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THE INTERNATIONAL DEBT CRISIS

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I wish to thank Jurgen Donges for his helpful comments and Kai Konrad, Harald Kotsch, and Stephan Panther for their help in collecting the empirical data. This paper is a revised version of an earlier paper published in German: Sinn (1989a). It was completed while the author was consultant of the IMF's Fiscal Affairs Department and Olin Visiting Fellow at the Woodrow Wilson School, Princeton University. The paper is part of the NBER's research program on international aspects of taxation. The support of these institutions is gratefully acknowledged.

American Economic Policy and the International Debt Crisis

Abstract

This paper advances the hypothesis that the world debt crisis was mainly induced by the dramatic rise of US interest rates in the first half of the eighties. It sees this rise in interest rates primarily as a result of a tight US monetary policy and excessively large investment incentives provided by the 1981 US tax reform. A welfare analysis shows that the policies could have increased the US advantage from lending its capital abroad, had they been more moderately designed. The actual policies, however, were by far too strong to produce this result.

Keywords: American policy, debt crisis, monetary policy, tax policy

JEL Classification: 440

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1. Preliminary Remarks

The international debt crisis began as a problem of the credit relationship between the USA and its Latin American neighbors. Since 1982 Mexico, Peru, Argentina, and Brazil have reduced or stopped servicing their debts, and in 1976, 60% of these countries' gross external debts were owed to private American banks.¹ Since 1982 the crisis has spread to other areas and European and Japanese banks have also had to write off part of their claims. African and Asian developing countries, too, have encountered payments difficulties.

How did this situation come about? Currently at least three different possible explanations have been offered.

The first attributes the problem to the carelessness of the debtor countries. These overestimated their ability to repay and underestimated the debt service burden. The loans were used primarily to finance public expenditure, which brought no pecuniary return, instead of being used to finance private investment projects, whose revenue could have helped service the debts (World Development Report 1988).

The second explanation accuses the debtor countries of being unwilling to pay. It is argued that they could service their debts but that there is no means available to put pressure on them to meet their obligations. This makes it rational for them to refuse to pay when they can no longer expect net imports of resources in future (Eaton and Gersovitz 1981, Eaton, Gersovitz and Stiglitz 1986, Cohen and Sachs 1986, and Niehans 1986).

The third explanation focusses on the behavior of the banks. The expansion of international banking in the 1960's increased competitive pressures to such a degree that the banks proved unable to resist the lure of the fast money they expected to earn by

¹Calculated from World Debt Tables Vol. I, November 1980, and from tables in Hardy (1979, p. 192).

lending to the developing countries – this despite early indications of the very high risks involved (Emminger 1986 and Wallich 1986).

None of these explanations will be disputed in this paper. The question of unenforceable claims is certainly extremely important for understanding the longterm problems of international lending. However, the role played by American economic policy in the particular debt crisis of the last few years should not be overlooked. The crisis itself resulted from the combined effects of many different factors, but American economic policy may have been responsible for the interest rate explosion that occurred at the beginning of the 1980's at the time the debt crisis started, and indeed seems to have triggered the latter off. The explosion of interest rates resulted in enormous capital imports into the US, part of these were supplied by additional capital exports from other developed countries but part were funds that otherwise would have been available to the less developed countries. Attempts to understand the debt crisis cannot afford to ignore this phenomenon.²

Section 2 presents some important empirical trends that characterize the debt crisis, and Section 3 discusses the role of American economic policy, especially the fiscal policy introduced during Reagan's presidency. The fourth section considers whether this policy and its effects on the world economy were beneficial for the Americans. The fifth section reaches some conclusions and, in addition, makes some brief comments on the significance of the American tax reforms of 1986.

