WORLD DEBT AND MONETARY ORDER: LEARNING FROM THE PAST

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> *It must not be forgotten that if there was bad borrowing . . . there was also bad lending. As a result of reckless competition, encouragement was sometimes given to borrowers and lenders alike without sufficient understanding of what was involved; loans were often made for unproductive purposes; sufficient care was not always exercised to see that a loan was used for the purpose for which it was granted; and high interest rates, instead of encouraging investors to inquire into the likelihood that the borrower could meet his obligations, failed to do anything but encourage them to invest their money. It is important that there should be in the future a greater sense of responsibility both in borrowing and lending than has frequently been the case in the past.*
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> World Bank, *Second Annual Report* (1946–47), pp. 14–15

As the above quotation suggests, the perceived nature of the current international financial situation, and some of the lessons being drawn from it, are eerily similar to what existed in the late 1940s, following the worldwide wave of defaults on foreign borrowings in the 1930s.

It is easy to overemphasize the similarities between the international debt situation arising out of the Great Depression and that which had its origin in the inflationary 1970s.[1] But I do think it is important to recognize that there are important common characteristics in the origins of these two periods of international financial

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[1]Roland Vaubel (1984) deals with the all-important question of monetary policy and the banking system during these two periods.

stress, that the geographic location of the initial manifestation of crisis was roughly the same (Austria in 1931; Hungary in 1982), that the problems caused by a heavy burden of debt in an unexpectedly noninflationary world are quite similar, and that some of the techniques used to ease these problems are nearly identical.

However, the real story is how the debt crisis of the 1980s has been contained and how the "debt-deflation-depression" spiral of the 1930s has been averted without the adoption of explosively inflationary policies. That is a subject I will return to shortly.

Origins of the Current Situation

Let me start with a highly condensed summary of the origins of the current international debt situation. In the 1970s, responding to a variety of economic, political, and social pressures, major governments around the world—including the United States—countenanced or encouraged excessively rapid acceleration in their national money supplies. The path of least resistance to a variety of adjustment problems, of which OPEC oil price increases were only the most visible, was seen to be in more rapid growth of the money supply and the resulting inflation. Simply put, if one is to have stable prices on average, for every price that goes up, some other price has to go down. And most people who are producing and selling are not terribly keen on falling prices for their own products or services. In the final analysis, inflation is the monetary expression of a political process, as Henri Aujac recognized many years ago.[2]

The tendency to point the finger at OPEC and oil price rises as the source of the inflationary upsurge of the 1970s, and the associated recycling of "petrodollars" and buildup of LDC debt is understandable. But it ignores a crucial link in what actually happened. It was necessary for the major central banks, above all that of the United States, to *ratify* the potential inflationary pressures which were being set in motion by higher oil prices. The OPEC oil price increases were neither a necessary nor sufficient condition for the inflation and debt buildup of the 1970s.

Thus, as a result of the interaction of politics and monetary policy, price increases in the 1970s accelerated with occasional periods of weakness corresponding to business recessions. An inevitable corollary of this process was an equally rapid expansion in credit of all forms, but most obviously bank credit. Indeed, the price of credit (interest rates) increased less than the average price level, resulting

[2]Aujac (1954).

in negative real interest rates—and, not surprisingly, further stimulating the demand for borrowing.

In this kind of environment, with expectations of double-digit inflation becoming more and more deeply embedded, those who failed to increase their borrowing, wherever they hailed from, were considered to be the slow learners. Those who made the front covers of *Farm Journal, Fortune,* or *Euromoney* were the big borrowers, each in his own league, with debt coverage ratios that would have made a 1960s financial adviser or analyst cringe.

What of the role of the commerical banks in this process? To what extent are they responsible for the situation which they (and their borrowers) find themselves? I view them more as passive actors than as conscious agents recklessly putting at risk shareholder equity or their depositors' funds. The necessary corollary to excessively rapid expansion of the money supply was excessively rapid extension of bank (and other) credit. With a banking system based on fractional legal reserves, and an underlying entrepreneurial spirit on the part of financial market operators, it was inevitable that excessively rapid creation of bank reserves would lead to a corresponding increase in lending activity, at home as well as abroad. The resulting acceleration in inflationary pressures altered expectations of future cash flows and views about appropriate debt/equity ratios and the structure of any given level of indebtedness. Indeed, when all the returns are in, I suspect we will find far more bank losses arising out of overly optimistic domestic energy lending than from loans to developing countries.

