WORLD DEBT AND THE INTERNATIONAL FINANCIAL SYSTEM
Remarks of Mr. Robert P. Forrestal, President
To North Fulton High School Students of International Business
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Good morning! I am delighted to be here with you today. I have been very impressed with the progress and performance of the magnet school program in Atlanta. As you may know, the Federal Reserve Bank of Atlanta, along with a number of commercial banks, sponsors the Harper High School magnet program in the financial services industry. The international program here at North Fulton High School, like the financial program at Harper, has come a long way in the very short time since its inception. Each of you deserves to be proud of your school's achievements and, more importantly, of your own initiative in tackling the additional challenges that this international program offers. I must say that when looking over the assignments and reading list for this class, it struck me as the equivalent of many college, rather than high school level, courses.

As you know, I have been invited to talk to you today about the problem of world debt and the implications of that problem for the American and the international financial systems. Although this problem is no longer of the crisis proportions that it was just a few years ago, it remains a serious cause for concern among bankers, business leaders, and policy makers. What I would like to do this morning is to begin by describing when and how the problems started. Next I'll review for you how the crisis that erupted in the early 1980s was resolved. Third, I'll try and bring you up to date on the current dimensions of the world debt problem, and to do so I have some hand-outs on which countries are most heavily in debt. Next I'll turn to the financial system and describe how this debt has affected banks and other financial institutions in the United States. In addition, I'll go into the potential problems that could arise in the American and international financial systems and how those could affect you and me. Finally, I'll review briefly some recent measures that have been initiated to avoid future problems and bring further improvement to the progress we have already seen in the world debt situation over the past several years. That's going to be a lot of material to cover in just an hour--and I would like to leave time for you to ask questions--so let's get started.

When and How Did the Debt Problem Begin?

The roots of the global debt problem can be traced to the mid-1970s. At that time oil prices began to rise sharply as a result of the actions of OPEC, the Organization of Petroleum Exporting Countries. The members of that organization control a large portion of the world's supply of oil and thereby have a major influence over its price. Since oil had become the primary source of energy in so many industries and countries, their agreement to restrict oil production and the rise in prices that followed had a tremendous influence on economies around the world. Even in the United States, which has the world's largest, most prosperous, and probably most diversified economy, the shock of the rapid increases in the price of such a basic commodity threw the economy into a recession. In view of the disruptions that beset the United States, you can imagine what the effects were on the many smaller economies, especially those which import virtually all their oil and which were trying hard to modernize and industrialize their economies. In the decade following the first jump in oil prices the value of oil imported by those developing countries rose from 6 percent of their total imports of goods to 20 percent. In other words, developing countries had to spend a much larger share of their export earnings to obtain the oil needed for their economic development programs.

Of course, not all developing countries are oil importers. Many OPEC nations fall into this category, and the rise in oil prices was a great boon to them. In fact, they were the ultimate source of many of the funds that developing countries subsequently borrowed in their massive build-up of debt. This process is often referred to as the "recycling of petrodollars." It is termed that because oil is typically bought and sold with dollars even by non-Americans. Many oil-exporting countries were now earning huge surpluses. These were reinvested, or "recycled," as loans to non-oil LDCs. Much of the recycling was done indirectly, through the international banking system. That is, oil exporters with large surpluses deposited these funds with major American and European banks; the banks, in turn, lent the money out to non-oil LDC's. Not all oil-rich countries became lenders, though. Some that had vast oil resources actually became far more indebted during this period. The most well-known example is Mexico, which, today, is one of the most heavily indebted nations in the world. Mexico was not a major oil producer when the first oil price shock occurred. As the price of oil rose in the 1970s, Mexico borrowed heavily to accelerate the development of its oil production. Other oil exporters have large populations but more modest oil supplies than some of the oil-rich nations of the Middle East. These countries, which include Nigeria, Venezuela, and Indonesia, are also much more heavily in debt than they were when oil prices first began to rise over ten years ago.

