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DEBT AND DEVELOPMENT

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A Presentation to Town Hall
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ABSTRACT

The external indebtedness of many developing countries -- Mexico, Brazil and Argentina in particular -- has been of considerable international concern. The debts arose partly because of changes in international banking practices and partly because of unwise short-term borrowing by governments accustomed to continuing international inflation. The problem has been made worse by high world-wide interest rates caused in part by the historically high domestic deficits of the United States government. There are signs that the crisis may be easing, however, and that moderate growth may soon resume in Latin America.

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In a presentation to the International Relations Section of Town Hall in the fall of 1978, I predicted that the price of petroleum relative to the prices of other world traded commodities would remain more or less constant for the remainder of this century. I had hardly uttered these brave words and left the country to work for six months with the OECD in Paris when a short man with a long beard moved from Paris to Teheran and supervised a revolution which, among other things, induced an almost three fold increase in the world price of petroleum.

I did predict that "as investments in alternative energy sources come on stream and as the high price of petroleum induces some conservation, ... the strains on the OPEC carrel will be increased, and the pressure on the relative price of petroleum is likely to be downward."

Still, I was not invited back to Town Hall in 1980, 1981, 1982, or 1983. Today, as the price of oil <u>is</u> falling while prices of most other goods continue to rise, I'm glad to be here again. Nor am I unduly chastened by my earlier experience, and, in the interest of offering a summary and conclusion in advance for anyone I lose along the way, for whatever reason, I hereby predict that headlines about the possible default by various developing countries on their external debt will appear less often in the foreseeable future. Argentina remains a very troublesome case, but more for political than economic reasons. Assuming, as I do, that the deficit of the federal government of the United States will decrease, that world-wide inflation will remain under control, that real interest rates will fall, and that the dollar will decline by enough to induce a better American export-import balance without substantially closing American markets to the exports of debtor countries, I believe the flow of capital to, and the consequent new growth of, many developing countries will recommence. Indeed, debtor countries which export manufactured goods may grow rapidly in the medium term as changes in exchange rates make their exports competitive <u>and</u> an elastic international demand encourages growth.

Let me begin be reviewing a few summary statistics from the International Monetary Fund.

-- The total external debt of all non-communist developing countries (excluding the oil exporters of the Persian Gulf and Libya) now exceeds \$800 billion. This compares with \$400 billion in 1978 and \$200 billion in 1974. Of this, just under \$100 billion or 12 percent is short-term debt. This is down from 20 percent in 1982 and 17 percent in 1978. Fifty seven percent (\$460 billion) is owed to private institutions. This is up from 51 percent in 1982 and 49 percent in 1978.

-- Thirty-Eight percent (\$315 billion) is owed by the developing countries of the Western Hemisphere as compared 22 percent ($185 billion), by the countries of Asia. Roughly $250 billion is owed by Mexico, Brazil and Argentina.

-- The external debt of all developing countries as a percentage of their gross domestic product has risen from 25 percent to 35 percent since 1978 and stands at a high for the past ten years.

-- The external debt of all developing countries has risen as a percentage of exports since 1978 from 131 percent to 147 percent, though it is down from 154 percent in 1983.

Of more significance, perhaps, is the sub-group of seven countries classified by the International Monetary Fund as Major Borrowers -- each with outstanding indebtedness at the end of 1983 of at least $30 billion overall or at least $20 billion to private creditors. These seven are Argentina, Brazil, Indonesia, Korea, Mexico, the Phillipines and Venezuela. Four of these are in Latin America and are included in all prominent lists of debtors in some trouble. None of the seven is included in the sub group of low-income countries eligible because of their poverty for grant-type World Bank IDA assistance. The problem debtor countries tend to be middle-income countries which, until 1981, were developing well, some of them spectacularly well, and herein lies is a clue to the much publicized payments difficulties.

An analogy can be drawn, it seems to me, between the borrowing of a growing country and an expanding business. One expects the debt of a business to grow as its sales and assets grow even though individual creditors may be paid off as new debt is incurred. The business borrows from its suppliers and from banks to purchase short-term assets and from banks and bondholders to purchase long-term assets. A proper mix and quantity of assets enables the business to increase its sales and, hopefully, its equity -- that fraction of its assets not encumbered by debt. A business may become illiquid and have trouble paying interest and principal on its debts if, relative to its assets, too many of its liabilities are short term. It can have trouble paying interest and principle if its sales decline. But borrowing is wise so long as the company's assets increase faster than its debt, and more borrowing makes sense when the interest rate is low than when it is high.

