The development of the Global Economy

Topic 2: Challenges in the Global Economy

SAJC History Unit, 2024

Learning Outcomes (from the Examination Syllabus)

Students are able to:

- evaluate the factors that contributed to the growth of the global economy over time.
- evaluate the challenges that affected the global economy over time.
- evaluate the factors that contributed the factors that contributed to the economic transformation of Japan and China over time.

Essential Questions for this topic:

- ***How did the global economy develop?***
- ***How did the development of the global economy impact different countries?***

****Questions set will not require candidates to compare the economic transformations of Japan and China***

Guiding Questions for this topic:

- When did the challenges in the global economy take place? How was it like and why did it manifest the way it did?
- How would you gain a broad overview of the problems faced by the economies from the 1970s to 2000, and the underlying reasons for such problems?
- What were the various characteristics and definitions that are associated with weak economies?
- What were the economic and political reasons for the outbreak of the first and second oil shocks?

- What were the wide-ranging effects of the oil shocks on oil-importing and oil-exporting countries?
- What were the cumulative impacts of the oil crises on the global economy?
- How would you describe and illustrate the impact of GATT on international free trade?
- What were the reasons for the rise of protectionism in the 1970s and 1980s?
- What was the impact of the rise of protectionism on developed and developing countries and its implications for free trade?
- What were the causes of the trade imbalances between the USA and the rest of the world? What was the impact of such imbalances on the US and world economy?
- What were the reasons for increased borrowing by the Third World in the 1970s?
- How did the debt crisis of the 1980s develop?
- What was the impact of the default on loans in Latin America on the global financial system?
- How would you assess the measures undertaken to resolve the debt crisis?
- How would you evaluate the economic, social and political impact of the debt crisis?

1. Overview

- The 'Crisis Decades' could be said to have started in 1971, with the first cracks appearing in the international economic system, as signalled by the collapse of the Bretton Woods System.

- During this period, there were occasional good years but a great deal of economic instability on the whole.

2. Major Events and Developments

  - **'First Oil Shock' (1973)**: Oil prices quadrupled as a result of OPEC action to limit production quota (partly for profit but largely for political reasons), affecting producers and consumers all over the world.

- **Recession, (1974-1975)**: Most severe in industrial countries, such as the USA, Britain, Germany and Japan, with the most serious fall in output since the 1930s. Economic growth rates were negative, mostly for 7 or more quarters.

- **Rise in unemployment in the West**: The unemployment rates rose from 1.5% in the 1960s to 10-12% in the crisis decades, a type of unemployment rate not seen since the 1930s.

- **Inflation**: Surprisingly, recession was followed by inflation. Normally, prices would fall since people had little money to spend, so inflation was unusual.

- **'Stagflation'**: Inflation and unemployment occurring at the same time in the 1970s.

- **Brief recovery in the late 1970s**: From 1977 to 1979, the economic situation improved because the West adapted to higher oil prices and enjoyed an export boom to the Middle East OPEC countries.

- **The Iranian Revolution (1979) and the 'Second Oil Shock'**: Overthrow of the Shah and the establishment of an Islamic republic by the second largest oil-exporting country in the Middle East resulted in the sudden cessation of oil coming out of Iran. This led to the second spectacular rise in oil prices within one decade and the industrialised economies could not function.

- **Recession in the major industrial countries (1979-1982)**: A result of the industrial economies having had to import oil at vastly inflated prices.

- **Third World Debt Crisis: Mexico (1982); Brazil (1986)**: A result of unmonitored easy loans, over-borrowing and defaulted payments.

- **Recovery in Europe, Japan and the USA (1983**-1990): A result of structural adjustments, technological upgrading and development of fuel-efficient techniques.

- **The 'Reagan Boom'**: An upsurge in American economic growth due to a combination of Reagan's economic policies and an increase in military expenditure for Cold War needs. Job creation in the military sector had a knock-on effect on other industries. General rise in income levels promoted consumerism, which was good for overall production levels.

- **Currency instability and the Plaza Accords (1985)**: With the ending of dollar-gold convertibility, major currencies of the world fluctuated for a period of time. The Plaza Accord was an agreement between the governments of France, West Germany, Japan, theUSA and the UK to depreciate the US dollar in relation to the Japanese yen and the German Deutsche Mark by intervening in currency markets. The primary purpose of this agreement was to help the US reduce its current account deficit and help the US economy emerge from a serious recession that began in the early 1980s. With the rise of other currencies vis-à-vis the greenback, American products became more competitive. This was important for global economic consumption patterns.

- **'Reverse Oil Shock' or the collapse of oil prices (1985-1986)**: Price fell from $30 to $10 a barrel in the space of just over a year (Dec 1985 to Aug 1986), in what was termed the 'reverse oil shock'. This was bad for oil-exporting countries, especially for those that relied heavily on exports, but provided a non-inflationary boost to the rest of the world's economy.

- **The 1987 Wall Street Crash**: Stocks fell by around 20% on average. This required the coordinated action by the US, British and Japanese finance ministers to sort out.

- **Collapse of the Japanese 'asset bubble' (1989)**: Collapse of the Japanese stock market as a result of over-speculation.

- **Recession in Europe and the US (1990-1992)**

3. Reasons for the 'Crisis Decades'

- The end of the 'great postwar economic boom'

- The cyclical nature of economic activity

- The collapse of the Bretton Woods System

- However, there were also reasons which were specific to the period and which led to the following developments:
  - The oil crises of 1973-74 and 1979-80
  - The third world debt crisis
  - The growth of protectionism (though this was as much a response to the problems as a cause of them).

- The responsibility of individual countries as well as influential nations, whose actions have global implications, in contributing to the problems must not be ignored.

4 Positive Aspects of the 'Crisis Decades'

- **Restructuring of western industry**: E.g. Chrysler under Lee Iacocca. Industries became more efficient, closing down inefficient plants and removing old models of production that were not working.

- **Greater fuel efficiency in the West and Japan**: Industries did not waste as much fuel as before, which in turn cut production costs and had a positive impact on the environment.

