against taxes, but extensive loan write-offs probably would affect bank profits and shareholders' earnings. Write-offs also could affect bank capital. Banks must maintain capital against losses, although the required amount is only a small share of total loans. Consequently, any reduction in capital could restrict bank lending and raise interest rates. Higher interest rates and reduced lending, moreover, could slow domestic economic activity, but the extent of this effect would depend on the monetary policy of the Federal Reserve System.

Debtor-country defaults on outstanding loans also would greatly restrict their ability to conduct international trade. A default would leave the debtor nation unable to obtain foreign credits to import vital commodities. In turn, could impinge on its ability to produce other goods for domestic consumption and for exportation. Without exports, these countries would find it difficult to earn foreign exchange. Moreover, the developing countries are important markets for developed-country exports. In 1982 the United States exported approximately $84 billion to the developing countries, an amount equal to 38 percent of total U.S. exports. The consequences of these markets would further reduce economic growth and employment in the United States.

A Climate for Improvement

Just as changes in the economic climate contributed to the crisis in the international lending environment, an improvement in the international economic environment would help resolve the international debt situation. Dooley, Helkie, et al. (1983) and Cline (1983) describe such an outlook. Both studies recognize the importance of real growth and significant industrial-country growth of approximately 3 percent per year to reduce the burden of debt in developing countries. This assumption seems to preclude another worldwide recession in this decade. Both studies recognize the importance of low interest rates but differ somewhat in the relative importance attached to attaining them. Dooley, Helkie, et al. emphasize that a reduction in real interest rates could have a larger near-term effect than more rapid growth in industrialized countries. Cline also notes that further sharp declines in oil prices could have a detrimental impact on the debt situation. Oil-exporting countries owe large amounts of debt, and the effects of an oil-price decline are more severe for oil exporters than beneficial to oil importers. Both studies assume an increase in oil prices in their scenario for an improved debt situation.

In addition, the developing countries should adopt policies to reduce domestic consumption, restrict imports, and encourage exports. They also would need additional external credits to finance their imports of vital commodities. In the absence of such credits, their economic growth could falter and inhibit the reduction of their debt burdens.

The dangers posed by the international debt situation will not easily, or quickly, be defused. There is always a chance that some desired aspect of international economic conditions would not materialize, creating new tensions and pressures. Only by recognizing what all nations stand to lose as a result of crisis mismanagement will we have the patience and courage to prevent a true crisis.

The Gathering Storm

The most important factor underlying the debt build up was the oil-price shocks of 1973 and 1979. Following the initial price hike, gross oil imports of the non-OPEC developing countries jumped from $4 billion in 1973 to $15 billion in 1974. Gross oil imports for these countries subsequently grew much more slowly and steadily to $20 billion in 1978, but the second oil-price shock in 1979 lifted their gross oil imports to $50 billion in 1980. Many oil-importing countries initially borrowed to finance the higher oil-import bills. Borrowing permitted these developing countries to mitigate the immediate impacts of the oil shocks on their standards of living and presumably provided them with time for adopting longer-term adjustment policies. International banks played an important role in this adjustment process by recycling funds from surplus countries to borrowing countries. Despite initial concerns, the recycling process went rather smoothly following the 1973 oil-price shock.

Ironically, the sharp oil-price increase also encouraged many oil-producing countries to borrow...
heavily. Some, like Mexico, initially borrowed to develop their oil-pro-
duction capacity. Many others borrowed against expected future oil
receipts to expand and diversify their industrial bases.

The oil price shocks in them-
selves did not create an unmanag-
able debt situation. As a group, the developing countries demonstrated
remarkably good performance on GNP growth throughout the 1970s despite
higher oil-import bills. Between 1973 and 1982, on average, the
major industrialized countries experienced real GNP growth of
2.5 percent per year, while developing countries in the western hemi-
sphere experienced real GNP growth of 4.5 percent per year. Moreover, not all developing
countries experienced trade deficits during the 1970s. Argentina and
Venezuela, for example, usually ran trade surpluses, while Brazil and
Mexico had trade deficits that were not strikingly large.

The excellent growth potential of the developing countries, the rela-
tively high interest rates on capital that this growth implied, and a foreign
loan-loss record no worse than that of domestic loans attracted U.S.
banks to the international lending market. As of June 1983, the 190 U.S.
banks reporting to a lending survey of the Federal Financial
Institutions Examination Council (FFIEC) had claims on non-oil
developing countries of nearly $47 billion, an amount equal to
269 percent in 1982.*

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*For data on growth rates, see Nancy H. Bresser and Henry S. Terrell, “The Rule of Banks in the International Financial System,” Federal Reserve Bulletin, vol. 69, no. 9 (Septem-

3. The Federal Financial Institutions Examination
Council includes the Office of the Comptui-
troller of the Currency, the Federal Deposit
Insurance Corporation, and the Board of Governors of the Federal Reserve System. Its Country
Exposure Lending Survey is conducted bimau-
nually and currently covers 190 U.S. banking
organizations. The data are released approxi-
mately six months after the surveys are con-
ducted.

4. A Changing Climate

Although the ultimate causes of declining commodity prices are more
demic to specific country, events of the late 1970s and early
1980s drastically altered the international
debt climate, making it difficult for many developing coun-
tries to service their debts. World
interest rates rose sharply in the
late 1970s. U.S. Treasury bill rates,
for example, averaged 6.3 percent in
December 1977 but rose to 14.9 percent by December 1980.

About one-third of the total growth of the large banks' capital.
U.S. banks have concentrated their international lending to a rela-
tively small group of "major non-oil income" developing countries. The
world's poorest nations rely pri-
marily on international organiza-
tions such as the World Bank to
finance their development. Argen-
tina, Brazil, Mexico, and Venezuela
account for 63 percent of the total U.S. reporting-bank claims, with
Brazil and Mexico accounting for
17.5 percent since 1973. Export
growth is crucial to debtor nations,
as it is the primary means by
which these nations earn foreign exchange to service their debts.

Because of higher interest rates and increased stock in exchange
debt-service ratios (interest payment
and amortization divided by exports) of developing countries
grew rapidly after 1982. According
to one expert, the combined debt-
service ratios of Argentina, Brazil,
Mexico, and Venezuela increased from 172 percent in 1981 to
269 percent in 1982.5

As previously suggested, the debt-servicing problems of certain
countries largely reflect specific
debt-management and economic
policies of those countries. The Latin American countries, for example, generally have permitted
inflation rates well above world
standards and have maintained
exchange rates at artificially high

levels. As the economic climate of
these countries worsened in recent
years, their banks moved funds out of
countries that were carrying un-
cial capital, currency devalu-
ations, and the change in market
interest rates. The shift of investable funds
outside these developing countries increased their need to borrow
externally for investment purposes.

A significant portion of total ex-
ternal borrowing has financed non-
capital flight in Argentina, Brazil, Mex-
ico, and Venezuela.6

Banking systems have become increas-
3. William R. Cline, International Debt and the
Stability of the World Economy, Policy Analysis in International Economics, 4th ed. (Washington,

tional Finance Discussion Papers, No. 227, August 1983, especially table 1.

6. For data on growth rates, see Nancy H. Bresser and Henry S. Terrell, “The Rule of Banks in the International Financial System,” Federal Reserve Bulletin, vol. 69, no. 9 (Septem-