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Debt and Danger

The World Financial Crisis

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Nigeria to act on overdue tra[le] debts

IMF orthodoxy fails to halt the economic rot in Zambia

IMF set to resume trust loans

[Br]azil set to win approval [for] delaying debt talks

Argentina moves to halt liquidity crisis

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CONTENTS

Preface
9
1 Introduction and Summary
11
2 The State of the Problem
21
3 The Origins of the Crisis 1: the Demand for Credit
39
4 The Origins of the Crisis 2: the Supply of Credit
51
5 A Critique of the IMF's 'Solution'
64
6 Economic Uncertainties and the Growth of Protectionism
84
7 The Political Economy of Default
99
8 The Risks and Costs of Doing Nothing
116
9 Towards Reform
128
Notes
145
Index
155

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INTRODUCTION AND SUMMARY

We have made a labyrinth and have got lost in it. We must find our way again.

DENIS DIDEROT

The flows of finance between the advanced and the developing worlds, which have in the past done so much to promote economic stability, employment and the progress of living standards, are now characterized by a perverse and dangerous anomaly. Until 1982 it was understood that there had to be, for a prolonged period, a one-way flow of resources from the advanced countries to the Third World to promote its development. The view went unchallenged in either official or private-sector circles and was supported by every school of economic thought, albeit for differing reasons. Since the debt crisis which broke in 1982, those flows have been reversed for each important group of countries in the Third World. International Monetary Fund (IMF) estimates imply that in 1985 there is to be a resource flow from the seven largest Third World borrowers to their more prosperous creditors worth $32 billion, or nearly one-fifth of their entire earnings from the sales of their exports of goods and services.[1]

This reverse or negative flow is a perversion of common sense and of sound economics. On a classical view, the developing countries should attract capital from the industrial world because they are able to increase output by more than rich countries for a given increase in investment. On an alternative view, the debtors need balance-of-payments finance because their domestic economies are capable of expanding more rapidly than they are able to increase their foreign-exchange earnings and imports, due mainly to their reliance on export commodities whose demand grows less rapidly than world income. To our knowledge, no economist has yet advocated a large flow of resources from the poorer countries as a way of stimulating their economic progress.

Nor was this ever the intention of those who encouraged or undertook the original lending to the debtors, the interest payments on which are the main cause of the reverse transfer. It

was always implicitly assumed that the financial markets would continue to refinance old debt and extend new credit so that the flow of resources to the developing world would continue, at least until some far-distant future in which the debtors would reach a level of development where it was feasible and desirable for them to export rather than import capital. This unplanned reverse flow of resources is made all the more extraordinary because it has been elevated into a necessary symptom of 'adjustment' by the official policy of the industrial countries, which are as unwilling today to take their proper responsibility for the healthy functioning of the world's economy as they were after the first oil shock of 1973, which laid the foundations for this anomaly.

Yet such abdication of responsibility is singularly misplaced. The world's financial safety and economic health is balanced on a knife-edge. If defaults halt the reverse flows, many of the largest banks in the advanced countries will become insolvent. A crisis of the kind which we have thankfully not experienced since the Great Crash of 1929 would once again be a terrible reality. But if the Third World's debtors continue to generate the large trade surpluses required to make payment to the advanced countries, their economic development, already manifestly inadequate, will be hobbled for a generation. The effort to sustain the large trade surpluses required imposes enormous strains on the world's trading system, as industries in the advanced countries have to make way for Third World exports and resist the adjustment by means of ever more strident appeals for protectionism. Moreover, the very uncertainty of continued payments in these circumstances of rising political pressures in both debtor and creditor countries causes the banks themselves to slow down their lending, adding a further depressive influence to world trade.

The debtors can do no more to resolve their predicament. All the pressures on them are to expand their economies more rapidly, which would inevitably entail smaller rather than larger trading surpluses and would quite possibly result in creeping defaults on debt. The bankers cannot realistically lend more money to offset the interest payments coming back to them on the outstanding debt without a further loss of credibility. As it is, their outstanding lending to the Third World outstrips their own capital by a factor of two or more. Only the governments

and monetary authorities of the advanced countries have the resources and the standing to reconcile the interests of both debtors and bankers – and to safeguard the world economy.