- **Modernisation, i.e. the move towards a 'post-industrial' economy**: Move towards a service industry that produced wealth. But this was not before an initial period of some temporary unemployment.

5. What happened to the Rest of the World?

- **Communist economies**: In the 1970s and early 1980s, the USSR was shielded by its own supplies of oil and so it continued on its own model of economic development unlike the West which modernised and eventually developed an advantage. Eastern European economies received oil supplies from the USSR at prices way below the world price and while they benefited and were also insulated from the problems of the 'crisis decades', the Soviet economy was severely strained.

- **'Newly-Industrialised Economies'**: NIEs of Asia (South Korea, Taiwan, Hong Kong and Singapore) industrialised rapidly and went from Third World to First World.

- **Third World countries**: Many other Third World countries struggled with development. Some managed to lift themselves out of abject poverty and embarked on industrialisation, but many others, due to largely internal socio-political problems, such as corruption, civil strife, regional turmoil and humanitarian and other health crises, went backwards instead. E.g. Uganda, Argentina, Zimbabwe.

6. The Oil Crises of 1973-74 and 1979-80

6.1 Background

- One of the favourable factors contributing to the 'long post-war boom' of 1945 to 1973 was the low price of oil – a barrel of Saudi crude oil averaged less than US$2 over this period.

- Before the first oil crisis, the cheapness of oil encouraged dependence on it (it amounted to 43% of total global energy use). Cars, ships, aircraft and domestic power for electricity and heating were all fuelled by oil. Without oil, all the advanced industrial economies would come to a shuddering halt.

- Movements in the price of oil affected everyone – producers, consumers and less- developed countries. Japan and Germany, the world's 2nd and 3rd largest economies respectively, are totally dependent on imported oil, mainly from the volatile and troubled Persian Gulf region.

- Oil was cheap and readily available because the oil producing nations had yet to realise the power they had in the form of their vast reserves of oil. The oil trade was instead dominated by big western oil firms, of which EXXON, Mobil, Royal Dutch Shell and BP were most prominent. Even till now, the international oil industry is the largest and, in many ways, the most important industry in the world. The value of the international oil trade is measured in hundreds of billions of US dollars per year. Oil accounted for 10% of all commodity trade.

- In essence, it is possible to argue that the international oil industry primarily influenced the economic developments of the 20th century. (Read the article **'World Trade and the Energy Crises'** to contextualise your understanding about the importance of oil and the significance of the oil crises for the world economy.)

6.2 The Formation of OPEC

- The world price of oil had lagged behind inflation for decades and in Sept 1960 the major developing country for oil production formed the Organization of Petroleum Exporting Countries (OPEC).

- Its original members were Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the United Arab Emirates and Venezuela.

- The largest oil exporters were the Persian Gulf oligarchies – Saudi

Arabia, Qatar, Kuwait, and the UAE had nearly half of the world's oil reserves and a quarter of its output – and they came to dominate OPEC.

- An additional source of power was the solidarity of OPEC's Muslim members in and around the Middle East who shared cultural and political ties.

- The principal goal of OPEC was to raise the royalty and tax rates private oil companies paid their hosts, which required coordination among producing governments and the avoidance of undercutting, in the meantime also recruiting more member countries.

- To put it more simply, the purpose of OPEC was to unify and coordinate members' petroleum policies and to safeguard their interests generally. It is essentially a cartel which attempts to control the price of its product through a control of supply and a system of quotas.

- However, OPEC's power is not unfettered since it still has to operate within the context of the world economy and is affected by relations between its members.

- World economic growth increases demand for oil, and in turn its prices. Recession reduces demand and prices. Winter in the Northern Hemisphere, energy-saving policies and alternative sources of oil are other demand-related influences. On the supply side, willingness of OPEC members to adhere to quotas will affect price.

6.3 The 1973 OPEC Oil Embargo

"The Middle East War made a chronic crisis acute; but a crisis was coming in any event." - Henry Kissinger, *Memoirs*

- The oil shock of 1973-1974 arose as a result of OPEC's decision to increase the price of oil.

- This came about following the devaluation of the US dollar and in response to the politics of the Arab-Israeli conflict.

- The devaluation of the US dollar in Aug 1971 and further devaluations thereafter sharply reduced the incomes of oil-producing nations as the price of oil was denominated in dollars. This development prompted OPEC to consider a more aggressive pricing policy.

- In addition, American support of Israel during the Yom Kippur War of Oct 1973 also generated Arab backlash. This further provoked the

Arab states, who were already infuriated with America's veto of a July 1973 UN Security Council Resolution which "strongly deplored Israel's continuing occupation of Arab territory."

- In the wake of the Arab-Israeli War, the Arabs used their 'oil weapon' to compel the USA to put pressure on its client state Israel.

- Early actions included the partial nationalisation of Basrah Petroleum by Iraq and increased state holdings of oil companies in Kuwait, Oman and Saudi Arabia.

- As part of the political strategy that accompanied the Yom Kippur War, Arab countries cut back production, embargoed shipments of crude oil to nations that had supported Israel in its conflict with Syria and Egypt and launched a complete boycott of Israel.

- OPEC members also agreed to use their leverage over the world price setting mechanism for oil in order to raise world oil prices.

- Subsequently, OPEC broke off talks with the oil companies. Its Arab members reduced oil supplies to developed countries, placed an embargo on oil exports to the USA and Holland in retaliation for their support of Israel and doubled the price of oil to more than $5 a barrel. Two months later, OPEC doubled it again to nearly $12 a barrel.

- It soon became clear that a small group of developing countries had dramatically changed the terms on which they sold their goods.

- There were few readily available substitutes for oil so price increases did not reduce consumption very much.
- Due to the dependence of the industrialised world on OPEC as a global supplier of oil, this led to dramatically inflationary effects on the economies of the targeted industrialised countries while at the same time, suppressed economic activity.

- By the time the embargo was lifted, OPEC nations had quadrupled the price of oil.

- This triggered the worst economic crisis in the West since 1929 and ushered in a period of 'stagflation', an unusual combination of falling output accompanied by rapid inflation.

  (Read the supplementary reading **'From Titusville to Baghdad'** to contextualise your understanding of the political significance of oil.)

