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# The Continuing World Debt Crisis

by  
Walter Goldstein<sup>†</sup>

## INTRODUCTION

Today, most of the nations of the world are deeply burdened with debt, not only to their own citizens but also to foreign banks and governments. At the end of 1983, the external debt of the poorest countries, the less developed countries (LDCs) that must import oil (hereinafter the non-oil LDCs), alone amounted to 900 billion dollars. Seven hundred and seventeen billion dollars of this amount constituted long-term debt, 472 billion dollars came from banks and private sources, and 245 billion dollars came from official lending agencies outside the market.<sup>1</sup> The total equalled one-third of the aggregate gross national product (GNP) of the non-oil LDCs.<sup>2</sup> The LDCs' annual interest payments and debt service on this amount approached 150 billion dollars, between twenty and twenty-five percent of the hard currency earned by their export trade.<sup>3</sup> It has long been recognized that the largest portion of foreign debt principal will not be repaid in this century, but it is only in recent years that the issue of debt servicing and interest payments has provoked sharp concern. Today, the argument rages over a specific issue: will a group of the most impoverished debtors default or fall seriously into arrears in meeting their debt service or interest payments during the 1980s? The optimists claim that the "Debt Crisis" has passed; the pessimists warn that the worst is yet to come.<sup>4</sup> The aim of this Article is to evaluate these two contradictory projections.

No matter which side they argue, critics agree that the world banking system is not sufficiently stable to handle the crisis that might occur if a group of debtors should fail to honor their foreign obligations and interest payments. Many of the largest multinational banks in the United States and

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1. The figure for the total Third World debt ranges from US\$700 billion to US\$900 billion, depending on how it is calculated. Kilborn, *Watershed Seen in Argentine Plan*, N.Y. Times, Apr. 2, 1984, at 26, col. 1. See also INT'L MON. FUND, WORLD ECONOMIC OUTLOOK, Sept. 1984, at 68, Table 35; WORLD BANK, WORLD DEBT TABLES, 1983-84, summarized in IMF SURV., Mar. 18, 1985, at 88 (figures for 104 developing countries).

2. For a detailed breakdown of debtor and creditor totals in 1983, see *International Debt: Banks and the LDCs*, 10 AMEX REVIEW SPECIAL PAPERS (March 1984), at 3.

3. See INT'L MON. FUND, ANN. REP. 1984 at 27, Chart 11; INT'L MON. FUND, WORLD ECONOMIC OUTLOOK, *supra* note 1, at 72, Table 35. See also Johnson, *International Bank Lending After the Slowdown*, THE BANKER, Jan. 1984, at 23, 26 (citing a 27% ratio).

4. Compare Frank, *Can the Debt Bomb Be Defused?*, 1 WORLD POL'Y J. 723-43 (1984), with Hector, *Third World Debt: The Bomb is Defused*, FOR., Feb. 18, 1985, at 36-50.

Europe are over-extended in their loan-to-capital ratios. In some cases, their most poorly secured loans exceed twice the sum of the multinational banks' capital worth.<sup>5</sup> If the multinational banks should be forced to increase their emergency loan reserves or to write off foreign "non-performing" loans from their balance sheets, their profit margins will be severely reduced. If the collapse of the Continental Bank of Illinois in 1984 serves as a precedent, multinational banks will find it difficult to rebuild their financial position after such large write-offs and will look to governments and the central banks for help.<sup>6</sup> In objective terms, the strain imposed by large LDC debts has never before so gravely threatened the stability of international commerce and credit.

Part I of this Article will investigate the origins and causes of the debt crisis, focusing on the upheavals of the 1970s when oil prices quadrupled and annual inflation soared above four hundred percent in some countries; when worldwide recession led to "stagflation", to a revival of "economic nationalism", and to trade warfare. Part I will also examine the impact of poor judgment by the multinational banks in forecasting changes in the world trade and financial markets, as well as the effects of the economic mismanagement contributed by LDC governments.

Part II will examine the impact of the worldwide debt crisis on three groups: the borrowers, the banks, and the money market. Part III will analyze the specific economic and political risks that these economic actors must face in the 1980s. Part IV will present sets of economic projections made by several agencies for the 1980s. Part V will evaluate the effectiveness of the proposed remedies to control the debt crisis. Short-range and cautious in character, the proposed remedies basically promise to delay the threat of the worldwide credit crunch, rather than to effect a comprehensive solution to the perilous situation of the world money market. These proposals, however, do not address the central issue: has the crisis peaked or will it escalate in future years?

## I

### THE ORIGINS OF THE DEBT CRISIS

Normally, capital flows from the industrialized countries, where it is abundant, to the LDCs, where capital is scarce and where risky loans must be

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5. See generally Clausen, *Let's Not Panic About Third World Debts*, HARV. BUS. REV., Nov.-Dec. 1983, at 106-14; W. CLINE, INTERNATIONAL DEBT: SYSTEMIC RISK AND POLICY RESPONSE 22 (1984). For example, at the end of 1983, Manufacturer's Hanover Trust Company's loans to the four largest Latin American debtors amounted to 284% of its shareholder's equity. Raut, *Postponement of Third World Debts Threatens Upheaval, Financial Collapse*, Wall St. J., June 22, 1984, § 2 (Special Report: World Debt in Crisis), at 1, col. 2.

6. For details of the government intervention in banking, see Carrington & Hertzberg, *FDIC in a Bailout of Continental Illinois Would Buy \$4.5 Billion in Problem Loans*, Wall St. J., July 24, 1984, at 3, col. 2; Bailey, *Continental Illinois Holders Are Offered Little, But Alternative is Insolvency*, Wall St. J., July 25, 1984, at 3, col. 2. For a pertinent and highly critical editorial, see *Continental's Crash: The Implications*, 15 INT'L CURRENCY REV. 13 (1984).

rewarded with more profitable premiums. In the 1970s, the magnitude of borrowing began to pose grave dangers to the entire credit system. Between 1973, when the first oil crisis occurred, and 1982, when Mexico initiated the first moratorium imposed by a major borrower, the external debt of the non-oil LDCs grew from 130 billion dollars to 612 billion dollars.<sup>7</sup> In addition, five of the poorer members of the Organization of Petroleum Exporting Countries (OPEC) borrowed eighty billion dollars, and East European countries (excluding the Soviet Union) borrowed a further fifty-three billion dollars.<sup>8</sup> Thus, the debt of the non-oil LDCs amounted to 745 billion dollars at the beginning of 1983.<sup>9</sup>

Several factors can explain the acceleration in debt accumulation in the 1970s. The most important include: (a) the 1,200 percent increase in the price of oil in 1973-79; (b) the trade recession that ensued as industrial consumption and demand for primary commodities fell sharply while the price of manufactured products continued to increase; (c) the phenomenal surge in inflation as each nation increased its money supply in order to stimulate its economy; (d) failures in economic and political judgment by multinational banks and institutional investors; and (e) the economic mismanagement by the LDC governments and their many state-owned enterprises.

#### A. Increase in Oil Prices

The phenomenal and unexpected rise in oil prices came in three stages. In 1973, following the Yom Kippur war, the basic reference price of oil quadrupled, from US\$3 to US\$12 a barrel.<sup>10</sup> In the next five years, it climbed to US\$18 and then to US\$23 a barrel.<sup>11</sup> After the overthrow of the Shah of Iran and the onset of a protracted war between Iran and Iraq, the second "oil shock" occurred. Iran and Iraq had previously exported nearly ten million barrels a day; during the war, production was cut back and the spot market price soared to US\$36 a barrel.<sup>12</sup> The third "shock" came in 1981 when the U.S. dollar, the world trading currency for oil, began to appreciate; by 1985 it had increased by more than sixty percent in value.<sup>13</sup> Importing nations were forced to severely reduce their consumption, further intensifying the global recession.<sup>14</sup>

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7. W. CLINE, *supra* note 5, at 2-3, Table 1.1. See generally *Special Report: World Debt in Crisis*, Wall St. J., June 22, 1984.

8. W. CLINE, *supra* note 5, at 1.

9. *Id.*

10. Goldstein, *Economic Nationalism and the Disruption of World Trade*, in WILL EUROPE FIGHT FOR OIL?, 173, 175 (R. Lieber ed. 1983).

11. *Id.*

12. *Id.*

13. Brownstein, *Why the World Loves the Dollar*, *FORT.*, Feb. 18, 1985, at 54, 55.

14. Goldstein, *Can OPEC Survive 1984?*, 11 *ENERGY POL'Y* 196 (1983). Chichilniski & Heal, *The World Oil Market, Past and Future*, 19 *COLUM. J. WORLD BUS.* 47, 49-50 (1984). The struggle of the OPEC cartel to police its members' activity is analyzed at length in Tagliabue, *OPEC's Mounting Problems*, *N.Y. Times*, Oct. 20, 1984, at 29, col. 2; Martin, *The Troub-*

### B. *The Global Recession*

The fall in primary commodity prices, including the relative price of oil, created enormous deficits on external account for most of the LDCs. These deficits increased as debtors were forced to pay higher prices for the industrial imports they vitally needed to sustain their economic development.<sup>15</sup> The newly-industrializing countries (NICs) were the exception. The NICs, especially those in Latin America and South-East Asia, had developed the capacity to manufacture products inexpensively and to export them at competitive prices; their exports of electronic components, steel, automobile parts, and textiles began to flood Western markets. Comparatively lower wage rates and devalued currencies enabled the NICs to undercut the higher-wage countries of Western Europe and North America.<sup>16</sup> The twenty-four Western-industrialized nations, members of the Organization of Economic Cooperation and Development (hereinafter the OECD nations), and the LDCs responded to this change in the flow of trade with a variety of protectionist measures to shelter their failing industries, their declining currencies, and their balance of payments difficulties. The principles of free and competitive trade, exemplified in the principles of the General Agreement on Tariffs and Trade (GATT), were increasingly flouted.<sup>17</sup>

The slump in world trade in the early 1980s led to another unfortunate development. As the trading position and the current accounts of the LDCs declined, the debtors were forced to raise expensive short-term loans to service debt arrears and to reschedule medium- and long-term borrowings. At the same time, the U.S. prime rate and the London Inter-Bank Offered Rate (LIBOR) rose sharply, adding to the cost of debt servicing and to the volume of outstanding debt. Normally, the LDCs expect to pay one percent over LIBOR on a floating, rather than fixed, basis. While they had paid interest charges at roughly seven percent in the mid-1970s, they had to pay three times as much in the early 1980s.<sup>18</sup>

The LDCs' efforts to repair the deficit on current account by reducing imports and subsidizing exports have led to a new difficulty. Western Europe and the United States sell thirty to forty percent of their exports in the developing world market; Japan sells forty-six percent of its exports in developing-world markets. Many industrial nations, feeling threatened by the LDCs'

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*ling Economics of Oil*, N.Y. Times, Oct. 28, 1984, § 3, at 1, col. 2; Diamond, *OPEC Panel Urges Cuts in Oil Output to Support Prices*, N.Y. Times, Oct. 29, 1984, at 1, col. 6.

15. W. CLINE, *supra* note 5, at 12-13; IMF, *INTERNATIONAL FINANCIAL STATISTICS*, May 1983, at 56-57.

16. Frank, *supra* note 4.

17. On new modes of monetary competition, trade protection, and exchange instability, see J. SPERO, *THE POLITICS OF INTERNATIONAL ECONOMIC RELATIONS* 74-101 (1981); Cohen & Zysman, *The Mercantilist Challenge to the Liberal International Trade Order*, 1 *INT'L TAX & BUS. LAW.* 1 (1983).

