the President:*

> Much of this trade balance improvement will probably come through reductions in imports, involving painful reductions in output and real wages in the debtor countries. This will also depress demand for the products of industrial countries—particularly the United States, which has especially close trading relations with some of the major Latin American debtors. The debt problem of the developing countries may worsen the U.S. trade balance by $10 to $20 billion and reduce U.S. GNP by one-half percentage point or more from the level it would otherwise reach.[18]

Finally, at least some of the measures that debtor nations take to improve their trade and current accounts balances—that is, cutting imports, cutting government spending on consumption, and so forth—will be unpopular. Thus, the rescheduling process could be difficult to adhere to long enough to achieve success, and it could give rise to political action by debtor nations. It is more likely, however, that some adjustment will be made in the rescheduling programs, specifically by easing their austerity elements. However, such adjustments could be a trap.

What Are the Dangers?

Rescheduling does not solve the problem; it simply buys time. The underlying assumption is that given time and the liquidity that the rescheduling agreements provide, debtor nations can and will increase their capacities to service their external debts, or exogenous events will do it for them. However, there are two grave dangers in this approach.

First, the premise of rescheduling, that the crisis is one of too little liquidity and that given time and adequate liquidity debtor nations will be able to meet their debt-service obligations, may be wrong. Exogenous events may not be favorable. The steps that debtor nations take to improve their trade and current account balances may be too austere to adhere to for a long enough time to be successful, or they may not be austere enough to work, or they might be simply ignored. As a result, any increases in capacities to service external debts would

[18]The CEA's estimate of a "one-half percentage point or more" reduction in GNP differs substantially from the estimated 1.5 percent GNP reduction given earlier in this section. One reason for the difference is that the CEA's estimate is not based on the widespread formal default case, as the earlier estimate was, but on LDCs adopting austerity measures to avoid defaults.

be marginal, and the rescheduling process will have to be both extended and expanded over and over again. That means increased exposure for banks and increased official aid. The indebtedness of Eastern bloc nations and LDCs would rise, as would their debt-service obligations, both absolutely and relative to their capacities to service their debts. Thus, rescheduling would pour more and more money down what could turn out to be a rathole. We could ultimately confront the same defaults we are now trying to avoid and with larger amounts of debt involved. We must be alert to this danger.

Second, there will be an attempt to ensure that rescheduling works by again courting inflation. Most analysts agree that even a modest economic recovery in OECD countries which is sustained through 1984 and 1985 will allow the rescheduling process to work. But policy makers in developed free world countries may try to boost the recovery that now seems under way by pursuing reflationary policies. Reaccelerating inflation in the United States and other developed free world countries would increase the demand for the goods debtor nations export. That would no doubt help them meet their debt service payments, since their demand for imports will not increase as rapidly.[19] Reflation would be a quick fix, but only a temporary one. In time, accelerated inflation would raise interest rates and recession would follow. The debt problem would return bigger than ever. The economy would still be on a roller coaster. Reflation must be avoided.

The challenge is to define the policies that will defuse the present debt crisis without doing more harm than good. It is taken up in the fourth and final section of this study after a brief discussion below of the political dangers of IMF austerity programs that are part of the rescheduling process.

The Political Dangers of IMF Austerity Conditions

In a 21 February 1983, article entitled "IMF Austerity Prescriptions Could Be Hazardous," *Business Week* reported that, "The prospect economists and bankers find most frightening is that austerity could ignite a political explosion." It is difficult to evaluate whether this hypothesis is true. However, it is possible to deduce what such an explosion would produce. *Business Week* referred to "riots" in Argentina and Bolivia and concluded, as have Kissinger and others, that "it would be a mistake to think that default would be beyond a government that is growing increasingly panicked as it tries to imple-

[19]The prices of goods that LDCs export are on average cyclically more sensitive than the prices of goods they import. Thus, their trade balance deteriorates in periods of world recession, like the 1981 to 1982 period, and improves in expansionary and inflationary periods.

ment IMF-ordered austerity." In this regard, the article reported that "some experts speculate that overextended countries might band together in a debt cartel. . . ."

