CHAPTER EIGHT

The Political Economy of International Finance

INTERNATIONAL finance is a major force in integrating the modern world economy. From the time of the Fuggers and other Renaissance bankers, private capital has nourished the international economy in the form of loans and portfolio investment (stocks and bonds). In the contemporary era, foreign direct investment by multinational corporations has augmented these traditional means of capital flow. Governments and international organizations have also become important sources of capital through the making of loans and the giving of official aid, particularly to less developed countries. Because foreign direct investment has already been discussed in Chapter Six, this chapter will focus on other forms of international finance.

From the perspective of liberal economics, the primary function of international finance is to transfer accumulated capital to the location where its marginal rate of return is highest and where it can therefore be employed most efficiently. The flow of capital internationally is a powerful driving force in the world economy, and the transfer of capital from regions with capital surplus, where the rate of return is relatively low, to potentially more productive regions is a major factor in the dynamics and expansion of the world system. Both the lenders and the recipients can benefit from a more productive use of the world's scarce supply of investable capital. This investment expands global demand and overcomes the inherent tendencies in a closed market economy toward underconsumption and surplus capital.

International finance links the international economy and also contributes to its dynamic nature. But international finance is also the weakest link in the international economy; speculative and volatile flows of capital can be a major source of global economic instability. In the words of Charles Kindleberger (1978d), the international financial system is inherently prone to "manias, panics and crashes." It is subject to periodic debt crises and destabilizing international flows of investment, speculative, and flight capital in search of higher rates of return or safe havens.

In a world divided among competitive states, however, international finance also has significant political consequences. It creates dependency relationships and is a major source of national power. Both foreign investment and official aid involve extensive penetration of an economy and, in many cases, lead to continuing external influence over domestic activities. Although trade and monetary relations may also impinge on an economy, foreign investment, aid, and loans have a greater tendency to create a superior-subordinate or dependency relationship and thus to lead to charges of imperialism. Stockholders and creditors have been known to call upon their own governments to intervene in other societies to protect their investments, and foreign investment and international finance have frequently aroused political and nationalistic passions.

Psychological and political factors inherent in international finance cause still further sensitivity. When an investment or a loan is negotiated, the immediate and obvious benefit is to the recipient or debtor economy; the creditor is thus usually in the stronger bargaining position and can exact favorable repayment and other terms. But once the investment is in place and the loan made, the recipient economy may be in the stronger position and can press for a revision of the terms of the investment or loan. The debtor may charge the creditor with exploitation and the creditor may accuse the debtor of violating good faith and contractual obligations. Both sides tend to feel aggrieved, and a politicization of what had been solely a commercial arrangement occurs.

International finance and the exercise of influence by the hegemonic power over international economic and political affairs are closely related. The hegemon is both the manager and a primary beneficiary of the financial system. It is the primary source of capital for developing economies, and its currency is the basis of global financial relations. If a financial crisis occurs, the hegemon is the only actor that can play the role of what Charles Kindleberger has called the "lender of last resort" and can take the necessary action to moderate the threat to the system.[1] In the nineteenth century this stabilizing responsibility of managing and overcoming financial crises fell to Great Britain; since the end of the Second World War the United States has managed the international financial system. As American economic hegemony declines, the question is whether Japan, as the emergent financial power, can assume this crucial role of economic leadership.

American domination of international finance since the end of the Second World War has been crucial to the simultaneous maintenance

[1] Kindleberger (1978d) discusses the need for and the functions of a "lender of last resort." Its basic task is to provide liquidity or money to insolvent businesses and thereby give them time to solve their difficulties. This responsibility of preventing financial crises is usually assumed by a country's national bank.

of its global political position and of domestic prosperity. The United States could not have fought two major conflicts in Asia, maintained a strong position in Western Europe, and sustained a major defense buildup in the 1980s without a significant lowering of the American standard of living if it had not been for its pivotal role in the international financial system. Through exploitation of its influence over global financial affairs, the United States has been able to cover the costs of its hegemonic position, preserve a false domestic prosperity, and mask the consequences of its relative political and economic decline.

Three Eras of International Finance

The world economy has experienced three phases of international finance within the past century: from 1870 to the outbreak of the First World War in 1914, a brief flourishing after the war until the collapse of credit markets associated with the Great Depression, and the era that opened after the Second World War.

The First Era (1870–1914)

Massive capital accumulation in Great Britain and subsequently in other advanced industrial economies from 1870 resulted in the export of capital and became a major new factor in international economics and politics.[2] Although France, Germany, and even the United States had become capital exporters by the end of the century, the foremost supplier of financial capital was Great Britain. The City of London increased its foreign holdings more than five times between 1870 and 1914. By 1914, over one-quarter of British wealth was invested in foreign government securities and foreign railroads. Britain was, in fact, investing far more abroad than it was at home. Repatriated earnings from these investments more than compensated for the fact that Britain ran a chronic trade deficit during this period. Britain had become a rentier economy by the close of the century and was living off the income from its vast overseas investments.

The economic impact of these capital exports was profound. For the borrowing countries, capital imports financed the creation of an infrastructure of urban centers, port facilities, and railroads that laid the basis for economic development. As railroads were constructed, the interiors of the continents were opened and hitherto isolated areas were linked to world commerce. The primary beneficiaries of this investment

[2] A brief and excellent history of this period is Condliffe (1950, ch. 11). This section draws heavily on this source. A more detailed history is Kindleberger (1984).

were the "lands of recent settlement" (e.g., the United States, Canada, Australia). At the same time, many countries became highly dependent upon the export of food and raw materials and the import of capital to balance their international accounts. This made them increasingly vulnerable to the vicissitudes of the world economy and the international business cycle.

For the capital-exporting countries, especially Great Britain, the economic consequences were mixed. British investors and financiers gained a high return on their overseas investments, and the British economy as a whole benefited from imports of cheap food and raw materials. But as John Hobson and other critics charged, the massive outflow of investment capital undoubtedly contributed to the industrial and overall decline of the British economy and accelerated the eclipse of Britain by rising industrial powers (Hobson, 1965 [1902]). While Great Britain tried to remain strong in the industries of the Industrial Revolution (coal, iron, and textiles), the United States, Germany, and other economies took the lead in the emergent industries of the Second Industrial Revolution (petroleum, steel, electrical, chemical, and motor vehicles).