18. See Folkerts-Landau, *The Regulatory Origins of the International Debt Crisis*, *BANKERS MAG.*, Sept.-Oct. 1984, at 44, 46-47, Exhibit 1. See also W. CLINE, *supra* note 5, at 6-7, 12; IMF, *WORLD ECONOMIC OUTLOOK* 1983.

export efforts, have begun to resort to mercantilist measures in the last few years: quotas to limit steel imports, non-tariff barriers to restrict manufacturing imports, and "orderly marketing arrangements" to curb textiles. In addition, OECD countries have attempted to protect internal markets through the use of export subsidies and the dumping of surplus agricultural exports abroad.<sup>19</sup> These measures not only distort trade, they also are politically harmful and could impede an upturn in the overall level of world trade.<sup>20</sup>

### C. Inflation

The third factor leading to the debt crisis was the worldwide spread of inflation. When inflation rates ranged from fifteen to twenty-two percent in the industrial creditor countries, real interest rates were depressed; for some years they were at a negative level, running five to ten percent below the rate of inflation. By pursuing a tight money policy in the 1980s, the OECD nations were able to suppress the inflationary spiral and to restore positive interest costs. In the United States, the mix of a tight monetary and a loose fiscal policy caused the spread between the prime rate and the inflation rate to widen to ten percent or more, thus attracting a huge flow of foreign money into the United States. The influx of billions of dollars a year in foreign capital substantially increased the relative value of the U.S. dollar; interest rates overseas were forced upward and the cost of credit on all world markets had to rise to match the rates prevailing on Wall Street.<sup>21</sup>

The consequences of this forced deflation and high inflation were grave for the LDCs since they could no longer finance their debt servicing with a continuously inflating, or devalued, supply of money. The debtor countries faced the difficult task of refinancing long-standing obligations at high rates of interest in a very expensive currency. Between 1980 and 1981, interest rates rose by nearly ten percent and each increase in the rates cost the debtor countries several billions of dollars.<sup>22</sup> Most of them were unable to meet the increased cost and had to plead for a rescheduling or a roll-over of their debt. Others had to borrow heavily to service their earlier borrowing obligations or to pay off accumulating arrears.<sup>23</sup> Although the creditor nations gained by successfully regulating inflationary pressures at home, the LDCs forfeited real GNP growth and found that the real cost of debt servicing had soared.

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19. Both the United States and the European Communities have been accused of "dumping" surplus agricultural commodities abroad in response to the political demands of domestic farmers. Similarly, the subsidizing of steel exports has produced bitter arguments at meetings of the OECD and General Agreement on Tariffs and Trade (GATT). See, e.g., Luyten, *Is Protectionism as Widespread as Everyone Claims?*, EUROPE, Jan.-Feb. 1985, at 12; Hirsch, *Export Policy Faces New Congress*, *id.* at 16.

20. See Lewis, *The U.S. and the Third World*, in U.S. FOREIGN POLICY AND THE THIRD WORLD 7-50 (J. Lewis & V. Lallab eds. 1983); W. CLINE, *supra* note 5, at 147, 167.

21. Brownstein, *supra* note 13, at 54.

22. W. CLINE, *supra* note 5, at 11.

23. See, e.g., Johnson & Abrams, *Aspects of the International Banking Safety Net*, IMF OCCASIONAL PAPER NO. 17, at 5 (1984); Kilborn, *supra* note 1, at 26, col. 1.

The combined onset of recession and worldwide inflation also gravely affected the profit margins of the multinational banks. In 1982, the net profits, after taxes, of America's nine largest multinational banks were five-and-a-half billion dollars, but their loans to debtors in the LDCs and the communist bloc were fifteen times greater, at eighty-two billion dollars.<sup>24</sup> In theory, these banks should have set aside up to fifty percent in loan-loss provisions against troubled debts. In fact, the nine multinational banks actually made a loss provision of less than thirty percent on their troubled debts. They assumed that few debtors would actually demand a roll-over or a moratorium on interest or debt payments, and consequently they carried doubtful loans at full book value on their balance sheets. The U.S. banks also calculated that they would earn sufficient fees and income on their domestic loans to compensate for any losses in foreign lending and that the Federal Reserve Bank would help rescue them if they ran into the magnitude of difficulty that Continental Illinois encountered in its 1984 cash crisis.<sup>25</sup>

#### D. Institutional Judgment Failures

In the 1970s, the oil exporters in OPEC—and a few non-OPEC exporters such as Mexico and Canada—decided to recycle their cash flow by channeling billions of “petrodollars” through the offshore lending operations of the multinational banks. Unfortunately, the creditor countries failed to forecast the worldwide recession of the 1970s and the resulting inability of the multinational banks to find secure lending opportunities for their accumulating balances. The multinational banks, for their part, tried to recoup losses at home by placing their clients' funds in LDC-lending syndicates that realized profitable premiums.<sup>26</sup> With these funds, the multinational banks began to extend substantial high interest loans to borrowers in the LDCs and Eastern Europe, on the basis of lax credit standards.<sup>27</sup> The directors of the multinational banks were certain that loans made to countries promising a fast rate of economic growth, especially in Latin America and Southeast Asia, would be profitable investments. No country had defaulted on its sovereign debt during the great growth years in the 1950s and 1960s, with the minor exceptions of Cuba and North Korea. The professional underwriters believed that LDC governments would assume all outstanding obligations as an aggregation of sovereign debt and that this debt would be secured with the LDCs' valuable resources of agricultural, oil, and other commodities. Today, the underwriters still insist that their calculations were correct, as no debtor has recently repudiated its debt.<sup>28</sup>

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24. W. CLINE *supra* note 5, at 26–27.

25. See Folkerts-Landau, *supra* note 18, at 51.

26. *Id.* at 45–47; Lomax, *Sovereign Risk Analysis Now*, THE BANKER, Jan. 1983, at 33–39.

27. See Lomax, *supra* note 26, at 33–34.

28. W. CLINE, *supra* note 5, at 90. See also Folkerts-Landau, *supra* note 18, at 50.

Unfortunately, the multinational banks failed to consider the mounting predicament of LDCs that had borrowed easily but could not meet their servicing payments as world trade began to decline. In August of 1982, Mexico stunned the multinational banks by declaring that it could not pay the twenty billion dollars then past due to over five hundred foreign banks. A syndicate of multinational banks, working with the U.S. government and the International Monetary Fund (IMF), hastily put together a rescue package, which brought emergency relief to the public- and private-sector debtors in Mexico at a point when all of their available funds were exhausted.<sup>29</sup>

The Mexican rescue action set an important precedent and a large number of countries began to demand the rescheduling of their short- and long-term obligations. The severe downturn in world trade had deprived LDCs of the commodity-export earnings needed to curb their deficits and to service their debts, a development that the multinational banks had clearly failed to predict. As the crisis deepened, eleven Latin American debtors met together, most dramatically in Cartagena, Colombia in 1984,<sup>30</sup> and talk was heard for the first time about staging transnational acts of debt repudiation if the multinational banks failed to reduce interest rates or to stretch out debt repayments to twenty-five years. In any event, no action was taken to form a debtors' cabal and the borrowers' threat to resort to collective action was ignored. Indeed, on the day after the conclusion of the Cartagena conference, the U.S. banks raised interest rates another half a point to thirteen percent.<sup>31</sup>

### E. LDC Economic Mismanagement

Between 1973 and 1982, the non-oil LDCs increased their indebtedness from 130 billion dollars to 612 billion dollars. Of this 482 billion dollar increase over ten years, fifty-four percent came from the LDCs' increase in oil-import costs, sixteen percent from the decline in their balance of trade, and eight-and-one-half percent from the rise in real interest costs.<sup>32</sup> Not included in this calculation, however, is the GNP growth that was forfeited because of the poor management by LDC governments and their leading enterprises, many of which are owned or run by public-sector agencies. Labor was

29. W. CLINE, *supra* note 5, at 257-62; Cline, *Mexico's Crisis, the World's Peril*, 49 FOR. POL'Y, Winter 1982-83, at 107-09. For an up-dating on the Mexican rescue package and the country's economic dilemmas, see *Mexico Cuts a Deal That's a Victory for Later Debtors*, BUS. WK., Sept. 10, 1984, at 58; Shelton-Colby, *Helping to Ease the Latins' Debt*, N.Y. TIMES, Mar. 19, 1985, at A-25, col. 1; Bogdanowicz-Bindert, *Getting Mexico From Remedy to Recovery*, WALL ST. J., May 2, 1984, at 30, col. 4.

30. W. CLINE, *supra* note 5, at 190-92; Lewis, *A 'Cartel' of Debtors Is Doubted*, N.Y. TIMES, June 19, 1984, at D-19, col. 1; Diehl, *Debt System Failing Latin Nations Charge*, WASH. POST, June 24, 1984, at A-20, col. 1. For an analysis of the issues raised at the debtors' meeting, see Bennett, *Can IMF 'Divide and Conquer' Debtors?*, N.Y. TIMES, June 17, 1984, at E-2, col. 2.

31. *Debtor Nations Throw Down the Gauntlet—Gently*, BUS. WK., July 9, 1984, at 98.

32. W. CLINE, *supra* note 5, at 13 (Table 1.4). Cline warns, however, that estimates as to the impact of these various exogenous shocks do not strictly correspond to actual debt increases, because countries pursued adjustment measures to reduce external debt levels. *Id.* at 14.

overpriced, inefficient industries were subsidized to win political support, and investments in government enterprises were managed carelessly.<sup>33</sup> Some of the LDCs had used their loans to buy expensive military hardware, largely for the purpose of gaining political prestige. Most of them refused to curb the runaway inflation that beset their economies, fearing that a political revolution would overturn any government intent on controlling the surge of money.<sup>34</sup> In all too many cases, debtor governments failed to account for the flight of capital through illegal transfers to foreign bank accounts which depleted capital formation.<sup>35</sup>

Though the early loans to the LDCs had been easily negotiated, the multinational banks became increasingly reluctant to lend new money to help retire old debts. The bankers realized that the earlier loans had been misused and that their clients could no longer pay high interest charges on short-term borrowings. The multinational banks balked at providing new capital, let alone "bridging loans" to service short-term obligations, to countries that were sinking ever deeper into debt. Between 1972 and 1981, gross exposure of multinational banks to non-oil LDCs had increased at the rate of twenty-two percent per year; in 1982 the rate fell to fourteen percent, in 1983 to seven percent, and after 1984 virtually to zero.<sup>36</sup> The flow of funds from multinational banks issuing international bonds and Euro-currency credits was reduced, especially for Latin American borrowers, to a slim trickle. Without the "involuntary lending" which multinational banks were obliged to undertake, and the long-term credits and transfers of official agencies, the supply of new funds in 1984 would have dried up completely.<sup>37</sup>

## II THE SIGNIFICANCE OF THE 800 BILLION DOLLAR DEBT

### A. *The Debtor Nations*

The significance of world debt from the debtors' perspective can be evaluated in several ways. First, it can be measured in terms of the debtors' potential resources, or cash flow. Forty of the LDCs and six nations in the Soviet bloc account for most of the debt; ten of the thirteen nations in OPEC and half of the OECD nations owe the remainder.<sup>38</sup> The former group does not possess sufficient export revenues and wealth resources to provide collateral for their debts; the latter enjoy sufficient trading income and wealth resources, but their economies and balance of payments are in deficit. The

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33. *Id.* at 16.

34. *See id.* at 14-16.

35. *See id.* at 15-16.