Curiously, *Business Week's* conclusion is reassuring. In essence, *Business Week* and the "experts" to whom it referred are stating that any "political explosion" will erupt in formal defaults or debt repudiations, possibly major and orchestrated. They do not raise the specter of Russian- and Cuban-sponsored revolutionaries taking over still other LDCs because of IMF "austerity prescriptions," and they do not do so for good reasons. Russian- and Cuban-sponsored revolutions have not been impelled by economic austerity programs to solve external problems in the past. And, if the IMF's prescriptions turn out to be intolerably austere and threaten the survival of a nation's political authorities, the political authorities will scrap the IMF's conditions and, if necessary, repudiate their nation's debts. That way they will remove the threat to their survival and head off unwelcome political changes. In short, it would appear that the worst we can expect politically is widespread, major defaults, identically the same as the worst we can expect financially and economically. We can live with that.

Widespread, major formal defaults, whether spontaneous or orchestrated by a "debtors' cartel," would not generate catastrophic economic and financial conditions. The financial and economic problems that result can be dealt with without major disruption; not without some painful adjustments and shifts of resources, but given responsible Federal Reserve actions and commonsense behavior by the bank regulators, there will be no major, enduring economic or financial disruption.

IV. Solutions

In the second half of 1982, it became clear that some Eastern bloc nations and LDCs could not service their external debts and that the solvency of some of their creditors was threatened. For U.S. banks, the external debts and economic problems of Brazil and Mexico and, to a lesser extent, Argentina, Chile, and Venezuela are especially troublesome.

The U.S. Solution

On 21 December 1982, Treasury Secretary Donald Regan told the House Banking Committee that "the U.S. strategy to deal with current strains on the international financial system contains five key elements." The first calls for "orderly, but effective domestic adjust-

ment efforts by each country concerned." On 14 February 1983, Secretary Regan told the Senate Banking Committee that this

> will entail multi-year efforts, usually involving measures to address some combination of the following problems: rigid exchange rates; subsidies and protectionism; distorted prices; inefficient state enterprises; uncontrolled government expenditures and large fiscal deficits; excessive and inflationary monetary growth; and interest rate controls which discourage private savings and distort investment patterns.

In supportive testimony before the House Banking Committee on 2 February 1983, Federal Reserve Board Chairman Paul A. Volcker stressed the need for

> determined action by major borrowing countries to change their economic policies . . . to cut down on very high rates of inflation and budget deficits, to establish realistic foreign exchange rates and domestic interest rates, to encourage greater economic efficiency, and, as a result, to aim for substantial reductions in external [trade and current account] deficits.

The second element of the U.S. strategy calls for "readiness to provide official financing." Secretary Regan identified the IMF as "the key institution for this purpose" stating that the Reagan administration favored "strengthening IMF resources. . . . by an increase from $67 billion to $99 billion (plus) an expansion of the IMF's General Agreement to Borrow (GAB)" in an amount equal to $12 billion. All IMF members would be given access to GAB funds under certain circumstances. Chairman Volcker testified that the IMF plays "the key coordinating and substantive role." Only the IMF, he said, "can effectively combine the several ingredients necessary to encourage both sound adjustments and necessary financing. . . ."

The IMF has requested that the quota increases and the new GAB money be paid into the IMF by the end of 1983. The U.S. share would by $5.8 billion of the proposed quote increases and $2.6 billion of the proposed GAB expansion. The total U.S. cost would be $8.4 billion. The United States would provide $8.4 billion of assets that can be converted by the IMF quickly into purchasing power. When converted, the United States would receive an equivalent book-entry claim on the IMF which, however, could be used only for purchasing foreign currencies to support the dollar.

Third, the U.S. strategy calls for "continued commercial bank lending." Chairman Volcker called for "arrangements among the bank creditors to provide enough continuing credit to maintain continuity of payments and a financial environment in which orderly adjustment programs can be implemented."

The fourth element, as stated by Secretary Regan, calls for "governments and central banks in lending countries to act quickly to respond to debt emergencies when they occur." In support, Chairman Volcker stated that we must assure, "in specific instances, short-term 'bridging' credit by national monetary authorities, acting bilaterally or through the Bank for International Settlements . . . to meet minimum and immediate liquidity requirements while adjustment and borrowing programs are being arranged."