Throughout much of the nineteenth century Great Britain undertook the role of what was called earlier the "lender of last resort." As first noted by Walter Bagehot in *Lombard Street* (1873), his classic study of British financial institutions, a modern financial system based on credit requires the existence of an authority that can rapidly provide liquidity to overextended and threatened financial institutions in the event of a financial panic or crisis. In domestic economies, this rescue function falls upon the central bank. This role was assumed by Great Britain and the Bank of England because of their interest in the stability of the international financial system. As the hegemonic economic power, Great Britain managed the world financial system until it collapsed with the outbreak of the First World War.

The Second Era (1920–1939)

The First World War brought to a close the first era of international finance and profoundly affected the nature and structure of international finance. The intensity and duration of the war forced the major European combatants to draw down (and in some cases even liquidate) their overseas investments to pay for necessary foodstuffs and war matériel. The war effectively paved the way for the eventual political emancipation of the colonies. And as the United States emerged from the war as the foremost creditor nation, it gradually began to change its outlook on world affairs.

Even though the United States did withdraw into political isolation

with the 1919 Senate defeat of the League of Nations treaty, American economic involvement with the rest of the world continued to expand. The American financial community began to recognize the increased stake of the United States in the world economy. U.S. finance assumed a growing international role; it was especially important in the funding of German reparations payments to France and other countries. This American-provided liquidity was a major factor in the stimulation of economic activity in the 1920s, and its cutoff in 1929 accentuated the severity of the Great Depression, which abbreviated the second era of international finance.[3]

During this era, both the cooperation and the rivalry between London and New York as centers of international finance intensified. Financial markets tend to be highly centralized and hierarchical in structure because of the importance of economies of scale and pooled information. This creates competition among individual centers to be dominant at the apex of the system (Kindleberger, 1978b, p. 74). That foremost center lends abroad, clears payments, and handles foreign reserves; it also serves as the "lender of last resort." In short, it manages the international financial system.

The history of international finance is one of a center that has migrated from the Mediterranean to the North Atlantic (Kindleberger, 1978b, ch. 4). In the sixteenth century Amsterdam replaced Florence as the center; subsequently London replaced Amsterdam.[4] Similarly, in the 1920s, New York began to displace London. Yet the United States had neither the power nor the will to manage and stabilize the international financial system. When economic leadership collapsed in the 1930s, international finance became characterized by increasing government intervention in financial markets, by imperial rivalries, and by economic disorder (Kindleberger, 1973). The resulting Great Depression brought the second era to a close.

The Third Era (1947-1985)

The third era of international finance, which began at the end of the Second World War, has differed from the first and second eras in several important respects. Whereas capital flows had previously consisted

[3] The causes of the Great Depression were complicated and are a matter of intense controversy. They certainly cannot be reduced to one or two factors such as the role of international finance and the absence of a hegemonic power, although the latter aspect was certainly relevant for its scope and intensity. As Kenneth Oye (1983) has argued, domestic policy choices were of crucial importance.

[4] Although Amsterdam in the seventeenth century performed the role of "lender of last resort," it did not assume the other functions of the hegemon.

almost entirely of private funds, after the war official foreign aid also became an important aspect of international finance. Initially, the United States sent aid to Western Europe through the Marshall Plan, which is estimated to have amounted to 4.5 percent of the American GNP between 1949 and 1952 (*The New York Times*, April 23, 1986, p. D2). Subsequently, as they recovered from the war, other wealthy countries gave aid to less developed economies. International organizations were created to funnel capital and other assistance first to developed and then to less developed economies. Beginning in the late 1960s, immense outflows of American dollars gave rise to the Eurocurrency market, transformed the scale and nature of international finance, and eventually contributed to the global debt problem of the 1980s. By the close of the era, Japan had become the principal creditor nation and the United States had become a major recipient of capital flows. This is thus a historical period that begins with American financial hegemony and ends with America increasingly dependent on Japanese capital for its world position and domestic prosperity.

The outstanding success of the Marshall Plan, the intensification of the ideological conflict between East and West, and the increasing recognition of the plight of less developed countries led to the establishment of large unilateral official aid programs in the 1950s. The United States and other developed countries made outright grants or low-interest loans to the less developed economies. With the launching of the "Development Decade" in the 1960s, the rich committed themselves to donating 1 percent of their national incomes to the poor countries. Although very few developed countries fulfilled this commitment, the amount of this official unilateral aid became substantial.

From its very beginning, official unilateral aid has been cloaked in controversy. Various groups in developed countries have regarded it as "pouring money down a rat hole," because the less developed countries have generally lacked the social and political base that would enable them to use the aid effectively. Conservatives have objected because they believe foreign aid encourages state intervention in the economy and discourages market approaches to economic development. They prefer to rely on foreign investment by multinational corporations and outward-oriented, export-led development strategies. Marxists and nationalists object because political and economic conditions are frequently attached to such aid, and the aid gives the donors leverage over the affairs of the less developed countries. Finally, critics and officials in less developed countries denounce such official aid as a new form of capitalist imperialism.

Although humanitarian and developmental concerns do play an im-

portant role, the primary motives for official aid by individual governments have been political, military, and commercial. The donors' desire to establish spheres of political influence, to bolster military security, or to obtain economic advantage have influenced the nature and patterns of aid. For example, when American foreign economic policy shifted in 1971, there was a reduction in total foreign aid and an allocation of a larger portion of aid to political allies (Scammell, 1983, pp. 76, 183). The two largest recipients of American aid have been Egypt and Israel. In the 1980s commercial motives explain a larger portion of Japan's aid than the latter cares to admit. In essence official unilateral aid has been an instrument of foreign or commercial policy for the two largest donors.