The criticism that commerical bankers are receiving today, as a group, overlooks the fact that they were responding as financial intermediaries are supposed to in an expansionary monetary policy environment. Many of the charges being made today are no more than echoes of the extensive Congressional hearings in the early 1930s, which delved into the role of the investment bankers and their flotation of developing country bonds on the U.S. market.

Although the opening stages of the 1982/83 crisis contain some fascinating parallels with the 1930s, the middle and later stages are clearly moving in a different direction. Two developments have played key roles in this change in script. First, in contrast to the actual contraction in money supplies that occurred in the 1930s, money growth rates in the major industrial countries have bottomed out and have increased moderately in recent months.

The acceleration in money growth has been accompanied by a recovery in nominal and real income growth rates in the major industrial countries, most dramatically in the United States. This development has major favorable implications for many countries. For example, largely as a result of our strong recovery, U.S. demand for imports has surged dramatically, with imports from the non-oil developing countries for the first 11 months of 1983 running 14 percent ahead of a year earlier.

The second key factor is the rapid development of an effective network of cooperation between the recently strengthened International Monetary Fund, the Bank for International Settlements, the major international commercial banks, and the various central banks and finance ministries of the major industrial nations. Although each country that has experienced difficulty in meeting its international obligations has been treated differently, given the varying circumstances, a rough pattern of adjustment has emerged. A fair characterization of this process is "ad hoc but not disorderly."

This network of cooperation is activated by a rapid rundown in the official reserves of a developing country (frequently precipitated by a withdrawal of foreign commercial bank short-term credit lines). The reserve rundown is first met by short-term official financing in a variety of forms from major central banks and finance ministries or, occasionally, the BIS. The borrowing country declares a short moratorium on repayments of principal, negotiates a rescheduling of official long-term credits through the Paris Club mechanism, enters into an adjustment program with the IMF, negotiates a rescheduling of medium-term commercial bank credits, and then frequently arranges for additional new commercial bank financing and official export credits. In the United States, considerable cooperation from the banking regulatory authorities is an integral part of the process. During this process the initial lenders are frequently "taken out" by subsequent lenders, so that the gross amount of new credit extended will substantially exceed the final net figure.

The objective of the process (although it is seldom characterized as such) is to avoid what has been called a "credit implosion," and to abort an incipient downward debt-deflation-depression spiral. In such a process, the running-off or calling of loans by commercial banks results in the destruction of privately created money that may not be offset by central bank creation of high-powered money. This process is associated with downward pressure on prices (as assets are liquidated to raise the cash necessary to service loans) and an ever-increasing real burden of debt. Such was the result of the unchecked debt-deflation spiral of the 1930s.

In the current period, however, as a result of the stabilization and modest recovery in money growth rates, accompanied by a flexible and informal network of cooperation among all major financial players, and strong, effective policy adjustments in many of the affected countries, the debt-deflation spiral has been aborted. This has been achieved without the adoption of consciously "reflationary" policies. The result is that a worldwide adjustment process is under way which promises healthy, sustainable growth with minimal inflation.

Following the rule that "no news is good news," as a result of developments over the past 12 months, there has been a generally unnoticed but marked improvement in the credit standing, reserves, and balance of payments position of some of the key Eastern European countries which were the first casualties of the winding down of inflationary pressures. There has been a remarkable turnaround in the Mexican situation and the adjustment process in Brazil, although difficult, shows considerable evidence of promising large, near-term gains, with a surplus on its balance of trade in 1984 likely to reach $9 billion, or more.

The Adjustment Process at Work

Even in the improving world economic situation a number of observers continue to question whether the threat of a generalized debt crisis has actually passed. They point to high real interest rates, relatively low prospective inflation rates (implying weak commodity prices and poor LDC export prospects), and the high levels of outstanding debt, equivalent to 143 percent of non-oil developing country exports at the end of 1982. With commerical banks apparently showing a lack of enthusiasm for international lending and export earning prospects supposedly bleak, pessimists do not see a way out of the current situation without major political problems or dramatic institutional initiatives.