Finally, the U.S. strategy calls for "economic policies in the major industralized countries that will produce economic growth." Chairman Volcker testified that this part of the program would establish "an environment of sustained recovery and expansion in the industralized world," a "critically important" priority.

Evaluation

The First Element. No approach to the international debt crisis can succeed if it does not achieve substantial reductions in the trade and current account deficits of debtor nations. The question is how to achieve these reductions. Secretary Regan and Chairman Volcker have suggested a number of constructive possibilities. The keystone is that financially strained debtor nations "establish realistic foreign exchange rates" either by devaluation or floating. In time, this would increase the exports of debtor nations and decrease their imports, improving both trade and current account balances. It would also attract new foreign direct investment, making it easier to balance current account deficits. To validate the new exchange rates, it is important that debtor nations reduce governmental expenditures and moderate money growth permanently in order to prevent renewed downward pressure on exchange rates. Finally, Secretary Regan and Chairman Volcker correctly urge debtor nations to abandon subsidies, protectionism, interest rate controls, and the like. This element of the administration's strategy is easy to support, but the debtor nations, not the United States, must implement it.

The Second Element. The most controversial element of the U.S. strategy is the proposal to "provide (more) official financing" by increasing IMF quotas by $32 billion and increasing GAB by $12 billion by the end of 1983.[20] There are a number of reasons for

[20][The "Domestic Housing and International Recovery and Financial Stability Act" (P.L. 98–181) was signed into law 30 November 1983. Section 802 of that act *increased* the U.S. quota to the Fund by 5.31 billion SDRs, approximately $5.5 billion (from 12.6 to 17.9 billion SDRs). In his April 1983 monograph, Weintraub opposed the quota increase, but argued that if the increase took effect, "it would be wise, to tie the expansion of IMF and GAB resources to decreasing members' borrowing powers.

questioning the proposal. The IMF does not need additional resources. The money will not be raised quickly enough to help and, in fact, events have already occurred that will solve the present crisis without further official financing. Also, more IMF aid could be counterproductive. Finally, viewed as insurance, the cost appears greater than the benefits.

The IMF already has substantial unused financial resources and the power to create and raise additional billions of dollars. It has $8 billion immediately available in the form of on-hand lending resources. It also has a large free or unpledged gold stock, the power to create new Special Drawing Rights (SDRs), and certain borrowing powers. Some would argue, however, that apart from the $8 billion on hand, the IMF's existing financial resources are more apparent than real.

First, the IMF's Board of Governors must approve any sale of its gold or its pledge to member nations for use as collateral, allowing them to borrow on the open market with favorable terms. The board would also have to approve any new SDR issue and allocation. These are major policy decisions, and there is no ordinary authority or historical precedent for such actions. In both cases, therefore, approval could be difficult to obtain. If the United States opposed such solutions, as it has in the past, no approval would be given, since an 85 percent affirmative vote is required and the United States holds more than 15 percent of the votes.

Second, it must be recognized that newly created SDRs would not be assigned to the IMF itself, but would be allocated directly to member nations by the existing formula. Thus, it would take a huge increase in SDRs to provide troubled Eastern bloc nations and LDCs with even moderate amounts of new, hard currency. In addition, since a country can use its SDR allocation as it sees fit, the IMF could not impose conditions that would constrain a nation from pursuing inflationary policies.

Third, although the IMF can now borrow from member or nonmember nations on a case-by-case basis—from Saudi Arabia, for example, or other nations with large liquid assets—and can do so by a routine vote of the Board of Governors, the sources of such borrowing are dwindling.

Although it would be difficult for the IMF to use its gold stock, create new SDRs, or obtain additional resources by borrowing, and although there are restrictions on how it can allocate newly created SDRs and limits on the leverage it would get from such allocations,

Currently, members can borrow 4.5 to 8 times their IMF quotas. These multipliers should be cut drastically" (p. 50).]

the IMF does have substantial unused financial resources and the potential for creating more. It holds approximately 100 million ounces of gold worth $40 to $50 billion (at current prices), plus $8 billion in cash. It also has virtually unlimited power to create new SDRs and it has certain borrowing powers. The combination of these assets and powers provides a formidable package of "last resort" financial resources and powers.