The postwar era of international finance has also witnessed the rise of multilateral aid agencies; the World Bank, regional development banks, and the International Monetary Fund are among the most important agencies.[5] The multilateral development banks (MDBs) are the largest source of official aid to the developing countries as well as providers of development policy advice and technical assistance. Although the United States has been the largest single contributor to these banks, its share declined both absolutely and relatively in the 1980s. In the preceding decade, countries other than the United States contributed a substantial fraction of total MDB resources, and the MDBs also borrowed in the private capital markets to supplement officially donated funds. Although the primary purpose of these banks is to provide financing for specific development projects, the World Bank has expanded its general responsibilities in light of the plight of many less developed countries. Whereas the purpose of the MDBs has been to assist development, the International Monetary Fund was established to help nations with balance-of-payments difficulties. The Fund provides the liquidity required while a nation carries out the adjustments in its economy and exchange rate that will correct its payments problem. Despite these differences in purpose, however, the tasks of the World Bank and the Fund have converged in recent years due to the necessity of dealing with the global debt problem.

Multilateral aid, like unilateral official aid, has been the subject of considerable controversy. Some conservatives in the developed countries have regarded the World Bank and the IMF as purveyors of socialism and dispensers of wealth to profligate countries living beyond their means. This was certainly the view of the Reagan Administration until it realized in 1982 that it needed the IMF to save the American

[5] Krasner (1985, ch. 6) presents a concise review of these agencies.

banking system, then threatened by the world debt crisis. Radical critics, on the other hand, denounce these Western-dominated institutions as imperialist agents of international capitalism. The recipients themselves tend to regard the aid as minimal at the same time that they denounce conditionality as a violation of their national sovereignty. Regardless of its substantial achievements, multilateral aid continues to be the focus of intense controversies.

One controversial issue is conditionality, that is, the imposition by lenders on borrowers of certain conditions for receipt of assistance, such as the reduction of budget deficits and currency devaluation.[6] The developed countries regard conditionality as necessary to ensure efficiency in the use of the aid and, in some cases, to achieve political objectives such as the Carter Administration promotion of "basic human rights" or the Reagan Administration promotion of "free enterprise." The recipients, especially in the less developed countries, denounce conditionality as imperialist interference in their internal affairs, especially when they are required to take restrictive economic measures that are politically dangerous. Conditionality will remain a highly explosive issue.

Another issue relates to concessionary or "soft" loans, that is, loans made at a low or no interest rate, principally by the World Bank's International Development Association and International Financial Corporation. Even though the number of such loans to the poorest countries has increased, the less developed and certain other countries have proposed an additional vast expansion. For both ideological and budgetary reasons, the United States has generally been critical of expanding this role of the Bank. The United States has occasionally tied concessionary loans to foreign policy objectives, as in its Caribbean and Central American initiatives; certain other donor countries follow a similar but less pronounced practice. General concessionary aid will probably never become a significant feature of the world economy, and it will undoubtedly continue to be subordinate to the foreign policy objectives of donor states.

Control of the lending agencies and of their ultimate purpose provides the core of yet another significant controversy. A major issue in the 1981 UN Conference on Global Negotiations at the North-South Summit in Cancún, Mexico, was the question of control over the MDBs, the GATT, and the IMF. There was a proposal that control be placed in the UN General Assembly where the less developed countries have a majority and could change policies regarding such matters as

[6] See Bienen and Gersovitz (1985) for a balanced analysis of the issue.

conditionality and concessionary loans. Another proposal would have the IMF increase world liquidity through the issuance of Special Drawing Rights and distribute the funds to those nations that need it most. Not surprisingly, the United States and other developed countries have strongly resisted the transfer of these economic institutions to the jurisdiction of the General Assembly.

The basic issue in this controversy between developed and less developed countries has been that of the purpose and control of these international economic organizations. The developed countries believe that the purpose of both unilateral and multilateral official aid is to assist less developed countries to reach a point where they can participate fully in an open, market-oriented international economy and that aid policies must therefore be subordinate to the norms of the market system. Less developed countries, on the other hand, give the highest priority to economic development and political independence; from their perspective, market norms must be subordinated to the goals of national autonomy, and control over these agencies must rest with the less developed countries themselves. These issues of purpose and control lie at the heart of their demands for a New International Economic Order, discussed in the last chapter (Krasner, 1985).

The third era of international finance came to a close in 1985. In that year, the United States itself became a debtor and Japan displaced it as the world's foremost creditor nation. Although this shift in the financial position of the United States was rightly hailed as dramatic and historic, it was the culmination and inevitable outcome of excessive American policies and mismanagement of the international monetary and financial systems ever since the escalation of the war in Vietnam and the simultaneous launching of the Great Society program. At the same time that the United States had managed the financial system, it had also used the system for its own national advantage and had thereby laid the foundations for the problems of the international financial system in the 1980s. Although problems of conditionality, concessionary aid, and purpose/control over international institutions would continue, even more vexing issues appeared with the rise of the Eurodollar market, the precipitation of the international debt crisis, and the decline of international leadership.

The Eurodollar Market

The Eurodollar market received its name from American dollars on deposit in European (principally London) banks yet remaining outside the domestic monetary system and the stringent control of national

monetary authorities.[7] In the late 1960s and 1970s, other currencies joined the dollar in that market, the Eurodollar or Eurocurrency market spread to financial centers in many countries, and American banks moved abroad to participate in that market. As noted in Chapter Four, foreign exchange trading was approximately $35 trillion in 1984. Thus, the size of the market dwarfs anything previously experienced in international finance.

A major cause of the Eurodollar or Eurocurrency market was the overly expansionary American monetary policy of the late 1960s and early 1970s. Although the market's capitalization is usually attributed to the OPEC surplus generated after the quadrupling of energy prices in 1973, the primary source was actually the huge dollar "overhang." In 1975, the rest of the world's nonbank private dollar holdings was $130 billion, by 1984 had grown to $800 billion, and threatened to reach the astonishing figure of $2.1 trillion in 1990 (Marris, 1985, p. 99). The Johnson Administration, carrying out its foreign and domestic policies, and the Nixon Administration, getting reelected, had printed dollars that eventually found their way to the Eurodollar market. The willingness of America's allies to hold dollars in excess of their needs and the crucial decision of the major OPEC nations (also friends of the United States) to continue the denomination of oil in dollars meant that dollars were in the market where they could be recycled from oil consumer to oil producer and back to the market again in the form of OPEC deposits.