Leaders of many developing countries, faced with this worsening situation in international trade and pressures at home to improve living standards increased borrowing to sustain the push for rapid economic growth that they had promised their people. Viewed from the perspective of the times, this option made some sense. First, it is quite normal for developing countries to look abroad for funds. The United States was a debtor nation during the nineteenth and early twentieth centuries. Funds borrowed from Europe helped us industrialize much faster than we would have been able to by relying simply on the savings of Americans, who were much less prosperous than we are today and who had far less income to put in savings. Secondly, interest rates in the 1970s were quite low, thus encouraging borrowing. Finally, as I noted, funds were readily available from many oil-exporting countries as well as the advanced economies of the world.

The solution of increased foreign borrowing to deal with the problem of rapidly rising oil prices seemed to work for most developing countries until the early 1980s. The industrialized economies recovered from the initial shock of rising oil prices in 1973 and 1974. As they did, their demand for goods, including the exports of developing countries, began to grow once again. Debt--at low interest rates-- was helping developing countries to finance fairly rapid growth at home. Some setbacks occurred with the second round of oil price increases in 1979-80. At that time Iran's pro-Western government was overthrown by revolution, and worldwide supplies of oil contracted. Nonetheless, growth in Europe, America, and Japan was initially not dampened very much after this second price shock. Even as interest rates began to rise in 1979 and the early 1980s, what economists call the "real" interest rate--the rate actually being paid minus the rate of inflation--remained low for some time. Inflation was becoming so rapid that a borrower could expect to pay off a loan in dollars that would be worth much less in just a few years. This combination of low real interest rates and strong demand for LDC exports encouraged developing countries to continue to rely on annual increases in external debts.

Four developments in the early 1980s changed this picture, turning it from a somewhat troubling but controlled situation into a full-blown crisis. These were (1) an abrupt slowdown in inflation; (2) severe recessions in the industrialized nations; (3) a decline in the value of goods exported by developing countries; and (4) the drying up of new lines of credit for many LDCs. These were essentially international factors. A fifth factor, domestic policies by many developing countries, also played a role in making the situation even worse.

One of the most important developments that precipitated the debt crisis in 1982 was the decline in inflation that began in the early 1980s. An end to ongoing price increases was a necessary and very healthy development in the United States and other industrialized countries. Yet, its short-term effects on developing nations were quite negative. The reason for this is that dollar interest rates did not come down in concert with the dampening of inflation. Interest rates remained quite high. Thus, it was now not only more expensive to borrow money but borrowing countries could not take comfort in knowing that inflation would make it easier to pay off these loans in the future.

Because real interest rates were so high, the world's advanced economies experienced severe recessions from 1980 to 1982. Businesses borrow to build new plants and buy more modern equipment. Many also rely on loans to meet their payroll during a peak production season before they have received payment for the goods they are producing. Others borrow to build an inventory of supplies. As the cost of borrowing became quite high, many businesses found it unprofitable to operate at the same level they had been. Consumers also are heavily dependent on borrowing to buy many goods including homes, automobiles, and major household appliances such as televisions, refrigerators, and washing machines. Consumers too had to cut back on borrowing and, hence, on making such purchases. The slowdown in demand generated by businesses and consumers in the United States, Europe, and Japan soon had an adverse effect on the exports of developing countries.

As businesses cut production, many workers were laid off or put on reduced hours. As a result, consumers in developed nations had less money to spend on all kinds of items, including imported shoes, coffee, and the many other goods that developing countries were producing for sale abroad. Similarly, U.S. businesses had less need for many of the raw materials and commodities such as copper and tin that are a basic part of numerous industrial processes and which are the main resource of many foreign countries. As the demand for the products of less developed countries fell, commodity prices dropped worldwide. The decline was quite dramatic--25 percent from 1980 to 1982. Meanwhile, for other reasons, the U.S. dollar began to rise dramatically in foreign exchange markets. This jump made many of the goods and services LDCs need to import--including oil, which is priced in dollars--more expensive. Thus, the prices of LDCs' exports were falling at the same time that their costs of borrowing and buying from abroad were rising sharply.