Even if [the] IMF had no unused resources, increasing IMF quotas and expanding GAB would not help and is not necessary. Events already have occurred that will defuse the current crisis before the new funds are scheduled to be paid into the IMF and GAB, which is not until the end of 1983. Debtor nations that could not service their debts in 1982 have taken steps to reduce their external deficits. Most important, exchange rates have been adjusted in many countries, including Mexico and Brazil. Creditors have eased the liquidity crunch, maturing loans have been rescheduled, and the IMF and commercial banks have granted additional loans. Finally, interest rates have fallen, and a strong economic recovery seems to be under way in the United States and other developed nations. New policies and economic trends will make it far easier for debtor nations to service their debts in 1983 than in 1982.

There is no need to increase IMF quotas or expand GAB now. In fact, it could be counterproductive to do so. Knowing that the IMF and GAB have acquired $44 billion in additional financial resources, debtor nations could avoid or renege on the "determined action" that must be pursued if they are to ever manage their external debts. Private lenders could be drawn into extending new credits with little chance of repayment. The problem would be put off, not solved, and would grow over time.

Analysis of near-term capabilities, problems, and trends does not support the administration's call for "strengthening IMF resources." There remains the question of whether the insurance that the U.S. contribution would buy is worth the $8.4 billion cost. The benefits depend on the loss that is insured against, an unknown figure. My best estimate of the maximum loss (in current value) is $30 billion.

Although anything is possible, the worst-case scenarios that have been presented in response to the current debt crisis, involving the collapse of the U.S. banking system and the virtual cessation of international trade, are too unlikely to be worth insuring against. If they were real dangers, the case for "strengthening IMF resources" would be strong, but they are not. Nor is there a case for protecting against a redistribution of market shares in banking, even though that would involve some painful local adjustments. The $8.4 billion

[in] proposed U.S. contributions must be viewed as insurance against a partial reduction of exports and a resulting decrease in real GNP in the event of LDC defaults. Considering all the factors that would affect international finance and trade and U.S. exports as a result of major widespread defaults, it is estimated that U.S. real GNP would be decreased by no more than 1.5 percent, or $45 billion (in current value). The Council of Economic Advisers estimates that U.S. real GNP is likely to be decreased by 0.5 percent, or $15 billion, as LDCs reduce their imports under the administration's strategy. (Part of this reduction has already occurred.) Thus, the proposed $8.4 billion in U.S. contributions would insure against a maximum loss of real GNP of $30 billion. Ordinarily, the potential loss in purchasing insurance against an event with a significant chance of occurring is a much greater multiple of the premium than is the case here.

The Third Element. Viewed alone, continued bank lending to debtor nations is not controversial. Banks will "provide enough continuing credit" if it is in their best interest to do so. The question is whether governmental policy should promote this action. There are indications that the U.S. government has encouraged bank lending to LDCs in the past, and the proposal to increase IMF quotas and expand GAB is designed in part to make it easier for banks to continue lending to developing nations, especially those that are financially strained. Doubtless banks would feel more secure lending to LDCs if their governments see the IMF as an elastic conduit for helping debtor nations. Under certain circumstances, however, continued lending could lead to a magnification of the same imprudent lending practices that helped create the present debt crisis. Governmental policy to promote bank lending to debtor nations is not desirable.

The Fourth Element. The fourth element of the U.S. strategy calls for "governments and central banks in lending countries to act quickly to respond to debt emergencies when they occur." Governments and central banks already have ample powers to do so, and the administration is not asking for anything new. This part of the strategy is not controversial.