6.4 The 1979 Iranian Revolution and Its impact on Oil Supply

- In 1979, a fundamentalist Islamic revolution overthrew the Shah of Iran, one of America's closest allies in the region.

- The Revolution shattered the Iranian oil sector and while the new regime resumed oil exports, it was inconsistent and at a lower volume, forcing up prices.

- With the second largest oil exporter being engulfed in revolution, the world oil industry was thrown into turmoil and the price of oil shot up again, reaching US$30 per barrel by early 1980, bringing with it a new round of pressures.

- Saudi Arabia and other OPEC nations increased production to offset the decline in Iranian oil supply, but the overall loss in production was about 4%.

- A rapid rise in the price of oil occurred, from US$13 per barrel in 1978 to US$30 per barrel by early 1980 and US$32.50 by 1981. Prices went over $40 a barrel on the open market.

- OPEC did not fully sustain these high prices; new sources of supply had been developed, and members of OPEC cheated on agreements to control supply.

- However, oil prices remained around $30 a barrel and another round of price shocks hit the world.
- In Sept 1980, following the Iraqi invasion of Iran, oil production in Iran nearly stopped and Iraq's oil production was severely cut as well. Iran and Iraq were, respectively, the second and third largest exporters of oil.

- The severe shortage of oil drove prices up drastically.

7. Impact of the Oil Crises on the Global Economy

- Due to the oil crises, the economies of the industrialised countries across the globe were damaged and by early 1974, most of the world was hit by the worst slump since the Great Depression.

- Across the world, oil importers faced the problems of inflation, balance of payments deficits and recession. It is no exaggeration to say that it was a turning point for the international economy.

- Government intervention was immediately necessary to soften the blow of the oil crises. For example, the German government gave emergency oil supplies to manufacturers who were running out of fuel and whose products would be ruined if their factories were forced to shut down.

- The oil crises also gave rise to social crises. In Japan, taxicab drivers demonstrated against the high prices of gas, housewives hoarded toilet paper and laundry detergent. American motorists faced gas station lines an hour or two long, and several gas stations were simply had no gas to supply along the many highways.

- The second round of OPEC oil shocks in 1979-1980 reinforced the belief that the world economy was out of control or at least beyond the control of the advanced capitalist countries.

7.1 Increase in Oil Prices

- The oil price increases had an immediate and electrifying impact and prices soared within days.

- As a result of the 1973 oil embargo, world oil prices rose to unheard of levels, four times the previous highs.

- Due to the high prices, the Arabs grew enormously wealthy from the 'oil shock'. Huge cash flows poured into the Gulf states, which responded with buying sprees for military weapons, building projects and lavish consumption. The Shah of Iran modernised his country in this period, in what was known as the 'White Revolution'.

- US and European arms manufacturers, banks, shipping and industrial building contractors benefited from doing business out of recycling 'petrodollars'.

- The higher prices of crude oil also stimulated development activity in every country that had any potential for oil fields.

- The global supply of crude oil was dramatically increased because of the high prices and resulted in the Middle East no longer being the dominant world supplier of oil.

7.2 Higher Costs of Production in Both Developed and Developing Countries

- Given the high dependency of the developed world on oil, the ridiculous price increases of oil meant that costs of factors of production were also increasing at an enormous rate.

- Stagnation in the West reduced the demand for their products while inflation raised the price of the factors of production and the manufactured goods they needed to import.

- Most developing countries were oil importers and faced much more expensive oil import bills. The 1970s were even more trying times for developing countries already struggling with the accumulated problems of import-substitution industrialisation. The rapidly industrialising LDCs continued to have trouble paying for imports to fuel industry and the higher costs of production.

- The first oil shock had added about $30 billion to the import bill of non-OPEC developing countries; the second oil shock added almost $50 billion.

- The desire for industrialisation was unabated but its cost was rising rapidly.

- Developing countries had to borrow vast amounts of money for industrial purposes and this contributed to enormous financial flows from OPEC countries to developing countries, with Western commercial banks as intermediaries.

- Such financial volatility would later have an impact on the third world debt crisis of the 1980s, as well as greatly unhinge the international financial system.

7.3 High Rates of Inflation

- The rapid growth of the early 1970s, the commodity boom and the oil shocks all increased inflation.

- In 1974, consumer prices around the industrial world shot up:
    - 12% in the US
    - 14% in France
    - 16% in Britain
    - 23% in Japan

- One reason for the inflation could be attributed to OPEC but it is estimated that the oil shocks accounted for only one quarter of the inflationary surge of the period.

- The oil price was a one-time shock with contradictory consequences for other prices.

- On the one hand, petroleum was widely used throughout the economy, so there were upward pressures on other prices. On the other hand, with oil more expensive, consumers had less to spend on other things, demand then fell and other prices might actually have dropped.

- With the collapse of the Bretton Woods system of the fixed exchange rate and most currencies floating, governments were free to accommodate the price hikes by increasing the money supply which led to a jump in inflation three to four times higher in most countries than the average since WWII.

- This largely signalled an end to the monetary stability established by the Bretton Woods system for nearly 30 years.

7.4 Economic Slowdown

- Despite government policies to stimulate the economy, the world plunged into the steepest recession during the 1930s.

- In 1974-1975, industrial output dropped by 10% in the industrial world and unemployment rose almost everywhere to unacceptable levels.

- By the end of 1974, the US stock market was at barely half of its 1972 level.

- The world financial system was hit by the two biggest bank failures since the Depression—the Franklin National Bank in the US and the Bankhaus Herstatt in West Germany.

- Rising prices and sinking economies caused panic because people in the industrialised world were accustomed to growth, full employment and stable prices—economy dislocation basically gave way to social strife and in turn changed the political landscape of the industrial world.

8. Did OPEC Benefit?

- OPEC as an organisation was not monolithic and not all members viewed the increase in prices and production quotas equally.

- While the general increase in oil prices benefited all in the short term, a number of oil- producers had little incentive to limit production of oil in order to keep prices high – these countries (e.g. Indonesia, Iran, Nigeria, Venezuela) preferred to maximize their income by keeping oil output at a constant high level and later resorted to flouting quotas.