It is not, though, their unique financial power which alone casts the advanced-country governments in the natural role of managers of the debt crisis. They also bear a heavy responsibility for the events which led up to its occurrence. Until 1973 it was widely understood that commercial lending was not a safe or sure vehicle for development finance. Banks could neither impose conditions to ensure the fruitful use of the funds they lent, nor could they, when the need arose, postpone debt servicing and provide new funds without undermining the confidence of those who deposit money with them. After 1973 it was absolutely right for the advanced countries to seek to ensure that the developing world had the funds to continue to import the material they needed for development, despite the sharp rise in the price of oil. Without those funds, Third World imports would have collapsed and, with them, the jobs of millions in the advanced countries who sell to them. What was wrong was for the advanced-country governments to push the commercial banking systems of their countries into a role which should have been supported and regulated by the authorities whose public purposes it rightly fulfilled.

In the years after the first oil crisis of 1973–4 the banks took the unspent cash surpluses of the oil-rich countries and lent them to the oil-dependent Third World. Reinforced by the approval and encouragement of their governments, the banks happily developed the conviction that there was no risk in this lending to foreign governments. They came to believe that they had hit upon the most profitable area in banking history. Nowhere else could such huge sums be placed at an assured profit and with minimal administrative cost. The banks that lent in this field soon found that the profits from what they had convinced themselves was risk-free lending greatly exceeded those from the rest of their much more complicated and onerous activities.

In the years after 1974 the borrowing countries financed the trade deficits of their imports over their exports increasingly by borrowing from the banks. The borrowing was originally prompted by the need to cover the cartel's oil price rises. It was soon much extended to cover virtually any borrowing that the

developing countries' governments saw fit to make. Indeed, countries like Mexico, Venezuela and Nigeria, which were beneficiaries of the oil price rises, were among the heaviest borrowers. There was no thought of servicing the debt by generating trade surpluses and reverse transfers. The service of interest and repayments was expected to be met, and was in fact met year after year, by new borrowing in addition to loans to cover current needs.

The happy-go-lucky assumption by governments and banks that the debts could be serviced indefinitely by new borrowing on the financial markets went virtually unchallenged. All the agreements with debtor countries for service of interest and capital were manifestly on terms which could not be met by the debtors' export earnings but only by new borrowing, as one of the present authors repeatedly warned both within the government between 1974 and 1979 and thereafter.

Yet uncritical self-congratulation over the advantages of these arrangements was the order of the day. The bankers liked them because apparently never were propriety and profit so happily conjoined. The borrowers liked them because they placed little restraint on the volume or the purposes of their borrowing. The Organization of Petroleum Exporting Countries (OPEC) liked them because they enlisted the banking system of the West in support of the ability of their poorest customers to meet the cartel's oil price rises. The aid lobby liked them because they provided a novel transfer of resources to the poorer countries on a scale greater than ever before. Santa Claus had appeared in the guise of sound commercial activity, and nobody wanted to shoot him. Western governments liked these arrangements because they appeared to support their belief that this lending was urgently needed in the world interest and could be dealt with indefinitely by unassisted bank intermediation rather than by recourse to public budgets.

The inexorable result, however, was the crisis of debt and growth which we suffer today. The period between borrowing and servicing of debt by a real flow of foreign currency back to the lender can be bridged by further commercial borrowing – but only as long as that real flow is a credible prospect. Nobody could claim that this prospect grew to match the ever-growing mountain of private debt, and this was bound to bring into question the credibility of most of the debtors and of the lending

system itself. The build-up to crisis was inevitable. Prolonged recession and the move to higher real interest rates after 1979 speeded up the disintegration of confidence, but they were not its fundamental cause.

The plan of this book is as follows. In Chapter 2 we deal in greater depth with the mounting total of debt, show its heavy concentration among a handful of leading debtor countries, especially in Latin America, and among the leading banks of the advanced countries, and explain the interdependence of the world banking system. We outline the fragility of large banks whose Third World lending substantially exceeds their capital and reserves and show why there is no room for official complacency. The pyramid of debt has proved sustainable since the Mexican crisis of 1982 only because of extraordinary sacrifices on the part of the debtors and considerable effort by creditors and official institutions alike. But most of the factors which have encouraged a 'co-operative' handling of the debt crisis will be hard to sustain.