36. OECD, EXTERNAL DEBT OF DEVELOPING COUNTRIES 46 (1984); IMF, WORLD ECONOMIC OUTLOOK, April 1985, at 192, Chart 9-3.

37. *See, e.g.*, IMF, WORLD ECONOMIC OUTLOOK, *supra* note 36, at 192-93.

38. *See generally Special Report: World Debt in Crisis, supra* note 7, at 2-3, col. 1. *See also* W. CLINE, INTERNATIONAL DEBT AND THE STABILITY OF THE WORLD ECONOMY 14 (1983).

fifteen countries appearing in Table I, below, present the most troubling cases because they lack the resources necessary to service their external obligations.

Table I: The Danger List

Country	Foreign Debt (Billions of U.S. Dollars)	Debt Service to Export Earnings Ratio %	Debt to GNP-GDP Ratio %	Deficit on Current Account (Billions of U.S. Dollars)
Argentina	\$45.3	58.1%	70.6%	\$2.57
Brazil	93.1	51.7	41.1	8.26
Mexico	89.8	56.7	60.5	+4.65
Philippines	26.4	31.6	77.2	3.69
Poland	27.0	80.8	29.3	1.21
Turkey	23.9	31.8	44.4	2.23
Chile	18.6	55.9	89.1	.94
Peru	12.5	35.2	79.5	.40
South Korea	40.1	19.1	53.5	1.61
Ivory Coast	9.4	44.5	116.9	1.16
Indonesia	29.5	17.3	37.3	4.50
Yugoslavia	19.5	28.0	41.6	+ .30
France	94.5	9.6	18.3	3.84
Nigeria	17.0	21.7	24.0	4.01
Israel	29.3	32.7	116.1	2.66

Source: Wall Street Journal, June 22, 1984, at 36.

Each country on the list provokes varying degrees of anxiety among multinational banks. The worst cases are the three big countries in Latin America: Argentina, Brazil, and Mexico. These countries bear a collective debt of almost 230 billion dollars and are burdened with high ratios of debt to GNP and debt to export earnings. Argentina, for example, maintains a debt equal to seventy percent of GNP, and its debt service, in theory, should be paid with fifty-eight percent of its hard currency earnings. Other non-oil LDC countries on the list similarly face grave problems. The Philippines and Chile, for example, must contend with violent unrest at home, a steep increase in population, and poor prospects for GNP growth.

While the communist countries on the list—Poland, Romania, and Yugoslavia—are in considerable arrears in servicing payments, it is unlikely that they would contemplate a formal default. The experience of the Soviet Union in 1917 provided them with a warning of the grave consequences of defaulting on foreign debt; the Soviets were cut off from the international credit markets for forty years, seriously retarding the country's industrial and agricultural development.<sup>39</sup> In the 1930s, U.S. investors had lost one-third of the ten billion dollars they had invested in Latin American bonds. However, an-

39. See generally Sandler, *U.S. Banks Prepare for Possibility of Third-World Debt Repudiation*, Wall St. J., July 6, 1984, at 17, col. 3.

other wave of bond repudiations like those of the Soviets and Latin America is not likely to recur in the 1980s. First, the repudiation of foreign obligations is too risky a strategy for any debtor to pursue; and second, the IMF would almost certainly intervene to dissuade a country intent on repudiation.<sup>40</sup>

The OECD debtor-nations on the list face a more complex, but less perilous, debt-financing prospect. France and Israel, for example, are both politically stable and economically prosperous, although their deficits on current account are gigantic. In fact, none of the OECD debtor-nations have found difficulty in raising new loans, and they pay interest rates only slightly above LIBOR when they renew their borrowing.<sup>41</sup>

The significance of the world debt crisis may alternatively, and perhaps best, be analyzed by calculating the percent of export revenues that should be shifted from consumption and capital expansion in order to settle outstanding arrears, short-term payments of interest, and long-term amortizations of principal. Table II, below, demonstrates that fourteen nations should theoretically allocate one hundred percent *or more* of their export revenues in order to settle with their creditors. Figures for another twenty-five countries show that such nations should allot more than fifty percent of their export revenues to settle external debt.

The fifty most-indebted nations include all the Eastern bloc countries, Scandinavia, and, most notably, the larger economies of Latin America. Brazil and Mexico each owe nearly 100 billion dollars, while Argentina owes fifty-eight billion dollars more in short-term obligations. Conspicuously missing from the list are the successful exporting members of OECD, OPEC, and Japan.

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40. See Folkert-Landau, *supra* note 18, at 50.

41. For a discussion of interest rates and money markets in the developed and developing world, see Hartman, *International Financial Markets and U.S. Interest Rates*, 3 J. INT'L MONEY & FIN. 56, 91 (1984); Gotur, *Interest Rates and the Developing World*, FIN. & DEV., Dec. 1983, at 33, 38.

Table II: Exports-to-Debt Ratios

Country	Percent of Export Earnings as a Ratio of:	
	Medium & Long-term Debt	Adding Short-term Services Payments
Argentina	58.1%	199.5%
Philippines	31.6%	173.5%
Uruguay	25.3%	159.6%
Israel	32.7%	156.8%
Mexico	56.7%	146.5%
Portugal	29.2%	141.2%
Chile	55.9%	140.4%
Ivory Coast	44.5%	138.4%
Colombia	38.8%	118.9%
Ecuador	39.9%	118.6%
Brazil	51.7%	113.5%
Peru	35.2%	109.7%
Venezuela	18.8%	106.9%
Costa Rica	51.4%	106.4%
Sudan	25.5%	96.7%
Zimbabwe	37.2%	95.4%
Morocco	54.4%	88.8%
Ireland	48.3%	85.0%
Poland	80.8%	84.6%
Zaire	53.3%	84.4%
Turkey	31.8%	82.5%
Egypt	31.9%	77.9%
Finland	18.2%	76.8%
Bolivia	52.7%	72.3%
Denmark	32.7%	65.1%
South Korea	19.1%	64.7%
Ghana	13.1%	62.1%
South Africa	8.8%	61.4%
Czechoslovakia	25.7%	60.5%
Hungary	31.0%	59.4%
Dominican Republic	29.4%	58.8%
Nigeria	21.7%	56.9%
East Germany	38.0%	55.6%
Honduras	32.9%	55.3%
Spain	16.8%	53.5%
Australia	28.4%	53.3%
Romania	34.3%	51.3%
U.S.A.	21.6%	50.7%
Bulgaria	22.0%	50.1%

Source: Wall Street Journal, June 22, 1984, at 38.

A third gauge of world debt may be obtained by measuring debt obligations as a percentage of per capita GNP. This measure reveals, in Table III below, that the most indebted countries include some of the most productive nations of the industrialized world. For example, even though the debt burden of Israel and Ireland is greater than their GNP per capita, they command sufficient resources (along with the eight other nations listed in Table III) to maintain a good credit standing. The exports-to-debt ratio of the United States is troubling, but less grave than that of Israel or Ireland;<sup>42</sup> in 1983, external debt in the United States amounted to US\$1,400 per person, while GNP per capita was ten times larger at US\$14,266.<sup>43</sup>

Table III: Debt-to-GNP Ratios

Country	GNP (per capita)	Debt (per capita)
Norway	13,366	7,290
Israel	6,264	7,283
Denmark	11,098	6,995
Iceland	8,936	6,383
Ireland	4,967	5,599
Sweden	10,931	5,237
Switzerland	15,227	4,524
Canada	12,803	4,291
Finland	9,867	4,208
Kuwait	14,058	3,450

Source: Wall Street Journal, June 22, 1984, at 39.

### B. *The Multinational Banks and the Creditor Nations*

The pertinent question often asked is: to whom is this debt actually owed? Of the 900 billion dollar external debt owed by the non-oil LDCs in 1984, approximately fifteen percent appeared as short-term debt, fifty percent as long-term guaranteed obligations to financial institutions, fifteen percent as unguaranteed long-term debt, and the remainder as obligations owed to governments and official agencies.<sup>44</sup>

42. See Table II, *supra*.

43. *Special Report: World Debt in Crisis*, *supra* note 7, at 5, col. 5.

44. See IMF, *WORLD ECONOMIC OUTLOOK*, *supra* note 36, at 61, Chart II-21.

Table IV: LDC Debt to Foreign Banks  
(billions of dollars, end of period)

	Total	U.S. banks	Non- U.S. banks	U.S. Share of total (%)	U.S. share of annual increase (%)
1975	\$62.7	\$34.3	\$28.5	54.5%	n.a.%
1976	80.9	43.1	37.8	53.3	48.4
1977	94.3	46.9	47.4	49.7	28.4
1978	131.3	52.2	79.1	39.8	14.3
1979	171.0	61.8	109.2	36.1	24.2
1980	210.2	75.4	134.8	35.9	34.7
1981	253.5	92.8	160.7	36.6	40.2
1982 (June)	268.3	98.6	169.7	36.7	39.2

Source: Johnson, *International Bank Lending After the Slowdown*, THE BANKER, Jan. 1984, at 26.

Table V: Debt of Major Borrowers, June 1982  
(billions of dollars)

Country	Total	U.S.	Non-U.S.	U.S. % share
Mexico	\$64.4	\$24.3	\$40.1	37.7%
Brazil	55.3	20.7	34.6	37.4
Venezuela	27.2	11.1	16.1	40.8
South Korea	20.0	8.7	11.3	43.5
Argentina	25.3	8.6	16.7	34.0
Chile	11.8	6.3	5.5	53.4
Spain	23.7	5.7	18.0	24.1
Philippines	11.4	4.8	6.6	42.1
Taiwan	6.4	4.4	2.0	68.8
Colombia	5.5	2.7	2.8	49.1
Greece	9.7	2.7	7.0	27.8
Yugoslavia	10.0	2.5	7.5	25.0

Source: Federal Reserve data based on (1) BIS semi-annual maturity survey; (2) U.S. Country Exposure Lending Survey (data adjusted to a BIS basis).

Table VI: Debt of All LDCs: End 1983

	\$ billion	% of total
Bank loans	\$265	37.8%
Export credits	175	25.0
Bonds	60	8.6
Multilateral institutions	100	14.3
Official bilateral loans	100	14.3
	\$700	100.0%

Source: Johnson, *International Bank Lending After the Slowdown*, THE BANKER, Jan. 1984, at 26.

Table VI reveals that 37.8% of the total debt came from banks. Export credits made up twenty-five percent of the total, at 175 billion dollars. While 8.6% of the debt came from bonds, and 14.3% from official bilateral loans, the balance of 14.3%, or 100 billion dollars, came from multilateral agencies, such as the World Bank and its development agencies. These long-term loans are repayable in soft currencies at low interest rates and do not substantially influence the outcome of the current credit crisis.<sup>45</sup>

It is difficult to segregate the lending arrangements in the international money market. Multilateral banks create a wide range of temporary syndicates; governments provide various forms of guaranteed loans or export credits; and public sector agencies encourage multilateral or bilateral negotiations to underwrite non-market lending. It is almost impossible to calculate the exposure of institutions in any one creditor country; however, extensive data tables are published by the IMF, the Bank of International Settlements (BIS), the United Nations (UN), and by several U.S. government agencies. Public agencies contributed an estimated 245 billion dollars of long-term debt to LDC borrowing in 1984, while private creditors accounted for an estimated 472 billion dollars of long-term debt.<sup>46</sup>

The available evidence indicates that a number of multinational banks may be perilously exposed in their holdings of LDC debt. From 1977 to 1982, U.S. banks increased their level of capital exposure in loans to non-oil LDCs and Eastern Europe from 131.6% to 155% of capital. For the nine largest multinational banks, the relative exposure for non-oil LDCs and Eastern Europe was 235.2%.<sup>47</sup> If five of the OPEC borrowers are added to the list of debtors, the exposure of these nine banks increases from 235.2% to 282.8% of the total capital.<sup>48</sup> In 1983, Federal Reserve Chairman Volcker estimated that eighteen multinational banks in the United States held between thirty and forty percent of the LDCs' debt.<sup>49</sup> In 1982, Manufacturers Hanover, for example, was extended to 262.8% of its capital worth, Crocker National to 196%, Citibank to 174.5%, and nine others to over one hundred percent.<sup>50</sup>

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45. Commitments made by the World Bank and its affiliate, the International Development Association, provided loans valued at US\$14.5 billion in 1983 and US\$15.5 billion in 1984. These were concessional or "soft" loan agreements that need not meet the stern tests set by the IMF. In addition, the World Bank's Special Action Program disbursed US\$8.6 billion in 1984. IMF SURVEY, *supra* note 1, at 285.