- Hence, the oil producing nations which had the political and economic motivations to adhere strictly to production quotas were soon undermined by the actions of the other group of producers.

- Nonetheless, OPEC members did leverage on the huge balance of payment surpluses to accelerate national development projects. Roads, housing, ports, airfields and new industries were established. For example, Saudi Arabia developed petroleum refineries, petrochemical works and cement plants.

- Many also placed their surplus funds (termed 'petro-dollars') in short-term investments (mostly in the United States and other industrialised nations) and pumped them into the international financial markets, deriving significant profits and interest returns.

9. Did the Negative Impact of the Oil Crises Last?

- While OPEC did manage to hold the world as 'economic hostage' for most of the 1970s, by the early 1980s, world oil prices were regulated by other factors, ending OPEC's powerful command of the global economy.

- The widespread recession and inflation following the oil crises reduced global economic growth, and in turn, the demand for OPEC oil.

- Short-term emergency energy saving measures ameliorated the impact of the crisis. For example, there was a temporary ban on Sunday motoring in Belgium and Denmark, a maximum speed limit of 50mph in Ireland, halving of street lighting in UK and Greece, rationing of petrol and oil, etc. This gave rise to a change in attitude towards energy usage.

- Over time, many of the industrialised countries developed more energy-efficient methods of production and transport. A case in point was Japan, which grew economically by 4% in 1980, but decreased its consumption of oil by 5%. Overall, the GDP/energy use co-efficient was halved from 0.8 to 0.4 in the 1980s.

- A new priority was devoted to harvesting from new oil fields (non-OPEC producers, e.g. in the North Sea and South America) and search for alternative forms of energy (e.g. coal, natural gas, hydro-electric power and nuclear power).

- Some oil importers developed 'special relationships' with members of OPEC – France with Algeria (France providing technology and a guaranteed market in return for oil) and the USA with Saudi Arabia (a bilateral agreement covering ownership, production and marketing which managed to stabilise the price of oil at US$15 per barrel by 1978).

- In Dec 1985, the price of a barrel of crude oil was US$30; in Aug 1986, it fell to less than US$10 per barrel. The period of 1985 to 1986 was termed the 'reverse oil shock'.

- The collapse of the oil cartel in the 1980s, the transformation in global energy markets and the political disunity in the Arab world have made the notion of the 'Arab oil weapon' a distant memory by the late 1980s.

- However, the next Persian Gulf crisis in the form of the Iraqi occupation of Kuwait in Aug 1990 sent oil prices sky-rocketing once more.

- In conclusion, while power did shift away from OPEC, the organisation was far from finished as an economic and political force.

10. What About the Soviets?

- The mid-1970s were a time of crisis and economic disruption for the West. Comparatively, it *seemed* as if the USSR was at the peak of its power relative to the West at this time.

- While the USA was troubled by the Watergate scandal, the resignation of Nixon and plagued by the Vietnam Syndrome, the USSR expanded its influence in Africa (Angola, Ethiopia) and South Vietnam fell to communism in 1975.

- *But* in many ways, the possession of vast reserves of oil by the USSR was a curse rather than a blessing, for it masked the inefficiency of the Soviet economy and removed the incentive for them to modernise.

- The West, on the other hand, *had* to modernise, adapt and re-structure: they became more energy-efficient; weak sectors of industry were closed; they developed a 'post industrial' economy.

- In essence, the oil crises were a turning point in global history in more ways than one.

11. Measures to Liberalise Trade after World War II

11.1 What is Free Trade?

- Free trade is a market model whereby trade in goods and services between (or within) countries flow unhindered by government imposed restrictions. The key focus of free trade is the concept of 'open markets'.

- Proponents argue that the advantages are that free trade achieves maximum economic efficiency and overall productivity gains.

11.2 GATT and its impact on Free Trade?

- In 1947, 23 nations concluded the General Agreement on Tariffs and Trade (GATT), which took the form of simultaneous tariff concessions by all the contracting parties. Non-discrimination and reciprocity were emphasised, meaning that any reduction granted to one trading partner was automatically applied to all others.
- World trade flourished following the 'Kennedy Round' of 1964-7, which led to the reduction of non-agricultural tariffs among industrial countries by one-third and to an average tariff of 10%.
- However, early agreements by GATT targeted certain products but were not applied across the board, leading to certain countries protesting that their interests were neglected or compromised.
- The 'Tokyo Round' of 1973-9 made more comprehensive headway, with attendance by 83 countries plus 25 observers; cuts in tariffs of 25-30% were agreed, bringing average rates down from 7% to 5% over the next eight years.
- Measures to remove some non-tariff barriers were also agreed on; Third World countries were to receive more flexible privileges; measures for health, safety and protection of the environment were also debated.
- But there was no agreement on a code for 'voluntary export restraints' (i.e. agreements by exporting countries to limit shipment of a particular product to another country, usually to avoid the imposition of an even more onerous retaliatory trade barrier) and little agreement on agricultural products.
- 'Unfair practices' and a whole range of other industries, especially service industries (e.g. telecommunication, aviation, shipping), were included in the 'Uruguay Round' of 1986-1994 (attended by 125 countries). There were substantial reductions in farm support.
- It was calculated that if all terms of the Uruguay agreement were carried out, it would increase world trade by 12%.
- On 1 Jan 1995, GATT was replaced by the more formalised institutional structure of the World Trade Organisation (WTO).

12. The Rise of Protectionism in the 1970s and 1980s.

12.1 The Global Economic Context in the 1970s and 1980s

- The US economy was running into trouble, with growing trade and budget deficits. Developed countries, such as Japan and those in Western Europe, were outstripping the USA in terms of the volume and quality of production, emerging as strong economic competitors.

- Asian NIEs were rapidly rising as significant regional and global economic players, flooding the traditional western industrial powerhouses with cheaper products.

- The third world was starting to industrialise, with significant economic and technological assistance from the West.

12.2 What is Protectionism?

- Protectionism is the economic policy of restraining trade between nations, through a variety of methods, but chiefly through imposition of high tariffs on imported goods.