Reschedulings, whereby certain interest and principal repayments which come due are postponed when the banks put up some new lending partially to offset them, will become more and more difficult. As it is, the banks are increasing their outstanding loans to most of the debtors only under official duress. The structure of the banking market is such that each creditor has an individual interest in reducing its exposure to the debtor countries, though if all creditors followed their individual interest and reduced their exposure (and hence met even fewer of the interest and principal payments coming back to them), the debtor countries would be put in an impossible position very rapidly.

Even if such a crisis could be averted, the situation from the point of view of the debtors looks no happier. Negative transfers and their associated trade surpluses are enormous and growing, despite some new bank lending and funds from the IMF. They have been achieved largely by drastic cuts in imports engineered by a depression of demand, output and employment. The recent increases in exports from the debtor countries, which alleviate the import-cutting effects of the negative transfers, are nevertheless woefully dependent on the buoyancy of the American marketplace. That cannot be sustained as American growth slows down and the United States' trade deficit is reduced.

Moreover, several of the reasons why the debtors have so far been prepared to accept the enormous sacrifices demanded of them, rather than to default on their obligations in the face of domestic pressures, may also be waning. The threat of vanishing trade credit if a country defaults is less potent when foreign-exchange reserves are building up and barter trade is growing. They have also hoped that eventually Western governments will come to see the difficulty of their situation and intervene with debt relief. If that prospect is not kept alive, defaults could follow swiftly.

In Chapter 3 we turn to the origins of the crisis and look at the reasons why countries incurred debt. Money – and particularly foreign exchange – is 'fungible' in the sense that it is not always easy to track down its true end use because a loan can easily be transferred to purposes other than those for which it was contracted. Lending is thus general lending to the country concerned to maintain a higher level of imports than would otherwise be the case and in the hope that it will be able to repay. With these caveats, it is clear that the increased oil bill of the non-oil Third World countries was the main cause of the debt build-up from the debtors' point of view, though rising interest rates and mistaken exchange-rate policies also played a role.

For every borrower, however, there is a lender. In Chapter 4 we look at the origins of the crisis from the point of view of the suppliers of credit, particularly noting the mechanisms in the Euro-market which allowed the banks to believe that the lending was sounder than it turned out to be. We also deal with some of the arguments of the leading banking advocates of the lending, notably the former head of Citibank, Mr Walter Wriston, and explain the fallacies behind the belief that sovereign borrowers are particularly safe risks. However, we also quote chapter and verse from various instances of official encouragement of the lending and describe the way in which Western governments ran away from the problems their policies helped to create.

In Chapter 5 we turn to an analysis of how the advanced countries, through their combined monetary institution the IMF, now foresee that the crisis will be resolved. We explain in detail why there is a conflict of interest between the banks' attempt to protect their fragile balance sheets by restricting their lending and the debtors' need for foreign exchange if they

are to grow. In drawing out the implications of the IMF's baseline scenario, we show that the rates of growth which it projects for the developing country debtors – if they hold to the prescribed course of generating large reverse transfers – are far from satisfactory in terms of either living standards or unemployment. We also show that, despite these disappointing growth rates, the IMF expects these countries to go on generating enormous (and in some cases growing) negative transfers in order to meet their obligations, a prospect which is wholly implausible.

The surprise is, however, that even if the debtor countries hold to the IMF's scenario and do not succumb to the temptation to grow more quickly (and import more), the position of the banks will hardly have improved by the end of the decade. The world's major financial institutions will remain, on realistic assumptions about the likely growth of their capital base, as vulnerable to default as they are today. Nor are there any easy ways of resolving the banker–debtor dilemma through an increase in other types of private finance to the developing world, for the increases required in, say, bond finance or private direct investment would be so enormous as to be incredible.

In Chapter 6 we examine some of the IMF's and others' assumptions about world growth and other macro-economic conditions and find that there is no likely (or unlikely) change in world circumstances which will relieve policy-makers of the need to tackle the debt problem. A sharp fall in oil prices now, for example, would merely aggravate the debt problems of oil-exporting countries like Mexico without providing enough help to oil importers like Brazil. The projected scale of negative transfers is simply too large to be reversed easily by a fall in interest rates or a decline in the dollar. However, there are substantial downside risks in the present situation which could make the debt problem worse, notably the evidence of a steady increase in protectionism against the exports of the developing world. The advanced countries are doing much to frustrate the Third World's attempts to repay its debt in the only way it can – by increasing its trade surpluses and its exports. Ominously, this was one of the causes of the chain of defaults during the 1930s.