46. *Id.* at 88.

47. W. CLINE, *supra* note 5, at 22; W. CLINE, *supra* note 38, at 32-44.

48. W. CLINE, *supra* note 5, at 22.

49. See W. CLINE, *supra* note 38, at 34.

50. See W. CLINE, *supra* note 5, at 24; W. CLINE, *supra* note 38, at 34. Two articles at the peak of the debt crisis sounded a note of alarm. See *World Banking System: How Close to Disaster?*, INT'L CURRENCY REV., May 1982, at 11; *World Banking System: Orchestration of Lending*, INT'L CURRENCY REV., Jan. 1983, at 7. For a more theoretical analysis, see W. CORDEN, INFLATION, EXCHANGE RATES, AND THE WORLD ECONOMY (1981).

Table VII: Percent of Bank Exposure at the End of 1982

	Argentina	Brazil	Mexico	Venezuela	Chile	Percent Total	Capital <sup>a</sup> (million dollars)
Citibank	18.2%	73.5%	54.6%	18.2%	10.0%	174.5%	\$5,989
Bank of America	10.2	47.9	52.1	41.7	6.3	158.2	4,799
Chase Manhattan	21.3	56.9	40.0	24.0	11.8	154.0	4,221
Morgan Guaranty	24.4	54.3	34.8	17.5	9.7	140.7	3,107
Manufact. Hanover	47.5	77.7	66.7	42.4	28.4	262.8	2,592
Chemical	14.9	52.0	60.0	28.0	14.8	169.7	2,499
Continental Illinois	17.8	22.9	32.4	21.6	12.8	107.5	2,143
Bankers Trust	13.2	46.2	46.2	25.1	10.6	141.2	1,895
First National Chicago	14.5	40.6	50.1	17.4	11.6	134.2	1,725
Security Pacific	10.4	29.1	31.2	4.5	7.4	82.5	1,684
Wells Fargo	8.3	40.7	51.0	20.4	6.2	126.6	1,201
Crocker National	38.1	57.3	51.2	22.8	26.5	196.0	1,151
First Interstate	6.9	43.9	63.0	18.5	3.7	136.0	1,080
Marine Midland	n.a.	47.8	28.3	29.2	n.a.	n.a.	1,074
Mellon	n.a.	35.3	41.1	17.6	n.a.	n.a.	1,024
Irving Trust	21.6	38.7	34.1	50.2	n.a.	n.a.	996
First National Boston	n.a.	23.1	28.1	n.a.	n.a.	n.a.	800
Interfirst Dallas	5.1	10.2	30.1	1.3	2.5	49.2	787

Source: W. CLINE, *INTERNATIONAL DEBT AND THE STABILITY OF THE WORLD ECONOMY*, at 34.

n.a. Not available.

a. Bank capital includes shareholders equity, subordinate notes, and reserves against possible loan losses.

Because bank loans are highly leveraged, often with capital amounting to only five percent of total loans, the cost of default on such leveraged loans would be multiplied many times over. Default would cause extensive damage, not only to the banks' equity and reserve ratios, but also to the economies of their home countries.<sup>51</sup>

The exposure listed in Table VII is highly concentrated among multinational banks; however, since it represents only 13.9% of the total loans made by these banks, the banks are reassured and claim that their current position causes them little alarm.<sup>52</sup>

The banks' positive outlook has not been accepted without question. At the end of 1982, nearly seventy-five percent of the capital of Citibank and Manufacturers Hanover was exposed in Brazil, sixty percent of three banks' capital was exposed in Mexico, and six banks' exposure in Argentina, Brazil, Mexico, Venezuela, and Chile exceeded 150% of capital.<sup>53</sup> To proceed on a larger scale, twenty of the outstanding debtors owed 311 billion dollars to

51. See W. CLINE, *supra* note 5, at 26-29. See generally Bennett, *Should U.S. Let Banks Fail?*, N.Y. Times, Sept. 12, 1984, at D-1, col. 3.

52. W. CLINE, *supra* note 5, at 23.

53. *Id.* at 22-23.

Western multinational banks as of June 1982.<sup>54</sup> Furthermore, two-thirds of Third World borrowing was subject to rescheduling or debt-service interruption in 1982-83.<sup>55</sup>

Although it is not likely that a major part of the debt will ever be repudiated, serious questions have been raised over the multinational banks' procedure of carrying insecure debt at full book value when so much of it has been rolled-over, extended, or subjected to non-payment of interest arrearages. Government agencies, including the Federal Reserve and the Comptroller of the Currency, have recommended an increase in reserves for bad debts, even if it costs the banks a great deal to raise their loan-loss provisions.<sup>56</sup>

### C. *The International Money Market*

Despite the current account deficits that burden the LDCs, the world money and trading systems have continued to function smoothly. The non-oil LDCs have stayed afloat by increasing, in small amounts, both their borrowing levels and their export revenues and by drastically cutting government spending and expenditures for imports. The OPEC countries have survived by using their cash reserves and by raising new loans from the multinational banks. Nonetheless, there are limits beyond which borrowers and lenders cannot venture without grave risk.<sup>57</sup>

The worst year for a potential upset in the international money market came in 1983. The hundreds of billions of dollars that had been transferred to the LDCs were insufficient to help them through their cash crisis and the trade recession. LDC export earnings fell just at the time that the rise in interest rates increased the cost of debt service. The LDCs' cash reserves were almost exhausted, their external deficits kept growing, and the multinational banks were reluctant to extend new lines of credit. It is surprising that a major disaster did not occur when the borrowers and lenders tensely argued over the management of the conflict.<sup>58</sup>

Fortunately, by the end of 1983, the strain on the world money system began to diminish, interest rates dropped, and some LDC loans were rescheduled. National governments and multilateral agencies provided additional grants, export credits, and soft currency loans. In the private sector, various multinational corporations increased their direct foreign investments and

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54. See P. MEEK, *U.S. MONETARY POLICY AND FINANCIAL MARKETS* (1983). See also W. CLINE, *supra* note 5, at 25.

55. See W. CLINE, *supra* note 5, at 23, 26.

56. See *id.* at 116-17, 148. For an analysis of the methods and the actual cost of bank regulation, see Hector, *The True Face of Bank Earnings*, *FORT.*, April 16, 1984, at 82-86. See generally Dini, *Where the International Financial System Needs Strengthening*, *THE BANKER*, Sept. 1983, at 29-38.

57. See Fishlow, *The Debt Crisis: Round Two Ahead?*, in *ADJUSTMENT CRISIS IN THE THIRD WORLD* 31-57 (R.E. Feinberg & V. Kallab eds. 1984).

58. See *IMF SURVEY*, *supra* note 1, at 88. The rate of growth in the total LDC debt fell from 15% in 1981 to an estimated 6.2% in 1984, and average interest rates from private lenders declined from 14.3% in 1981 to 10.9% in 1983. *Id.* at 88-89.

production schedules in the LDCs.<sup>59</sup> More importantly, the economic recovery in the OECD nations, and especially in the United States, helped to improve the balance of payments of many trading countries. The reduced danger of a system-wide collapse was greeted with relief, but the question was raised, once again, as to whether the reprieve in the debt crisis was permanent or only temporary. As one of the most optimistic of the critics concluded, there remained to be resolved:

the still-stupendous task of servicing foreign debt—a total of some \$520 billion for the 16 largest Third World debtors, with interest payments amounting to about \$55 billion a year. A spike in interest rates, a drop in commodity prices, or a sudden downturn in the world economy could bring fresh setbacks on the long journey back to creditworthiness.<sup>60</sup>

### III

#### THE RISKS GENERATED BY THE DEBT CRISIS

##### A. *The Debtors*

Resolution of the debt crisis requires that the governments of debtor countries make financially complex and politically sensitive decisions, many of which involve a high degree of risk. The capability of borrowing countries to meet the financial demands of their creditors varies with their political power and their economic strength. The governments of many debtor countries, however, lack the popular support necessary to curtail employment, to reduce food subsidies, and to lower living standards in order to meet debt deadlines. All too many governments fear that a reduction in domestic spending and imported goods will provoke strikes, riots, and possibly revolution. On the other hand, governments recognize that if they fail to implement restrictive policies, they will perpetuate their nations' debt burdens for years to come.

LDC governments may be tempted to escape from their fiscal dilemmas by declaring a moratorium, but they are aware that such action would result in exorbitant costs. If a defaulting country hoped to return to the credit market at a later time, it would have to pay higher fees and interest rates when it attempted to reschedule its borrowings. Should it repudiate its debt altogether, the government would effectively cut itself off from the international capital markets and would forfeit the short-term aid, trade credits, and standby loans that every economy needs to finance its day-to-day operations.<sup>61</sup>

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59. Johnson, *supra* note 3, at 25.

60. See Hector, *supra* note 4, at 36. For an assessment of the recovery in GNP, see IMF SURVEY, Oct. 15, 1984, at 292. For a more critical appraisal, see Weinert, *Coping With LDC Debt*, 38 J. INT'L AFF. 1 (1984).

61. See *Is Debt Repudiation Out of the Question?*, 15 INT'L CURRENCY REV., Mar. 1984, at 27-30.

The technical issues of debt management have been handled so far with adroit maneuvers and an ingenious packaging of agreements. Third World leaders have learned how to arrange compromises with the multinational banks and the IMF. In some cases they threatened to create a debtors' cabal to mastermind a strategy of collective bargaining; in others, they asked only to extend the grace period of a loan so that payment arrears could be settled. Nevertheless, debtor-country governments realized that domestic political difficulties cannot be indefinitely postponed while they hammer out a negotiation strategy with their creditors. When confronted with the choice of placating overseas bankers or raising the living conditions of their population, countries on the Table I Danger List have responded in different ways. Their response was largely determined by the degree of domestic political support that the government enjoyed and by its skill in negotiating with its creditors for additional time to roll-over external debt.

*Brazil.* A country of 120 million people, with nearly 100 billion dollars in debt, an inflation rate of nearly 300 percent, and a recent history of political violence, Brazil has pledged to repay half of its obligations by 1989 if it can secure lower rates of interest. Nearly one-half of its debt has been postponed in the last two years, but it has failed to meet the austerity restrictions demanded by the IMF, and it has repeatedly violated its spending limits.<sup>62</sup> The comment made by the Brazilian Minister of Finance is indicative of Brazil's attitude toward debt management: "[w]e're going to pay our interest to the extent of our possibilities, and when we cannot, the bankers will lend us the money and then we will."<sup>63</sup> Concerned that Brazil was irresolute in fighting runaway inflation, the IMF suspended the disbursement of 3.9 billion dollars in credit.<sup>64</sup> Although Brazil's export trade has greatly improved and its imports have been drastically reduced, producing a 13 billion dollar surplus on current account, its newly-elected civilian government has failed to renew or reschedule the 100 billion dollars that was borrowed by the outgoing military regime over the last twenty years.<sup>65</sup>

*Mexico.* The Mexican government initially triggered the world debt crisis in August 1982 when it announced that it could not make twenty billion dollars in short-term payments to its 530 leading bank creditors. It then set out to become a model of debtor behavior. In fact, Mexico has cooperated with the IMF more rigorously and more willingly than any other borrower. Although it curbed inflation from one hundred percent to eighty percent in

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62. Riding, *A Sudden Revival in Latin Debt Fears*, N.Y. Times, Feb. 26, 1985, at D-1, col. 4.