- Non-tariff barriers also help countries evade free trade rules that restrict the use of tariffs.
- Examples include:
- State subsidies to domestic industries, especially those producing for exports or manufacturing import substitutes;
- Foreign exchange controls;
- Restrictive licenses;
- Restrictive quotas on imports;
- Bans on imports which do not meet national health, safety or environmental protection standards (e.g. EU restrictions on genetically modified organisms or beef treated with growth hormones).

- By 1987. some 28% of all trade in industrial countries was affected by non-tariff barriers, which are less visible and much less controllable than tariffs. NTBs are more difficult to bargain about and to remove.

- Protectionist policies were favoured by developing countries in a bid to speed up industrialisation and catch up with developed countries. The assumption was that domestic infant industries could grow if protected against cheaper foreign imports.

- From the 1970s, there were increased pressures in developed countries to jettison overly liberal trade practices and embrace protectionist measures as well.

12.3 Reasons for Rise of Protectionism

- Besides the increased use of non-tariff barriers in the 1970s and 1980s as well as the adoption of import substitution industrialisation (ISI) policies by newly developing countries, the rise of the overall levels of protectionism on a global scale can be attributed to the following.

12.3.1 Economic Slowdown in Developed Countries

- The 1970s oil shocks resulted in recession, slowdown and unemployment in the developed world.

- Governments had to create millions of jobs in the public sector and pumped billions of dollars into struggling economies. Between 1971 and 1983, the average industrial country's government increased spending from 33% to 42% of the economy.

- Few governments could afford to raise taxes to cover expense, so budget deficits crept up. However, deficit financing was not a permanent solution and states had to look at long term measures to protect their domestic industrial capacity against that of foreign competitors.

- During the period 1966-1986, the share of imports restricted by non-tariff barriers increased by 20% in the US, 40% in Japan and 160% in the EU.

- In the US, the Omnibus Trade Act of 1988 required the US administration to identify "unfair" trade barriers most harmful to American exporters. The administration had 12-18 months to negotiate the removal of these trade barriers. If unsuccessful, the administration could levy tariffs of up to 100% on selected imports from an offending country.

12.3.2 Increased Competition among Developed Countries

- Certain actions taken by countries and regional trade groups against one another have led to a deterioration of relations and the threat of retaliatory, protectionist measures.

- These actions include:
    - The determination of successive US administrations and the EU Commission to protect farming interests in their countries, which led to sharp disagreements between the

USA and the EU on a number of occasions.

- The persistent, large and growing US trade deficit, which led to harsh words between the USA and Japan in the 1980s and early 1990s.

- These actions include: On the first point, as early as 1957, the Common Agricultural Policy allowed members of the European Economic Community (which later became the EC in 1967 and the EU in 1991) to guarantee prices of agricultural products within the customs union, which in effect protected high-cost French and German farmers against US competition.

- This was a major factor in the early growth of protectionist sentiment in the USA and of the threat of 'trade wars'.

- On the second point, American political and economic leaders have decried the trade imbalance between the USA and Japan and placed the responsibility on what they saw as unfair tactics employed by the Japanese, such as 'dumping' goods in the American market.

- The Japanese have defended themselves by arguing that the trade imbalances simply reflect higher Japanese standards of quality and greater efficiencies in the manufacturing process.

- From the mid-1960s, the trade balance has indeed been in Japan's favour and continued after 1985, gravely straining economic relations. In the late 1970s and 1980s, Japan was making a serious bid to become the largest economy in the world, with competition focused on the manufacturing sector, particularly consumer electronics, automobiles, and information technology.

- In the late 1970s, calls emerged in the USA for retaliation against the Japanese, with the Japanese threatening to respond in kind. High-level trade talks between the two countries dragged on for several years, hampered by the USA threatening a number of anti-Japanese trade laws.

- The Japanese in turn complained of American discrimination and incompetence and of being made the scapegoats for inefficient and non-competitive American manufacturing industries.

- Eventually, the US lost dominance in consumer electronics but salvaged its auto-manufacturing sector, through bilateral trade arrangements that set import quotas on imported Japanese vehicles but allowed Japanese auto production in the US.

12.3.3 Competition from Developed Countries

- The Asian Newly-Industrialising Economies (NIEs) had become major trading partners of the western developed countries by the 1970s.
- In these NIEs, factors of production such as labour and raw materials were cheaper to obtain, and so comparable goods could be produced at lower cost.

- By the late 1970s, South Korea and Taiwan were flooding world markets with toys, clothing, furniture and other simple manufactures. Between the 1970s and 1990s, they had progressed to selling sophisticated mid-market industrial products.
- Because these Asian NIEs were export-oriented and producing at competitive prices, countries such as US, Japan and EU member states had to respond with protectionist measures, such as quotas and import duties (which were low for raw materials but higher for processed commodities).
- More recently, from the 1990s, the economic rise of China has been seen as a threat to the USA, with cheap Chinese exports flooding the American market and leading to a huge trade imbalance between the two countries.
- The USA resented the 'loss' of jobs to cheap Chinese labour and, in particular, the non- enforcement of laws in China against intellectual piracy.
- The latter problem centred round alleged Chinese piracy of American products, costing US firms over $1 billion in lost sales. The pirated copies are sold not just in China, but also internationally, undercutting American producers and copyright holders in turn.
- In 1995, there was talk of a 'trade war', whereby the USA imposed 100% tariffs on $1.08 billion worth of Chinese goods and the Chinese retaliated by saying they would impose 100% tariffs on American video games, compact discs, cigarettes and alcohol.

12.3.4 Domestic Political Pressures for Protectionism

- Protectionism is also deeply rooted in the domestic politics of nations throughout the world, and special interest groups may pressure their governments to impose import protectionism in return for political support.
- For example, in the USA in the mid-1970s, President Nixon promised protection to the textile industry in exchange for its support during his campaign for re-election.
- In France, powerful farm lobbies often successfully pressure the

government to retain significant agricultural subsidies and scupper plans to reform the CAP.