This point of view overlooks two important trends apparent in recent debt negotiations and international trade. First, and most important, is the substantial amount of relief for borrowing countries that is arising from official and private reschedulings. William Cline has drawn attention to this phenomenon in the case of four major debtors who have recently rescheduled their obligations, Argentina, Brazil, Mexico, and Yugoslavia. His data suggest that no less than $30 billion in scheduled amortizations or of public and private debt repayments was affected by agreements reached in late 1982 or early 1983.[3] Missing from his list are prospective arrangements for a number of other large debtors, such as Nigeria, Peru, Morocco, the Philippines, and Venezuela. Cline (1983, p. 77) goes on to construct an

[3]Cline (1983). Computed from Table 8, p. 42.

entirely plausible model which shows how rescheduling (or "forced lending") is a rational approach, and that,

> over the range of most relevant situations likely to arise—except in cases of relatively clear country insolvency—it will pay the banks to extend additional credit in order to secure the value of existing exposure.

Assisted by the spread of rescheduling agreements, the IMF's initial projection for total amortization payments in 1983 for the non-oil developing countries shows its first significant decline in over 20 years.[4]

Some of the techniques used to ease the burden of debt service in the 1930s look vaguely similar to those discussed today. When interest on foreign dollar bonds floated in the 1920s could not be paid in a convertible currency, it was occasionally paid in funding bonds or a "blocked currency." The first technique is comparable, in an economic sense, to some of the "new money" bank loans being arranged for certain countries, and the second has its counterpart in some Latin American arrangements, where local currency is paid into an escrow account for eventual conversion and full hard currency debt service.

The second development that is overlooked in today's environment is the favorable shift in terms of trade that is benefiting a growing number of developing countries. With prices of most non-mineral commodities up sharply over the past 12 months, the computed terms of trade for the non-oil developing countries are likely to show their first improvement since 1977. Formal index numbers, however, may understate the benefits for many countries. Scattered evidence from projects financed by the World Bank suggests that competitive pressures among suppliers and contractors on major infrastructure projects and energy development have resulted in sharply lower than anticipated prices. This implies that the squeeze on certain developing countries facing debt servicing difficulties may be somewhat less than generally assumed. Some commentators have suggested that sharply reduced import levels will result in drastic declines in production or investment. But estimates of the prospective real volume of imports may be too low if the price levels have been assumed to be too high.

However, I do not intend to be a Pollyanna about the current situation or the short-term outlook. A number of countries such as the Philippines and Nigeria continue to experience severe problems in servicing their debt, and the adjustment process will continue to

[4] *IMF World Economic Outlook* (May 1983), Table 35, p. 204.

be fitful, difficult, and frustrating. We will need to be on our guard not to relax the combination of speed, sensitivity, and international cooperation that has proven successful to date in dealing with individual countries' debt problems.

The Role of the World Bank

It is probably appropriate at this point to say a few words as to the role of the World Bank in this process. A number of commentators have suggested that the Bank take a more active role in assisting countries deal with their debt difficulties.

I am not very enthusiastic about such suggestions. The Bank's primary role and inherent comparative advantage is in long-term, project-oriented development lending. It is not designed to be, nor should it become, a central player in dealing with debt rescheduling problems or a global business cycle. There are a sufficient number of other national and multilateral institutions to deal with the situation. At the same time, the Bank can and has played a useful role in supplementing the efforts of other agencies in certain situations. Its macroeconomic policy advice and structural adjustment and other non-project loans have generally been carefully coordinated with the IMF. Supplementary loans or accelerated disbursement schedules have been adopted for countries where projects were in danger of falling behind schedule due to shortages of local funds and where the authorities are dealing with their difficulties in a positive fashion.