The Fifth Element. The final element of the U.S. strategy calls for free world industrialized nations to expand their economies. No one can effectively argue against this, provided that policies adopted do not lead to another inflationary surge in the industrialized free world. If inflation is reaccelerated, recession will eventually follow. As stated by the IMF's Interim Committee of the Board of Governors in its 10 February 1983 Paris communiqué, "successful handling of the infla-

tion problem is a necessary—albeit not sufficient—condition for sustained growth." The communiqué "urged national authorities, in their efforts to promote sustained recovery, to avoid measures that might generate harmful expectations with regard to inflation." Unfortunately, it is not clear that inflationary measures will be avoided.

Summary. The U.S. strategy for solving the debt problem is debatable and risky. First, the proposed increases in IMF quotas and GAB are not necessary at this time. The legislative debate on the proposal to increase IMF quotas and expand GAB should be delayed until next year. Events are defusing the debt bomb, and it is wiser to discuss the proposal in a noncrisis atmosphere.

Second, although continued bank lending per se is not controversial, promoting such lending involves risks. Banks should be allowed to determine what is in their own best interests, with the understanding that they alone bear the risks. If it can be shown that the national interest is involved, national resources should be put at risk. No such interest has yet been demonstrated.

Third, although economic recovery and sustained growth are critically important, it is essential to avoid inflationary policies in pursuing recovery and growth. Specific policies for achieving recovery and sustaining growth without reaccelerating inflation have not yet been delineated. That deficiency should be corrected promptly.

Asset Exchange Proposals

There is considerable sentiment for making banks "pay" for Congressional approval of increased IMF quotas and expanded GAB and then giving the payment to debtor nations so they can live with their debts more easily. One plan would require banks to discount foreign loans in exchange for securities issued by a U.S. government or international agency. The buying agency would reschedule the loans on terms more favorable to debtor nations. For example, banks might be required to discount their foreign loans to the Federal Reserve at prices well below par, and the Federal Reserve would reschedule them at interest rates well below market rates and with stretched-out repayments.

There are at least four problems with this approach. First, the external debt problems of Eastern bloc nations and LDCs are country specific, so it makes no sense to treat the loans as equally risky. Some foreign loans even to non-OPEC developing countries, are in little danger of default or being repudiated. Thus, under the asset exchange proposal, the purchasing agency (for example, the Federal Reserve) would have to decide which loans banks were required to discount.

Given such power, the agency would be in a position to discriminate among countries and banks. It would be unwise to give such discretion to any agency, national or international.

Second, it should be remembered that medium- and long-term loans made by U.S. banks constitute only about 20 percent of the total medium- and long-term indebtedness of non-OPEC developing countries. It would be neither fair nor sensible to force U.S. banks to discount their loans to these countries if other creditors remained unaffected. Further, there is no way that the United States could require creditors (other than U.S. government agencies) to discount their loans to these countries.

Third, if banks are forced to discount loans which they have made to specific countries, to the Federal Reserve or some other national or international agency, they would be unlikely to issue new loans to these countries. Thus, asset exchange plans would make it more difficult to give financially strained countries "enough continuing credit to maintain continuity of payments and a financial environment in which orderly adjustment programs can be implemented." In short, rather than helping debtor nations, compulsory asset-exchange plans could force them into default.

Fourth, asset exchanges at discounts would necessitate reducing the capital of participating banks simultaneously by amounts equal to the discounts from par at which the loans are sold to the Federal Reserve or other agency. At the same time, the gain realized by debtor nations in reduced debt service payments from loan reschedulings would extend only over a period of years. For these schemes to significantly help financially strained debtor countries, they would have to create serious capital problems for some banks.

Some proposals urge that voluntary asset exchanges be negotiated between debtor nations and their U.S. banks, perhaps with assistance of the Federal Reserve or some other U.S. agency. Debtors would offer their banks new loan agreements in exchange for existing ones. For example, new agreements might give the banks claims on debtors' exports in return for lower interest rates and stretched-out repayment schedules. There is no reason why banks and debtors should not negotiate such exchanges, but there also is no reason why public policy should encourage such negotiation.

The Challenge: Avoiding Doing More Harm Than Good

The current debt crisis can be solved, but the policies adopted to solve it could cause more long-term harm than near-term good. Such policies must be avoided in designing a package of remedies [The

following package is proposed to effectively deal with the present debt crisis. It consists of four elements.]