The conventional wisdom of the U.S. government and the economics profession is that the great bulk of the OPEC surplus was deposited in the Eurodollar Market from whence it was recycled by the large international banks to oil-deficit LDCs and that this alleged "privatization" of the international financial system made official aid unnecessary.[8] Through a complex chain of financial intermediation, the commercial banks recycled the producer surplus to the neediest consumers. Thus, following the trauma of the oil shock, the market is believed to have worked effectively to restore equilibrium to the system.

As David Spiro (1987) has shown, what really happened was very different. The market worked to some extent, but it also had the guiding hand of the American hegemon. In the first place, a substantial portion of the financial surplus, especially from Saudi Arabia, was invested in the United States and into American Treasury bills; in effect, this im-

[7] The assistance and doctoral dissertation of David Spiro (1987) have strongly influenced the argument of the following two sections.

[8] The McCracken Report (OECD, 1977) is an excellent example of this position.

portant friend of the United States used part of its surplus to assist the American balance of payments. Second, only a relatively small portion of the OPEC surplus and commercial bank lending was made available to the neediest less developed countries; most adjusted primarily by reducing oil imports, and insofar as they received assistance with their oil bills, a substantial portion of that aid came from the multilateral aid agencies. Commercial bank loans were given primarily to the middle-income LDCs, a number of whom were themselves oil-exporters; in fact, relatively few of the NICs and the larger LDCs received the overwhelming fraction of the loans: Algeria, Argentina, Brazil, South Korea, Mexico, Venezuela, and Nigeria. The international commercial banks, the United States (and to some extent the other advanced countries), and certain of the richer LDCs were the principal beneficiaries of the OPEC financial surplus.

This economic "alliance" led the NICs and other LDCs to launch a new strategy of "indebted industrialization" (Frieden, 1981). For reasons of their own—the recession in the advanced economies and the promise of extraordinary profits—and in the naive belief, as one prominent American banker put it, that "nations never go bankrupt," the international commercial banks assumed the responsibility of recycling the OPEC surplus and accommodating the ambitions of the borrowers. The less developed countries fortunate enough to be classified as "creditworthy" had at last found a way around the "conditionality" of multilateral aid agencies, the influence of unilateral aid givers, and the domination of the multinationals. In this fashion the advanced economies and the United States in particular gained new and expanding markets for agricultural, machine tools, and other exports at a time when other markets were in recession. During this period, as William Branson (1980) has argued, a substantial shift in American trade took place in the direction of the Pacific and the LDCs.

This symbiotic relationship among bank creditor, LDC borrower, and advanced country exporters worked effectively throughout much of the 1970s. The market was praised for its successful recycling of petrodollars. Then came the second oil crisis in 1979, the recession of the late Carter Administration, and the even deeper recession of the first years of the Reagan Administration. These disturbing events were followed by the Reagan "revolution" in economic policy. As pointed out in Figure 2 (see Chapter Four), the world economy and America's role in it was dramatically transformed.

The massive American budget deficit and accompanying restrictive monetary policy had a profound impact on LDC debtors. The United States was forced to raise interest rates to finance its unprecedented

budget deficit; this siphoned off the world's capital. In addition to raising global interest rates and service charges, American policies induced a world recession that decreased debtor earnings on their commodity exports. The unanticipated reversal in interest payments placed the debtors in an impossible position; the rise of protectionism against their manufactured goods aggravated their plight by decreasing their export earnings. The debtors suddenly found themselves caught between increased interest payments due to the "crowding out" phenomenon caused by the American budget deficit and decreased prices for their commodity and other exports due to the global recession. The world debt crisis had arrived.

In brief, the combination of the massive OPEC financial surplus, the overeagerness of the international private banks (frequently abetted by their governments) to recycle that surplus, and the multitude of capital-hungry economies in Eastern Europe and the Third World proved to be a dangerous mixture. This curious alliance of capitalist bankers hoping to profit from the accumulated OPEC surplus and the governments of less developed and East European countries seeking unrestricted financial support for state-directed programs of rapid economic growth brought the capitalist world to the brink of financial disaster. Although the tale is complicated and its conclusion has not yet unfolded at this writing, it is clear that the debt problem introduced a novel and unstable element into the postwar international financial system.

The Debt Problem in the 1980s

Although debts and defaults have been a constant feature of the international economy, the present magnitude of the world debt problem overwhelms the imagination. The total world debt soared from approximately $100 billion in the early 1970s to nearly $900 billion dollars by the mid-1980s. In *Time* magazine's apt phrase, "never in history have so many nations owed so much money with so little promise of repayment" (*Time*, January 10, 1984, p. 42). The liens are held by governments, international organizations, and, most important, scores of commercial banks in the advanced countries. The heavy debtors, most of whom have been unable to service their debt, included approximately ten less developed economies in 1985. Brazil ($99 billion), Mexico ($97 billion), and Argentina ($48 billion) were the three largest debtors (*The Economist*, March 1, 1986, p. 69). In these conditions, creditor countries fear that the default of a single major debtor could trigger a financial panic that would bring down the whole edifice of international finance.

Throughout much of the 1970s international finance appeared to be operating reasonably well. Not only did levels of consumption rise in many societies, but the strategy of indebted industrialization promised to provide a new route to rapid development of the LDCs and to reintegration of Eastern bloc countries into the world economy. Commercial banks, in contrast to the IMF and World Bank, imposed few conditions on borrowers. Moreover, less developed countries expected that their dependence on the multinationals would be lessened as the banks provided the capital with which foreign technology could be purchased and import-substituting industries created. The recycling of a massive amount of money gave a Keynesian stimulus to an otherwise depressed world economy and proved a boon to exporters of consumer and capital goods in the advanced countries. LDC exports and receipts rose faster than their debts and interest payments. Optimism reigned; the market worked.