12.3.5 Weakening US Political Will and Economic Capacity to Maintain Free Trade

- With the collapse of the Bretton Woods system, the waning of US economic and political power and the diffusion of global economic power following the rise of the EU and Japan, the international trade regime suffered from a real lack of leadership.

- The EU and Japan, though economically-prominent, still lacked the political clout and ability to replace the USA in the international economic regime.
- The EU was not a state and therefore did not have a strong central authority to determine commercial policy. It was riddled with internal strife. As a comparatively-small country with a troubled political reputation and a firmly-held protectionist streak, Japan was simply not influential enough.
- Following conclusion of the Tokyo Round of 1973-9, which was far from satisfactory in removing barriers to free trade, the next GATT round did not convene until the second half of the 1980s, when the US slowly recovered its confidence in international politics and the global economic system.
- In the meantime, protectionism seemed to be a rising trend in international trade.

12.4 Impact of the Rise of Protectionism and Implications for Free Trade (Counter Argument)

12.4.1 Benefits of Protectionism

- Protectionism is not irredeemably bad, as its proponents would attest. There are two main arguments for protectionism: the 'infant industry' argument and the 'domestic protection' argument.

- The 'infant industry' argument outlines the need for temporary protection of such industries so that they can form a comparative advantage, grow and eventually survive.

- Although this means a reduction in free trade, which would otherwise bring about transfer of advanced technology, managerial expertise and diversified imports, this was a worthwhile trade-off. When infant industries become self-sustaining, protectionist measures would be removed and competition and efficiency are restored.

- The 'domestic protection' argument states that because free trade and increased global competition can result in structural unemployment, it is necessary for national governments to protect domestic industries and prevent dumping, so as to sustain domestic employment levels and thus ensure the defence and self-sufficiency of the nation.

12.4.2 Disadvantages of Protectionism

- In the meantime, protectionism seemed to be a rising trend in international trade. This is not an exhaustive list and will not be elaborated in great detail, as this is ultimately not an economics course:
    - Misallocation of resources by government when imposing protectionist measures, hampering overall efficiency of the national economy;
    - Over-reliance on government subsidies, resulting in complacency and inefficiency in industries;
    - Reduction in overall level and scale of technology shared between countries, in a bid to out- compete one another, thereby resulting in slower rate of technological innovation and duplication of effort;
    - High prices and limited choices of goods for consumers;
    - Decline in diplomatic relations between countries as a result of retaliatory measures and 'trade wars'.

12.4.3 Development of Regional Trade Groups as a Means to Balance Free Trade and Protectionism

- Despite the strengthening of multilateral trade rules by the successful completion of the Uruguay Round, at least a hundred regional trade groups has been formed by the end of 1994, nearly a third of them in the previous five years.

- Besides the EU which had been discussed above and the ASEAN Free Trade Area (AFTA) which some of you may come across in Paper 2, the more prominent regional trade blocs include:

- The Asia-Pacific Economic Cooperation Forum (APEC). This was established in Nov 1989 and has 18 members, including the USA, China, Japan, the Asian NIEs, the five founding ASEAN members, Australia and NZ. Agreement on farming permitting, APEC hoped to achieve free movement of capital and goods among developed countries in the region by 2010 and to have drawn in developing countries by 2020.

- The North American Free Trade Area (NAFTA). This was created in Dec 1992 and consists of the USA, Canada and Mexico. By 2000, this represented a market of over 400 million people, combining the technology and finance of the USA with the natural resources of Canada and the cheap labour of Mexico.

- These blocs were formed to facilitate multilateral economic negotiations among members and with the hope of obtaining more leverage in global economic negotiations.

- While supporters argue that they promote liberalisation among members (and thus free trade in the world as a whole), opponents argue that they distort world trade and are an impediment to genuine international free trade.

12.4.4 Continued Commitment to Free Trade Regimes and Norms

- Despite the alarming trend of protectionism, free trade is not in retreat. Even with the contraction of many Asian economies following the Financial Crisis of 1997, the volume of trade in goods and services grew by 3.6% in 1998.

- Protectionism was not a major impediment to imports flowing into traditional markets: in 1998, imports grew by 10.5% in Canada and the USA, 7.5% in the EU, 9.5% in Latin America and 10% in the countries of the former Soviet bloc. (Good Evidence) Trade volume still grew.
- Increasingly, developed countries have regarded imports as vital for helping keep inflation in check and providing the competition that could spur productivity. (E.g. it was the import lobby that ended US restraints on steel in the early 1990s.)

- Furthermore, advanced countries are one another's major trading partners (e.g. 3/5 of US imports come from Canada, Europe and Japan; 4/5 of US exports are bought by other developed nations), making any flirtation with protectionism particularly vulnerable to crippling retaliation.

- Protectionism is also harder to impose because international trade rules at the end of the 1990s were much more stringent than they were a decade before: commitments made in the Uruguay Round make it difficult to erect traditional trade barriers; establishment of WTO dispute settlement mechanism exerts new discipline on national trade practices.

12.4.5 New Opportunities for Protectionism

- While trade imbalance is one of the factors accounting for the rise of protectionism, this section examines trade imbalances between the USA and its trading partners specifically.

- Given that the USA is the most prominent player in the global economy for the second half of the 20th century, we need to understand how economic problems emerged for the country in the 1970s and 1980s and, subsequently, how such problems had a major impact on its ability to dominate and lead the international economic system.

- The trade imbalance between the US and other developed countries, most notably Japan and West Germany, was an ironic reflection of the 'success' of America's post-war commitment to rebuild their shattered economies.

- Rebuilt from scratch, the industries of West Germany and Japan began to outperform the older, less modern factories of the USA, seizing an increasingly large share of the world market. America was also experiencing competition from the Asian NIEs.

- Merchandise exports from the USA fell to 18% of the world total, while cheaper goods from abroad flooded the American market. By 1972, the USA was experiencing a $10 billion balance of payments deficit, threatening the credibility of the American gold reserve and of the dollar.

13. Causes of US Trade Imbalances

13.1 Weakening of the US Economy in the 1970s

- In the 1970s, the US economy suffered from a phenomenon known as 'stagflation' – a combination of stagnant (or even falling) output and rapidly rising prices.