1. Resumption of Economic Growth by the United States and Other Developed Countries. The present debt crisis is unlikely to be ameliorated until the economies of the United States and other developed countries recover substantially the production and consumption lost in the 1981 to 1982 recession and provide evidence of sustaining growth. Developing nations must have growing markets for their exports.

Developed countries must be careful, however, to prevent new inflationary surges from accompanying or closely following their recoveries and the corollary growth of developing nations' exports. The inflationary surges in the United States and other industrialized countries from the late 1970s to 1981 generated an economic environment in which developing nations flourished but in which the seeds of the debt crisis were sown. Developing nations' output and exports increased, but so did their indebtedness. Ultimately, inflation in the United States and other industrialized countries produced high interest rates and set the stage for the 1981 to 1982 recession. These events were important causes of the present international debt crisis.

New inflationary surges in developed countries must be avoided if we are to ensure both sustained growth and a permanent resolution of the international debt crisis. Specifically, achieving real economic growth without inflation requires constraining but not contracting monetary growth, especially in the United States. One does not have to be a monetarist to understand Chairman Volcker's statement before the Joint Economic Committee (*Federal Reserve Bulletin,* February 1980) that "the inflationary process is ultimately related to excessive growth in money and credit. This relationship is a complex one, and there are many facets of it that are sensitive to nonmonetary economic variables. But, in spite of all the nuances, it is clear that inflation cannot persist over the long run in the absence of excessive monetary growth."

Based on the history of the post–World War II period, 0 to 2 percent per year M1 growth is large enough over the long term to sustain normal real growth, but not so large as to produce inflation. Currently, M1 growth is well above 2 percent a year. Quickly reducing growth to the 0 to 2 percent range would abort the present recovery of the U.S. economy. However, there is no need to increase money growth at this time; it is fast enough and recovery is under way. The policy should be to steadily reduce M1 growth to the 0 to 2 percent range over four or five years and keep it there.

2. *Improvements in the Trade and Current Account Balances of Debtor Nations.* Debtor nations must take "determined action" to *increase their exports and the investment of foreigners in their plant* and equipment, decrease their imports, and constrain their consumption. Most important, debtor nations must allow their exchange rates to float downward or devalue them realistically, as Mexico and Brazil have recently done, and enforce the new rates by reducing their fiscal deficits and moderating money growth.

Downward exchange rate adjustments will increase the exports of debtor nations and decrease their imports, thereby improving both their trade and current account balances. In addition, debtor nations that allow their exchange rates to adjust downward will become, relatively speaking, low-cost producers. In time, this will attract investment capital, making it easier for debtor nations to finance current account deficits and, over a period of years, spurring their GNP growth rates. Low domestic tax rates on saving and investment income, removal of all capital controls, and noninflationary money supply growth would also encourage investment and growth and improve their external accounts. It is a mistake to view so-called austerity programs as recessionary or anti-growth. They are, rather, pro-saving, pro-investment, and pro-growth.

Finally, the United States and other developed countries should do nothing to impede debtor nations in their pursuit of increased exports and investment. This means that the United States and other free world developed countries must avoid protectionist measures, equalization taxes, and capital controls.

3. *Willingness of Bank Creditors to Reschedule Maturing Loans and Extend Additional Credits.* Debtor nations need time to implement realistic adjustment programs. Their bankers must be willing to give it to them, and where prudent, to provide new credits. However, banks cannot and should not be pushed or tempted to reschedule and extend new credits. They must do it on their own initiative, in meeting their own needs, and at their own risks. It will be in their best interests, if debtor nations in danger of defaulting take "determined action" to improve their trade and current account balances.

4. *Willingness of Governments, Central Banks, and the BIS to Provide Short-Term Credits in Debt Emergencies While Loan Reschedulings Are Being Negotiated.* Providing short-term credits is a proper crisis role for governments, central banks, and international agencies, since loan reschedulings necessarily take time to negotiate.

These four elements comprise a solution package that will defuse the present international debt crisis without doing more harm than good. *The challenge is to limit our initiatives to this package.* As is often the case in economics, activist policies to solve crises are unnecessary and could be counterproductive.