2. The Debt Crisis in the Light of International Economic Developments

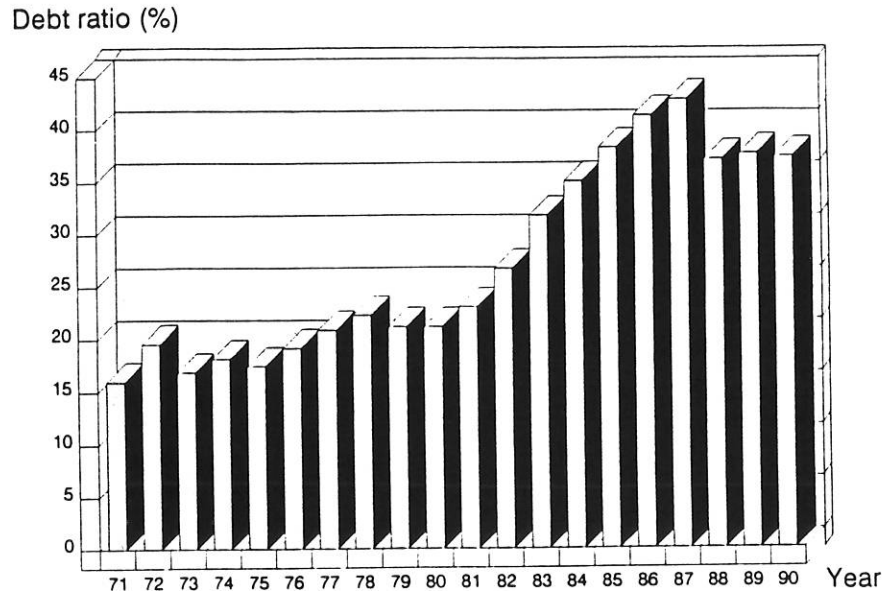
At the end of 1989 the total external debt³ of the less developed countries (LDC's) amounted to almost \$ 1.2 trillion. Almost one third of this had accrued since the start of the international debt crisis in 1982. The increasing indebtedness was not the kind

²Cf. also Tanzi (1989), World Development Report (1988), and Sinn's (1988a) "background paper" to this report.

³World Debt Tables 1989/90, p. 78.

normally associated with economic growth, and seems threatening particularly when compared to the other economic aggregates. The development of total LDC external debt relative to GNP – the debt ratio – is shown in figure 1. The size that the debt problem has taken on in the eighties is obvious.

Figure 1: Growing Debt Burden of Less Developed Countries 1970–1990



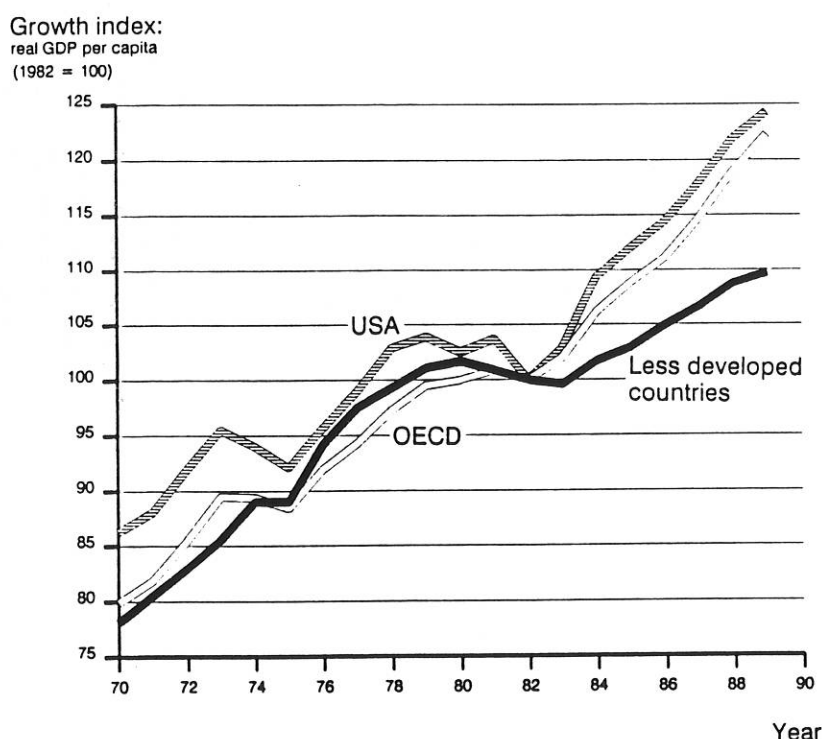
Sources: World Debt Tables 1980/81, Table 1 and pp. 3, 85, 119, 179, 205, 229; 1987/88 (Vol. I) pp. 2–5, 1989/90 (Vol.1), p. 78. World Economic Outlook: May 1990, Tables A5, A8, A46.