To make matters worse, a number of developing countries pursued domestic policies that increased their debt burden further. Even before the conditions leading to the crisis began, many developing countries had followed a course often termed "economic nationalism." One aspect of this course involved restrictions on what is called "foreign direct investment"--that is, investment by foreign companies in factories and other developments in the developing countries. Moreover, many countries protected inefficient local industries by limiting imports. When the debt crisis hit, these industries were ill-equipped to earn export revenue, which could have helped in meeting debt payments.

In addition to such nationalistic economic policies, many LDCs also had very large public sectors. Government agencies employed thousands of workers, but the cost of their salaries, along with that of the many commercial projects these governments typically engaged in, tended to put the governments' budget in the red and, therefore, require extensive borrowing. This public sector borrowing crowded out many projects by private enterprises in LDCs. After the crisis erupted, some developing countries increased the role of the public sector even further. They did so in hopes of maintaining the sort of high growth rate that they felt was essential to their national goal of economic development. However, the timing for such a policy was no longer appropriate. In many LDCs such policies contributed to rampant inflation. It would have been better in these circumstances to follow a much more cautious course of action. Inflation caused many people with savings to move them abroad rather than invest them at home because the value of their own currency was falling so rapidly. I'm not condemning those foreign leaders who adopted such measures in the midst of the debt crisis. It's easy to be a Monday morning quarterback but much tougher to be calling plays under the pressure of the moment, and, at that moment, very few people--in the advanced economies as well as in the LDCs--could foresee what was in store.

What was in store was the sudden announcement in August 1982 by Mexico, then Argentina and Brazil, that they were unable to make payments on the very considerable debt each of these countries had built up. Once a debt crisis erupted in one country, it quickly spread to others. By the end of 1982 over 30 countries were in arrears. One factor that contributed to this rapid spread of problems was that new sources of credit had dried up. New lending fell from over $50 billion in 1981 to $11 billion by 1983. This sequence of events spelled major trouble not only for the countries involved and for the banks that had lent them such considerable sums but also for the American and the international financial system as a whole. Fortunately, quick and wise action on the part of a number of Western leaders defused this crisis and in the years since then the situation has steadily improved.

Before I turn to this crisis and how it was handled, let's review what led up to it. As I've mentioned, the main factors were the sharp rise in oil prices in the early 1970s and again in 1979 and 1980, escalating interest rates during the early 1980s--increases that were not offset by rapid inflation--declining prices for the exports of developing countries that were now heavily in debt, a sharp curtailment in credit by industrialized nations to those in the developing world, and domestic economic policies in many LDCs.

How Was the Debt Crisis Resolved?

Four major rescue operations--involving Mexico, Brazil, Argentina, and Yugoslavia--were carried out by leaders of the United States and other Western nations along with certain international organizations. The initial action in the case of Mexico, where a crisis erupted first, was taken by U.S. authorities. The United States prepaid a large amount of oil purchases that our government was stockpiling for strategic purposes, and we advanced credits for other commodities from Mexico. Private banks agreed to a delay in payments due them. More importantly, we mobilized the central banks of other Western nations to lend money on a very short-term basis to Mexico. These loans served as a bridge until a more permanent solution could be thought out and implemented.

This longer-term solution, not only in Mexico but in virtually all the countries that were involved in the crisis, was handled primarily by the IMF, the International Monetary Fund. Under IMF pressure private banks agreed to a rescheduling of the loans that were due in return for the IMF's agreement to provide additional funds. In other words, the dates on which current principal payments were due to commercial banks were pushed into the future and spread over a longer period of time, typically five to eight years, than had been specified in the original loan. With respect to the borrowing countries, the IMF required certain changes in domestic economic policies. These changes were intended to stabilize the domestic economy and, in particular, to bring inflation under control. For example, large government budget deficits were to be reduced so that private borrowers were less likely to be "crowded out" of domestic credit markets. In addition, imports were to be brought more closely into line with exports.

