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I. Introduction

The availability of international capital plays a crucial role in the economic development of many third world countries. Since the early 1980s, successful economic development of many developing countries has been threatened by a continuing financial crisis. The origins of this financial crisis can be traced to the doubts about the willingness and ability of debtor countries to meet their existing debt obligations. The main problem for many debtor countries is their inability to generate enough net foreign income to pay the interest and the principal due on foreign loans. In this respect, the world recession as well as severe economic difficulties of many debtor countries have aggravated this problem. The world recession experienced in the early 1980s led to the decline of many of the export prices of the debtor countries, which strained their ability to earn sufficient foreign incomes to service their external debts. Furthermore, many debtor countries have encountered severe economic difficulties since 1980, particularly rising unemployment and falling output. This situation usually precludes pursuing restrictive domestic economic policies which would enhance the debtor countries' capacity to meet their external debt obligations.

Two basic explanations exist for the current predicament of debtor countries. The prevailing view states that the financial crisis was predominantly created by the excessive borrowing of the debtor countries and the excessive lending of the large international banks. Although this explanation may be true for developing countries which relied on future exports of raw materials to pay their debts (such as oil-exporting debtor countries), this explanation may not be appropriate for all debtor countries. Other external factors, such as macroeconomic policies of major
developed countries, may have played a primary role in the severity of the problems encountered by many other debtor nations.

The purpose of this paper is to examine the validity of the second above outlined theory. The paper examines the effects of the monetary policy pursued by the United States on debtor countries during the late 1970s and early 1980s. In particular, the impact of this policy with respect to inflation, interest rates, and exchange rates is outlined. Effects of the U.S. monetary policy on real interest rates and their impact on the debtor countries are also presented. Discussion of the United States monetary policy and its effects on the debtor countries is of special interest, not only because the U.S. economy is the largest free world economy exerting considerable influence on other nations economies, but also because of the unique position the U.S. dollar occupies in the world exchange markets.

II. U.S. monetary policy in the late 1970s

U.S. monetary policy has typically been formulated in terms of two major targets: the interest rate target and the rate of growth of the monetary aggregates target. During the late 1970s, the U.S. economy experienced accelerating inflation. As inflation put an upward pressure on nominal interest rates, the interest rate exceeded its targeted level. The Fed reacted to this situation by pursuing an interest rate stabilization policy and by practically abandoning its monetary growth targets. This meant pursuing essentially a procyclical monetary policy. This policy resulted in a worsening economic situation in the United States. It led to accelerated inflation, retarded economic growth, and the balance of payment difficulties in the late 1970s.

Although this monetary policy was disastrous from the U.S. domestic
point of view, it had an important positive impact on the debtor countries: The policy of artificially keeping interest rates down while accelerating domestic inflation led to a substantial decline in the exchange value of the U.S. dollar. It also resulted in low and often negative real rates of interest. The declining exchange value of the dollar and low real interest rates encouraged more borrowing by the debtor countries.

Theoretically, a decline in the real cost of borrowing tends to encourage more borrowing. Although debt payments are often stated in terms of nominal interest rates, nominal interest rate is a misleading measure of true debt obligations. It does not account for the effects of inflation on the real burden of the debt. Clearly, inflation reduces the debt burden through its negative effect on the future purchasing power of money. Consequently, the true burden of the debt should primarily be measured in terms of the real rate of interest. Low real rates of interest prevailing in the late 1970s implied a relatively low cost of borrowing. International loans, designated in U.S. dollars, therefore became more attractive.

Table 1 presents the inflation rate, the nominal interest rate and the real interest rate situation in the U.S. in the late 1970s and early 1980s. It is clear that during the 1970s the real rate of interest remained low, often taking on negative values. During the early 1980s, however, this situation drastically changed. The real rate of interest increased sharply, reaching seven percent in 1981. Although it would be difficult to determine to what extent the debt can be attributed to the above factors, a theoretical link can easily be established: Falling U.S. exchange rates and relatively low U.S. real interest rates led to increased borrowing. Clearly, a decline in the expected real cost of borrowing tends to encourage borrowing. This change in expectations about the real cost of
Table 1

Inflation Rates, Nominal Interest Rates, and Real Interest Rates during the 1970s and the 1980s. Percent per Annum.*