Note: The debt ratio is defined as the ratio of long term external debt and GNP. The amount of debt does not include IMF loans and loans of less than one year duration. The value for 1990 is calculated from an estimate of the World Economic Outlook, May 1990.

The growth of the debt ratio does not only reflect LDC borrowing behavior. The very large changes in the dollar exchange rates in recent years also have influenced this ratio. There are two countervailing effects. On the one hand, a depreciation of the dollar relative to the currencies of less developed countries leads to a rise in the dollar value of their GNPs. On the other hand, a depreciation of the dollar raises the dollar value of those debts denominated in currencies other than the dollar. The latter effect seems to be

stronger than the former, explaining the major part of the growth rate of the LDC debt in 1985 and 1986 (cf. OECD 1987, p.50). While the growth rate in dollar-denominated LDC debt was as high as in previous years, the growth rate adjusted for exchange rate factors had fallen monotonically from 17% in 1982 to 9%, 8%, 3%, and 2% in 1986. Similarly, the sharp decline in the debt ratio after 1987 cannot only be attributed to debt reduction operations – which certainly were important at the time – part of it was the result of the temporary dollar appreciation in 1988 and 1989.

Figure 2: Changes in Growth Ranking



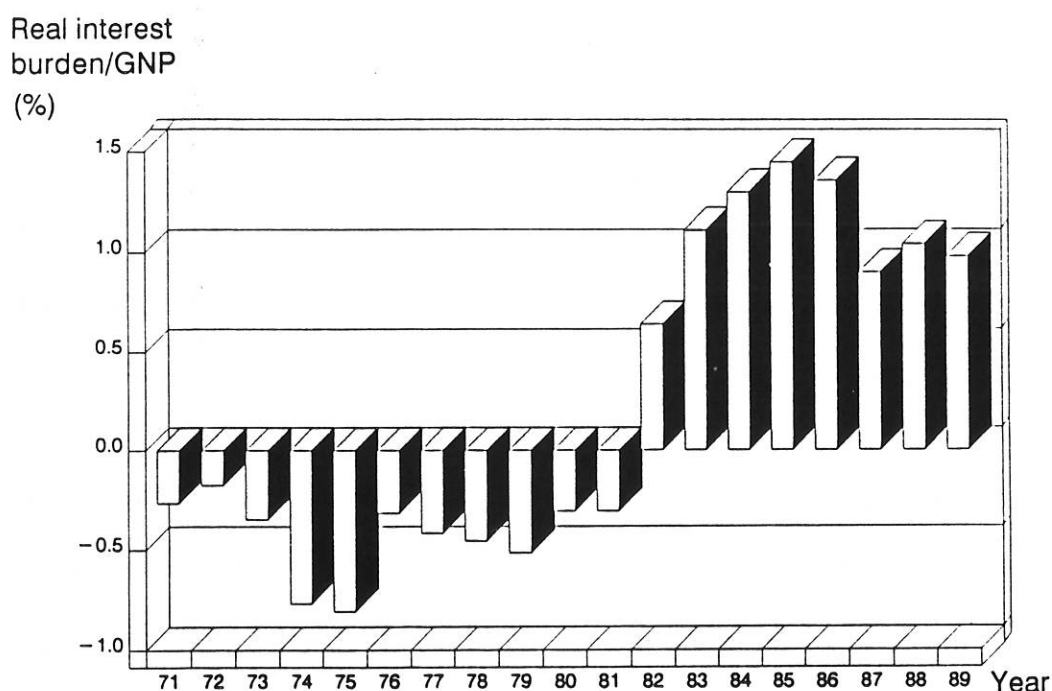
Sources: World Economic Outlook: May 1980, Table 2; April 1987, Table A6; April 1988, Table A6, May 1990, Table A6. Historical Statistics: Table 3.2, 1960–1980, 1960–1986. World Development Report: 1987, Table A1, A2. Main Economic Indicators: August 1988, p. 176, May 1990, pp. 172, 178.