- Unemployment rose, the standard of living fell, prices rose—the USA seemed to be in serious economic decline.

- What were the reasons for the decline:
    - Government spending on the 'Great Society' programmes (social welfare).
    - Government spending on the Vietnam War.
    - Government refusal to raise taxes, resulting in budget deficits.
    - Consumer spending over which over-heated the economy.

- Unemployment rose, the standard of living fell, prices rose—the USA seemed to be in serious economic decline. Following a slew of ill-advised financial policies implemented by President Nixon, inflation skyrocketed to 8% at the beginning of 1973 and to nearly 10% at the end.
- On top of these, there were long-term problems of declining productivity and changes in employment patterns and the short-term problems of the two 'oil-shocks' of 1973-74 and 1979.
- During the period 1972-78, industrial productivity in the US rose by only 1% per year (the average had been 3.2% between 1948 and 1955), compared to a 4% annual average in West Germany and 5% in Japan.
- US spending on imported oil rose from $4 billion in 1970 to $90 billion in 1980.
- As a result, the US economy experienced two periods of recession, one from 1974 to 1975 and another from 1979 to 1983.
- This decline was thrown into sharper relief when juxtaposed with the rise of the European and Japanese economies, which apart from the recession of 1974-75, prospered as the American economy declined.

13.1.1 Budget and Trade Deficits

- The USA's 'twin deficits' — budget and balance of payments — began to grow for a number of reasons.
- In the late 1940s and early 1950s, it had spent vast amounts of money on the reconstruction of Europe (the Marshall Plan) and of Japan.
- At the same time, American spending overseas grew because of its military commitments, a situation which became particularly severe in the late 1960s with spending on the Vietnam War exceeding $2 billion per month.
- Domestic spending was also significant because of the large increase in social spending such as 'War on Poverty' and the 'Great Society' programme. The Johnson and Nixon Administrations resorted to deficit spending.
- By 1971, the USA, which for decades had always exported more

than it had imported, saw its trading account go into deficit (its payment account had been in deficit for some time).

- In the 1980s, the Reagan administration massively increased its defence spending and at the same time cut taxes. This led to an explosion of the budget deficit and a consequent vast increase in the USA's overseas debt.

- Between 1983 and 1986, deficits hovered around $200 billion, nearly three times the level in 1980.

- This resulted in a rise in Protectionism Among Trade Partners.

13.1.2 Currencies Under-Valued Vis-à-vis the US Dollar

- Throughout the 1970s and the 1980s, the US was experiencing historically high deficit levels.

- A tight monetary policy was imposed to control currency flows and this in turn pushed interest rates to record levels.

- High interest rates served to attract foreign funds, driving up the exchange rate of the US dollar.

- Eventually, a strong US dollar discourages exports (US products become too expensive for foreign consumers) but promotes imports (because the US dollar is so strong and can buy a whole lot more imports), leading to a trade deficit (since imports exceed exports).
- Faced with such huge trade deficits, the US could do several things: cut spending, raise taxes or devalue the US dollar.

- A strong US dollar also discourages investment by other countries in the US, but promotes US FDI in other countries, meaning that capital flowing out of the US exceeds capital flowing in. Hence, the choice became quite clear.

13.2 US Response to the Trade Deficit and Its Consequences

13.2.1 US Abandoned Parity in 1971- Collapse of the BWS Fixed Exchange Rates System

- On 15 Aug 1971, the US suspended indefinitely the commitment to fix the US dollar to the gold standard, ending the Bretton Woods system of fixed exchange rates pegged to the US dollar.

- Over the next few months, the dollar dropped about 10%.

- Nixon reinforced the impact of devaluation by imposing a 10% import tax to protect American producers, and he also introduced wage and price controls.

- Although the major financial powers attempted to patch together a reformed Bretton Woods system, in 1973 the Nixon administration again devalued the dollar by 10%.

- Trade moved back into surplus, the economy picked up speed and unemployment declined.

- However, while this had a positive effect for the American economy, trade partners of the USA were not so happy with the outcomes because it meant that the trade balance had shifted.

13.2.2 Joint Effort to Manage Exchange Rates: The Plaza Agreement of 1985

- Following the collapse of the Bretton Woods system of fixed exchange rates, there existed more than a decade of floating exchange rates and severe disequilibrium in the world economy.

- In the midst of such difficulties, world leaders needed to create a system for coordinating their behaviour.

- Beginning in 1985, the new US Secretary of Treasury James Baker moved to organise an international effort to lower the value of the dollar. This was a move primarily meant to adjust the large trade imbalance between the US and Japan.

- In a meeting at the Plaza Hotel in New York, the finance ministers and central bank heads of the G-5 (US, Germany, Japan, France, Great Britain) orchestrated a collective effort to increase the exchange value of the main non-dollar currencies.

- This was to be accomplished by coordinated market intervention; each country pledged a substantial sum of foreign exchange for this operation.

- Although initially scheduled for six weeks and a 10-12% drop, the dollar’s fall actually extended until Dec 1987. Between Sept 1985 and Jan 1987, the dollar fell from 240 to 140 yen and from 2.8 to 1.8 deutsche marks.

- Finally, in Feb 1987, at the Louvre, in Paris, the US reversed its position and reached an agreement to support a stabilisation of its currency. This proved ineffective until after the stock market crash in Oct of that year.

14. Dependency on the USA

- The world was far too dependent on the USA for a stable trade and financial regime and a decentralisation of economic leadership and power was necessary. This was something that the international economic institutions and regional blocs could undertake.

- The USA was not immune to severe economic dislocation, especially with its expanding political role.

- When faced with what it perceived to be unfair competition, the USA can compromise on its own liberal capitalist ideals and impose counter-intuitive measures such as the introduction of protectionism and market intervention.

15. Causes of the Debt Crisis

15.1 The Concept of Third World Debt

- Debt is not a new concept which appeared only in the 1970s.

- Many developing countries incur debt in the hope of making an investment that will produce enough money to pay off the debt (as well as interest payments on the loans) and to generate economic growth that is self-sustaining.

