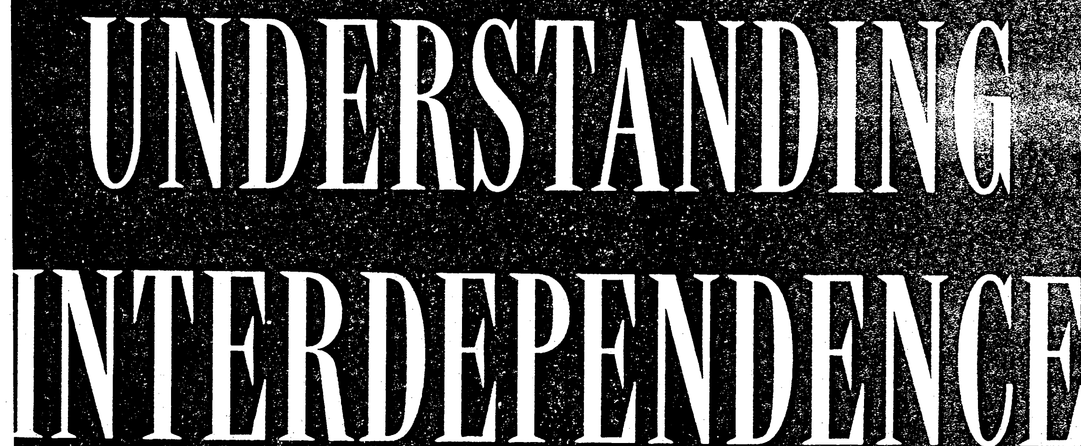

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A Retrospective on the Debt Crisis

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1 Introduction

In 1992 and 1993, private capital inflows to Mexico equaled about 7 percent of Mexico's gross domestic product (GDP). These private capital inflows were larger than in any year before 1982, when Mexico's suspension of debt-service payments marked the beginning of the debt crisis that dominated the economic circumstances of many developing countries for a decade. The resurgence of private capital inflows to developing countries has been widely distributed but has been particularly evident in developing countries that did not experience debt-servicing difficulties and in countries that have participated in Brady Plan rescheduling agreements (Calvo, Leiderman, and Reinhart, 1993).

This remarkable turnaround makes it particularly important to take a retrospective look at what has been called a "lost decade" of economic stagnation for the debtor countries.[1] Only a few years ago, experts agreed that the developing countries would not return to private international credit markets for at least a generation. Do we now understand enough about the 1982 crisis to predict that a renewed accumulation of external debt will not lead to a repeat of 1982 and to the considerable costs that followed for the debtor countries? Unless the memories of investors and debtor-country governments are very short, they must believe this new round of international lending will have a different outcome.

It is very likely that economic developments external to the debtor countries, in particular recent declines in interest rates in industrial countries, explain an important share of recent capital inflows (Bulow, Rogoff, and Bevilaqua, 1992; Dooley and Stone, 1993). It therefore follows that highly indebted developing countries will remain vulnerable to external shocks, particularly to a combination of recession and high real interest rates in the industrial countries. The analysis of the 1982 crisis developed in this chapter

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[1] See Dooley and Corden (1989), Cohen (1991, 1992), Cooper (1992), and Arora (1993) for comprehensive reviews of the debt crisis.

suggests, however, that the recent buildup in external debt is unlikely to generate economic costs for debtor countries comparable to those that followed 1982, even if bad luck or bad policies lead to another round of debt-servicing difficulties. By contrast, those debtor countries that have not restructured and reduced their existing debt to commercial banks are vulnerable to a return to economic stagnation.

The basic theme of this discussion is that the enormous costs borne by the debtor countries after 1982 were the result of prolonged self-interested bargaining between the commercial banks and their own governments, not between the banks and the debtor countries. The new buildup of debt will not generate similar bargaining because recent lending has not involved the commercial banks of the industrial countries.

The origins of the bargaining game between international commercial banks and industrial-country governments are found in relationships among creditors established long before the summer of 1982. For this reason, I begin with a brief review of the buildup of the external debt of developing countries in the 1970s.

2 Accumulation of External Debt, 1970–82

Historical Review

The striking aspect of the debt buildup before 1982 is the dominant role of commercial banks in providing medium- and long-term credits to residents of developing countries. Following widespread defaults on international bonds issued by developing countries in the 1930s, new lending to developing countries before 1974 was generally restricted to government-to-government loans or loans from international organizations such as the World Bank and the International Monetary Fund (IMF). One of the keys to the interpretation of the debt crisis offered in this chapter is that the emergence of banks as financial intermediaries in the 1970s can best be understood as a process in which the banks replaced the governments of industrial countries as lenders to developing countries but did so with the approval, encouragement, and implicit support of the governments of the industrial countries.

The economics behind the debt buildup are straightforward. The dramatic rise in the price of oil in 1974 and again in 1979 generated huge current-account surpluses for oil-exporting countries. As shown in Table 7.1, the counterparts of current-account surpluses for the oil exporters were deficits for both the industrial and the developing countries. The oil exporters' current-account surpluses reflected their desire to smooth consumption. This implied that a large share of their revenues had to be "recycled" to oil-importing countries in the form of capital flows from oil exporters to oil importers.

