THIRD WORLD DEBT AND ECONOMIC DEVELOPMENT
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Good afternoon! I am pleased and honored to be a participant in this stimulating conference on U.S. military policy. My role is to discuss the debt problems of what are usually referred to as the "less developed countries" (LDCs). As a central banker, my expertise lies more in the economic than the military implications of LDC debt. For that reason, I intend to sketch the economic forces that have contributed to the emergence and continuation of this problem and survey possible U.S. foreign policy responses. I will, however, also give you my personal views on the extent to which LDC debt must figure into our national security considerations.

The United States has had national security interests at stake ever since the debt crisis surfaced in 1982. However, earlier in the decade the great exposure of U.S. banks kept our emphasis more on the financial dimensions of LDC debt. Now we seem to have passed a significant milestone, as indicated by elements of the Brady plan, and relative emphasis is shifting toward the humanitarian and national security issues implicit in the continuing difficulties of debtor nation economies. I will follow this shift in perspective through my discussion of the manner in which we have approached the debt problem since it emerged in 1982 and the current status of the situation. First, however, I will touch briefly on the economic conditions that underlie and perpetuate the inability of the LDCs to repay their debts.

The Scope of Third World Debt

The roots of the global debt problem lie in the 1970s, when prices for commodities like copper, tin, coffee, and, most importantly, oil rose dramatically. These commodities tend to be the main exports of developing nations, and they borrowed heavily to step up production to meet strong worldwide demand. For example, Mexico, which was not a major producer at the time of the first oil shock, used foreign capital to boost oil production.

However, world macroeconomic conditions and inconsistent domestic policies combined to undermine the viability of most LDC loans in the 1980s. Four factors in the global economy help account for the debt crisis that began in 1982. The first was the rise in real interest rates, which abruptly slowed inflation. For LDCs, most of whom borrowed short-term at variable rates, this meant a sudden acceleration in cost of funds. It also meant that repayment would no longer be eased by inflation as it had in the past. Developing nations were not alone in being whipsawed by interest rates at that time. American farmers, too, borrowed when real rates were low and found themselves in trying straits when their debt service soared.

The second factor working against the LDCs was the severe recessions in most advanced economies. Recession led to a drop in consumption in those countries, including expenditures on manufactured goods and raw materials from developing countries. This in turn helped cause a third contributing factor to LDC debt woes--a severe decline in the prices for their chief export commodities. Commodity prices dropped some 25 percent from 1980 to 1982, and have only retraced part of these declines. In addition, the dollar began to rise toward its postwar peak of 1985 versus other currencies, making many of the goods and services LDCs need to import increasingly more expensive. Finally, after Mexico announced it could no longer meet its payments in 1982 and other LDCs followed suit, sources of new credit quickly dried up.

Aside from these international factors, a number of developing countries pursued domestic policies that added to their problems. Many followed the course of "economic nationalism," which entails restricting foreign investment and attempting to develop local industries through protectionist policies. One of the flaws in this approach has been heavy reliance on a relatively small domestic economy, which is unable to absorb sufficient amounts of goods. Protectionist policies also make it more difficult to export as other countries typically set up trade barriers in response.

Many LDCs also have very large public sectors. Public sector expenditures have actually been increased since the crisis erupted in the vain hope of maintaining or restoring earlier high growth rates. Tax revenues usually fall short of paying for spending programs, and governments resort to internal borrowing and ultimately to printing more money to pay for them. This, of course, contributes to rampant inflation, which, in turn, drives private capital abroad. Such ill-conceived fiscal decisions combined with the international factors I have mentioned--the spurt in real interest rates, recession in the advanced economies, declines in commodity prices, and the drying up of credit--to put 34 countries in arrears by the end of 1982.

Patterns of Official Response in the U.S.

At that time, nine major U.S. banks had funds amounting to nearly three times their regulatory capital committed in these developing countries. It is little wonder that policymakers in the industrialized countries were initially concerned about the stability of these financial institutions under the circumstances. Over time, however, the urgency of dealing with that aspect of the problem has diminished as I will explain presently. Instead, what has assumed more importance is our concern that LDC efforts to meet their obligations is eroding living standards to the point of provoking social unrest in those countries. I would like to trace this shift of emphasis with reference to the various policy initiatives that have been advanced by the U.S. government.

Essentially, this shift represents the growing realization that the inability to service debt is more than the short-term liquidity problem it was at first thought to be. As is reasonable in dealing with liquidity problems, the earliest method of handling suspension of payments by LDCs was to provide bridge loans and other credits in the hope of tiding the countries over until growth could resume. This approach was first applied to Mexico. The U.S. government prepaid purchases of a large amount of oil destined for strategic stockpiles, and private banks agreed to a delay in payments due them. We also mobilized other Western central banks to provide short-term loans.