63. Riding, *Brazil Will Seek Flexible Debt Plan*, N.Y. Times, July 30, 1984, at D-1, D-2, col. 3.

64. Riding, *A Sudden Revival in Latin Debt Fears*, *supra* note 62, at D-1.

65. *Id.* See also Pang & Jarnagin, *Brazilian Democracy and the Foreign Debt*, 83 CURRENT HIST. 63, 63-67 (1984).

1983, and in 1984 to forty percent, it missed the IMF's 1983 target of forty percent. Moreover, it produced a favorable trade balance of thirteen billion dollars by cutting imports forty percent, by reducing the government deficit from 8.7% to 6.5% of GNP,<sup>66</sup> and by depressing living standards by nearly one-half. With these draconian measures completed, Mexico was able to bargain for sizeable loans from the IMF and for an unprecedented fourteen-year extension on principal, together with a one-year grace period for payments of arrearages and a lower interest rate.<sup>67</sup> The agreement to restructure 48.6 billion dollars of debt, which is roughly half of Mexico's total foreign debt, has yet to be signed.<sup>68</sup>

*Argentina.* Although Argentina had been the most recalcitrant of all the debtor nations, and the one that multinational banks feared would create a strong precedent of default for others to follow, Argentina has since become more cooperative.<sup>69</sup> Nonetheless, the new government has refused to execute the austerity program of expenditure cutbacks mandated by the IMF or to comply with the demands set by its creditors. Argentina has consistently refused to curb wage increases, to cut food subsidies, or to curtail wage rates.<sup>70</sup> It has also failed to reschedule its crushing debt payments. Instead, Argentina has demanded several "bridging loans" and short-term emergency payments to stave off every thirty-day default deadline. A restructuring agreement was eventually worked out.<sup>71</sup>

*Eastern Europe.* While Western governments have imposed sanctions on Poland to demonstrate their rejection of the martial law dictated by General Jaruzelski's regime, Poland's creditors are unwilling to force the government into bankruptcy.<sup>72</sup> One-half of Poland's thirty billion dollar debts are owed to or underwritten by Western governments rather than multinational banks. Federal regulators in the United States and West Germany have forced banks to set aside expensive reserves against their lending to Poland pending the conclusion of a renegotiated repayment agreement.<sup>73</sup> Romania and Yugoslavia are also in technical default to Western creditors and the economic prospects of these two countries are not impressive. Neither side cares to press for a resolution of debt issues when the relations between East and West are so strained. Western governments have noted that the countries of Eastern

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66. See Hector, *supra* note 4, at 38.

67. Bennett, *Breakthrough Seen on Mexican Debt*, N.Y. Times, Aug. 28, 1984, at 31, col. 3.

68. Kristof, *Debt Crisis Called All But Over*, N.Y. Times, Feb. 4, 1985, at D-1, col. 3.

69. See generally *The Battle of Wills over Argentina's Debt*, BUS. WK., Feb. 6, 1984, at 63-64. See also, W. CLINE, *supra* note 5, at 271; Kilborn, *supra* note 1, at 1, col. 1; Hector, *supra* note 4, at 38.

70. See Riding, *supra* note 62; Hector, *supra* note 4, at 38; *Latin American Debt*, ECON., Mar. 30, 1985 at 89.

71. Kristoff, *supra* note 68.

72. W. CLINE, *supra* note 5, at 279.

73. *Special Report: World Debt in Crisis*, *supra* note 7, at 2, col. 1.

Europe have turned their deficit of six billion dollars on current account in 1981 to a surplus of 1.7 billion dollars in 1983 and that Poland has promised to match the full accounting supplied by Hungary. The fact remains, however, that in 1984 Poland's net debt of twenty-five billion dollars was equal to 519% of its export earnings.<sup>74</sup>

*The Philippines.* Since the 1970s, the Manila government has operated under IMF surveillance, but its political stability is rapidly eroding and its GNP is shrinking significantly. Widespread domestic protests against the Marcos regime have deterred multinational banks and multinational corporations from renewing their investments in the failing economy.<sup>75</sup>

*Smaller Latin American Countries.* A number of countries suffer from declining exports, falling GNP, political disunity, and increasing debt payments. Foreign companies are preparing to leave and sell off their local interests; should they do so, these countries will encounter an increase in unemployment and in deficit on external account. The statistical data for the hemisphere in general are certainly daunting. Latin debt has grown at a rate of thirty percent a year, and interest payments equaled roughly forty percent of export revenues. Nearly seventy-five billion dollars in capital has fled to off-shore havens, and only two countries (Panama and Colombia) still enjoy access to market sources of finance.<sup>76</sup>

*Turkey and South Korea.* Although they have achieved an aggressive policy of economic expansion, the military governments of these two countries are neither popular nor politically stable. Unlike the LDCs in Latin America, both have succeeded in reducing domestic expenditures and encouraging the export of manufactured products. Both countries carry a high ratio of debt-to-GNP and a high index of exports-to-debt, but neither has met great difficulty in rescheduling loans with syndicated creditors. Significantly, multinational banks often prefer to negotiate with military *juntas* which can suppress populist protests and ignore democratic opposition as they mobilize their resources to accelerate economic expansion.<sup>77</sup>

*Indonesia and Nigeria.* The twenty percent decline in oil prices has caused most OPEC countries, including Saudi Arabia, to accumulate current account deficits. Of the thirteen OPEC countries, Indonesia and Nigeria record the largest population increases and probably the worst poverty. Since they lost more than one-half of their export income when the oil market

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74. See *East European Debt*, ECON., Mar. 23, 1985, at 78; *Special Report: World Debt in Crisis*, *supra* note 7, at 2, col. 1.

75. Rowen, *Philippine Debt Stunned Lenders*, Wash. Post, Jan. 29, 1984.

76. Silk, *Latin Nation's Capital Flight*, N.Y. Times, Apr. 17, 1985, at D-2, col. 1.

77. See generally M.A. ODLE, MULTINATIONAL BANKS AND UNDERDEVELOPMENT 77, 142, 165 (1981); Rustow, *Turkey's Liberal Revolution*, 176 MIDDLE EAST REV. 5-11 (1985).

slumped after 1981, they have been acutely short of foreign currency and short-term credit. Both governments try to pursue restrictive policies to please the IMF and the multinational banks, but they cannot continue indefinitely to ignore the compelling need to speed economic growth and agricultural development.<sup>78</sup>

*The African Countries.* The fifty African countries collectively owe 150 billion dollars, but few of them command the resources to roll-over their debt or to settle their arrears. Indeed, twenty of the thirty-two LDCs reported to be in arrears in 1981 were African, and in 1984 African countries accounted for ten of the fourteen LDCs whose accounts were submitted for critical scrutiny by the Paris Club, an informal association of creditor countries that monitors troubling debt obligations.<sup>79</sup> Recently, attention has focused on the famine and political instability that afflicts the poorest countries of Africa, such as the Sudan. Sudan's external debt has risen to ten billion dollars, or ten times greater than its hard currency earnings, and it cannot obtain the funds needed to promote its lagging agricultural development or to stave off starvation for six million people. Sudan's failure to maintain its debt servicing led the United States to cancel scheduled aid funds and the IMF to rescind a standby loan agreement. The United Kingdom, Saudi Arabia, and West Germany subsequently cancelled their aid programs in order to force the Sudanese government to abide by IMF requirements.<sup>80</sup>

### B. The Creditors

The LDCs' total debt of 900 billion dollars is carried by nearly a thousand different banks, Western creditor governments, and multilateral agencies. It is difficult to gauge the aggregate consequences if a wave of debt moratoria and defaults were to occur. One commentator estimated that if only the three largest debtors—Brazil, Mexico, and Argentina—were to miss one year's payments on principal and interest, the nine largest American banks could expect profit losses equal to twenty-eight percent of their capital, even after they had offset the profits realized on all other secure loans.<sup>81</sup> Many more banks would have to reduce their lending activity drastically if they were to maintain the required loan-to-capital ratio of 95:5 percent; they would also have to raise their interest rates and increase risk premiums in their Third World lending.<sup>82</sup> A wave of debt moratoria among the LDCs is generally thought to be unlikely, but if such a movement did materialize, a

78. See generally *Special Report: World Debt in Crisis*, *supra* note 7, at 2, col. 4; *The Winner's and Loser's From Cheaper Oil*, *BUS. WK.*, Aug. 13, 1984, at 57.

79. Jackson, *In the Sudan's Boat, Other Africans*, *N.Y. Times*, Apr. 10, 1985, at 35, col. 1.

80. *Id.*

81. W. CLINE, *supra* note 5, at 27. See also *How Can American Banks Account for Those Latin Loans?*, *ECON.*, June 2, 1984, at 87-88.

82. W. CLINE, *supra* note 5, at 27-28. Data on the vulnerability of American banks to possible defaults by LDC borrowers is carefully evaluated in W. CLINE, *supra* note 38, at 31-36.

number of banks would immediately have to file for bankruptcy.<sup>83</sup>

For the time being, the threat of a surge of defaults and moratoria has subsided. The recovery in world trade picked up strongly in 1983-84 and a portion of the LDCs' debt was rolled over. Neither the creditor institutions nor the debtor countries raised serious objections even though the rescheduling conditions imposed considerable costs and risks on both sides. Unfortunately, the respite is not likely to be permanent. The LDCs' struggle to improve cash flow depends on external factors that operate largely outside their control. They cannot influence future interest rate increases, depressed commodity prices, or the spread of protectionist measures in the world marketplace. Their domestic inflation is subject to volatility in exchange rates and borrowing costs in the OECD nations, and their economic future depends to a considerable extent on the expansion of trade in the industrial world. If trade should lessen, the LDCs might bear the brunt of a downturn in the global business cycle.<sup>84</sup>

### C. *The International Money Market*

If the optimistic forecasts for OECD-nation growth should materialize, both debtor and creditor countries may be able to gain room to maneuver. Once relieved of the anxieties of recession and inflation, both creditors and debtors could hope to reschedule agreements that had been negotiated when the course of world trade was depressed and the sense of financial alarm was moving to hysteria. But if forecasts of economic growth prove to be false, the task of damage limitation will fall most heavily on creditor governments, their central banks, and the interlocking syndicates of multinational banks.

If trade and credit expansion were to fade in the 1980s, clearly a worst-case scenario, debtor and creditor nations might retreat to a zero-sum strategy. Logically, they would sacrifice the collective good of stabilizing global financial markets in order to safeguard their own finances. Debtor countries would be tempted to halt debt service payments and possibly to repudiate principal as well. If no new money could be borrowed, there would be little reason for debtors to tax themselves strenuously to honor old debts. Lacking both purchasing power and trade credits, the debtors could buy few Western exports or produce goods for export to OECD-nation markets. Creditors, in turn, might deny borrowers the right to roll-over or reschedule payments. The multinational banks already find it expensive to set aside reserve provisions to compensate for non-performing loans. In a trade downturn they would find the costs and risks of debt rescheduling to be excessive. If necessary capital flows dried up, the level of world trade would be rapidly depressed, debtors would enter into default, and the entire trading system could

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83. The expectation that multinational banks would face grave peril, at least in the short run, is questioned by Folkerts-Landau, *supra* note 18, at 51. See generally W. CLINE, *supra* note 5, at 67-68.

