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The World Debt Crisis: Working Out Solutions

1985 Free Market Calendar
A Daily Chronicle Of Enterprise

In a joint venture project with Louver Manufacturing Company (Lomanco) of Jacksonville, Arkansas, the Harding University Students in Free Enterprise Economics Team has launched a major six months project: "The 1985 FREE MARKET CALENDAR — A Daily Chronicle of Enterprise."

A calendar is a record of days past and days to come. Since the ancient Egyptians first devised calendars to tabulate the inexorable passage of time, men's lives have been regulated by its pages. Each day, each month is a milestone in the passage from youth to old age. Each week holds its promise of struggle and reward, of ideas achieved and triumphs won. But more than this, the FREE MARKET CALENDAR is the record of the progress of our nation and its people, of mankind's onward march through the centuries to economic freedom and greater material blessings.

The 1985 FREE MARKET CALENDAR offers not only room to jot down notes of daily affairs but also 365 brief reminders of great enterprising events and relevant comments on the idea of freedom applied to the marketplace. One will enjoy recalling and commemorating the stirring events, and the great men and ideas behind them, which have been the basis for history's greatest economic miracle — American Capitalism.

Printed in blue and red ink on which stock, the 1985 FREE MARKET CALENDAR is punched for hanging and measures 11" x 14" folded or 22" x 14" unfolded. The National Federation for Independent Business (NFIB) has been reprinting portions of our calendar in their FORUM and INSIGHT publications. A limited amount of copies are available for $1.50 to cover printing, postage, handling costs.

by James B. Burnham

I would like to start with a quotation that I find helpful in understanding the general issue of international debt and the immediate problem facing us. It is from a World Bank Annual Report, and it reads as follows:

It must not be forgotten that if there was bad borrowing . . . there was also bad lending. And there was also reckless competition, encouragement was sometimes given to borrowers and lenders alike without sufficient understanding of what was involved; loans were often made for unproductive purposes; sufficient care was not always exercised to see that a loan was used for the purpose for which it was granted; and high interest rates, instead of encouraging investors to inquire into the likelihood that the borrower could meet his obligations, failed to do anything but encourage them to invest their money. It is important that there should be in the future a greater sense of responsibility both in borrowing and lending than has frequently been the case in the past.

As I mentioned, the quotation is from a World Bank Annual Report: the date is 1947. What was being discussed was the legacy of over-borrowing and over-lending that had taken place in the 1920s, actions which subsequently imposed tremendous burdens on the developing world as well as on parts of Eastern Europe. In the 1940s and 1950s the World Bank was striving to reestablish the credit-worthiness of the developing countries, mainly in Latin America. That is what, in large measure, we are trying to do today as well. What we are going through now, therefore, is not an unprecedented situation. And it could be that some of the lessons we are supposed to learn today are the same ones that should have been learned more than fifty years ago.

Let me start with a capsule analysis of how we got to today's situation. The world credit crisis is a legacy of the inflation of the 1970s, an inflation that encouraged over-borrowing and over-lending. It is not just a question of over-borrowing in the case of developing countries, but also over-borrowing for energy development or for real estate in the developed countries as well. Indeed, I think write-offs of such domestic lending are going to exceed what is likely to take place in terms of international loans. The basic point is that double-digit inflation and negative real interest rates in the 1970s led to over-leveraged balance sheets for everyone — whether it was individuals, businesses, or entire countries. Today we are struggling to readjust everyone's balance sheets to a new reality, the reality of lower inflation and lower expectations about the future rate of price increases.

AVOIDING A GREAT-DEPRESSION-STYLE FINANCIAL COLLAPSE

If the situation today is, in some respects, similar to the 1930s and 1940s, do we need a Great Depression to work our way out of the problem? Fortunately, the answer is "no." We did learn something from the 1930s. The policies developed to address current debt problems fully recognize that we cannot afford a contraction of money and credit — and the resulting deflation — such as took place in the 1930s.

International Cooperation

For example, we have seen extraordinary examples of assistance by the major finance ministries and central banks around the world to indebted countries, combined with repeated instances of cooperative efforts by commercial financial institutions. It sort of reminds me of the old "Tinker-to-Evers-to-Chance" double-play combination of the Chicago Cubs. Of course, every situation we have encountered is different in some respects. Hungary experienced the first major international debt-liquidity problem, although most people did not notice it at the time. (I put Poland in a somewhat different category.) In the case of Hungary, the problem was precipitated by withdrawal of short-term foreign deposits in the Hungarian central bank, followed by a threat of imminent default. The Bank for International Settlements, the central banker's bank, stepped into the breach, followed by some other central banks, and thus default of the Hungarian external debt was averted.