Although lending continued, optimism faded in 1979 with the second oil crisis, produced by the fall of the Shah. Yet another massive increase in the price of energy, the shift of advanced economies to constrictive economic policies that harmed LDC commodity export earnings, and heightened interest rates quickly brought many debtor nations to the brink of bankruptcy. For the largest debtors such as Argentina and Brazil, "the ratio of debt to exports increased by a striking seventy percentage points" from 130 to 200 percent and "interest payments more than doubled as a percentage of exports from 1976 to 1982—from 10 percent to over 20 percent—and reached 50 percent for Argentina and close to that for Brazil" (Hormats, 1984, p. 168).

The shift by the United States to a more restrictive monetary policy in 1979, the spread of global recession, and the energy conservation efforts of the advanced economies produced a third oil shock, a major decline in revenues for oil exporters like Algeria, Nigeria, and Mexico. These countries had gone heavily in debt to finance development projects, subsidize food imports, and expand welfare programs. With the drop in oil revenues they found themselves unable to finance their debt burden.

The global recession, the rise in real interest rates due to the drop in the rate of inflation, and the declining terms of trade for the exports of debtor economies produced the global debt problem and a severe threat to the integrity of the international financial system. The market was unable to manage the escalating crisis. In 1982, with the Mexican economy $86 billion in debt and at the verge of default, optimism gave way to deep pessimism. Drastic and immediate action was clearly required.

The unified strategy of the creditor nations took shape during the Mexican rescheduling crisis of August 1982.[9] Suddenly awakened to the severity of the external threat to the American financial system and realizing that a "market" solution would not work, the Reagan Administration took the leadership in rescuing Mexico and established the pattern that, with some modifications, subsequently has defined the approach of the creditor nations to the problem (Kahler, 1985, p. 369).

The basic creditor strategy has had three key elements: (1) a combination of banks, governments, and international organizations has acted as lender of last resort and provided liquidity to a debtor while the rescheduling of the debt has been negotiated, (2) the debtor has been required to accept a severe adjustment or austerity program, and (3) although other actors and institutions such as the Federal Reserve and the Paris Club of creditor nations have played important roles, the IMF has been given primary responsibility for enforcing adjustment based on the principle of conditionality and for certifying eligibility for financial assistance.[10] Although there have been subsequent modifications in this creditor strategy, its primary principle that the major task in resolving the problem rests with the debtors themselves has not been substantially altered.

In the negotiations between the creditor and debtor nations, the former assumed the lead in defining the nature of the debt problem and its solution. The creditor nations have largely determined the terms on which debts would be rescheduled and the policies to be implemented by the debtors. Despite the threats of some debtors and their champions to form a debtors' cartel, the creditor nations have dominated the situation. What could be a more telling example of the failure of the less developed countries to accomplish their goal of a New International Economic Order?

In effect, the IMF, with the strong support of the creditor nations, asserted international control over the commercial banks and the international financial system as it set the rescheduling terms and the conditions for both debtors and bankers. Through the use of promises and threats on such matters as future access to finance or export markets, the IMF and the creditor coalition defeated calls for a debtors' cartel and easier terms. The creditors successfully imposed their will on the debtors.

The position of the large debtors (mostly Latin American countries),

[9] Kraft (1984) is a useful source on this subject.

[10] The Paris Club is a set of procedures for negotiating debt payment deferrals and other arrangements (Rieffel, 1985, p. 3).

which became known as the "Consensus of Cartagena," was that the debt problem was really a growth problem created by the overly restrictive economic policies of the advanced countries. Their solution was a universal package settlement that avoided severe austerity programs and did not require sacrificing economic growth in the LDCs.[11] Throughout, the debtors have demanded that the responsibility for the problem and for its solution be shared by the creditor countries. They have pushed for lower interest rates, the continuing flow of foreign capital into their economies, and the tying of interest payments to export earnings and ability to pay. The united front of the creditors as well as the weaknesses and division of the debtors, however, have meant that the remedy of the former has prevailed.

The creditor strategy of "cooperation without reform" meant dealing with each debtor on a case-by-case basis rather than attemping to find a systematic overall solution (Kahler, 1985, p. 372). This essentially "divide and conquer" strategy meant that individual debtor nations would be assisted and rewarded by the banks, the IMF, and creditor governments according to their ability and willingness to demonstrate "progress" through implementation of strong austerity measures and other internal reforms. This solution implied, of course, that the major responsibility for causing the debt problem lay with the debtors and also assumed that they had the burden of solving the problem. Consequently, deep resentments have been generated in the debtor countries as living standards have declined and domestic political stability has been threatened.

The creditor approach failed to recognize either the extraordinary nature of the debt problem or its inherent political dangers. It did not take into account the fact that the debtors have, to some extent, been the victims of profound and sweeping changes in relative prices caused by the two oil shocks, the massive increase in the value of the dollar and of global interest rates, and, in the case of oil-exporting debtors, the collapse of energy prices in the mid-1980s. All of these developments have drastically altered the favorable international environment of moderate economic growth, relatively low interest rates, and good export markets that existed when much of the debt was incurred.

Developing economies have of course always borrowed from more advanced economies to finance imports and development projects. In the nineteenth century, British and European capital financed the infrastructure investments of the United States and other "lands of recent settlement"; these lands became in turn major importers of British and

[11] This view of the debtors is close to that of Keynes at Bretton Woods.

European manufactures. Despite occasional defaults and panics, the export earnings of productive investments made it possible for most borrowers to repay their debts. Both creditor and debtor benefited.

There is no problem with indebtedness as such, provided that the finance is used productively, the world economy is growing, and creditor economies are open to the exports of debtors. Under these circumstances debtors have no difficulties in repaying their debts. Unfortunately, these ideal conditions did not exist in the 1930s and the system collapsed. Nor, in the final quarter of the century, do conditions assure a solution of the debt problem. Instead, structural features of the international economy along with certain developments have aggravated the problem and made it more difficult to resolve. As a result, a continuing and dangerous international financial instability exists.