84. See IMF SURVEY, *supra* note 60. See also W. CLINE, *supra* note 5, at 67-68.

move toward collapse.<sup>85</sup>

It is fashionable to dismiss such worst-case scenarios as leftist propaganda or science-fiction. Futurologists and evangelical industrialists insist that the world will soon become richer, not poorer.<sup>86</sup> Nonetheless, in a world trade system that has become markedly interdependent, the worry remains that the weakest links in the chain might snap under pressure. A chain reaction of LDC defaults would do more damage than any futurologist has dared envision.<sup>87</sup> Even if only three or four defaults were to be declared at any one time, the multinational banks would raise interest rates to protect their own capital, the central banks would probably respond by loosening controls over the money supply, and national governments would be forced to tighten fiscal policy.

To prevent such a crisis, banks could make efforts to create additional liquidity by enlarging their cash base, extending their lending limits, and helping to bail out their worst-hit debtors. But it is questionable whether high-risk programs of this order could succeed without stimulating inflationary pressures. If inflation were to move the world economy back toward double-digit growth rates in the money supply, trading activity would sharply decline, multinational banks would curtail some of their lending, and the least-secure debtors would be forced to declare a moratorium on further debt payments. In short, an initially modest level of debt repudiation could create, in time, a series of defaults and repudiations similar to the chain-reaction scenario played out in the 1930s, when the collapse of the international credit market pulled all nations down into a ten-year long depression.

#### IV

##### PROJECTIONS FOR THE 1980s

###### A. *Economic Recovery Predictions*

A sustained economic recovery has been projected for 1985–86, with OECD-nation growth predicted to range from two to five percent.<sup>88</sup> The sharp drop in oil prices has helped to fuel the recovery, but may prove to be a mixed blessing. Lower oil prices will shift the burden of the debt crisis from the oil-importing to the oil-exporting countries, especially debtor countries like Mexico, Venezuela, and Nigeria that earn seventy-five to ninety-five percent of export revenues from their sale of crude oil.<sup>89</sup> The oil exporters have lost substantial revenues and many are now on the banks' danger lists.

85. For a critique of current practices and their potential hazards, see Garten, *Gunboat Economics*, 63 FOREIGN AFF. 538 (1984).

86. See, e.g., H. KAHN, *WORLD ECONOMIC DEVELOPMENT: 1979 AND BEYOND* (1979); Schmidt, *The Role of Private Capital in Developing the Third World*, in *THE THIRD WORLD* 267 (W.S. Thompson rev. ed. 1983).

87. See W. CLINE, *supra* note 5, at 26–29.

88. *Id.* at 159–60; N.Y. Times, May 6, 1984, at E–5, col. 1.

89. Hurtado, *Mexico: The New Challenges*, 63 FOREIGN AFF. 62, 66 (1984); Diamond, *This Time, an Oil Price Cut Could Hurt*, N.Y. Times, Aug. 19, 1984, at E–5, col. 1; *The Winners and*

Although lower oil prices will help the non-oil LDCs to balance their external accounts, the sluggish market for other primary products is not likely to be re-invigorated in the years ahead, further inhibiting economic growth in the Third World. The NICs will probably continue to prosper, since they export manufactured products rather than raw materials and foodstuffs. The NICs helped expand the Third World's share of world exports from eight to eighteen percent between 1970 and 1980, though at the steep price of triggering protectionist measures by the OECD nations.<sup>90</sup>

### B. Interest Rates and Debt Accumulation

In 1984, a set of optimistic projections was compiled by four leading international bodies: the IMF, the World Bank, the OECD, and the BIS.<sup>91</sup> Though the four reports predicted a substantial improvement in the current account and the export-to-debt ratios of member states, they found reason to worry over the continuing growth of world debt.<sup>92</sup> The steady accumulation of debt could eventually disrupt the stable flow of money and trade, and consequently create widespread hardship and renewed threats of default.<sup>93</sup> Prospects for the late 1980s will be more heavily influenced by the movement in interest rates than by any other factor. Every one percent rise in LIBOR costs the LDCs over 2.5 billion dollars, making rescheduling more expensive and depleting the LDCs' scarce cash flow.

### C. LDC and OECD-nation Interdependence

The interdependence between LDC and OECD-nation economies was documented in a model developed to project the financial growth and economic recovery possibilities in the 1983-86 period for the nineteen largest debtor countries.<sup>94</sup> Among them, the nineteen countries accounted for two-thirds of the LDC debt (484 billion dollars of the 739 billion dollars at the end of 1982) and for three-quarters of LDC borrowings from private banks

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*Losers From Cheaper Oil*, BUS. WK., Aug. 13, 1984, at 57. See also W. CLINE, *supra* note 5, at 11.

90. See Sewell, *Testing U.S. Reassertionism*, in U.S. FOREIGN POLICY AND THE THIRD WORLD 3-30 (J. Sewell, J.P. Feinberg & V. Kallab, eds. 1985).

91. INT'L MON. FUND, WORLD ECONOMIC OUTLOOK 1984; WORLD BANK, WORLD DEVELOPMENT REPORT 1984; OECD, ECONOMIC OUTLOOK OF THE OECD 1984; BANK FOR INTERNATIONAL SETTLEMENT, FIFTY-FOURTH ANNUAL REPORT 1984. See also McCracken, *The World Economy Bounces Back*, Wall St. J., Aug. 1, 1984, at 24, col. 3.

92. In 1977, the LDCs' ratio of interest payments to export earnings ("debt service ratio") stood at ten percent but in 1984 this ratio had climbed to thirty percent. See McCracken, *supra* note 91.

93. See Donovan, *Nature and Origins of Debt-Servicing Difficulties*, 21 FIN. & DEV. at 22 (1984).

94. W. CLINE, *supra* note 32, at 46-71. Several models have been published in recent years. See, e.g., T. ENDERS & T. MATTIONE, *LATIN AMERICA: THE CRISIS OF DEBT AND GROWTH* 35-56 (1984).

(291 billion dollars of the total of 379 billion dollars).<sup>95</sup> Four critical factors were varied in the model: the rate of economic growth in the industrial countries; the international interest rate; the price of oil; and the real exchange value of the U.S. dollar in comparison to other currencies.<sup>96</sup>

Based on a statistical study, it was assumed that for each additional one percent of growth in the OECD nations' GNP, there would be an additional three percent in export earnings for the LDCs.<sup>97</sup> Logically, the LDCs' terms of trade would improve as the creditor nations bought more LDC primary commodities and creditor nations sold manufactured products to LDCs at non-inflationary prices. According to the model, however, the economic position of the LDCs would not improve if real interest rates were to further increase. If each one percent increase in the interest rate cost the LDCs another 2.73 billion dollars,<sup>98</sup> a five percent rise in interest rates would take an even greater toll. The model also predicted that changes in world oil prices would be critical to the recovery of OPEC and other oil-exporting nations, but would exercise a less significant influence on worldwide economic trends than would a continuing expansion in the OECD-nation economies.<sup>99</sup>

In summary, the model found that future developments in the debt crisis would depend to a considerable extent on the economic growth and trade expansion of the creditor, rather than the debtor, nations. If the OECD-nation economies achieve a growth rate greater than 2.5%, the debt crisis will ease; if the creditor nations achieve a steady rate of three percent growth until the late 1980s, many of the Latin American and East European countries could even remove themselves from the Danger List.<sup>100</sup> Alternatively, if economic growth rates should fall to 1.5% or less in the OECD nations, debtors will be forced to contend with grave issues of illiquidity.<sup>101</sup> In such a dire case, the management of aggregate global debt might exceed the capabilities of the IMF, creditor governments, and the multinational banks, even if they learned to work together with optimal efficiency.

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95. See W. CLINE, *supra* note 5, at 40-41. The reliance of the LDCs on U.S. monetary policy, dollar exchange rates, and import trade is documented in Krugman, *U.S. Macro-Economic Policy and the Developing Countries*, in U.S. FOREIGN POLICY IN THE THIRD WORLD, *supra* note 90, at 37. The United States buys US\$60 billion worth of LDC exports, or nearly one-third of their external trade, and it runs a deficit of US\$22 billion in its commerce with the LDCs. Given the LDCs' reduction of imports from the United States, the change in U.S. trade with Latin America alone accounted for a significant portion of the unprecedented deficit (US\$123 billion) in the U.S. trade balance. IMF, *WORLD ECONOMIC OUTLOOK* 1983, at 200.

96. W. CLINE, *supra* note 32, at 47.

97. W. CLINE, *supra* note 5, at 41.

98. *Id.* at 60.

99. Oil provides 78% of the revenues of exporters but only 31% of the expenditures of importers. A fall in oil prices from US\$29 to US\$20 a barrel would be helpful to a large number of non-oil LDCs but it would pose grave consequences for the economies of oil exporters. See generally *The Winners and Losers From Cheaper Oil*, *supra* note 89; *Why This Oil Glut Could Spill Into The 21st Century*, *BUS. WK.*, Nov. 12, 1984, at 37.

100. W. CLINE, *supra* note 5, at 46, 52-53.

101. *Id.* at 52-53.

V  
PROPOSED REMEDIES

A range of proposals has been advanced to alleviate the debt crisis. Most of them aim for medium- to long-term solutions, but their effectiveness will depend on the economic and global developments described in Part IV.

*A. Discounting Loans*

The most publicized of the reform solutions suggest that the multinational banks should absorb and consolidate LDC loan losses by discounting their insecure loans.<sup>102</sup> Such a procedure, however, would be destructive to the banks and creditor institutions. Discounting loans would severely deplete the multinational banks' capital reserves and profit margins and would eliminate any further lending to debtor nations. In the United States alone, such discounts would cost the multinational banks roughly 350 billion dollars and would oblige them to raise interest rates at home.<sup>103</sup> Overseas, discounting procedures might give the impression that sovereign debt is immune to market pressures, thus removing a powerful "market discipline" acting on debtor countries.<sup>104</sup>

*B. Bank Bail-Outs*

The 4.5 billion dollar emergency bail-out of the Continental Illinois Bank in 1984 suggests that other procedures might be used to reduce the hardships to banks forced to write down large losses on LDC debt. Several critics in the U.S. Congress opposed rescue operations for the banks as a normal procedure, though they conceded that U.S. government agencies could not idly stand by if the banking industry were threatened with collapse. An offer to bail-out the banks would necessarily include a federal commitment to expand the money supply. In return, Congress and the Federal Reserve might call for an extension of federal regulatory controls and surveillance over the foreign operations of U.S.-based banks.<sup>105</sup>

The call for greater government regulation of banks<sup>106</sup> arose in the

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102. See Gwyn, *The IMF and the World Bank: Measures to Improve the System*, in *UNCERTAIN FUTURE: COMMERCIAL BANKS AND THE THIRD WORLD* 87 (R.E. Feinberg & V. Kallab eds. 1984).

103. *Id.*

104. See Brainard, *More Lending to the Third World?*, in *id.* at 31-44.

105. See generally *International Bank Lending: Hearings before the Subcommittee on Financial Institutions, Supervision, Regulation, and Insurance of the House Committee on Banking, Finance, and Urban Affairs*, 98th Cong., 1st Sess. (1983).

