The International Debt Situation
by Owen F. Humphage

The precarious international debt situation clouds the economic outlook, worrying bank regulators and complicating international commerce. The world's developing countries, excluding members of the Organization of Petroleum Exporting Countries (OPEC), have debts outstanding totaling approximately $575 billion. Of this amount, U.S. banks hold approximately $100 billion. The economic climate of the past few years has left many developing countries unable to meet the interest and principal payments on their debts according to their original loan agreements. Although no country has repudiated its debt, many have entered into negotiations with their creditors to extend repayment schedules. A default or major disruption in meeting payments on debts might shake confidence in the U.S. banking system, producing a contraction in both domestic and international bank lending. Such developments could reduce international trade and slow the pace of the economic recovery worldwide.

The most important factor underlying the debt build up was the oil-price shocks of 1973 and 1979. Following the initial price hike, gross oil imports of the non-OPEC developing countries jumped from $4 billion in 1973 to $15 billion in 1974. Gross oil imports for these countries subsequently grew more slowly and steadily to $20 billion in 1978, but the second oil-price shock in 1979 lifted their gross oil imports to $50 billion in 1980. Many oil-importing countries initially borrowed to finance their higher oil-import bills. Borrowing permitted these developing countries to mitigate the immediate impacts of the oil shocks on their standards of living and presumably provided them with time for adopting longer-term adjustment policies. International banks played an important role in this adjustment process by recycling funds from surplus countries to borrowing countries. Despite initial concerns, the recycling process went rather smoothly following the 1973 oil-price shock.

Ironically, the sharp oil-price increase also encouraged many oil-producing countries to borrow against taxes, but extensive loan write-offs probably would affect bank profits and shareholders' earnings. Write-offs also could affect bank capital. Banks must maintain capital against loans, although the required amount is only a small share of total loans. Consequently, any reduction in capital could restrict bank lending and raise interest rates. Higher interest rates and reduced lending, moreover, could slow domestic economic activity, but the extent of this effect would depend on the monetary policy of the Federal Reserve System.

Debtor-country defaults on outstanding loans also would greatly restrict their ability to conduct international trade. A default would leave the debtor nation unable to obtain foreign credits to import vital commodities. This in turn could impinge on its ability to produce other goods for domestic consumption and for exportation. Without exports, these countries would find it difficult to earn foreign exchange. Moreover, the developing countries are important markets for developed-country exports. In 1982 the United States exported approximately $8 billion to the developing countries, an amount equal to 38 percent of total U.S. exports. The consequences of these markets would further reduce economic growth and employment in the United States.

A Climate for Improvement
Just as changes in the economic climate contributed to the crisis in 1973 and 1979, there is evidence that conditions may improve. Cline notes that further sharp declines in oil prices could have a detrimental impact on the debt situation. Oil-exporting countries owe large amounts of debt, and the effects of an oil-price decline are more severe for oil exporters than beneficial to oil importers. Both studies assume an increase in oil prices in their scenario for an improved debt situation.

In addition, the developing countries should adopt policies to reduce domestic consumption, restrict imports, and encourage exports. They also would need additional external credits to finance their imports of vital commodities. In the absence of such credits, their economic growth could falter and inhibit the reduction of their debt burdens.

The dangers posed by the international debt situation will not easily, or quickly, be defused. There is always a chance that some desired aspect of international economic conditions would not materialize, creating new tensions and pressures. Only by recognizing what all nations stand to lose as a result of crisis mismanagement will we have the patience and courage to prevent a true crisis.

1. For data on total debt, see remarks by Paul A. Volcker, Chairman of the Board of Governors of the Federal Reserve System, Annual Convention of the American Bankers Association, Houston, HI, October 10, 1983, p. 3; processed. 2. For data on oil imports, see statement by Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Finance and Urban Affairs, House of Representatives, February 3, 1983, Table 1; processed.
heavily. Some, like Mexico, initially borrowed to develop their oil-pro-
majors, only to find that they had borrowed against expected future
oil receipts to expand and diversify
their industrial bases.

The oil-price shocks in them-
selves did not create an unmanage-
able debt situation. As a group, the developing countries demonstrated
exceptional real GDP growth throughout the 1970s despite
larger oil-import bills. Between 1973 and 1982, on average, the
major industrialized countries experienced real GDP growth of
2.5 percent per year; the develop-
ing countries in the developing countries of nearly
8 percent per year. Moreover, not all developing
countries experienced real GDP growth of
4.7 percent per year, while developing countries in the
major industrialized countries demonstrated excellent real GDP growth of
4.5 percent per year. Moreover, not all developing
countries experienced trade deficits throughout the 1970s. Argentina and
Venezuela, for example, usually ran trade surpluses, while Brazil and
Mexico had trade deficits that were not striking.