It makes sense, similarly, for developing countries to borrow to finance imports so long as the interest rate on its accumulated debt is less than the growth rate of its real gross national product. If this criterion is met, the size of the debt should not matter; in the case of the developing country, one would expect the external debt to grow as the country grows. With rising G. N. P. and rising exports relative to its external debt, a country can make the necessary payments of interest and principal due and still be better off than if it had not borrowed at all.

If a disproportionate fraction of the principal on past debts comes due all at once, however, payment may interfere with imports and, therefore, growth. If external borrowing does not finance real growth, repayment must reduce living standards: imports financed by more borrowing will postpone but not forever prevent this problem. If the export capacity as well as the total production capacity of a debtor country does not grow as its external payments increase, debt service may require a decrease of imports and, therefore, growth. If the rest of the world will not purchase the exports a debtor country has the capacity to produce, the same thing may occur.

So much for generalities. What has happened in fact in the real world? Except for the direct investments in other countries by private enterprises such as the great international oil companies, long-term international capital movements shrank almost to zero in the depression and war decades of 1929 to 1948. There was so little long-term international borrowing and lending that the governments of the free world sponsored and subscribed to the World Bank and then to regional development banks to stimulate externally financed economic development in the low-income less-developed nations of the world. At first the Bank found little to do: because it borrowed most of the funds it it loaned from private investors, it was obliged to take few risks and to investigate carefully the projects it financed. In time, it perceived that the poorer credit risk countries were unlikely to develop at all if they had to borrow at commercial rates of interest, so it established a subsidiary, the International Development Association, to make loans to the poorest countries at virtually zero rates of interest. This helped development, but questions about the rate at which countries could usefully use external finance still had to be answered. By the late ʹ60s, the growth process was sufficiently understood so that a growing number of low-income countries were developing, the ordering of projects being guided adequately either by development plans or by the free market. Inevitably, private lending organizations began to be interested in international loans.

Concurrently, the world of private banking was changing. There was the development of the unregulated Euro-currency market and the expansion of branch banking, at home and overseas. Foreign branches of American banks rose from around 100 in the early 1950s to over 800 by 1983. A major purpose of these branches was to finance trade and investment in the countries in which they are located. Foreign lending grew with foreign trade, and competition was fierce. Interest rates higher than one percent above the London Inter-Bank offering Rate were unusual -- except for loans to governments of newly developing countries, where the rewards seemed greater than the risks.

More recently, the deregulation of banking and the competition for deposits has had the effect of raising costs and, therefore, interest rates. Bankers have had to worry about keeping depositors as well as making sound loans. And inflation has had the effect of causing banks to offer loans with shorter maturities. As the Saving and Loan Industry discovered in the seventies, it is dangerous for a financial institution to have long-term investments yielding relative fixed rates of return at the same time that interest rates on deposit liabilities are rising. What I am suggesting is that changes in banking practices beginning in the late sixties made lending to newly developing countries more attractive, at least for awhile, but they also affected interest rates and maturities -- to the detriment of borrowing governments.

Interest rates and export prices matter. By 1976, the external debt of eighty-six non-oil exporting less developed countries had doubled in four years, but the prices of the exports of these developing countries -- on the average -- had also doubled. In real terms, the external debt of these countries had increased by only 20 percent and the real value of their output had also increased by 20 percent. In spite of oil price increases, the burden of their external debt was not increasing. Borrowing to finance development made sense. The lending by private American banks (seventy five percent of which in 1976 was guaranteed against default by the United States government) seemed also to make sense because loans were made for the most part to middle-income developing countries such as Brazil, whose real G. N. P. more than doubled during the decade of the seventies while, between 1957 and 1970, industrial production grew by 8.4 percent a year. It is hard to find fault with the international lending of private American banks during the early and middle seventies. There was some concern during the recession of 1974-75 as United States imports from less developed countries fell drastically, but by 1977 all seemed well again. Then, slowly at first but rapidly beginning in 1981, things seemed to go awry.

Between 1978 and 1984, the external debt of all developing countries doubled, and the ratio of external debt to G. N. P. rose from

25 to 35 percent. For major borrowers, the debt to export ratio rose from 199 to 238 percent while the debt to G. N. P. ratio went from 20 to 48 percent. As we all know, some of the major borrowers seemed to be in over their heads. What went wrong?

I believe the answer is two fold: the domestic economic policies of some borrowing countries, particularly some in the Western Hemisphere, were unsound, particularly in a world of disinflation; and the disinflation brought about in the United States by high real interest rates and a deep recession created problems for the rest of the world which will be alleviated only gradually over the next half decade or so. But these problems are not different in kind from the problems of the oil drillers in Oklahoma who borrowed too much in anticipation of higher energy prices and brought down the Penn Square Bank and almost the Continental Illinois; or the mid-western farmers now stuck with declining land, and depressed grain, prices; or the real estate speculators who borrowed from Crocker Bank and paid too much for land.