Next, we had a Yugoslav crisis that was somewhat similar. It was, in turn, followed by the Mexican crisis which required a different type of solution. The U.S. Treasury and the Federal Reserve were very intimately involved in averting a Mexican default. We have now moved on to Brazil and Argentina. We will also have "work out" situations in Nigeria and the Philippines that are going to be difficult and complex. Nonetheless, we have an interlocking network of cooperation between the central banks, the International Monetary Fund, the World Bank (to a limited extent), the Bank for International Settlements and, most importantly of all, the commercial banks.

The Effects of Economic Recovery

The second factor that I believe makes a repeat of our experience in the 1930s unlikely is the very strong, broad, and deep recovery in the United States. By now, nearly all of us have experienced some impact of the high rate of growth in the domestic economy. But from the developing countries' point of view, the most important aspect of this recovering is the tremendous increase in U.S. imports that is taking place. In 1982, the U.S. ran a slight surplus on its trade account with the non-oil, developing countries — a little under $2 billion. In 1983, we ran a deficit of about $12 billion with those same countries. Thus, the swing in terms of foreign exchange earnings for those countries was roughly $14 billion. That massive swing in and of itself is one of the most powerful factors in getting the international banking system and the economies of developing countries back into a healthier, more sustainable posture.

Some Pain is Part of the Cure

Let me next discuss some of the policy adjustments that the International Monetary Fund and the World Bank have required in these "workout" situations. I believe that the IMF and the World Bank have received a bad rap for asking these countries to adopt policies — exchange rate devaluations, budget restraint, credit growth limitations, and the like — that are supposedly unduly harsh. The question is, "What is the alternative?" There really is no alternative to requiring these countries to put their economic houses in order, because if they do not do so today, they will have to do it twelve or eighteen months from now. Delay will only make the pain more intense.

On the positive side, I believe that the boat is being righted in some of these countries. If you look at Eastern Europe today, the economic growth and creditworthiness of a country such as Hungary has significantly improved compared to the situation eighteen months or two years ago. In the case of Mexico, you can detect a sense of confidence returning to the banking system, even though we recognize there is going to be a medium-term rescheduling problem in that nation (and elsewhere). Confidence in the system is rebuilding.

Ad Hoc Solutions versus "Silver Bullets"

As I indicated, there are a lot of players in this current financial situation. The International Monetary Fund is the most visible and essential player. All parties look to the IMF to provide a degree of coordination in any given debt crisis. But the commercial banks are clearly a key ingredient in this process as well. By and large, their response has been quite positive. It has not always been easy. But the fact is, we are seeing a joint sharing of the costs of adjustment by the developing countries themselves, the commercial banks, the IMF, and indeed, the central banks of some of the countries involved. The whole exercise is an attempt to distribute the cost of adjustment. Each case is unique; each requires a different combination of measures, a different formula for burden-sharing that has to be worked out. The process is "**ad hoc** but not disorderly," although it may appear to be so from the outside.

Some people have pet schemes for what I call magic "silver bullets." For example, they want the World Bank to buy up the developing countries' debt and give the commercial banks some type of paper in exchange. That, to my mind, is the old approach of papering your way out of the problem. I do not support that type of solution. Fortunately, there seems to be less and less talk of that type of "quick fix" today than there was a year ago. Furthermore, I believe it would be a great mistake to try to set up a new institution or a new financial instrument to solve these problems. Any attempt to do so runs the very real risk of only making the problem worse, as the parties concerned "rest on their oars," waiting for a Sugar Daddy to come along.

WORLD TRADE AND THE DEBT CRISIS

Protectionism and Debt Repayment are Incompatible

It is highly relevant to say a few words about the trade aspects of world debt problems. The recovery in the United States and our tremendous demand for imports from abroad are very powerful positive factors in working our way out of this situation. I believe genuinely open trade is one of the most difficult issues facing us today. People's attitudes about the benefits of freer trade depend upon how it affects them — whether one is an exporter, an importer, a consumer, a banker, or someone facing competition from foreign suppliers. One of my biggest complaints is that U.S. government trade promotion policies seem to be concerned only with exports. Certainly, exports are a very important part of the general international economic system. In fact, as U.S. Executive Director at World Bank, I actively encourage American firms to bid on World Bank projects. But what about imports? Unless we import from the developing countries, they will not have the dollars to pay for our exports. Trade is a two-way street.