In Chapter 7 we turn to the predicament of some leading South American debtors and examine the political pressures

which are pushing them towards a unilateral limit on debt service, or creeping default. Their overall level of income is low and maldistributed. Social unrest is mounting. The new urban working class has expressed its discontent through labour militancy and sporadic outbreaks of rioting and looting. The middle class, whose expectations rose markedly in the years of high growth, have seen the prospect of consolidating their gains crumble. Against a background of the increasing political appeals for moratoria and debt-service restrictions, we look at the implications of several individual forecasts of the outlook for Argentina, Mexico and Brazil, the three largest Latin American debtors. The negative transfers expected of these countries are utterly far-fetched, and the sanctions which some claim might be imposed against a defaulter are a mirage. A default in these crucial countries cannot be ruled out on either economic or political grounds.

In Chapter 8 we sketch out the likely consequences of defaults for the world financial system and the world economy. Few of the more exposed banks could escape effective nationalization. A bank which found so much of its loans of no value would also have to cut back on other loans by a multiple of the original default, so that a sharp recession would ensue. There would be gravely disruptive consequences for the whole world's banking system. The advanced countries would pay many times over any costs of a modest reform of present arrangements. In the second part of the chapter we argue that the present situation not only entails the risk of a crash but also exacts continuing costs from both debtors and creditors even while a collapse is averted.

This paradox, whereby the repayment of debt makes the creditor countries poorer rather than richer, arises from the nature of the world economy, whose activity is not a zero-sum game. One participant's success does not imply another's failure. All can lose, or all can gain. The attempt of the debtors to repay their obligations by cutting their imports and generating more exports increases unemployment in the rich countries and ensures a deflationary bias to the world economy. The profligate, unregulated lending of 1973–82 greatly advantaged the world, even if the whole of the lending were ultimately to be defaulted. But the mirror-image paradox is that the present repayment of that debt is disadvantaging both debtors and creditors.

In Chapter 9 we draw the strands of the argument together and set out some criteria for a solution to the debt problem. We look briefly at some of the proposals which have been put forward and explain what their failings are. Finally, we set out our own preferred proposals for dealing with the crisis. Regulated, official guarantees for commercial bank lending to the debtor countries would help to resolve both aspects of the debt problem. They would be adequate at least to ensure that the reverse transfers were ended and that debtor growth and imports could resume a normal path. They would thus also implicitly guarantee the worth of the outstanding debt of these countries and hence the health of the banks. Such a programme would give the banks time to make appropriate write-offs of the existing debt and hence limit the need for guaranteed lending to pay the interest on the debt overhang.

Whatever optimism governments choose to nourish about the far-distant future, they must now concede that there is no prospect of full service of these banks' debts either by the countries concerned or by refinance in the markets in the years immediately ahead. This means policy will continue to be dependent on rescheduling, the credibility of which is fast running out and, with it, confidence in the stability of our leading banks. The markets' refusal to find further finance for the debtors calls into question not only the debtors' solvency but, by ominous implication, the solvency of their creditors too. In the years ahead, therefore, with existing policies we will, even on the most hopeful view, be continuously at risk from widespread default and its calamitous consequences. The world cannot prosper with a banking system whose solvency is chronically dependent on unsupported optimism about future debt payments and with South American and other developing economies struggling with grim economic and political difficulties.

The moves in the summer of 1985 to limit debt servicing by Peru and South Africa underline the urgency of the problem. Above all, there must be protection against the most immediate perils of major defaults by the debtors to the banks. The bank debts are a hangover from the emergency responses to the oil shocks and ill-thought-out methods for recycling the OPEC money. But vital world purposes were served, however clumsily. It is not in the interests of our peoples to have governments encourage and approve these bank commitments and then walk

away to leave the banking system and the debtors to financial collapse. Most of the populist clamour against 'bailing out the banks' is based on ignorance of the history of this lending and of the consequences of its breakdown. The failure of governments so far to acknowledge their responsibility has been due not to moral principle but to political timidity.

The official response to present difficulties is as little thought out and as much under the pressure of immediate concerns as the reactions of 1974. The problem is not to discover a solution which will protect the major interests at risk. We are not immodest enough to suppose that there is any shortage of valid solutions. The difficulty is to get congresses, parliaments and governments to understand the problem, to assess the costs and dangers and to develop the political courage to act. It is to that task that this book is primarily directed.