106. Three agencies in the United States, the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (FDIC), presently monitor the banking industry. All three agencies are now represented on a new Interagency Country Exposure Review Committee. The U.S. Treasury and various Congressional committees have also exercised a monitoring role. The latter were accused of bailing out the banks' loans to the LDCs when Congress voted to enlarge the U.S. quota of payments to the IMF and its special fund, the General Borrowing Agreement. See *To Increase the U.S. Quota in the International Monetary Fund*

United States after the collapse of the Drysdale and Penn Square energy loans and the virtual bankruptcy of the Continental Illinois Bank. The banks resisted the call for government intervention and fought against the extension of federal regulations. The banks were concerned that they would have to account publicly for troubled LDC loans that they carried at full book value. They feared that the cost of writing off their non-performing loans to LDC governments would greatly reduce their net earnings.<sup>107</sup> The banks supported their position by citing the fact that in 1982 the domestic losses incurred by the nine largest banks in the United States amounted to only 0.72 percent of total equity.<sup>108</sup> They therefore claimed that their current loan loss reserves were ample. The validity of the claim was contested, and critics pointed out that in Europe banks are required to provide reserves on doubtful loans of nearly fifty percent.<sup>109</sup>

In Europe, the argument for closer bank regulation was made after the collapse of the Herstatt Bank in Germany, the Franklin National Bank in the United States, and the Banco Ambrosiano's subsidiary in Luxembourg.<sup>110</sup> In previous years, European branches of multinational banks had been particularly reckless in their operations in the Eurodollar market. Transactions in the Euromarket lie outside the jurisdiction of any one central bank, and only parent multinational banks have the power to control the lending policies of their foreign affiliates. Multinational banks have begun to impose tighter controls in the wake of these scandals, largely because of their fear that Euromarket operations could put them into costly and risky loan positions that might lead to serious difficulties.

### C. Rescheduling Debt

The rescheduling of debt does not remove the multinational banks from danger, but it allows time for the debtors to restore a more normal borrowing profile. In the easier money terms of the 1970s, short-term debt was rescheduled without difficulty or anxiety over mounting risks. In 1983, however, only five billion dollars was rescheduled, although debtors had asked for rescheduling of another 115 billion dollars; of that amount, ninety-three billion dollars was sought by only three LDCs: Argentina, Mexico, and Venezuela.<sup>111</sup> Rescheduling or debt interruption imposes higher costs on borrowers, as interest is charged at rates above LIBOR, and prolongs the

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*and Related Matters: Hearings before the Subcommittee on International Trade, Investment, and Monetary Policy of the House Committee on Banking, Finance and Urban Affairs, 98th Cong., 1st Sess. (1983).*

107. See the detailed assessment of Dhar, *U.S. Trade with Latin America: Consequences of Financing Constraints*, 9 FED. RESERVE BANK OF N.Y. Q. BULL. 14-18 (1984).

108. See Lissakers, *Bank Regulation and International Debt*, in *UNCERTAIN FUTURE: COMMERCIAL BANKS AND THE THIRD WORLD*, *supra* note 104, at 45-67.

109. Blanden, *Consolidation in Luxembourg*, *THE BANKER*, Mar. 1984 at 101, 105.

110. See J. SPERO, *THE FAILURE OF THE FRANKLIN NATIONAL BANK: CHALLENGE TO THE INTERNATIONAL BANKING SYSTEM* 5-11 (1980); Blanden, *supra* note 109.

111. *IMF SURVEY*, *supra* note 1, at 89.

exposure span of the multinational banks; however, the interruption also provides creditors and borrowers with more room to maneuver and avoids the serious alarm that would result if a debt moratorium were declared.

While rescheduling often requires that the multinational banks agree to a lengthy postponement in the repayment of principal, the higher fees and interest premiums generated by rescheduling provide an incentive for lenders to agree to make new loans. When Mexico rescheduled its debt in 1982, interest charges doubled from 0.9% to 1.87% above LIBOR; the increased spread was greatly valued by the multinational banks, as their liabilities were highly leveraged.<sup>112</sup> In turn, the renegotiated terms of the debt eased Mexico's burden in funding twelve billion dollars a year in interest payments.<sup>113</sup> In other cases, rescheduling has allowed the more successful borrowers to prepay loans or to replace them with funds borrowed at a lower rate.

The rescheduling of debt can be negotiated in different ways. Mexico attempted to reach the inflation-rate target of forty percent set by the IMF, and it aggressively promoted its oil exports in order to move its current account balance from a deficit to a thirteen billion dollar surplus. As a result, Mexico moved closer toward the renegotiation of its debt in 1984. Brazil, with its nearly 300 percent inflation rate, missed all of its IMF targets and could renegotiate only the four billion dollars of its long-term bank debt due in 1984. The grace period allowed in rescheduling can vary from one to five years and can apply to interest, principal, or both, depending upon the debtor's financial strength. In most cases, LDC governments choose to guarantee or to assume responsibility for the debts of both their public and private sector enterprises. The integration of "sovereign" and "commercial" debt provides the LDCs with greater internal control and furnishes the guarantees that multinational banks need to negotiate rescheduling arrangements.<sup>114</sup>

#### *D. Increase IMF Resources*

In recent years, the IMF has come to exercise considerable authority over sovereign debt, and its rule-making activities now play a crucial role in managing the global debt crisis. If the IMF staff is satisfied that debtors will correct their behavior, the IMF will vote that its standby credit facilities, though small, should be used to extend loans of last resort.

The granting of an IMF standby loan to a debtor country has both symbolic and practical significance. Symbolically, the IMF's vote represents a "seal of approval" to a debtor country, and it indicates to the multinational banks that the borrower is determined to meet the strict "conditionality"

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112. See Taylor, *Mexico's Adjustment in the 1980s*, in *ADJUSTMENT CRISIS IN THE THIRD WORLD* 147-158 (R.E. Feinberg & V. Kallab eds. 1984).

113. See Riding, *The New Crisis for Latin Debt*, N.Y. Times, Mar. 11, 1984, at D-1.

114. On the assumption of corporate borrowing into sovereign debt, see M. GUITON, *FUND CONDITIONALITY: EVOLUTION OF PRINCIPLES AND PRACTICES* (IMF Pamphlet Series No. 38) at 29 (1981).

terms of the IMF. In practice, the IMF provides an emergency "firefighting facility" to cope with extreme difficulties or with sudden changes, such as the aftermath effects of the 1979 oil shock, that could set off a chain of major disasters.<sup>115</sup>

Since 1982, the IMF has changed its mode of operations and has dictated terms to the lenders as well. The IMF has warned banks, singly or in collective syndicates, that if they failed to roll-over existing debts, it would refuse to lend its own limited resources to the borrower.<sup>116</sup> In many cases, the IMF has determined that quotas of "involuntary lending" must be assumed by the multinational banks; in return for the new funds furnished by the multinational banks, the IMF has guaranteed that the borrowers will adhere to the "conditionality" rulings set out by the IMF staff.<sup>117</sup>

Critics have alleged that the IMF is an international agency that rescues banks and LDCs from their own mismanagement.<sup>118</sup> The accusation, however, is exaggerated and unjust. The organization serves a function that no other institution could perform. Basically, the IMF polices the credit system by monitoring the "conditionality" requirements that it sets for syndicates of lenders and for sovereign borrowers. The IMF neither competes with multinational banks nor controls debtor countries on a day-to-day basis; it would lose much of its legitimacy if it should attempt to do so. Nor has the IMF been profligate in funding new loans. On the contrary, it has forcefully disciplined both borrowers and lenders in its various attempts to reschedule debt. The respected international stature of the IMF has allowed it to impose harsh conditions and disciplinary standards that might otherwise have been rejected if proposed by an interested party.<sup>119</sup>

In the 1970s, the financial quotas paid into the IMF by member nations were equal in value to ten percent of world trade, but in the 1980s these quota totals had fallen to four percent of a growing magnitude of world trade.<sup>120</sup> To correct this decline, members' subscription levels to the IMF were raised in 1984 and its credit facilities grew from sixty-seven billion to one hundred billion dollars; at the same time, the special General Borrowing Agreement (GBA) fund was raised from six billion to nineteen billion dollars.<sup>121</sup> Although the enlargement of IMF credit resources was of insignificant mag-

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115. In addition, there are small credit funds lodged with the World Bank and its "soft loan" agencies, but they are reserved for countries that are so desperately short of hard currency that they fail to qualify for commercial loans. See Feinberg, *Bridging the Crisis: The World Bank and U.S. Foreign Policy*, in U.S. FOREIGN POLICY AND THE THIRD WORLD, *supra* note 90; W. CLINE, *supra* note 5, at 34-37.

116. Gwyn, *supra* note 102.

117. *Id.*

118. *Global Economic Outlook: Hearings Before the Subcommittee on International Economic Policy of the Senate Committee on Foreign Relations*, 98th Cong., 1st Sess. (1983).

119. See the review of the IMF's application of conditionality clauses in *Conditionality*, IMF SURVEY, Sept. Supp., 1984, at 1; W. CLINE, *supra* note 5, at 36-37.

120. W. CLINE, *supra* note 5, at 124.

121. *Id.*

nitide in the face of world trade worth roughly two trillion dollars, the practical and the symbolic value of IMF intervention had been effectively proven. It was with some surprise, therefore, that the IMF members learned that the United States opposed the enlargement of IMF funds.<sup>122</sup>

Jolted by the Mexican crisis in 1982, and pressured by the other OECD nations also members of the IMF, President Reagan and the U.S. Congress only grudgingly gave their approval to the increase in the U.S. quota of IMF subscriptions. The added U.S. quota was in fact only eight-and-one-half billion dollars, and most of the outlay was to be staggered over several years, yet the funding proposal generated acrimonious debate.<sup>123</sup> Congressional critics contended that the increased quota served to bail out the multinational banks from their own folly and to shield the LDCs from their own incompetence.<sup>124</sup> President Reagan and then-Treasury Secretary Regan suggested for some months that Democratic support for the IMF additional quota was, in reality, a deception: the Democratic leaders were really trying to dismantle the Administration's inflation-fighting policies by flooding the money markets with new funds. President Reagan reversed his position only when other OECD-nation leaders insisted that additional IMF resources were needed to maintain the stability of the international trading order. The OECD-nation leaders pointed to the heavy exposure of American as well as European multinational banks in the financing of Third World trade; they stressed that all economies would benefit from IMF efforts to consolidate the purchasing power of the LDCs and to strengthen LDCs' credit arrangements with Western banks. Continued political and financial support for the IMF, they argued, was vital to creditor and debtor interests alike, and no other agency could possibly contribute more to the resolution of the current debt crisis.<sup>125</sup>

### E. Other Proposals

Another set of more technical proposals and solutions has been advanced by professional economists and bankers to take advantage of the expansion of trade in 1984 and the concomitant easing of debt tensions.<sup>126</sup> The first proposal recommends the formation of an International Debt Discount Corporation to buy LDC loans from the banks at ninety cents on the dollar by issuing its own long-term bonds.<sup>127</sup> Another suggestion, analogous to the Municipal Assistance Corporation of New York City, is to convert the LDCs'

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122. See Brainard, *supra* note 104, at 31.

123. HOUSE COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS, INTERNATIONAL RECOVERY AND FINANCIAL STABILITY ACT, H.R. DOC. NO. 2957, 98th Cong., 1st Sess. (1983).

124. *Global Economic Outlook: Hearings Before the Subcommittee on International Economic Policy of the Senate Committee on Foreign Relations*, 98th Cong., 1st Sess. (1983).

125. See Killick, *The IMF: Case for a Change in Emphasis*, in ADJUSTMENT CRISIS IN THE THIRD WORLD, *supra* note 112, at 59-82.