<table>
<thead>
<tr>
<th>Year</th>
<th>$\Pi_t$</th>
<th>$R_n$</th>
<th>$R_r$</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>5.0</td>
<td>6.5</td>
<td>1.5</td>
</tr>
<tr>
<td>1</td>
<td>4.6</td>
<td>4.4</td>
<td>-0.2</td>
</tr>
<tr>
<td>2</td>
<td>4.1</td>
<td>4.1</td>
<td>0.0</td>
</tr>
<tr>
<td>3</td>
<td>7.8</td>
<td>7.0</td>
<td>-0.8</td>
</tr>
<tr>
<td>4</td>
<td>11.0</td>
<td>7.9</td>
<td>-3.1</td>
</tr>
<tr>
<td>5</td>
<td>5.6</td>
<td>5.8</td>
<td>0.2</td>
</tr>
<tr>
<td>6</td>
<td>5.2</td>
<td>5.0</td>
<td>-0.2</td>
</tr>
<tr>
<td>7</td>
<td>5.9</td>
<td>5.3</td>
<td>-0.6</td>
</tr>
<tr>
<td>8</td>
<td>8.7</td>
<td>7.2</td>
<td>-1.5</td>
</tr>
<tr>
<td>9</td>
<td>7.9</td>
<td>10.1</td>
<td>2.2</td>
</tr>
<tr>
<td>1980</td>
<td>9.5</td>
<td>11.4</td>
<td>1.9</td>
</tr>
<tr>
<td>1</td>
<td>7.0</td>
<td>14.0</td>
<td>7.0</td>
</tr>
<tr>
<td>2</td>
<td>4.7</td>
<td>10.6</td>
<td>5.9</td>
</tr>
</tbody>
</table>

Source: Barro, R.J. Macroeconomics, 1984, p. 163.

*Note: $\Pi_t$ is the annual rate of inflation measured by change in the GNP deflator from the first quarter of each year to the first quarter of the next year. $R_n$ approximates the nominal interest rate. $R_n$ is calculated as the average annual yield on secondary markets for U.S. Treasury Bills with three months maturity. The real interest rate, $R_r$, equals $R_n - \Pi_t$. 
borrowing takes place if the value of the debt (measured in U.S. dollars) declines relative to the value of the debtor country's exports. Consequently, it should only be expected that the external debt is likely to increase under such circumstances.

Table 2 supports the conclusions reached above. The external debt and the debt service increased for all categories of debtor countries between 1970 and 1981. This increase was particularly large for the middle-income oil exporting countries. One explanation of this factor is readily apparent: increasing oil prices contributed to increased borrowing by the oil-producing countries. It also appears, however, that most other debtor countries (non-oil producing countries) increased their debt considerably, too. In this respect, the U.S. monetary policy and its results may have been the most important factors in their decision to enlarge their debt.

III: U.S.: monetary policy in the 1980s

In 1979 the Fed had drastically changed its monetary policy. Interest rate stabilization was replaced in October 1979 by a policy emphasizing the control over the growth rate of the money supply. To implement this policy, the Fed widened the range for the fluctuations of the federal funds rate, and it also began to use total bank reserves as the operating target of monetary control. This change in operating procedures, involving tighter monetary restraint, led to higher and more volatile nominal interest rates. It also resulted in a subsequent reduction of the domestic U.S. inflation rate. However, nominal interest rates did not decline in line with inflation: As the result of this occurrence real interest rates increased considerably. This upward shift in real interest rates had serious implications for debtor countries; high real interest rates implied increasing cost of servicing the debt.
TABLE 2. External Public Debt and Debt Service Ratios of Developing Countries

<table>
<thead>
<tr>
<th></th>
<th>External Debt as a percentage of GNP</th>
<th>Debt Service as a percentage of GNP</th>
<th>Debt Service as a percentage of export earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low-income countries</td>
<td>17.5</td>
<td>18.6</td>
<td>1.1</td>
</tr>
<tr>
<td>Middle-income oil exporters</td>
<td>13.7</td>
<td>20.3</td>
<td>1.8</td>
</tr>
<tr>
<td>Middle-income oil importers</td>
<td>13.4</td>
<td>19.1</td>
<td>1.4</td>
</tr>
<tr>
<td>Lower middle-income countries</td>
<td>15.6</td>
<td>23.2</td>
<td>1.6</td>
</tr>
<tr>
<td>Upper middle-income countries</td>
<td>12.4</td>
<td>17.8</td>
<td>1.6</td>
</tr>
</tbody>
</table>