Note: The curves show the value of current per capita GDP divided by the corresponding value in 1982 when the debt crisis began.

The development of the debt ratio was furthermore influenced by the growth rate of LDC output. On average, the real growth rate of per capita GDP of less developed

countries in the decade before (1972 - 1982) was 1.9 %. Since then (1982 - 1989) the average growth rate has been 1.3 % and is showing no tendency to improve. As against this, the growth rate of US per capita output was only 0.8 % in the decade before the crisis and rose in the following seven years to an average of 3.2 %. Figure 2 compares the LDC growth rate with the growth rates of the OECD countries and the USA. It can be seen that, in the years before the international debt crisis the LDC growth rate exceeded that of the USA. However, when the debt crisis emerged, the USA and less developed countries changed places in the growth rate ranking order.

Figure 3: From Interest Subsidy to Interest Burden



Sources: World Debt Tables: 1980/81, Table 1 and pp. 3, 85, 119, 179, 205, 229; 1982/83, pp. 2, 3; 1987/88 (Vol I), pp. 2-5; 1989/90, p. 78; Survey of Current Business: 1989, June, Table 8.1; 1990 June, Table 8.1.

Note: The ratio shown in the table is defined as $[\text{Nominal long term LDC debt service} - (\text{US GDP inflation rate} \times \text{size of nominal long term LDC debt})] / \text{nominal LDC GNP}$.

It is not the debt itself, but the debt service that constitutes the burden for

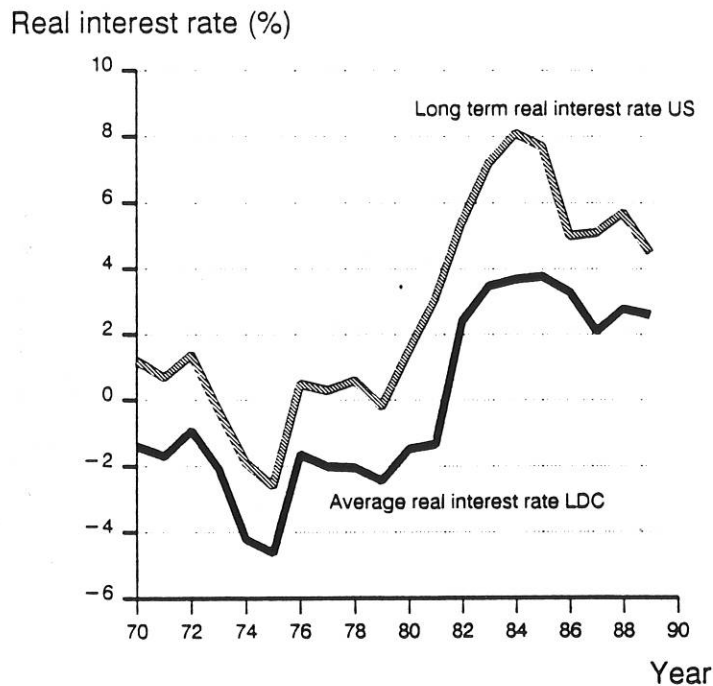
less developed countries. Figure 3 shows how the real interest burden has changed relative to LDC GNP. The real interest burden is defined as the nominal interest burden minus the inflation-induced reduction in the real value of LDC debt. The latter is calculated using the US GDP price deflator. Weighted indexes of LDC dollar export or import prices could have also been used, but, as most of the debts are defined in dollar units and as the dollar is the most important transactions currency, it seems appropriate to use the basket of goods produced in the USA as the numeraire. (To be sure, terms of trade changes have contributed to the debt crisis, but these changes should not be confused with debt service effects.)