TABLE 7.1
Current-Account Balances (billions of U.S. dollars)

	All Industrial Countries	Fuel Exporters	Non-Fuel Exporters
1970	6	2	−9
1971	9	1	−11
1972	6	2	−5
1973	11	6	−4
1974	−27	65	−22
1975	7	33	−31
1976	−15	31	−18
1977	−20	20	−13
1978	11	−5	−21
1979	−27	53	−32
1980	−64	94	−52
1981	−23	32	−68
1982	−27	−20	−59

Source: IMF, *World Economic Outlook.*

The economics behind the pattern of financial intermediation between surplus and deficit countries is much less obvious. Although private capital markets were the obvious vehicle for capital inflows to industrial countries, the traditional pattern would have been for governments and international organizations to act as intermediaries for lending to developing countries. Governments, however, particularly the U.S. government, were reluctant to take on this responsibility either directly through an expansion of government-to-government loans or indirectly through international organizations.

Oil exporters were also an unlikely source of direct credit for the developing countries. In fact, oil-exporting countries realized that they were not the most popular investors at that time and wanted financial assets that were as liquid and immune from political reprisals as possible. Direct loans to residents of developing countries did not fit this description.

Bank deposits were an ideal instrument from the point of view of the oil exporters, and commercial banks saw the recycling of oil money as a profitable new business. Banks operated in many offshore banking centers, and deposits were typically passed on to several banks in different countries before being loaned to a nonbank. There was thus no correspondence between the location of a deposit and the location of the ultimate loan to a nonbank. More-

over, it was generally recognized that banks were special institutions that had proven to be "too big to fail." Governments had consistently stepped in to save large banks in order to prevent a general financial panic.

On the other side, borrowers in both industrial and developing countries preferred bank credits to more traditional private and official financial intermediaries because banks were willing to charge only a small margin over their cost of funds when setting lending rates. The wisdom of banks in entering into this business and lending at very narrow spreads to compensate for credit risk has been widely questioned in recent years. My interpretation of this phase of the crisis is that banks were rational; they realized a bad outcome was possible but also realized that the losses generated by bad outcomes could be shifted to their own governments.

In summary, the buildup of external debt in the 1970s is generally attributed to a series of external events that seemed to provide economic reasons for lending to the developing countries. Relative price increases for oil and other commodities provided a demand for credit, and the surplus of the Organization of Petroleum Exporting Countries (OPEC) provided a supply of internationally mobile savings. Low *ex post* real interest rates on loans denominated in major currencies may have contributed to the willingness of the developing countries to incur debt, although those low interest rates should have encouraged other borrowers equally.

Policy during the Buildup of Debt

The hypothesis that banks relied on their own governments' implicit guarantees of their loans to developing countries helps to make sense of the implausibly naive statements by bankers about the inability of countries to fail. The one thing that could stop the banks from taking on this profitable but risky loan portfolio was the attitude of regulators toward country risk. The banks knew that their exposure to individual countries was much larger than would normally be permitted under domestic concentration ratios. Thus, the banks had every incentive to reassure the regulators that there was no risk involved in the quite clearly risky positions the banks were taking.

An alternative interpretation is that banks really were naive but turned to their governments for a bailout after the crisis occurred and used the earlier official support for the recycling of oil money as a convenient *ex post* rationalization for help from their governments. The banks were quick to point out after 1982 that "the public and government applauded them for successfully 'recycling' the soaring revenue of oil-producing countries in the 1970s" (Lawrence Rout, "A New Solution for the World's Debt Crunch," *Wall Street Journal*, March 3, 1983).

The conjecture that creditor governments were expected *ex ante* to guaran-

tee bank claims on the developing countries is important to my interpretation of the buildup in debt but is less important to my interpretation of the subsequent bargaining between banks and their governments, which can be explained in terms of an *ex post* claim to support. In either case, the banks saw a good chance of collecting from their own governments what they could not collect from their developing-country debtors following 1982. The policy decision that led to protracted negotiations between the banks and creditor governments was the refusal of conservative governments in the United States and other industrial countries to provide the expected backup. The longer this game went on, the higher was the loss to the debtor countries.

There is ample evidence for the existence of an implicit backup by creditor governments before the debt crisis became apparent in 1982. Officials of the Federal Reserve System, for example, were concerned about the size of the banks' exposure. As early as 1974, Arthur Burns (1978), then chairman of the Federal Reserve Board, warned that banks were taking excessive risks in international lending. Governor Henry Wallich (1981, 1987) repeatedly pointed out before 1982 that the banks' exposure to sovereign risk threatened their capital and argued that additional lending should be constrained by the regulatory authorities.

Economists also pointed out the potential problem arising from the excessive concentration of country risk on the banks' balance sheets. John Kereken (1977, p. 506) warned that, "at the end of 1976, Citibank had LDC loans amounting to about 6 percent of its total assets. And we know it had capital, as conventionally measured, amounting to 5 percent of its assets. That suggests, at least to me, that there may be some slight danger, particularly if Citibank is not all that untypical. The Federal Reserve, which along with other central banks can make good loans out of bad, may in certain circumstances, be tempted to do just that." Marina Whitman (1978, p. 151) argued that the official sector should play a larger role in intermediating oil surpluses through the IMF. "Should the pessimists turn out to be right," she wrote, "and widespread defaults loom, the American banks would look for bailout, not to an IMF facility totaling less than $10 billion, but to the incomparably greater resources of our own Federal Reserve System."

By contrast, the U.S. Treasury consistently argued that the banks were the preferred financial intermediaries for loans to developing countries. As De Vries (1985) shows in her history of the IMF, Treasury secretary William Simon was the main opponent of an expanded role for official lending through the IMF. Moreover, as Weintraub (1983) notes, the U.S. Treasury had encouraged U.S. banks to pursue international lending long before the first oil shock.

Finally, the fact that regulatory agencies allowed banks to "bet the bank" on loans to individual countries suggests that the official community believed that the public benefits of smoothly and efficiently recycling oil money would exceed the potential costs of bailing out the banks. Wellons (1987) documents