The Fed changed the thrust of its monetary policy in 1982 and 1983. In October 1982, the Fed decided to deemphasize the monetary growth rate target. In fact, the FOMC decided not to set a specific objective for the rate of growth of M1. This action was taken in view of a severe downturn in the level of economic activity in the United States. Undoubtedly, the main purpose of this policy was to reduce temporarily domestic nominal interest rates and thus stimulate economic growth. This reversal of the Fed's monetary policy signalled the return to interest rate stabilization in the United States:

Although both nominal U.S. interest rates and the domestic rate of inflation have declined since the beginning of 1982, real interest rates have remained relatively high. There exist numerous explanations for high real U.S. interest rates. These explanations include a reduced domestic rate of inflation and a continuously increasing U.S. budget deficit, among others. Although a detailed description of these causes is beyond the scope of this paper, their effects on the debtor countries can easily be explained. Tighter U.S. domestic monetary policy has not only led to a lower domestic inflation rate, but also to the real appreciation of the dollar. The appreciation of the U.S. dollar has significantly increased the real value of the outstanding debt of those debtor countries whose debt is denominated in U.S. dollars. At the same time, relatively high real rates of interest have implied an increased burden on the part of the debtor nations. These new economic developments have put a serious squeeze on the debtor countries; their ability to meet their debt obligations has been greatly reduced because of an increased real cost of servicing their debts. At the same time, export prices plummeted, especially oil prices. This means that the foreign capital earning capacity of many debtor countries
has eroded while their debt obligations have increased; It should come as no surprise that in this unfavorable environment creditors have become more reluctant to extend new loans or roll over existing loans, thereby greatly increasing the fear of default by many debtor countries.

IV. Concluding remarks

Although excessive borrowing by many developing countries and liberal lending policies of some large international banks have undoubtedly played an important role in the financial crisis of the 1980s, these factors may not be entirely or even primarily responsible for the crisis. Instead, some of its origins can be traced to domestic U.S. monetary policy. Procyclical monetary policy of the late 1970s resulting in low interest rates, the falling exchange value of the dollar, and the relatively low real rates of interest greatly encouraged external borrowing by the debtor countries. Rising oil prices during this period of time also played a contributory part in increased borrowing by oil-producing debtor countries. In the early 1980s, drastic changes in U.S. monetary policy from easy monetary policy to a much tighter policy resulted in lower domestic inflation and relatively higher U.S. real interest rates; This drastic change in U.S. economic circumstances had a serious impact on debtor nations. This negative effect was recently strengthened by generally falling export prices.

Undoubtedly, the impact of domestic U.S. monetary policy on the third world debtor countries is considerable. Reversals and flip-flops in this policy have harmful effects on these countries. Consequently, one obvious way to alleviate the problems besetting the debtor countries is for the Fed to pursue a predictable and consistent monetary policy; Such a policy would not only serve well the interests of the United States, but it would also improve the financial situation of many third world debtor countries.
Notes

1. The situation of Brazil, one of the largest debtor countries, can adequately illustrate this point. Mussa (1984) estimates that Brazil needed some $24 billion net foreign income in 1984 to satisfy its total debt service requirements. Its actual net foreign earnings fell far short of this target. For further details, see Mussa (1984, p. 83).

2. The U.S. dollar is commonly used as the means of settling debt obligations among trading countries of the world. Consequently, the foreign debt obligations of many debtor countries are stated in terms of the U.S. dollar.

3. In the late 1970s, the Fed accepted the federal funds rate as indicative of its interest rate target. The target growth ranges were also set for M1, M2, and M3.

4. Roos (1979) charges that during 1975–79, the Fed allowed the growth rate of money stock M1 to exceed its targeted level 23 times, while during the same time, the federal funds rate was allowed to exceed its upper target only 5 times. According to Roos, this clearly indicates that the interest rate stabilization was the major thrust of the monetary policy during this period of time.

5. Procyclical monetary policy implies increasing the money supply in times of inflation and reducing it during economic contractions.

6. Inflation in the United States (measured by the consumer price index) reached 13 percent in 1979. The rate of growth of real GNP fell to 0.8 percent during 1979. For further discussion of economic circumstance during this time, see Economic Report of the President (1980, pp. 25–65).

7. The real rate of interest can be defined as the nominal rate of interest minus the rate of inflation.

8. For a further explanation of this procedure, see Siegel (1982, pp. 228–29).

9. The U.S. rate of inflation was in 3 to 4 percent range (depending on the measure of inflation used) in 1985. This relatively low inflation rate should be compared with a 13 percent rate prevailing in 1979.

References