The figure demonstrates what is arguably the most important single cause of the debt crisis: the dramatic rise in the real interest burden in 1982. This is the year in which Mexico declared itself unable to meet its payment commitments and which is seen as the start of the crisis. Before 1982, LDC's were paying interest but the interest paid was not sufficient to outweigh inflation losses of the creditor countries. De facto, LDC's were being rewarded by their creditors for being willing to look after the latter's money capital. Their indebtedness was not a burden for less developed countries, on the contrary it provided them with an ever flowing source of real income. They could afford to continue borrowing a net amount that was higher than their interest payment obligations and in the process were not becoming poorer. Only since 1982 have they actually had to carry an interest burden. A fundamental change in actual credit conditions occurred in that year, a change that could in no way be expected to proceed smoothly.

The reason for the changed conditions was the rapid increase in US nominal and real interest rate levels which quickly spilled over to the rest of the world. The turn of the decade from the 70's to the 80's was characterized by falling inflation rates combined with sharply rising interest rates. This resulted in a rise of real long term interest rates in the US from around zero in 1978/79 to almost 8% in 1984. Since then the rates have fallen

but have not returned to anywhere near their old levels. As figure 4 shows, the average real interest rate that the less developed countries actually had to pay on their outstanding debt was always below the US real long term rate, but its time pattern was similarly dramatic, showing the same jump in the period before 1984.

**Figure 4: The Pattern of Change in Real Interest Rates in the USA
and the Less Developed Countries**



Sources: Historical Statistics: Table 8.1, 1960–1980, 1960–1986; Survey of Current Business, Dec. 1988 and May 1990, Table 8.1; Main Economic Indicators, August 1990; World Debt Tables: 1977, Table 1B, 1G; 1980/81, Table 1; 1982/83, pp. 2,3; 1987/88 (Vol. I), pp.2–4, 1989/90 (Vol. 1), p. 78.

Note: The US real long term interest rate is defined as the nominal interest rate on US government securities with a maturity of at least five years minus the US GDP inflation rate. The real LDC interest rate is equal to the average nominal interest rate paid by LDC's for government and private loans (except for IMF loans), with a maturity of at least one year, minus the US GDP inflation rate.

One reason for the similarity is that both interest rates are calculated using the US GDP inflation rate. Another reason, however, is the equalizing effect of interest arbitrage. This arbitrage is of little importance for that part of LDC loans made by public