The crux of the problem (at least from the perspective of the creditor nations) is the heavy indebtedness of a relatively few countries that are potentially unstable, both economically and politically. The three largest Latin American debtors (Argentina, Brazil, and Mexico) in 1985 owed approximately \$260 billion; 40 percent of the \$400 billion Latin American debt was held by U.S. banks. Most of these debtors had severe difficulties meeting their interest payments due in large part to the combination of decreased export earnings and higher interest rates; in the mid-1980s, for example, interest payments amounted to almost 40 percent of the annual export earnings of the region (Kuczynski, 1985). In 1985 alone, Brazil and Mexico were scheduled to pay \$24 million interest on their debt (*New York Times*, Oct. 3, 1985, p. D6).

Mexico has become the most desperate case. Between 1979 and 1986, its gross external indebtedness actually increased from approximately \$40 billion to approximately \$100 billion. Its economy was seriously damaged by high inflation and the exodus of massive amounts of capital. Struck by a severe earthquake in 1985 and by collapsing energy prices, Mexico found its financial position slipping from illiquidity toward national insolvency. Only continuous American financial and other support has maintained Mexico's economy. In effect, Mexico has become a ward of its powerful northern neighbor.

Many of the debtors, like Mexico, were harmed by problems of their own making. In some nations excessive taxation and economic mismanagement created "flight capital" in tens of billions of dollars; by some estimates, this flight capital equaled 80 to 100 percent of the loans that those nations assumed. Frequently, these impoverished countries borrowed to finance imported consumption goods and to industrialize at what later appeared to have been too rapid a rate, given the overall state of their economies; too many investment projects were poorly

chosen. Most debtors had extraordinary rates of domestic inflation, and this made the economic adjustment required by their creditors and the IMF even more difficult. The increasing number of rescheduled loans, that is, loan packages that have been renegotiated, has revealed the fundamental weakness of the global financial system.

In the nineteenth century, most debt was in the form of bonds issued by hundreds of public and private entities to literally thousands of investors; governments were less involved in the market. By the 1980s, these features had changed in ways that made the financial system more susceptible to destabilization and subject to politicization. The financial markets had become more concentrated and government-regulated. Decentralized bond markets had been replaced by mammoth banking consortia that made loans to relatively few nations. The shift to bank lending has led to the pyramiding of massive and risky bank liabilities on a thin base of assets. These complex financial structures become very fragile indeed and the collapse of one poses a threat to all. Political bargaining and the exercise of power displaces competitive market solutions as the mechanism for resolving the debt problem (Fishlow, 1985).

Furthermore, the overall economic environment has changed in ways that make the resolution of debt problems significantly more difficult. Whereas the era of the gold standard had low rates of inflation and low interest rates, in the 1980s adjustment and rescheduling frequently occurred in extraordinarily inflationary situations; at one point inflation reached 800 percent in Argentina. After 1982 some governments, Mexico for instance, had to ask their people to accept austerity programs not only in order to service their international debts but also to reduce inflation.

At the same time that interest payments were rising and debtors were told to export more in order to repay their debt, advanced countries were closing their markets to LDC goods. In this way the debt problem was greatly aggravated by the macroeconomic policies of the Reagan Administration and the protectionist policies of all the advanced countries. Caught in this vicious cycle, the debtors asked how they could be expected to repay the interest or the debt itself without some relief from their creditors. Whereas previous defaults had been sporadic and nonthreatening to the system, the existence of several heavily indebted economies caught between a rising interest burden and decreased income posed a general threat to the overall financial system in the 1980s.

The political context of the debt problem has made the search for compromise solutions more difficult. The domestic and international environment has shifted from the previous relatively automatic operation of the market to a more politicized environment (Kahler, 1985, pp. 365-68). Government regulation of banking and concern for the stability of the domestic financial situation within the creditor nations complicates negotiations with the debtors. With the rise of the welfare state and mass politics, governments in debtor countries risk political suicide when they attempt to meet the austerity and other demands of creditor governments and of the IMF. Domestic political stability is undermined by the increases in unemployment, cutbacks in social programs, and reduced economic growth that follow austerity programs.

With some justification, debtors protest that the banks foisted the money on them and that the governments of the creditor countries permitted this to occur. They argue that both debtors and creditors must therefore make at least equal sacrifices to solve the problem, rather than placing the whole burden upon the debtors in the form of IMF-imposed austerity programs. Debtors have called for solutions that range from reduced interest rates to tying debt repayment to export earnings. These political pressures have elevated the debt issue to the level of international politics, and debt relief has become one of the demands of the LDCs for a New International Economic Order.

Among the issues that required solutions were the following: (1) How should the costs of adjustment be distributed among sovereign debtors, international banks, and the taxpayers of advanced economies? (2) Should the debtor nations pay the full cost as creditor nations appear to believe, because it was their allegedly profligate behavior that brought on the crisis in the first place? Or (3) as many LDC economists and political leaders argue, should a large portion of the costs be borne by the banks and the developed countries whose self-serving policies caused a systemic crisis within international capitalism? Or (4) perhaps the United States, as some critics believe, should pay a disproportionate share of the costs because its fiscal policies were so vital in causing and aggravating the crisis? (5) Could the solution be found in some combination of all the above? These and other highly political issues have been deeply embedded in the economic and technical discussions about such measures as lowering interest rates, tying interest payments to export earnings, or lengthening the payback period, and in the numerous and frequently innovative proposals for solving the debt problem.

However these issues may be resolved in the future, some conclusions regarding the economic and political consequences of the debt problem can be reached. Setting aside the special circumstances of Israel and the African countries, there are in reality three separate and distinct debt problems. One is the problem of the Eastern bloc countries, another is concerned with the Asian NICs, and the third is that of

the large Latin American debtors. These specific problems and the varying interests involved in each make it unlikely that a universal or multilateral solution could or would be found. Instead, the solutions (or rather what passes for solutions) have been devised through bilateral and frequently regional negotiations on a case-by-case basis.