The course of events in each of these countries was somewhat different, but in the three Latin countries the IMF programs were similar. Looking back it is almost surprising that this crisis was resolved so quickly and effectively. Mexico's announcement came in the summer of 1982, and by the late fall an IMF agreement had been signed. Brazil's inability to make payments actually came after Mexico's, when credit markets began to dry up, but by the end of 1982 it too had reached an agreement with the IMF. Argentina's agreement was slower in coming but was signed early in 1983. By the end of 1983 Argentina, Brazil, and Mexico were no longer running trade deficits. That is, their imports were no longer outstripping their exports. Instead they had an overall trade surplus of $24 billion. The current account deficit of LDCs--that is trade in goods and services plus transfer from abroad such as official grants--had been slashed to one-third of the 1981 level. Over the next two years, the record has generally been good even though from time to time there have been some problems.

Recovery in the advanced economies has helped the situation tremendously. Developing countries have been able to increase their exports of manufactured goods, especially to the United States, where expansion has been quite strong and markets are more open to imports. However, prices of basic commodities--natural resources like copper, tin, and even oil--have remained very low. Consequently, exports earnings have not risen as dramatically as many had expected. Since export growth has been less than hoped, most LDCs have brought their trade balances into line, as called for by the IMF, by drastically controlling imports. This cut has been hard on farmers and manufacturers in the United States who had come to rely heavily on LDCs to buy their products. Another troubling factor has been that interest rates have stayed fairly high in comparison to inflation. This high cost of credit has not made matters any easier for developing countries to pay down their debt. Thus, despite the considerable progress that has been made, I'm afraid we're not out of the woods yet.

Current Dimensions of the Problem

What is the situation today, not just in the countries that were directly involved in the crisis of the early 1980s, but more generally among heavily indebted nations and their creditors? I've brought along a few hand-outs that will help answer this question. As you can see from Table 1, the problem of a heavy debt burden among developing countries is by no means limited to those countries that were directly involved in the rescue operations I described. Mexico, Argentina, and Brazil are still among the largest debtors, but a number of other developing nations also owe considerable sums to the financial institutions of industrialized nations. Prominent among these are Venezuela, Chile, and the Philippines. Despite the inclusion of the Philippines on this list, most Asian nations do not face debt problems. Instead, these heavily indebted countries are concentrated in Latin America. Together the Latin American and Caribbean nations owe almost $68 billion to 200 or so American banks. Incidentally, you should be aware that this figure has been adjusted to factor out loans that are covered by government guarantees. If we add to this figure the amounts these countries have borrowed through other foreign subsidiaries, the figure climbs even higher--to more than $72 billion as of last June. This is a considerable sum of money in itself. Its sheer size would give us cause to be concerned about another debt crisis.

However, this figure is not the whole story. First, these same countries are indebted not only to U.S. banks but also to financial institutions elsewhere. Mexico, for example, owes more to other lenders than its total debt to the United States. The same is true of Brazil, Argentina, and the Philippines. Thus, the problem of debt is truly international in scope, not only among borrowers but also among lenders. Second, as we can see from Table 2, this volume of debt is placing a heavy burden on the economies of the developing countries involved. The cost of servicing this external debt—essentially the amount of interest due at each payment period--is consuming about one-fifth of the value of exports that these countries are selling. This debt service is absorbing almost 4 percent of the GNPs in these countries. In addition, progress against inflation in LDCs has been disappointing, and average income levels for people in these countries remain below what they were before the crisis. What all these numbers mean, in very simple terms, is that the debt burden is exerting a considerable drag on the national goals of economic growth and development to which these developing countries are deeply committed.

Effects on the World Banking System

From our point of view as citizens of a highly developed country, this situation is equally troubling. It contains the seeds of a financial crisis, one that could possibly get out of hand and bring the entire world into a recession. The reason that such a financial and economic disaster could occur pertains to the agencies involved in the lending. In the 1930s foreign borrowing was often done through bonds. If a default occurred, losses were limited to the bond holders, who had willingly undertaken the risk in return for the chance to earn a substantial return. In the post-World War II era, much lending was carried out through international credit agencies such as the World Bank. Since the 1970s, however, private banks have been the major lenders, and the amount of foreign loans relative to the capital base of a number of banks has become dangerously large. As Table 3 illustrates, the volume of loans to Latin American and Caribbean countries equals over two-thirds of the capital of the 200 largest banks in the United States.