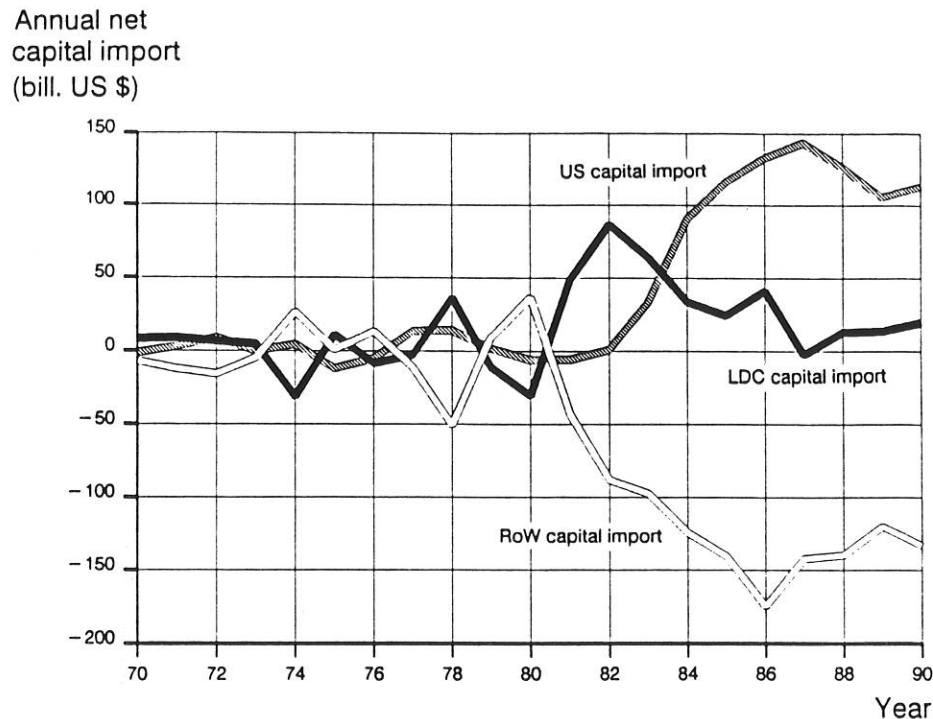
authorities. It is, however, very important for the lion's share of the loans which is made by private banks, the more so as private loans are relatively short term and are therefore frequently rescheduled. In 1980, for example, according to World Bank estimates, only a quarter of Latin American countries' debt was very long term; 70% of the loans had a maturity of less than three years; and 40% had to be paid back in less than one year (World Debt Tables, Vol I, 1987/88, p. XI). A change in US interest rate levels could therefore be transmitted very quickly to interest rates on LDC debt.

The picture would appear even more ominous if the real interest rates of the less developed countries were defined in terms of LDC export goods rather than US output goods. Because the appreciation of the dollar since 1981 reduced the relative price of LDC exports, the estimates for real interest rates would be even higher for the period following the crisis (cf. World Debt Tables, April 1988, Table A26). However, interest rates thus defined may not be very appropriate for evaluating US policies.

Capital that otherwise would have been available for other countries was kept in the USA, or attracted there, by the high US interest rate levels. Initially this took the form of a run on dollar securities which, concurrent with the ongoing rise in the US real interest rate, led to a steady rise in the value of the dollar in the first half of the 80's.⁴ Later, the subsequent normal reaction of the American current account balance resulted in a very large inflow of capital into the US. From 1985, when the dollar began to fall again, short run revaluation effects helped US capital imports to reach a peak value of \$ 150 b. in 1986 and 1987. As suggested by figure 5, the US was able to import the capital partly by generating export surpluses in other OECD countries, partly by crowding out LDC capital imports. From 1982 to 1987, annual US capital imports rose by \$ 144 b., exports by other OECD countries increased by \$ 57 b., and LDC capital imports fell by \$ 87 b.⁵

⁴See Sinn (1985, 1987b).

⁵It is true that the Plaza agreement in September 1985 was an international attempt to reduce the value of the dollar, however, as argued in Sinn (1987b) this attempt had no

Figure 5: The Change in the Direction of International Capital Flows

Sources: Annual Report: Table 8, 1973, 1974. Survey of Current Business Table 5.1, July 1974, July 1978, July 1984, July 1986, July 1987, May 1988. World Economic Outlook 1982, Table 15; April 1988, Table A36, May 1990, Tables A31, A36. Estimates for 1990 from World Economic Outlook May 1990, Table A33.