Meanwhile, longer term solutions for Mexico and other countries were advanced by the International Monetary Fund (IMF). The IMF pressured private banks to reschedule loans and required fiscal and trade policy reforms from the LDCs. Debtors agreed to these IMF conditions and actually began to post trade surpluses after the first year. Such gains were not without their costs, though. Rescheduling simply spread the total debt obligation over a longer period. Higher interest rates on old debt caused debt service to exceed new loans, and the net inflow of funds to major LDCs soon turned negative. Thus overall indebtedness continued to pile up, albeit at a slower pace than before the crisis.

In 1985, then Treasury Secretary James Baker proposed a plan to encourage increased lending from commercial banks, again in the interest of revitalizing economic growth. Secretary Baker called on banks to engage in country-by-country negotiations to reduce the net outflow of funds by about one-fourth over three years. However, many smaller banks--some of them in our region--were opting instead to sell their loans at a discount on the growing secondary market for LDC debt. Individual banks had little incentive to agree to much debt service reduction unless all others went along. As their earnings grew, they started reserving against these loans. As a result, prospective sources for new money were reduced, and the plan fell short of its goal. And once again any new loans were contingent on IMF programs which generally forced further austerity measures on debtor nations.

The Baker plan seems to have provided the political leverage to avert default and buy time for banks to further consolidate their positions. By the end of 1988, exposure among the same nine major U.S. banks had dropped to where it roughly equaled regulatory capital. This has occurred through some reduction in exposure in dollar terms and more significantly by an increase in capital to levels that provide a better cushion against default. Banks have issued more stock to raise capital, and over the past two years they have also boosted loan-loss reserves on LDC loans to somewhere in the range of 25 percent of book value. Because they have taken these steps, U.S. banks could now remain solvent even in the event of default by several of the largest debtors at once.

The debtors' condition deteriorated further during the same period, however, in part as a result of earlier loan reschedulings. Real per capita GDP growth was flat in 1987 and negative in 1988 among developing countries with debt-servicing difficulties, and inflation averaged over 150 percent. In addition, the steep drop in oil prices in 1986 hurt Mexico severely by cutting into dollar earnings that might have gone to servicing debt, and this also played a major role in turning Venezuela into a problem debtor. Cheaper oil should have benefited importers of oil like Brazil and Argentina, but their situation was in fact made even worse by out-of-control budget deficits and inflation. Thus all the major debtors owe considerably more today than they did when efforts to ease the crisis began in 1982--Argentina's debt has increased by over one-third, Mexico's by one-quarter, and Brazil's by a fifth.

Nevertheless, over the same period some progress has been made in meeting IMF criteria. Fiscal deficits in countries with debt-servicing difficulties have fallen by about one-third since 1982, for example. But signals that further austerity measures were becoming politically unacceptable have begun to become more frequent. The persistence of guerilla groups like the Shining Path in Peru has been attributed to the stress of austerity programs, and there were repeated warnings that civil unrest was imminent in other countries. These forebodings were borne out by disturbances in Venezuela, Argentina, and Brazil earlier this year. Some debtors, strained to their limits, took unilateral action. Brazil, for example, announced a moratorium on payments in 1987; Peru has put a ceiling on debt service at 10 percent of its exports.

Compounding the frustration, there were certain countries that had done a good job of meeting IMF requirements only to find themselves slipping further into arrears. Mexico had taken steps to open its markets and returned some of its state-run enterprises to private control. It had also been involved in creative debt-restructuring plans like the Morgan Guaranty debt-swap announced in late 1987. Yet Mexico's debt was nearly twice as high as a percentage of GNP in 1988 over its position in 1982. Thus when the Bush administration took office in 1989, one aspect of the debt dilemma--financial system risk--had been brought relatively under control, but with debtors at an impasse, a new approach was clearly needed.

The Brady Plan

That new approach--the Brady plan, announced early in the new administration--preserves some features of earlier attempts to deal with the crisis. The country-by-country format for negotiations and the insistence on continued efforts to reform domestic economies remain as basic principles of our national policy. However, the Brady plan departs from the bridge-loan concept of 1982 and the later Baker plan in two respects. It recommends reduction in debt and debt service through below-market interest rates and write-downs of principal, concepts which have been resisted by creditors previously. The Brady plan also looks to the IMF and World Bank to guarantee restructured debt or provide funds to debtor countries by which to repurchase debt.

By recognizing the need for debt reduction, the Brady Plan acknowledges that the debtors' problem is more than a temporary liquidity shortage and in fact threatens the overall solvency of those nations. As such, it seems to say that it is in our national interest to scale down the debt burden to a level that can be sustained without further squeezing the populace in debtor countries. Through our participation in the international agencies, we are willing to help guarantee the write-downs that will help moderate the pressure on debtor-nation economic systems.

