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economic commentary

The International Debt Situation

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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.[1] 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.

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.[2]

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

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The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

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, Honolulu, 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 2, 1983, Table 1; processed.

heavily. Some, like Mexico, initially borrowed to develop their oil-producing capacity. Many countries borrowed against expected future oil receipts to expand and diversify their industrial bases.

The oil-price shocks in themselves did not create an unmanageable debt situation. As a group, the developing countries demonstrated excellent real 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 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.[3] 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 large.

The excellent growth potential of the developing countries, the relatively high returns 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 139 percent of the capital of these banks.[4] Although many regional and small banks entered the international lending market in the 1970s, international lending remained the domain of large banks with expertise in the area. The nine largest U.S. reporting banks, for example, held 62 percent of the total reporting-bank claims on developing countries as of June 1983. This amount equaled 212 percent of the large banks' capital.

It is difficult to define what would constitute a "too-high" level of foreign lending. Total bank loans typically exceed bank capital many times over. Observing changes in the data over time provides a clue (see table 1). Although the total number of reporting banks has changed since the FFIEC survey began, blurring comparisons, the nine largest reporting banks have remained the same in this period. In 1977, the first year of the FFIEC survey, the 124 reporting banks lent non-oil developing countries $47 billion, or 115 percent of their capital. Over the next five years, total reporting-bank claims grew at an annual average pace of approximately 17 percent, and foreign loans rose as a share of total assets and capital. For the nine largest reporting banks, total claims equaled $30 billion in 1977, or 163 percent of their capital. Lending by the nine largest reporting banks increased at a 16.5 percent average annual rate through 1982. Again, foreign loans rose relative to total assets and capital.

U.S. banks have concentrated their international lending to a relatively small group of "middle-income" developing countries. The world's poorest nations rely primarily on international organizations such as the World Bank to finance their development. Argentina, Brazil, Mexico, and Venezuela account for 63 percent of the total U.S. reporting-bank claims, with Brazil and Mexico accounting for 20 percent and 24 percent, respectively. Loans to Argentina, Brazil, Mexico, and Venezuela equal 88 percent of the total reporting-bank capital and 131 percent of the capital of the nine largest reporting banks. Consequently, banks are vulnerable to adverse developments in these countries.

Table 1 Outstanding Loans to Non-Oil Developing Countries

				Total assets		Total capital	
Date	Number of reporting banks	All reporting banks	Nine largest reporting banks	All reporting banks	Nine largest reporting banks	All reporting banks	Nine largest reporting banks
		Billions of dollars		Percent		Percent	
12/77	124	46.9	30.0	6.5	8.1	115	163
6/78	124	48.7	31.0	6.5	8.0	115	164
12/78	129	52.2	33.4	6.3	7.9	116	176
6/79	128	54.4	35.0	6.3	7.8	115	166
12/79	130	61.8	39.9	6.6	8.2	124	182
6/80	143	66.2	41.9	6.6	8.2	123	182
12/80	153	75.4	47.9	7.1	9.0	132	199
6/81	158	82.3	51.6	7.4	9.3	137	206
12/81	159	92.8	57.6	8.0	10.2	148	220
6/82	167	98.6	60.3	8.3	10.6	149	222
12/82	171	103.2	64.2	8.2	11.0	146	222
6/83	190	103.7	64.1	8.1	11.0	139	212

SOURCE: Federal Financial Institutions Examination Council.

3. For data on growth rates, see Nancy H. Teeters and Henry S. Terrell, "The Role of Banks in the International Financial System," *Federal Reserve Bulletin*, vol. 69, no. 9 (September 1983), pp. 663-71.

4. The Federal Financial Institutions Examination Council includes the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Board of Governors of the Federal Reserve System. Its Country Exposure Lending Survey is conducted biannually and currently covers 190 U.S. banking organizations. The data are released approximately six months after the surveys are conducted.

A Changing Climate

Although the ultimate causes of debt-servicing problems often are endemic to a specific country, events of the late 1970s and early 1980s drastically altered the international debt climate, making it difficult for many developing countries to service their debts. World interest rates rose 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 burden of debt servicing. In the late 1970s and early 1980s, as an inflationary psychology became widespread and the Federal Reserve System and other central banks adopted disinflation monetary policies, both nominal and real interest rates rose sharply. Also reflecting 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. Consequently, 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, a decline equal to that experienced in industrial-country output in the worldwide recession of 1975. The industrialized nations constitute the major market for developing country exports; as the economic growth of major industrial countries slowed, so did the volume of exports of developing countries. The worldwide recession also depressed commodity prices, which fell approximately 15.0 percent in 1981 and 12.0 percent in 1982, after rising nearly 15.0 percent per year on average since 1973. The exports of many developing countries are concentrated in commodities and, hence, are very sensitive to commodities' price trends. As a result of these price and quantity trends, the dollar value of exports fell 11.5 percent in 1982 for Argentina, Brazil, Mexico, and Venezuela after increasing at an average annual 17.5 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 a country's foreign-debt burden relative to its exports. Because of higher interest rates and a decline in exports, the debt-service ratios (interest payment and amortization divided by exports) of developing countries grew rapidly after 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.[5]

As previously suggested, the debt-servicing problems of certain countries largely reflect specific debt-management and economic policies of those countries. The Latin American countries, for example, generally have permitted inflation 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, wealthholders moved funds out of these countries, fearing 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 capital flight in Argentina, Brazil, Mexico, and Venezuela.[6]

Banks have 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 understood. Between December 1982 and June 1983, claims of banks in the lending survey showed virtually no growth. In part because of this reluctance to lend, the reporting banks have been able to improve their exposure over the past year relative to their capital.

The Impact of Loan Losses

It is difficult to speculate on the effects of a major disruption in the servicing of international loans, such as a moratorium or repudiation, 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 nonperforming when borrowers have not made interest and/or principal payments for a period of 90 days. The banks have some recourse to tax laws that permit losses to be carried back and offset

5. William R. Cline, *International Debt and the Stability of the World Economy*, Policy Analysis in International Economics, No. 4, Washington, D.C.: Institute for International Economics, September 1983.

6. See Michael Dooley, William Helkie, et al., "An Analysis of External Debt Positions of Eight Developing Countries through 1990," *International Finance Discussion Papers*, No. 227, August 1983, especially table 1.

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 $84 billion to the developing countries, an amount equal to 38 percent of total U.S. exports. The contraction 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 atmosphere in international lending, 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 also 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.

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