You might be thinking that this large sum could lead to problems only if virtually all countries were engulfed in a crisis simultaneously. However, it's important to bear in mind that these loans are concentrated in two ways. First, a fairly small number of countries accounts for the lion's share of total borrowing, and, as we saw in 1982, problems in one or two countries can quickly lead to a drying up of new credit in other countries and subsequent crises there as well. Second, this lending is also concentrated among a fairly small number of U.S. banks. Of the $80 billion in Latin American and Caribbean loans outstanding to 200 American banks, $50 billion is owed to the nine largest institutions. Moreover, among these nine banks, the volume of loans to just four countries--Argentina, Brazil, Mexico, and Venezuela--exceeds their total capital. If one or two of these countries got into trouble and, in essence, defaulted on their loans, other countries might quickly be drawn into similar circumstances. The result would be to deplete the capital of a number of U.S. financial institutions. This development, of course, would be quite severely felt by the owners of those banks--their stockholders. However, it would also affect you and me in a very adverse way. The affected banks would have to draw out of their capital in order to pay off these huge losses. Since banks are allowed to make loans far in excess of their capital--on a ratio of more than 10 to 1--the loss of the capital of these large banks would abruptly curtail lending to a vast number of businesses and individuals. Banks would have to reduce their total loans outstanding in order to come back into conformity with banking regulations. People could begin to lose confidence in financial institutions generally and withdraw their deposits. Such a development would lead to a run on banks and put further strains on the financial system by reducing the core of deposits which serve as the base for loans. If our domestic credit markets were to dry up, all of us would find it very difficult to conduct business or to make our usual purchases of cars, homes, and other items that we consumers usually buy on credit. The result could easily be a recession both here and in many other countries.

This extreme chain of events that I have just described is very unlikely to happen because the Federal Reserve System and the central banks of other industrialized nations along with international organizations like the IMF would intervene quickly, just as they did in 1982, to bring matters under control. Nonetheless, we must keep in mind how serious the consequences would be if we fail to keep close tabs on the situation and act promptly and wisely when the necessity arises.

Even in the absence of such a disaster, the present situation is causing strains on the world economy and financial system. As I've mentioned, developing countries are having difficulties in buying as many American products as they once did. I'm sure I don't have to remind this audience that we are living in a global economy now, and American manufacturers and farmers depend increasingly on exports to foreign markets for sources of growth. At the same time, the lending flexibility of many major financial institutions is being impeded by the uncertainties surrounding their debt burdens to developing countries. This uncertainty factor is probably keeping interest rates here higher than they would be otherwise and thus acting as a slight deterrent to economic expansion.

Meanwhile, the heavily indebted developing countries are becoming increasingly frustrated with their stalled progress. Most never expected the austerity measures imposed in 1982 to continue for as long as they have, and today many feel there is no end in sight. This economic frustration increases the chances for political unrest and instability. It also is encouraging talk of more drastic measures, such as repudiation of major portions of this debt by a coalition of borrowing countries. Such measures are quite unlikely. Foreign debt has only rarely been repudiated because the possibility that a country will get new credit is thereby destroyed. However, this frustration cannot be ignored entirely. Neither can we overlook the problems that I've noted in the advanced economies--slower economic growth due to lower exports to LDCs and continuing financial stress. In 1984 Argentina threatened to interrupt its payments because of difficulties in complying with certain IMF programs. This threat had immediate repercussions on those American banks that have a large concentration of loans to Argentina. When confidence in a major financial institution is eroded, it doesn't take long for such attitudes--whether grounded in fact or not--to spread and disrupt large sections of our financial system.