The excellent growth potential of the developing countries, the rela-
ively high interest rates on capital that this growth implied, and a foreign
loan-loss record no worse than that of domestic loans attracted U.S.
banks to the international lending market. As of June 1983, the 190 U.S.
banks reporting to a lending survey of the Federal Financial Institutions
Examination Council (FFIEC) had claims on non-oil
developing countries of nearly $104 billion, an amount equal to
39 percent of the capital of these banks. Although many regional
and small banks entered the international lending market in the late 1970s, international lending re-
mained the domain of large banks

### Table 1: Outstanding Loans to Non-Oil Developing Countries

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### A Changing Climate

Although the ultimate causes of developing countries' debt problems are endemic to specific country
events of the late 1970s and early 1980s drastically altered the intern-
national debt climate, making it difficult for many developing coun-
tries to service their debts. World interest rates soared sharply in the
late 1970s. U.S. Treasury bill rates, for example, averaged 6.3 percent
in December 1977 but rose to 14.9 percent by December 1980. Throughout
much of the 1970s, real interest rates (nominal rates adjusted for inflation) remained
low and often negative. Negative real interest rates reduce the real
debt service. In the late 1970s and early 1980s, infla-
tional psychology became widespread and the Federal Reserve System and other central banks
adopted disinflation monetary pol-
cies, both nominal and real inter-
est rates rose sharply. Also reflect-
ing the inflationary psychology of the late 1970s, banks began writing
international lending agreements in such a way as to permit frequent adjustments of interest payments
to changes in market rates. Conse-
quentially, the sharp rise in market
interest rates in the late 1970s and early 1980s rapidly translated into
increased debt-servicing costs for
developing countries.

Soon after the sharp rise in real
interest rates, world economic
activity began to slow. Economic
growth among the industrialized
countries was very sluggish in 1980
and 1981, and economic activity fell 0.2 percent in 1982. According to one expert, the combined debt-
service ratios of Argentina, Brazil, Mexico, and Venezuela increased from 172 percent in 1981 to
269 percent in 1982. As previously suggested, the debt-servicing problems of certain
countries largely reflect specific
debt-management and economic pol-
cies of those countries. The Latin American countries, for example, generally have permitted infla-
tion rates well above world
standards and have maintained exchange rates at artificially high
levels. As the economic climate in these countries worsened in recent
years, they have moved funds out of these countries, fearing capital
controls or currency devalua-
tion. The shift of investable funds outside these developing countries increased their need to borrow
externally for investment purposes.

A significant portion of total ex-
ternal borrowing has financed capi-
 tal flight in Argentina, Brazil, Mex-
ico, and Venezuela.

Banks, therefore, became increas-
ingly reluctant to extend further
credits to developing countries. The growth of total reporting bank claims to non-oil developing coun-
tries slowed in 1982, as the seri-
ousness of the international debt
situation became widely under-
stood. As a result of the price and quantity
trends, the dollar value of exports fell
11.5 percent in 1982 for Argentina, Brazil, Mexico, and Venezuela and increased by
175 percent since 1973. Export

growth is crucial to debtor nations, as it is the primary means by
which these nations earn foreign exchange to service their debts.
For that reason, economists often measure the debt burden of a debtor nation relative to its exports.

Because of higher interest rates and exchange rates, debt-servicing
ratios are higher in export-dependent
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The Impact of Loan Losses

It is difficult to speculate on the effects of a major disruption in the
international servicing of international loans, such as a moratorium or repudi-
ation, as much depends on the extent of the disruption and the response of regulatory agencies, commercial banks, shareholders,
and depositors. U.S. banks consider a loan as non-performing when bor-
rowers have not made interest and/
or principal payments for an exten-
sion of 90 days. The banks have some recourse to tax laws that permit
losses to be carried back and offset

3. For data on growth rates, see Nancy H. Teten and Henry S. Terrell, "The Role of Banks in the International Financial System," Federal Reserve Bulletin, vol. 69, no. 9 (Septemb-

4. The Federal Financial Institutions Examination Council includes the Office of the Compt-
troller of the Currency, the Federal Deposit Insura-
tance Corporation, and the Board of Governors of the Federal Reserve System. Its Country
Exposure Lending Survey is conducted biann-
ually and currently covers 190 U.S. banking
organizations. The data are released approxi-
ately six months after the surveys are conducted.


tional Finance Discussion Papers, No. 227, August 1983, especially table 1.
heavily. Some, like Mexico, initially borrowed to develop their oil-pro-
million for development projects and, at one time, in 1979, agreed to 

borrowed against expected future oil receipts to expand and diversify their industrial bases.