In general, funds are provided to nations either through trade by importing, with the result that foreign countries earn the dollars they need to buy our exports — or it is done through foreign aid, by having Congress appropriate money and lift it out of the pockets of taxpayers. Most of us would agree that the preferable situation is to have a voluntary, two-way process and not to rely on foreign aid. Protectionism makes it difficult for our trading partners to pay for our exports. As Murray Weidenbaum and his associates at the Center for the Study of American Business have shown, protectionist interference with imports also imposes a large cost on the American economy and the American consumer. In 1980, this cost was about $58 billion a year and was passed on to consumers in the form of a "hidden tax" included in the price of American goods and services.

In this regard, one of the things that the World Bank is trying to do in working with developing countries is to persuade them to adopt policies that liberalize their import regimes and that do not discriminate against imports of capital goods or raw materials coming from abroad. In particular, we encourage fewer restrictions on imports for those nations which need imported inputs for their exports, in order to get the two-way street of trade flowing more rapidly. The World Bank is making major efforts in this regard, both in terms of its lending program and in terms of the policy advice given to these countries. But that process will not work if the United States increases its barriers to imports from abroad.

Bilateral Blinders

I am also concerned that we have a tendency in the U.S. to look at trade issues bilaterally. At a time such as the present, when we are running a large trade deficit, we tend to focus on the balance of trade with specific countries, such as Brazil or Japan. If we do not like the Japanese inroads into our economy, we go after the Japanese. This is what I call "creeping bilateralism." One of the great dangers in this approach to world trade is that it involves the U.S. government more and more in the commercial details of bilateral trade relationships. We should leave such details to the private parties involved.

The alternative is the long-standing approach of addressing trade issues on a multilateral basis. Large, complex multilateral negotiations such as those conducted within the General Agreements on Tariffs and Trade take a lot of time, of course. But they reduce the potential for mischief that is inherent in bilateral negotiations. Japan may be a special case, since there are some peculiar problems involved in dealing with the Japanese. Nevertheless, our basic objective should be to draw the Japanese into a speedy, productive set of multilateral negotiations. Negotiating meaningful multilateral trade agreements is one of the major challenges in international economic policy facing us in the months and years ahead.

CONCLUSION

Let me conclude by summarizing the current situation. We have an economic recovery underway in the U.S. that is strong and deep. The estimates for economic growth in 1984 have been continually revised upward over the last quarter of 1983 and the first quarter of this year. The Japanese recovery is also strengthening. The recovery in the United Kingdom, although weak, has also strengthened somewhat. An improved worldwide economy is certainly a necessary part of working our way out of the international debt situation.

It is also clear that economic growth is increasing in a number of the developing countries. We tend to think that all developing countries are in the same shape as some of the poorer performing African economies. However, even in Africa, there are countries that do fairly well. Botswana, in southern Africa, has a fairly successful record. It has an open economy, and it has been blessed with some great mineral resources — but so have a number of other African countries. The secret of Botswana's success is that it has encouraged foreign investment and human capital to come in and cooperate with the local authorities.

China is another interesting case. Chinese economic growth has been extraordinary over the last several years. That nation's foreign exchange reserves are now well over $10 billion, and the country is running a substantial trade surplus. China's progress is not the result of massive amounts of foreign aid — it has received practically no aid — but it has adopted market-oriented policies that are encouraging individuals to work, to save, and to invest. India also has had a very strong economy over the last three or four years and will continue to be in good shape. Pakistan has made fairly good progress in recent years, mainly as a result of adopting good economic policy.

Still, complex problems persist. The debt situation for countries such as Nigeria and the Philippines is going to be difficult to work out. But I believe we have good examples to guide the parties involved. The challenge now is to avoid creating once again the economic conditions which led to the present international debt crisis. We must avoid the inflation that arises from excessively easy monetary policies: there must be a continuing resolve by our public policymakers around the world to keep inflation under control. I believe that restraining inflation is the single most important key to avoiding the conditions that could lead to another international debt crisis — and for preventing the 1984 World Bank Annual Report from being quoted fifteen years from now in the same spirit and tone in which I cited the 1947 edition.

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