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Volume Author/Editor: Georges de MÃ©nil and Robert J. Gordon, editors

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Chapter Author: Georges de MÃ©nil, Robert J. Gordon

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Introduction to Part III

Along with structural maladjustment and exchange rate volatility (the themes of the previous two parts of this volume), the ballooning of internal and external debt can be viewed as the final member of the 'terrible trio' of economic maladies in the 1980s. And these themes interact. The sharp increase in the U.S. internal and external debt in the first half of the 1980s was often singled out as the most important cause of the real appreciation of the dollar, and in turn of the internal imbalance between the U.S. manufacturing and services sectors. In less-developed countries the links between external debt, exchange rate adjustment, and structural problems have been even more direct. In some countries heavy external debt burdens lead governments to distort exchange rates, fix domestic prices, inhibit imports, and other combinations of structural and exchange rate remedies.

This final part of the volume contains papers which emphasize theoretical aspects of internal and external debt. In each case, they provide examples of the way in which economic events stimulate economic ideas. The emergence in the United States of a large structural fiscal deficit (i.e., corrected for the business cycle) stimulated a substantial amount of new theoretical work on the long-run sustainability of fiscal deficits, and the implications of fiscal deficits for external borrowing and for the interaction of monetary and fiscal policy. One of these theoretical contributions appears as the first paper in this part of the volume, 'Current and Anticipated Deficits, Interest Rates, and Economic Activity', by Olivier J. Blanchard. The paper takes as its point of departure a 'new view' that fiscal deficits hurt rather than help an economic recovery after a recession; it examines the relationships among anticipated future internal government deficits, current real interest rates, and real output.

Starting from first principles, Blanchard begins by constructing a formal model in which outstanding government debt influences consumption and saving decisions and thus interest rates, despite the fact that individuals treat government as transparent and thus discount fully all future tax payments (this is the assumption of Barro-Ricardian equivalence). In his model, uncertainty regarding life expectancy makes individuals require interest in excess of pure time discount as an inducement to hold bonds. The resulting non-neutrality implies a positive relationship between the size of the current government debt and the contemporary short-term interest rate.

The main conclusions follow directly. Progressively increasing deficits create expectations of higher future debt and thus higher future short-term interest rates. These expectations in turn raise the current long-term interest rate and thus depress real activity. Whether or not this depressive rate effect is large enough to offset the traditional Keynesian stimulus to demand (as would be necessary to confirm the 'new view') depends on the quantitative importance of the relative effects. The object of the model is to demonstrate that a perverse effect is possible and plausible.

A qualification of the Blanchard paper, recognized by the author, is that he deals only with the effects of deficits within closed economies. If deficits are anticipated to be much larger in the U.S. than in other countries, then in open economies with international capital mobility there would be large movements in exchange rates. Indeed, the large appreciation of the dollar that peaked in 1985 is widely believed to have been caused in large part by the emergence of the U.S. structural fiscal deficit.

The emergence of an international 'debt crisis' was a continuing feature of the 1980s and generally refers not to the growing external debt of the U.S. but rather that of the developing countries. The problem suddenly emerged into the consciousness of academicians in August, 1982, at the time of the Mexican debt crisis, when Mexico became unable to pay the interest and principal due on its ballooning debt, and when lenders refused to advance it any additional funds. In one interpretation, the huge debt of the developing countries was a side-effect of the supply shocks of the mid and late 1970's, and of the role of banks in the developed countries in 'recycling' the surpluses of oil-producing nations to the poorer oil-using nations. Some of the developing countries, e.g., Mexico and Venezuela, were themselves oil producers, borrowed to support a consumption boom under conditions of an overvalued currency and capital flight, and then found that they could not roll over short-term debt when the price of oil began to drop after 1981.

The last two papers in this volume deal not with the specific events that led to the debt crisis of the 1980s, nor with the details of its resolution (which is not yet complete), but rather with first principles essential to understand the nature and effects of international lending for any country in any era. The first of these is 'The Pure Theory of Country Risk' by Jonathan Eaton, Mark Gersovitz, and Joseph E. Stiglitz. Their analysis helps to clarify a number of central issues. They distinguish among default, insolvency, and illiquidity in the context of a multi-period model in which default has future consequences. They stress that internal debt is a legal obligation, enforceable in courts, and thus differs from external debt for which repayment is largely voluntary with only indirect penalties possible. Collateral plays little role in external debt, because there is little that a creditor can do to seize it.

The authors use several simple models to focus on a key issue in international lending, the need for creditors to devise penalties that provide incen-

tives for debtors to avoid default, and to maintain credibility in applying the penalties. They discuss two models, in one of which lenders do cut off credit from those who are in default (as part of a reputational equilibrium), but in the other they do not, and the market ceases to function. They also draw a parallel between the incentive problems of external lenders and the traditional problem of domestic bank runs. The paper contains no empirical analysis but rather provides a number of comments and guidelines on how econometric studies of external debt should be carried out. The authors conclude by stressing the central role played by the enforcement problem and the absence of collateral, both of which make the international credit market differ fundamentally from domestic financial markets. They emerge surprised that there was so much lending to developing countries, in light of the evident risks for creditors. They do not believe that their analysis allows predictions to be made about future repayment behavior by debtors, or future extensions of new loans by creditors.

The final paper in the volume is 'Growth and External Debt under Risk of Debt Repudiation' by Daniel Cohen and Jeffrey D. Sachs. They take as given the theoretical insights of the previous paper and examine their implications for the growth patterns of developing countries. Their paper is an abstract analysis of the pattern of growth of a nation which borrows abroad and which has the option of repudiating its foreign debt. The authors show that the equilibrium strategy of competitive lenders is to make the growth of the foreign debt contingent on the growth of the borrowing country.

The result is a two-stage pattern of growth. During the first stage, the debt grows more rapidly than the economy. During the second stage, both the debt and the economy grow at the same rate, and more slowly than in the first stage. During this second stage, the total interest falling due on the debt is never entirely repaid. Only an amount equal to the difference between the rate of interest and the rate of growth of the economy, multiplied by the level of the debt, should be repaid each period. This permanent refinancing of part of the interest is the only way for a country to reach the optimum pattern of growth consistent with no default.