Even though the problem of the Eastern bloc debtors has not posed a major threat to the stability of the international financial system, it has been important because it signaled the failure, at least for the moment, of the effort to reintegrate these nations into the world economy. These economies had adopted a strategy of rapid technological modernization through borrowing capital to purchase Western technology and then repaying the debt by exporting manufactured products. Unfortunately, in too many instances they used the borrowed capital and imported technology inefficiently, as, for example, in the case of Poland. The Asian NICs followed a similar strategy of indebted industrialization, but their strategy proved successful and their superior goods soon drove East European goods out of world markets (Poznanski, 1985). Although the Eastern bloc countries will continue to borrow in Western capital markets, prospects remain remote that they will soon again become major participants in the larger world financial and trading systems.

The debt problem of the Asian NICs is more manageable because of the low ratio of debt to GNP. For example, there has been little concern over the servicing and eventual repayment of South Korea's debt because the strategy of indebted industrialization has worked very well there and in other Asian NICs. Net lending to many of these countries was, in fact, resumed in the mid-1980s. Nevertheless, in the United States, the principal international supporter of these countries, strong reservations have existed about a development strategy in which state intervention in the economy plays such a prominent role; many critics have preferred a return to a greater emphasis on American and other multinationals as the vehicle of capital export. American unions and businesses ask why the United States should support the development of industries that would compete against them in their own and world markets. It therefore seems doubtful, for economic and political reasons, that international banks will endlessly continue to finance the strategy of indebted industrialization with the enthusiasm of the past.

As has already been noted, the large Latin American debtors have provided the crux of the debt problem. Together they hold a substantial portion of the total world debt; they have also been the most susceptible to default or actual debt repudiation. Latin American commitment to an import-substitution strategy and state enterprise has generally

failed, and these economies have found themselves caught in the impossible situation of being capital exporters, mainly in the form of interest payments on their accumulating debts, to the advanced economies. Since these countries also have had the highest population growth in the world, any cutback in domestic investment promises economic and political disaster.

Although adjustment programs, debt rescheduling, and interest rate or other concessions to particular debtors eased the debt crisis after 1984, the long-term solution may have become even further complicated. Following the depth of the crisis in 1982, the external debt increased at the rate of 30 percent a year to $380 billion in 1984. This increase was due mainly to further borrowings needed to make the interest payments. Although these new loans were mainly from the IMF, the World Bank, and the InterAmerican Development Bank and had lower interest rates with longer maturities than previous loans, they did not address the fundamental long-term problem.

Whereas creditor nations have argued that austerity programs and a revival of world economic growth will eventually solve the problems of the Latin American debtors, the debtors have believed that the advanced capitalist countries must overcome those structural problems of the world economy that are preventing a revival of economic growth. The latter argue that debtors can do little to solve the debt problem unless economic growth revives and interest rates are moderated. Debtors who expected to escape dependency through debt-financed industrialization feel themselves being thrown back into that position while at the same time creditors assert that a major reorientation of LDC economic policy is required and that the debtor nations must move from indebted industrialization and import substitution to an outward-oriented policy, giving a greater role to the MNCs.

In the 1980s many debtors were paying a high price in costs to their economies and in the welfare of their people due to IMF-imposed austerity programs. Although debtor governments strongly resisted these austerity programs and they were not always as austere as alleged by the debtors, the programs bred anti-Americanism and threatened to destroy the unsteady progress of Latin America toward political democracy. Furthermore, they were not really effective, because the total debt was growing faster than export earnings and the ability of the debtors even to service the debt (Bogdanowicz-Bindert, 1985/86, p. 272). Obviously these threatening circumstances required a new and even more radical approach.

At the annual meeting of the IMF–World Bank in Seoul, South Korea, in October 1985, the United States responded to the slow pace of

the adjustment programs and to growing concern about their political consequences and put forth what was billed as a new approach to the problem. The so-called Baker plan proposed a three-way bargain among the debtors, the creditor nations, and the large commercial banks in order to reach a solution through economic growth rather than through austerity. The debtors would take steps to open their economies to trade and foreign direct investment, reduce the role of the state in the economy through "privatization," and adopt "supply-side" market-oriented policies. The creditor nations would stimulate their economies and open them to debtor exports, enlarge the role of the World Bank in assisting the debtors, and increase debtor financing, especially for the poorest (mainly African) debtors. The commercial banks would loan billions of new monies to the debtors in order to facilitate the shift to the new policies and increase the overall rate of economic growth.

In this action the United States acknowledged for the first time that the debt crisis was a long-term economic and political problem threatening both the development of the LDCs and world economic recovery (Bogdanowicz-Bindert, 1985/86, p. 259). The plan recognized the need for the exercise of greater American leadership and the infusion of large amounts of external capital into the debtor countries to stimulate their depressed economies. The problem of how this leadership was to be exercised and this capital was to be made available when the United States itself was shifting from the status of creditor to debtor nation and the world had an acute capital shortage was left unresolved.

Of equal importance, however, was the fact that the Baker plan also revealed what the United States and other creditors were *not* prepared to do to solve the debt problem. The creditor approach to the debtors would still be on a case-by-case basis. Although the role of the World Bank would be increased, the IMF would retain its role as the central authority in supervising the policies of the debtors. The creditor governments themselves would not put substantial new amounts of their own money into this scheme. Interest payments on the debt would not be decreased across the board nor would commodity prices received by the debtors be increased. The burden of solving the problem would continue to rest squarely on the debtors and on the hope that a revival of global economic growth would somehow solve the problem. As the Cartagena group complained, the plan did not provide for increased funding and lower interest rates. Thus, the plan did not repudiate the existing strategy of the creditor nations or fundamentally change the situation.