New Initiatives

Although this list of problems does not mean that a new crisis is around the corner, and in fact, much improvement has taken place, there is increasing concern about the strains I've outlined. Recognizing the need to address some of these problems before they become more serious, leaders of the World Bank and the IMF met in Seoul, Korea, a few months ago and began to spearhead an effort to bring about further progress. This latest initiative has four main major components. First, private sector banks are being asked to open new credit lines to developing nations. The amount of new credit American banks are being asked to lend to 15 heavily indebted LDCs is $20 billion over the next two to three years. This figure is equivalent to a 2-3 percent annual increase. The other aspects of this latest initiative include an increased role for the World Bank and certain commitments by the governments of both developing and developed countries.

The role envisioned for the World Bank is not really a new concept. Actually, the IMF was initially intended to solve short-term monetary problems, whereas the World Bank was to be involved more in long-term economic development projects. Now that the debt problem is clearly more than a short-term financial crisis but closely related to a series of longer term economic problems, it seems appropriate that the two agencies resume the roles for which they were originally intended. According to the Seoul agreement, the World Bank would provide $9 billion of additional funds over the period. In addition, the World Bank's focus would change from its traditional emphasis on large, public sector projects such as roads, dams, and harbors to laying the groundwork for more private sector activities in developing countries.

The commitments asked of LDCs essentially involve the continuation of the policies of economic stabilization they have pursued in the past few years and the implementation of the same type of market-oriented policies the World Bank will be focusing on. The developed countries are being asked to sustain a level of economic growth in the neighborhood of 3 percent. Such a level is deemed necessary if LDCs are to find enough outlets for their exports to enable them to pay down their debt burden within the rescheduling periods agreed upon.

Conclusion

It's too soon to say what will come of this latest initiative. Many players are involved, and each might have to make certain sacrifices. I would say, however, that I regard the problem of world debt as a serious one that requires constant vigilance until further progress can be assured. Therefore, I applaud these latest efforts, and I certainly hope the goals that underlie them are achieved. If they are not, the potential losses to the entire world are frightening to think about. If, however, progress can be made toward reducing world debt and easing pressures on the economies of both developed and developing nations and on the international financial system, I am sure that the gains to be made in terms of economic prosperity and individual well being around the world are of enormous proportions. I want to leave you with a note of optimism: I firmly believe that we can and will succeed in achieving these goals.

Table 1

Debt Owed to U.S. Banks by Major Foreign Borrowers, 1985

Country	Amount Owed (in millions of U.S. dollars) To 200 Largest U.S. Banks	To 9 largest U.S. Banks
Argentina	7,527	4,847
Brazil	22,385	14,628
Mexico	24,094	13,517
Venezuela	10,148	7,075
Subtotal - Argentina, Brazil, Mexico, Venezuela	64,154	40,067
Chile	6,285	3,636
Peru	1,880	1,028
Total - All Latin America and Caribbean	79,767	49,798
Philippines	4,996	3,500
Yugoslavia	2,217	1,380

Source: Federal Financial Institutions Examination Council

Table 2

Principal External Debt Ratios (Percent), 1983

Country	Debt Service: Exports	Debt Service: GNP
Argentina	24.0	3.8
Brazil	28.7	3.5
Mexico	35.9	7.3
Venezuela	15.0	3.7
Chile	18.3	5.1
Peru	19.6	4.6
Philippines	15.4	3.7
Yugoslavia	7.6	2.2
Total, All Borrowers	19.1	3.9

Source: World Bank

Table 3

Foreign Loan Exposure of U.S. Banks:
Foreign Loans as a Percent of Capital

Country	200 Banks	9 Largest Banks
Argentina	7.6	12.3
Brazil	22.7	37.2
Mexico	24.4	34.4
Venezuela	10.3	18.0
Subtotal - Argentina, Brazil, Mexico, Venezuela	64.9	101.9
Chile	6.4	9.3
Peru	1.9	2.6
Total - All Latin America and Caribbean	80.7	126.7
Philippines	5.1	8.9
Yugoslavia	2.2	3.5

Source: Federal Financial Institutions Examination Council