Still, a number of obstacles remain to be overcome if the plan is to succeed. One is the problem of "free riders" on both the banks' and the debtors' side who sit back and wait for others to act in the hope of ending up with a better deal for themselves. The Brady plan suggests several options for banks which agree to reduce principal or interest. They can swap debt for bonds at a discount or lower interest, participate in debt-for-equity swaps, or roll back interest on current debt. But these are voluntary choices--banks can also hold debt at existing levels in the belief they will some day be repaid. Of course, if other banks bite the bullet by agreeing to reductions, the chances of the holdouts' being paid back a larger portion of their investments would clearly improve. This is the crux of the "free rider" problem on the banks' side. Likewise, debtor countries could allow their peers to go through difficult negotiations and demand similar concessions when their turn comes whether their situation is comparable or not. This latter possibility points to a second major hurdle in these negotiations, and that is the lack of policy reforms in many of the debtor nations--Argentina and Brazil come immediately to mind.

In my view, we should continue to deal on a country-by-country basis to overcome these stumbling blocks. It would make sense for negotiations to follow on the heels of the adoption of sound, internationally supervised adjustment programs. Countries like Mexico, which have made good progress in this direction, deserve to be among the first in line of countries to engage in debt reduction talks under the Brady plan. For the banks' part, the market has already discounted the value of LDC loans in bank stock prices, and loan-loss provisions are now largely in place. Perhaps finding a solution to the free-rider problem would help inspire more interest in the Brady plan options among banks. As part of the recent Mexican agreement, the claims of banks that do not go along with new initiatives would move to the end of the line and be the last serviced. Such an arrangement may provide the incentive needed to obtain a critical mass of bank participation in restructuring debt in Mexico and other LDCs.

LDC Debt and National Security

Whether or not the Brady plan will work in its present form, it is clearly a realistic approach to a problem that has lingered too long. The largest debtors and the greatest number of debtor nations are in this hemisphere. They are long-standing allies and trading partners, and we cannot afford to have either of these relationships imperiled. Yet a growing number of people in these countries view the sacrifices necessary to repay debt as if it were a tax being imposed by U.S. banks as opposed to their own misguided fiscal policies and unfavorable macroeconomic conditions. This is clearly a situation that threatens to become a full-blown foreign relations problem the longer the economic squeeze continues.

We should be looking at more than just the possibility of anti-American sentiment, in these countries, though. The misallocation of resources in the LDCs carries unconscionable costs in human suffering. It means malnourished children and young people who have no opportunity to become educated as they work at subsistence jobs to help supplement family incomes. It means vast numbers of people who cannot afford proper medical care, let alone the basic amenities of life. It is within our ability to relieve some of these pressures, and as an advanced economy I believe we have an obligation to do so as quickly as possible.

In my opinion, the potential military, economic, and humanitarian dimensions of the LDC debt situation are intertwined in the globalization of world markets. With gathering momentum, the economies of the industrialized countries are merging into a single market-driven structure. What's more, we are seeing signs that the Soviet Union, Eastern European countries, and, despite its recent setback, China are being drawn into that structure. Thus I feel the military threats which once guided our thinking in international security matters are being moderated by the prospect of competition in the marketplace.

As we look with enthusiasm toward Europe's economic integration in the 1990s and the longer term prospects for the "Second World" countries--the Soviet Union and its satellites--to participate more fully in the global market, it is dismaying to see the nations of the Third World being dragged backward by their debts. Thus LDC debt is a crucial test of the viability of the global market. We could enter the twenty-first century with a worldwide economic system that puts an acceptable standard of living within the reach of anyone willing to work for it, or we could find ourselves divided ever more sharply into two worlds--the haves and have-nots. Should this happen, I can almost guarantee that we will be spending more of our national resources than we care to dealing with the fires of discontent in those countries likely to remain less developed.

Conclusion

In conclusion, I feel that the Brady plan represents the first attempt to deal with the full scope of the LDC debt problem. With U.S. banks in a stronger position, we have been able to turn our attention more to the foreign policy dimensions of the situation. Progress on this second horn of the debt dilemma requires reducing the threat to LDC solvency and action by debtors to eliminate counterproductive policies. The moves debtor countries need to make to become viable candidates for debt reduction--less protectionism and more emphasis on exporting--are the very steps needed to speed their incorporation into the global marketplace. Thus it is important to work with the indebted countries to tailor constructive debt reduction programs to their individual conditions. By enhancing the economic security of the LDCs in this way, we contribute to our own national security at the same time. We also reflect our commitment to the vision of a fully globalized market in which the potential for military conflict is tempered by economic interchange.