The sharp reduction in the capital imports of the less developed countries confirms the monotonic fall in the exchange-rate-adjusted growth rate of these countries' debts, mentioned above, which fell from 17% to 2% between 1982 and 1986. It is true, in 1974 and 1980 there also had been a drastic reduction in LDC capital imports, even to the extent of a change in sign. In those years, however, the oil price shocks and the resulting short run export surpluses of the LDC's were responsible. The recent reduction in LDC capital imports came about despite a worsening of their terms of trade (World Debt Tables, April 1988, Table A26) and cannot therefore simply be attributed to revaluation

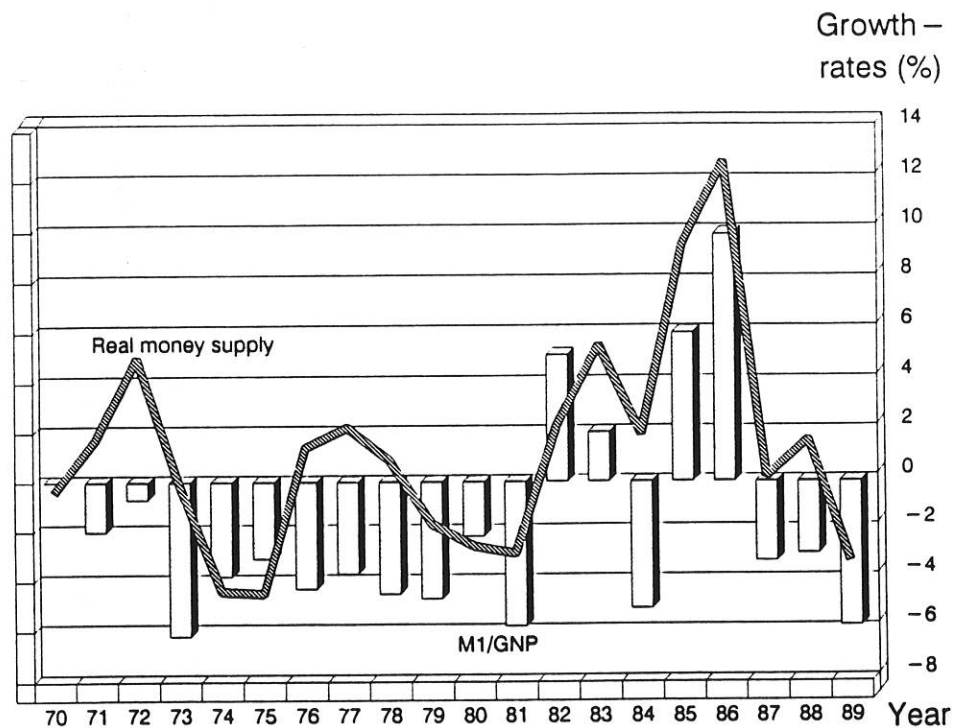
visible impact on the exchange rate. The dollar started to decline in February 1985 and continued doing so after the agreement. The true explanation for the dollar's decline may be the anticipation of the 1986 US tax reform which was announced shortly after President Reagan had been reelected in Autumn 1984. See also Feldstein (1988) and Sinn (1988a).

effects. The rapid rise in US real interest rates is undoubtedly a very important factor in the deflection of the capital flows. The cause of the debt crises is to be sought not only in the less developed countries themselves but also in the USA, their largest creditor.

3. The Role of American Economic Policy

The sudden explosive increase in American interest rates can be explained in terms of at least three economic policy measures: the tight monetary policy, the budget deficit, and the tax incentives for investments introduced by the Reagan government when it took office in 1981.

Figure 6: US Monetary Policy



Sources: Historical Statistics: Table 8.1, 1960-1980, 1960-1986. Main Economic Indicators: 1964-1983, p. 77; Feb. 1986, p. 90; Aug. 1988, p. 94, August 1990, pp. 96, 98, Survey of Current Business, Dec. 1988 and May 1990, Table 8.1.

Note: The growth rate of the real money supply is defined as the difference between the growth rates of M1 and the GDP deflator.