Let me speak about the problem of disinflation. When world prices were rising at a percentage rate which exceeded interest rates -- as they did during much of the seventies, borrowers could pay interest and principal at a discount so to speak. In some years, the effective interest rate was less than zero. Just as it paid a speculator to borrow at 10 percent to buy a house which could be sold in a year with more than a 10 percent net appreciation, it paid Mexico to borrow at 10 percent to buy oil drilling or refining equipment if, during or the lifetime of the equipment, the world price of oil continued to increase annually by more than 10 percent.

In the seventies, the prices of exports (and imports), kept rising by enough to offset interest rates, so borrowing made a great deal of sense. Specifically, from 1973 to 1980 the value of the exports of developing countries grew at 21 percent per year while international interest rates averaged 10 percent. Since 1981, export prices have risen at a rate lower than prevailing interest rates, and the volume of exports had declined. In 1981 and 1982, the value of world exports increased by a mere 1 percent while world interest rates averaged 16 percent. In such a period it makes less sense to borrow, and it becomes a great deal more difficult for a debtor to earn the foreign exchange needed to amortize and to pay interest on past borrowing.

In 1980, it took 19 percent of the exports of Latin America to earn the foreign exchange needed to pay interest on external debt; by 1982 it took 35 percent. In fact, in 1982, amortization and interest payments on past debts amounted to over half of Latin American exports, this in comparison with a debt service ratio of only 11.2 percent for Asian debtors and 11 percent for debtor countries in Africa, Europe and the Middle East. This explains why outright defaults by some Latin American debtors, at least on interest payments, would certainly have occurred in 1982 had special measures not been worked out by the International Monetary Fund, the United States Treasury Department and the great commercial banks of Europe, Japan and the United States.

Without getting into an extended discussion with political overtones at this point, let me just say that, in my judgment, the American disinflation of the 1980-84 period could have been engineered with a great less pain both nationally and internationally if personal income tax cuts had not been enacted and if monetary policy had been allowed on that account to combat inflation in the context of lower interest rates. It has been estimated that a 1 percent increase in American interest rates adds $2.5 billion to the annual interest payments which must be made by Western Hemisphere debtor governments.

Let me turn now to the borrowers. What did the governments of Mexico, Brazil and Argentina, the most notorious debtors, do wrong? One thing they all did wrong was to permit their currencies to become overvalued in exchange markets at one time or another -- most of the time, actually, after 1980. Overvalued currencies induced a level of imports which could not be sustained even with a continuation of external borrowing at a constant real ratio. They also encouraged uneconomic exports of capital -- by wealthy Mexicans, for example, who bought American real estate -- and, as the overvaluation became obvious, they induced a flight of capital which seriously reduced foreign currency reserves otherwise available to service external debt.

The Mexican case is the simplest to understand. The sharp increase in oil prices in 1979 and 1980 gave the Mexican government overconfidence in future growth rates and in the extent to which Mexico could prudently borrow to finance the expansion of the petroleum and other industries. The resulting increase in aggregate demand produced domestic inflation at a rate more than twice that in the United States. The peso was allowed gradually to decline but it remained overvalued until, on February 18, 1982, it was allowed to float quickly down to the level of 45 to the dollar. Meanwhile, the interest rate on its external debt had risen, exports had declined, and the internal public sector deficit reached 15 percent of G.N.P. The era of rapid growth of output, employment and per-capita income suddenly ceased, and, though austerity is now making it possible for Mexico to service a restructured external debt (Mexico's imports from the United States fell by $10 billion in 1982), a resumption of rapid growth now seems unlikely for some years.

The case of Brazil is not a great deal more complicated. Brazil is a net oil importer. In an effort to sustain continued high growth after the major oil price increases of 1973 and 1979, Brazil increased its external borrowing. Brazil's external debt rose from $10 billion in 1973 to $47 billion in 1979 and nearly $100 billion today. From a very nearly balanced current account in 1972, Brazil moved to a $12 billion current account deficit in 1980: increases in imports and interest payments on Brazil's external debt more than offset the growth of exports. By the end of 1982, Brazil had exhausted its international reserves, and suspension of interest and amortization payments on external debt became a very real possibility. At this point the U. S. Treasury, the Bank for International Settlements and a small group of commercial banks provided Brazil with stop-gap funds while the International Monetary Fund and private banks arranged new medium term loans and the roll over (renewal) of existing loans coming due. The total package amounted to $20 billion, temporarily saving the day, but raising Brazil's interest payments without affecting the underlying problems of trade and growth. In an effort to free resources for use in the foreign-trade sector, the government has cut subsidies, real aggregate demand has fallen as has employment -- by more than 15 percent since 1981. But with domestic inflation high and rising, the cruzero must fall more than it has. Meanwhile, the $10 billion per year interest due on Brazil's external debt cannot be financed by an export surplus of $7 billion, and the current $7 billion export surplus is due more to a decline of imports than an increase of exports. So borrowing continues.