Implementation of the Baker plan will reinforce other developments

in trade and monetary relations that will make it increasingly difficult to maintain a liberal international economy. Perhaps the most important effect will be a greater regionalization of the world economy. Despite their conflicts, debtors and creditors in particular regions are drawn together by shared concerns and interests. For economic and political reasons, Western Europe has been most concerned with the Eastern European debtors, and the United States with those of Latin America. European banks have been most heavily exposed in the East; European political and security interests are most at stake in that area. American banks have been most involved in Latin America, and American political worries are strongest there. Japan has taken initiatives to assist South Korea (Strange, 1985c, pp. 250-51). The dominant economic powers are highly motivated to give assistance or trade preferences to their own major debtors. This debt-trade linkage will become an increasingly significant factor in the further regionalization of the world economy and is explored in more detail in Chapter Ten.

The debt problem of the 1980s also meant that international capital flows to many countries were not likely to return to the levels of the 1970s. By the 1980s, the flow of all forms of capital to non-OPEC developing countries had declined dramatically (*The Economist*, March 15, 1986, p. 67). The international financial market has become increasingly segmented with a "fairly clear-cut delineation between credit-worthy borrowers" and the rest, who will have great difficulty borrowing in world financial markets (Sargen, Hung, and Lipsky, 1984, p. 2). There is general recognition, for example, that most Eastern bloc countries lack the capacity to use efficiently the large volume of loans available to them in the past. In the 1980s Latin American debtors were able to borrow only in order to service prior debt. Banks became much more circumspect about making new loans and the governments of creditor countries instituted new regulations that strictly limited foreign loans. Although Asian NICs, "friends" of creditor nations, and lands rich in raw materials will undoubtedly continue to have privileged access to bank loans, a large number of the less developed countries (such as those of tropical Africa) will most certainly not. They will remain almost totally dependent on underfunded official aid. In sum, there will be a contraction in the global supply of capital, and political criteria will play a more important role in international financial decisions. It appears that the tendency toward the politicization and regionalization of the world economy will be accelerated.

It is also likely that the debt problem will continue to be a brake on the growth of international trade and will encourage the already powerful forces of protectionism to spread. Through the 1970s the recy-

cling of Eurocurrencies gave a Keynesian impetus to the world economy, benefiting American exporters particularly. With the developed world then in the depths of recession, debt-financed purchases had a stimulating effect on the international economy. Debtor nations used petro-currencies borrowed through the Euromarket to buy American goods, the United States purchased the exports of other developed and less developed countries, and those countries in turn bought oil, thus returning funds to the Euromarket. In the 1980s the growing reluctance to loan Eurocurrency decreased this global monetary stimulus and had a depressing effect on the overall world economy.

Japanese Subsidization of American Hegemony

Along with the rise of the Eurocurrency market and the onset of the global debt problem, the third extraordinary development in international finance during the postwar period has been the historic reversal of the financial positions of the United States and Japan. This financial turnabout has transformed the political and economic relations of the two dominant capitalist powers. Each for its own reasons entered into a relationship in which the Japanese became the principal underwriters of American hegemony.

By the end of the First World War, the United States had displaced Great Britain as the world's foremost creditor nation. This financial supremacy was consolidated in the interwar period, and at the end of the Second World War the United States became the hegemonic financial power. Although its financial status diminished during the 1970s, the United States retained its dominant financial position until the Reagan Administration. Then, in the 1980s, Japan supplanted the United States as the dominant creditor nation and financial power. Never before in the history of international finance has such a dramatic shift taken place in such a relatively short time.

In 1981, Japan became the world's most important capital exporter. Its huge trade surplus, which rose from about $35 billion in 1983 to over $53 billion in 1985, enabled it to rise rapidly as a financial power. In 1983, Japan's net capital outflow was only $17.7 billion; a year later it had jumped dramatically to $49.7 billion and to an astonishing $64.5 billion in 1985 (*The New York Times*, April 27, 1986, p. 16). This last figure was more than all the OPEC countries at the height of their wealth (ibid., August 31, 1986, p. F7). By 1986, Japan's net assets abroad had risen to $129.8 billion, making it the world's largest creditor nation. Great Britain's net assets abroad were $90 billion and West

Germany's, $50 billion at that time (*The Japan Economic Journal*, June 7, 1986, p. 1). In the same period, the net asset position of the United States was approaching zero.

Although it is true that total OPEC foreign investment in the mid-1980s was substantially larger, it was primarily placed in bank deposits and thus was recycled through the market by Western commercial banks. Japanese overseas investment, however, was heavily in bonds and, as one Japanese bank official put it, "we have direct control over our money" (*Globe and Mail, Report on Business Magazine*, April 1986, p. 28). The four largest banks and six of the top ten in the world are Japanese. These banks as well as other financial institutions and the Japanese government have a significant influence over the disposition of Japan's vast savings, and their power over international finance and the allocation of capital has become formidable indeed. In the mid-1980s the leaders of Japanese finance chose to place a substantial portion of their overseas investments in United States Treasury bonds.[12]

This remarkable transformation of Japan's trading and financial position had begun in the early 1970s when, responding to the OPEC price increase, Japan drastically cut its oil consumption, expanded its exports to pay for the increased cost of energy, and accelerated the speed at which it scaled the technology ladder. In addition, several important features Japan's economy contributed to its massive trade and payments surplus. They include its high savings rate (about 18 percent in the mid-1980s) in combination with reduced domestic investment, the high productivity of Japanese industry, and the shift in the mid-1970s to a policy of economic contraction and export-led growth (Yoshitomi, 1985). The unusual structure of Japanese trade—the exporting of high value-added manufactured products and the importing of unprocessed commodities—meant that Japan was ultimately the principal beneficiary of the glut and price collapse of food, oil, and other commodities that occurred in the 1980s. These developments produced a "structural" surplus in Japan's trade and payments balances.

Using Marxist language, one could say that Japan in the mid-1980s had become a mature capitalist economy afflicted by the classic problems of underconsumption and surplus capital. It could not absorb the huge quantity of goods its factories turned out, nor could it find productive uses at home for its accumulating capital surplus. The causes of

[12] Although it is certainly the case that Japanese financial institutions invested in the United States because of interest rate differentials and other market considerations, the discretionary power of the Japanese, as revealed by past experience, is not to be denied.