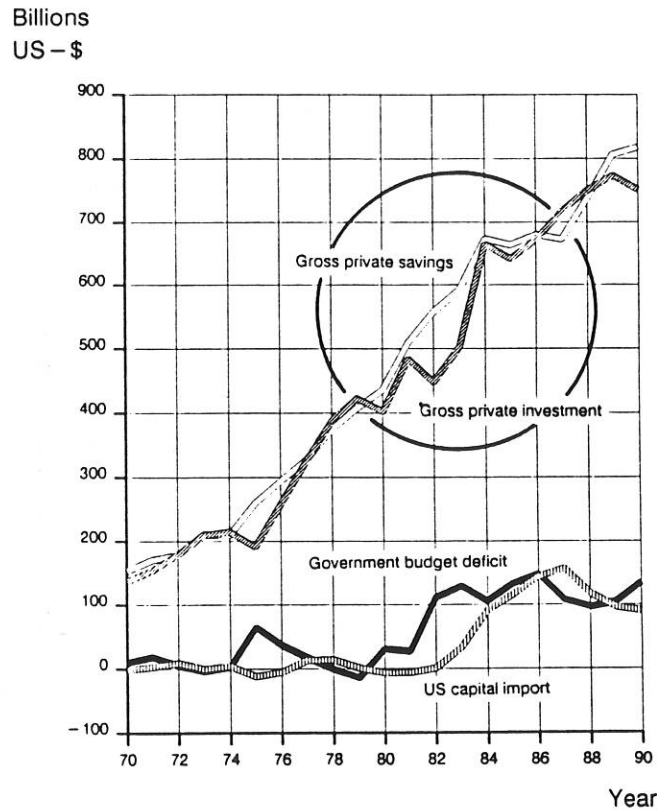
Before the crisis, monetary policy tended to be passive and its effects were not immediately apparent. In the sixties, the growth rate of the nominal money supply fluctuated between 4% and 9%, and, until 1982, showed a slightly rising trend. From 1976 the growth rate was never below 6%. cursory observation would therefore not initially suggest much of a role for US monetary policy as an explanation for the high American interest rates. It must be remembered, however, that the inflation rate at the end of the 70's was extremely high and had to a large extent soaked up the nominal growth of the money supply. As figure 6 shows, the real money supply hardly rose at all and certainly did not keep pace with the growth of real national product: the M1/GNP ratio was falling over the whole decade, contracting each year from 1973 by at least 2%. To this extent, US monetary policy in the period before the debt crisis was clearly restrictive. Monetary policy made a decisive contribution to the rise in US interest rates at the beginning of the eighties and to the subsequent debt crisis.

Under the Reagan administration American budgetary policy took a particularly dramatic turn, and, despite window-dressing attempts to suggest otherwise, it was basically of keynesian design. On the one hand, although a supply-side orientation was claimed, only half-hearted consideration was given to a reduction in government expenditure; there was primarily a transfer from social to defense expenditure. On the other hand, a substantial reduction in tax revenue followed from the passing of the Economic Recovery Tax Act in August 1981, only nine months after Reagan took office. In the five years from 1982 to 1986 the cumulative US budget deficit reached what many saw as the ominous level of \$ 630 b.

It has frequently been argued that this deficit was unplanned and that it took the government by surprise, convinced as it seemed by Laffer's self-financing hypothesis. However, the truth is different. In the appendix to the Tax Reform Act of 1981, a tax loss

of \$ 744 b. had already been predicted for the above-mentioned five year period (Joint Committee on Taxation 1981) and the Department of the Treasury had in August 1981 independently estimated a tax loss of \$ 724 b.⁶ In government circles at least, it was fairly precisely known what to expect.

Figure 7: US Flow of Funds



Sources: Survey of Current Business: Table 5.1, July 1974, July 1978, July 1982, July 1984, July 1986, July 1987, May 1988, May 1990.

The US budget deficit had burst out of its usual boundaries and has often been held solely responsible for the high level of American capital imports in recent years. As figure 7 shows, this is an obvious interpretation in view of the similarity between the budget deficit curve and that which shows both the current account deficit and the level of

⁶US Department of the Treasury, Office of Tax Analysis, Table "Changes in Fiscal Year Receipts Resulting from Conference Agreement on H.R. 4242", The Economic Recovery Tax Act of 1981, August 3rd, 1981, unpublished.