Inflation in Argentina had fallen to 50 percent a year in 1979, the government deficit to 3 percent of G. N. P. Then, as oil prices increased and public spending, largely military, soared, the government deficit soared. By 1983 it had risen to 14 percent of G. N. P. Inflation increased, and the devaluation of the peso continued apace, though rarely by enough to stay ahead of inflation; and the flight of capital rose so much that, for all practical purposes, new external borrowing went to finance private capital outflows. Unlike Mexico and Brazil, Argentina had had little growth in the 'seventies. Indeed, by mid-1982, industrial output had fallen to the levels of the 'sixties. Argentina's external debt was near $36 billion, more than half of it short term, and annual interest payments were $4.5 billion. After the Falklands, a historically rich and potentially richer country was as near bankruptcy as a country is likely to be insofar as the term bankruptcy can be applied to a country. As with Mexico and Brazil, Argentina was bailed out of its immediate crisis by the loans and cooperation of the International Monetary Fund and leading commercial banks.

Have Mexico, Brazil and Argentina and, for that matter, Venezuela, Peru and Chile borrowed too much abroad? As of 1982 and '83, obviously yes: without new loans, they could not have avoided outright default on annual interest and amortization payments. But are they unsolvent or illiquid? Were they more like the Penn Square Bank or the Chrysler Corporation? I believe they are more like the Chrysler Foundation: given time, they _can_ sell more; they can service their debts _and_ resume their economic growth. As the Manufactures Hanover Trust Company -- a not altogether disinterested party -- recently pointed out, the six high-debt Latin countries boosted their aggregate trade surplus from less than $3 billion in 1981 to nearly $30 billion in 1973. Unfortunately, from the point of view of growth and living standards in the debtor countries only $2 billion of this improvement came from an increase in exports; $25 billion came from a decrease in imports, largely from the United States. Still, the dangers of outright default are considerably less than they were two years ago except, perhaps, in Argentina where inflation is raging out of control at an annual rate of 1,000 percent and more and more prices are being quoted in dollars rather than pesos. Argentina is becoming like Germany in the early 'twenties where the money supply fell relative to

G. N. P. because the transactions velocity of circulation rose causing and being caused by hyperinflation. In Germany the hyperinflation was solved by massive foreign loans, by a reduction of government spending as a fraction of G. N. P. and an increase of taxes. The International Monetary Fund is trying to induce a similar solution in Argentina, but the newly elected government may be too weak for the task. Unemployment is already high, and it is likely to rise further if government spending is reduced. It may be that an incomes policy as used in Mexico will be needed in Argentina if inflation is to be brought under control.

New loans to repay old loans are needed across the board, just as they were needed by the Chrysler Corporation. Nearly 53 percent of the external debt of the six major Latin American debtor nations has a one year maturity and must be rolled over. Lest you cringe at this statistic, however, I must quickly add that, according to Manufacturer's Hanover Trust, 48 percent of Corporate America's debt and 34 percent of U. S. government debt has a one year maturity.

More lending is needed in the sort run and an increase in exports is needed in the longer run. Thus, it is desperately important that the United States not deny the exports of developing countries, even if those exports are subsidized. A few of you may remember the absurdity of the early 1930s when the United States reduced its imports so low that the rest of the world, even if it had bought nothing from the United States, could not have earned enough dollars to service outstanding dollar debts. Let's hope such a situation doesn't happen again.

A decrease in American interest rates will help a great deal. and I rather expect American interest rates to continue to decline, at least in the short run. Real interest rates in the United States have fluctuated between an abnormally high seven and ten percent since September, 1981. As expectations of new inflation subside, however, real interest rates will surely decline in spite of the historically high deficit of the federal government. If the deficit could be substantially reduced, real interest rates could be expected to decline even more. As American interest rates decline, the dollar will probably decline, and this will reduce the foreign currency import costs not only of American goods but of dollar-priced middle-eastern petroleum as well. Foreign exports will earn more dollars per unit. Of course American exporters will be more competitive, but in economics its hard to have everything go right the same time!

I am optimistic. I hope you are too and that we are all right.