126. The proposals listed to reform the patterns and procedures of borrowing appear in many of the sources cited above, and especially in W. CLINE, *supra* note 38, at 113-27.

127. Kenen, *A Bail Out Plan for the Banks*, N.Y. Times, Mar. 6, 1983, at F-3, col. 1. See also W. CLINE, *supra* note 5, at 130-31.

expensive short-term debt into bonds that mature in fifteen or twenty-five years, thus reducing interest charges from twelve percent to perhaps six percent.<sup>128</sup> A similar proposal envisions the conversion of troubled bank loans to long-term and low-interest instruments to be managed by the IMF and other international agencies; alternatively, the conversion could be accomplished through an equity swap in which the loans could be converted into notes entitling the holder to participation in export earnings.<sup>129</sup> Yet another scheme would offer insurance rather than conversion as a means of supporting new issues and loan rollovers; the lender would find some form of governmental insurance to cover the risk of extending credit to uncertain borrowers.<sup>130</sup>

The common flaw in each of these proposals is that they tend to discourage new bank lending to the LDCs.<sup>131</sup> Lenders will certainly hesitate over proffering loans if they suspect that short-term loans may be converted to thirty-year bonds at a possible rate of ninety cents on the dollar. The proposal that creditor banks should sell their LDC loans to international agencies at a discount suffers a similar defect; there would be an immediate decline in the book-value profits of the banks and their loan-loss reserves might be exhausted. The use of international agencies to manage risk will lead to further difficulties. International agencies obviously do not possess the market skills or access needed to acquire or underwrite the LDCs' debts. These agencies would in any case have to rely on funds contributed by each member country, many of which have already indicated a distaste for emergency or standby credit facilities. With total LDC debt at 900 billion dollars, it is unlikely that many creditors will be eager to bear greater responsibilities. Creditors today argue that if borrowers hope to find debt relief through the intervention of international agencies they will be tempted to default on their debt obligations. The incentive to default will mount, the critics allege, when the sum of the LDCs' outstanding debt tops the one trillion dollar mark in 1986.<sup>132</sup>

A more acceptable proposal, and one which will continue to serve as the basic model of debt management, involves case-by-case negotiation with the debtor countries. This is the most conservative of all proposals and basically aims to shore up the present status quo. Emergency rescue plans and reserve facilities can always be improved, of course, but no new international institution should attempt to intercede in the delicate relationship between lenders and sovereign borrowers. Better participation might be gained by bringing more banks, government underwriting programs, and official credit resources into the bargaining process. Nevertheless, the *ad hoc* relation of lender and

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128. See W. CLINE, *supra* note 5, at 131.

129. *Id.* at 132.

130. *Id.* at 133.

131. *Id.* at 134.

132. The conflicting arguments among bankers are reviewed in *The Two Faces of Third World Debt: A Fragile Financial Environment and Debt Enslavement*, 35 MONTHLY REV. 1, 1-10 (1984).

borrower must be preserved and must be regulated only by the forces of autonomous market decisions.<sup>133</sup>

Along these lines, in 1983 the multinational banks created the Institute for International Finance (IIF) as a voluntary body to help rate borrowers' credit worthiness and to mobilize lending support.<sup>134</sup> The IIF is supported by 189 banks from thirty-nine countries; the support for the IIF comprises eighty percent of all banks that are exposed in lending to the LDCs. The goal of the IIF is not to build a cartel of creditors, but to promote cooperation between creditor governments, central banks, the multinational banks, and the IMF. The IIF aims to collect better information for the banking system and to encourage communication among creditor countries and multinational banks.<sup>135</sup> If it functions well, the IIF will help remove some of the doubt and uncertainty that clouds the issues of Third World borrowing.

### CONCLUSION: HAS THE CRISIS PEAKED?

While the case-by-case approach fails to create a compelling or a comprehensive solution to the debt crisis, there appears to be no sound alternative. Governments and international agencies are expected to provide sympathetic assistance, either by modifying macro-economic policy or by exercising greater surveillance of the multinational banks' lending policies. Governments assume, correctly, that they are not going to intervene forcefully in the business of the banks or to share responsibility for the multinational banks' management of credit. They recognize, too, that it is inappropriate for governments and international agencies to intervene in the internal politics of sovereign debtor nations. The debtors must remain free to determine their own political solutions and to choose the cost options that they are ready to pursue. If creditor governments assert themselves aggressively in dictating terms to debtor regimes, they will convert issues of commercial and financial judgment into the "high politics" of Cold War strategy and foreign policy manipulations. Such a conversion would not only complicate the resolution of the debt crisis, but it would gravely impair business relations between creditors and debtors.

The question remains to be answered, therefore, whether the present arrangements of the global credit system can cope with the challenge over the next few years of carrying one trillion dollars of poorly-secured debt. The crucial issue is whether the climax in the debt crisis has passed or is yet to occur. Optimistic and reassuring arguments, published in leading U.S.

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133. See Mohammed, *The Case-by-Case Approach to Debt Problems*, 22 FIN. & DEV. 27 (1985). See also W. CLINE, *supra* note 5, at 135-36.

134. On the founding of the I.I.F., see *Private Banking Institute Aims to Improve Debt Data Available to Its Members*, IMF SURVEY, Mar. 5, 1984, at 72. See also Farnsworth, *Gathering Debt Data for Banks*, N.Y. Times, June 25, 1984, at D-1, col. 3; W. CLINE, *supra* note 5, at 114-15.

135. Farnsworth, *supra* note 77.

business journals, insist that the "Debt Bomb" has indeed been defused.<sup>136</sup> Economists have taken a contrary position and doubt the confidence expressed by bankers and business leaders.<sup>137</sup> Though both schools share the same explosive metaphor, they use the same data on international trade and liquidity to justify contradictory inferences.

The optimists report that the trade balances and the current account positions of the LDC debtors have improved markedly since 1981 and they expect the recovery to continue to flourish through 1985. As one commentator stated:

Evidence is building that the international debt crisis is over. Gone is the nerve-jangling prospect that the world banking system might suddenly collapse as large Latin American countries proved unable or unwilling to honor their external debts. . . . [As one banker said,] "The progress in the debt crisis is coming about three times as fast as we thought possible."<sup>138</sup>

Strong evidence was cited to support the argument. The current account deficit of the sixteen largest LDC borrowers in 1981 totalled fifty-five billion dollars; by 1984 it was only twelve billion dollars.<sup>139</sup> The sixteen LDCs still owe 520 billion dollars in foreign debt, but their ability to cover interest payments with export earnings has dramatically improved. In 1981, their earnings fell far short of servicing requirements, but in 1984 they earned a trade surplus covering eighty-seven percent of debt interest charges. In a similar manner, the six countries in Latin America with the highest debt suffered in 1981 a deficit on current account of 21.9 billion dollars and a trade surplus of only 2.7 billion dollars; by 1984 the deficit was down to 3.2 billion dollars and the trade surplus stood at 29.8 billion dollars. To complete the rosy picture, interest rates and oil prices have declined greatly, LDC imports have been reduced and exports have grown, and most of the debtor regimes have committed themselves to accept the policy guidelines and conditionality requirements set out by the IMF.<sup>140</sup>

The bankers have also strengthened their position. No more objections are heard from the smaller or regional banks that had once tried to opt out of the collective arrangements made by the multinational banks to levy additional involuntary quotas in order to replenish the roll-over loans needed by debtor regimes.<sup>141</sup> Nor has any further criticism been made of the IMF "bail-out" decisions and the stern conditions under which it grants access to its standby credit facilities.

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136. See Kellner, *Developing Country Debt Bomb Defused?*, *BANKER'S MONTHLY*, Apr. 15, 1985, at 12-16; Hector, *supra* note 4.

137. Frank, *supra* note 4; Garten, *supra* note 85.

138. Hector, *supra* note 4, at 36.

139. *Id.*

140. See Folkerts-Landau, *supra* note 18, at 51.

141. The *Allied Bank* litigation arose because one of the banks in the loan syndicate refused to go along with the negotiated rescheduling of the debt. See *Allied Bank Int'l v. Banco Credito Agricola de Cartago*, 757 F.2d 510 (2d Cir. 1985).

The pessimists cite the same sets of data, but they draw contradictory conclusions. They assert that the stock of external debt is still alarmingly high and is increasing by ten percent a year. Debt is 120% of GNP in Costa Rica, 103% of GNP in Chile, seventy-six percent of GNP in Peru, sixty-six percent of GNP in Argentina, and forty-four percent of GNP in both Brazil and Mexico.<sup>142</sup> Most of these countries should set aside from fifty to one hundred percent of their export earnings to service their constantly rising accumulation of interest arrears.<sup>143</sup> If they did so, however, these countries would never promote GNP growth at home or provide work for the hundreds of millions who will join the armies of the unemployed before the end of the 1980s. Admittedly, the price of oil and interest rates have declined, helping many debtors to improve their liquidity position. Nonetheless, the rate of new lending to the LDCs has considerably slowed; lending increased by fifteen percent in 1981 but by only six percent in 1984.<sup>144</sup> Hence, many borrowers now feel trapped. They are still burdened with enormous debts and stagnant economies. In most cases, they have failed to negotiate new loans or to restructure their earlier borrowings. The sixty percent increase in the value of the U.S. dollar has burdened more LDCs than it has helped. Moreover, the emergence of the United States as a major debtor in the world market has led, tragically, to a situation in which the poor nations make transfers, through flight capital, debt payments, and dividend repatriations, to the rich. As a noted critic recently commented, "The United States is conducting a raid on world savings."<sup>145</sup>

Making projections for world debt is always difficult. It is impossible to predict whether interest rates will rise if the U.S. economic recovery should falter or if rates will fall when the overvalued dollar begins to decline. In the 1950s and 1960s, the volume of world trade rose by seven percent a year or more, and creditor and debtor nations enjoyed both time and room to maneuver. It does not appear likely that the OECD nations will experience in the late 1980s levels of economic expansion sufficient to benefit the LDCs and help them cope with their debts.<sup>146</sup> Three factors could impede the expansion of global trade and credit: (1) an upsurge of trade protectionism, import tariffs, and trade wars; (2) a resurgence of inflation, tight money policies to enforce deflation and forced spending cuts; and (3) a return to instability in the world currency exchanges, as nations race to devalue their money in order to obtain competitive export price advantages.<sup>147</sup>

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142. Weisner, *Domestic and External Causes of the Latin American Debt Crisis*, 22 *FIN. & DEV.* 24 (March 1985).

143. *Id.*

144. IMF SURVEY, *supra* note 1, at 88.

145. Garten, *supra* note 85, at 548.

146. Cohen, *High Finance, High Politics*, in *UNCERTAIN FUTURE: COMMERCIAL BANKS AND THE THIRD WORLD*, *supra* note 104, at 107-23.

147. Fox & Cooney, *Protectionism Returns*, 53 *FOR. POL'Y* 74 (1983-84).

These are powerful impediments but they may not provoke violent disruptions in global trade and credit. It is more probable that they will slowly retard the course of economic growth and gradually erode the prospects of future development. Should all three of these factors begin to exercise a braking effect on the expansion of global trade and credit, tensions in the money market will once again escalate. Currently, institutions and procedures for managing vast sums of debt are not strongly based or sufficiently capitalized. If they should once again be subjected to severe strain, they may not be able to cope with the tensions generated by an overburdened monetary system. Unfortunately, only if and when the vast sums of debt become unmanageable for the present system will it be possible to judge whether it was realistic to trust in the *ad hoc*, country-by-country case judgments dictated by today's conventional wisdom.