In planning for the future, it might be helpful to define the World Bank's basic objective with respect to those middle-income developing countries which are experiencing financing difficulties in terms of restoring their access to the private capital markets. The Articles of Agreement make it clear that the Bank's basic objective is to "supplement private investment," and to act generally as a catalyst, and not as a central player. Restoring access to the private capital markets means that the "B loan" co-financing program with commercial banks should be vigorously pursued. Restoring access also means greater stress in the operations of the Bank's affiliate, the International Finance Corporation, on bringing private companies back into the international syndicated loan market, as has been done recently for several companies in Mexico.

It is not helpful, however, to define the Bank's role in terms of its net transfer of financial resources to developing countries. The model of economic development which is implicit in such a concept is, in my view, irrelevant and misleading as to how the Bank can be most useful. Extensive calculations which purport to show some long-term aggregate "resource gap" for the developing countries as a whole, or for an individual country, involve heroic assumptions about saving, investment, productivity, international prices, and the role of government. It is far more preferable—even if considerably more modest—to see how the Bank's traditional strengths in project finance, economic analysis, and policy advice can be brought to bear on a country's development potential on a case-by-case basis. And in all cases the Bank's financial resources should be used only where they do not run the risk of displacing alternative sources of finance.

Looking to the Future

What are the implications of this necessarily sketchy tour of financial history and current developments? I think there are two basic conclusions that are supported by the evidence.

First, the concept of intense financial cycles, international in scope, is further supported by the developments of the late 1970s and early 1980s. This suggests that the preconditions for another buildup of excessive international debt are likely to emerge well before the end of this century. It is in the interests of analysts and policy makers to examine what steps might be considered now if such a buildup is not to threaten, once again, the world monetary order.

This leads to a second conclusion. The chief distinction between today's situation and that which existed as a result of foreign debt defaults of the 1930s is the central role of the commercial banks. The banking system's role in efficiently shifting funds on a worldwide basis (and I use "efficiently" here only in the sense of low transaction costs) was far superior to that of the investment banking community in the 1920s. But the cost of that gain in transaction efficiency was the financial system's increased fragility and susceptibility to financial crisis. The substitution of indirect securities (bank deposits) for primary securities (bonds) increased the operational efficiency of the system and tightened the links between financial institutions around the world; but it also increased the system's vulnerability to a systemic crisis by involving, indirectly, millions of bank depositors.

The issue then becomes, is the current "ad hoc but not disorderly" manner of coping with a potential crisis satisfactory? Judging by the results, I think we should be prepared to give it—and those individuals who have labored long and hard at making it work—high marks. But we might want to consider how their jobs could be made easier, and how the public's concern over "bailing out the commercial banks" with taxpayers' funds might be met in the future.

It seems to me that there are three criteria which should guide any such proposal. First, it should involve the commercial banks directly. Not because they are necessarily "responsible" for the problem of overindebtedness, but because they are inextricably part of the problem and thus they should be part of the solution. Second, proposals should ensure that the possibility of unleashing a flood of high-powered money or liquidity, with all the accompanying inflationary implications are reduced as close to zero as possible. Third, proposals should ensure that fair international burden-sharing is respected. It is not appropriate that the commercial banks or public authorities of any one country assume a disproportionate share of the effort to avert a worldwide banking or financial crisis.

In this context we might want to begin considering how the commercial banks themselves might fund, through a system of required interest-bearing reserve deposits, a facility that would provide at least the bridging loans that central bankers, the BIS, and others have been called upon to provide in recent months. Required reserves would be calculated as a percentage of exposure to the developing countries. Such a facility would reduce the potential inflationary pressures arising out of excessive short-term official finance in times of crisis and could also be designed to temper excessive enthusiasm for foreign lending at the most expansive phase of the next financial cycle. It need not be operated as an entirely separate institution, but could fit into either of the existing multinational, short-term-oriented financial organizations, the IMF or the BIS. I should emphasize that this idea is offered as a personal suggestion, and not in any official capacity.

Such an approach would appear to me to be worth examining, in a highly tentative manner, and recognizing that economists, like generals, have a habit of always fighting the last war. No doubt talented individuals will develop new techniques capable of extending credit throughout the world in the years ahead. But it does make sense to try and learn from the past so that the future may be a trifle easier for all of us.

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