The oil price shocks in themselves did not create an unmanage-
able debt situation. As a group, the developing countries demonstrated excellent repayment of GNP growth throughout the 1970s despite higher oil-import bills. Between 1973 and 1982, on average, the major industrialized countries experienced real GNP growth of 4.7 percent per year, while developing countries experienced real GNP growth of 2.5 percent per year; the developing countries enjoyed real GNP growth of 4.7 percent per year, while developing countries in the western hemisphere experienced real GNP growth of 4.5 percent per year. Moreover, not all developing countries experienced trade deficits during the 1970s. Argentina and Venezuela, for example, usually ran trade surpluses, while Brazil and Mexico had trade deficits that were not strikingly high.

The excellent growth potential of the developing countries, the relatively higher growth rates on capital that this growth implied, and a foreign loan-loss record no worse than that of domestic loans attracted U.S. banks to the international lending market. As of June 1983, the 190 U.S. banks reporting to a lending survey of the Federal Financial Institutions Examination Council (FFIEC) had claims on non-oil developing countries of nearly $104 billion, an amount equal to developing countries of nearly $47 billion, or 115 percent of their capital, as much depends on the capital controls or currency devaluation. The shift of investable funds outside these developing countries increased their need to borrow externally for investment purposes. A significant portion of total external borrowing has financed a major capital flight in Argentina, Brazil, Mexico, and Venezuela.

Banking in these countries has become increasingly reluctant to extend further credits to developing countries. The growth of total reporting bank claims to non-oil developing countries slowed in 1982, as the seriousness of the international debt situation became widely under-

Table 1 Outstanding Loans to Non-Oil Developing Countries

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<th>Date</th>
<th>Number of reporting banks</th>
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A Climate for Improvement

Just as changes in the economic climate contributed to the crisis in the international financial environment in 1973, an improvement in the international economic environment would help resolve the international debt situation. Dooley, Helkie, et al. (1983) and Cline (1983) describe such an outlook. Both studies recognize the importance of real growth and suggest industrial-country growth of approximately 3 percent per year to reduce the burden of debt in developing countries. This assumption seems to preclude another worldwide recession in this decade. Both studies recognize the importance of low interest rates but differ somewhat in the relative importance attached to attaining them. Dooley, Helkie, et al. emphasize that a reduction in real interest rates could have a larger near-term effect than more rapid growth in industrialized countries. Cline notes that further sharp declines in oil prices could have a detrimental impact on the debt situation. Oil-exporting countries owe large amounts of debt, and the effects of an oil-price decline are more severe for oil exporters than beneficial to oil importers. Both studies assume an increase in oil prices in their scenario for an improved debt situation. In addition, the developing countries should adopt policies to reduce domestic consumption, restrict imports, and encourage exports. They also would need additional external credits to finance their imports of vital commodities. In the absence of such credits, their economic growth could falter and inhibit the reduction of their debt burdens.

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This Economic Commentary provides some perspective on the development and implications of the international debt situation, focusing on Argentina, Brazil, Mexico, and Venezuela. These four Latin American countries account for roughly 63 percent of all U.S. bank loans to developing nations. Situations in these countries are fairly typical of economic trends in other developing economies. Argentina and Brazil are oil-importing countries, while Mexico and Venezuela are oil-exporting countries.

The Gathering Storm

The most important factor underlying the debt build up was the oil-price shocks of 1973 and 1979. Following the initial price hike, gross oil imports of the non-OPEC developing countries jumped from $4 billion in 1973 to $15 billion in 1974. Gross oil imports for these countries subsequently grew more slowly and steadily to $20 billion in 1978, but the second oil-price shock in 1979 lifted their gross oil imports to $50 billion in 1980. Many oil-importing countries initially borrowed to finance this higher oil-import bills. Borrowing permitted these developing countries to mitigate the immediate impacts of the oil shocks on their standards of living and presumably provided them with time for adopting longer-term adjustment policies. International banks played an important role in this adjustment process by recycling funds from surplus countries to borrowing countries. Despite initial concerns, the recycling process went rather smoothly following the 1973 oil-price shock. Ironically, the sharp oil-price increase also encouraged many oil-producing countries to borrow...