- Where the loans are well-used and conditions in world markets favourable, the production derived from the capital investment created by the original loans should provide a surplus.

- Where the investments are less soundly based, or the money had been used wastefully, no such surplus arose and the borrower country would be faced with the need to find foreign currency to service the loan, on top of its original difficulties.

- The characteristic of developing country debt prior to 1973 was that it was largely the international financial institutions (e.g. World Bank, IMF) that financed and guided the countries on the use of loans.
- However, in the 1970s, the easier loans provided by western commercial banks led to the proliferation of external debt owed by Third World countries.

- Poor investment decision, corruption and a lack of monitoring by creditors eventually resulted in the spiralling of debt and the eventual debt crisis of the 1980s, whereby debtor nations were no longer able to service the loans.

- In 1992, the fifteen most severely indebted nations were: Algeria, Argentina, Bolivia, Brazil, Bulgaria, Congo, Cote d'Ivoire, Ecuador, Mexico, Morocco, Nicaragua, Peru, Poland, Syria and Venezuela.

15.2 Reasons for Increased Borrowing by Developing Countries in the 1970s

15.2.1 Economic Problems of the Third World

- The colonial legacy left many Third World countries with a variety of problems:

  - Natural resources were exploited, with profit going to the metropolitan countries rather than used for re-investment and development in colonies;

  - Over-reliance on the export of low value-added primary products meant that profits were minimal;

  - Lack of economic diversification due to concentration on a few cash crops or extraction of a single major mineral resource (e.g. tin in Malaya and copper in Northern Rhodesia) made them vulnerable to dramatic fluctuations in commodity prices on the world market.

- After independence, the Third World's demand for manufactured goods grew more rapidly than the First World's demand for raw materials, as the former needed manufactured goods for industrial development, whereas the latter had already reached a stable level of consumption that could fulfil its basic needs.

- This led to unfavourable terms of trade for the Third World. For instance, in 1973, it took one Latin American cow to buy one barrel of oil; in 1983, it took nine. In 1970, it took one ton of bananas to buy on steel bar; in 1980, it took two tons.

- The problem was worsened when Third World countries exporting similar products competed fiercely amongst themselves for ever larger world market shares—each poor country constantly tried to produce more, which resulted in the world market being saturated with their products.

- Under-cutting of competition contributed to falling prices, which fell by 18% in the first half of the 1980s, cutting $40 billion from Third World incomes every year.

- Protectionist measures erected by the First World countries exacerbated the situation for the Third World. These took the form of quotas and import duties which were low for raw materials but higher for processed commodities.

- For example, to sell pineapples within the European Community, a Third World producer faced a tariff of 9%; to sell tinned pineapples it had to pay 32%; and to sell pineapple juice 42%.

- This severely hampered the development of processing industries within the Third World.

- Against such a backdrop, Third World countries desperately needed funds both to sustain short- term spending and for long-term industrialisation drives.

- While such loans could be obtained from the international financial institutions such as the World Bank and IMF, the attachment of stringent conditions to such loans made many developing countries loath to borrow from them.

15.2.2 Availability of 'Petrodollars'

- During the oil shocks of the 1970s, the quadrupling of the price of oil by OPEC sent world markets tumbling but enriched the oil producers.

- The vast extra revenue (far more than they could spend) which the oil producers earned—dubbed 'petrodollars'—were deposited in Western banks. OPEC members deposited much of it—about $150 billion between 1974 and 1980—into the world's financial markets.

- The banks then had to move quickly to re-lend them, so that they could earn the interest needed to pay OPEC.

- Only the Third World, with its insatiable demand for capital for industrialisation, seemed like a likely customer for such a large amount.

- With the increase in oil prices, many Third World countries felt the pinch and borrowing more money was one attractive solution.

- Even oil producing countries in Latin America (e.g. Mexico, Venezuela, Colombia and Ecuador) saw loans as a way to capitalise on their much improved financial status and they assumed that high oil prices would last for a while.

15.2.3 Low Interest Rates

- With the arrival of petrodollars, there was so much money and so few borrowers that the banks began to compete savagely for business.Thus began the lending frenzy of the 1970s so that they can profit from these new deposits.

- They started to offer Third World governments cut-price interest rates—often, in real terms, negative rates when set against the rate of inflation. In effect, the banks were paying people to borrow from them.

- Banks lent money to Third World countries based upon hopes that the ambitious development schemes espoused by government planners would fuel rapid Third World growth and export expansion.

- Such misplaced optimism was obviously shared by bankers and borrowers alike, but such faith was shattered when it became clear that too little of the funds borrowed from the banks found their way into projects capable of reaping profits.

16. How the Debt Crisis Developed

- Third World debt became a problem and turned into a crisis situation where Third World borrowers were not able to keep up with loan and interest repayment and saw the need to default. What were the factors that gave rise to such a situation?

16.1 Drying up of 'Petrodollars'

- 'Petrodollars' were lent out readily by Western banks keen on making a profit from the vast deposits.

- Besides this, Arab oil-exporting nations used their surpluses to fund foreign aid programmes, with Arab nations being one of the largest donors of foreign aid since 1973.

- The IMF also introduced a new lending facility called the Oil Facility during the period of oil boom; this facility was funded by oil-exporting nations and other lenders and was made available to nations suffering problems with their balance of trade due to the rise in oil prices.

- The petrodollars which were so abundant thus dried up, limiting future loans offered by banks originally flooded by petrodollars. This created difficulties for Third World debtor nations attempting to borrow more money to service their loans or for further development.

16.2 Slowdown of the US Economy and Increase in US Interest Rates

- Can you recall what were the reasons for the USA's 'twin deficits' by the 1970s– budget and balance of payments.

- The USA's economic problems continued into the 1980s, and were aggravated by Reagan's increase in defence and foreign policy expenditure and tax cuts.

- Following the second oil shock of 1979, in an attempt to control inflation and to attract capital into the US to finance the deficit, the Federal Reserve raised the interest rates in 1981.

- Interest rates were pushed continually higher, and within six months, they had risen to 19.5%. This precipitated a rise in interest rates throughout the world as well.

- Higher interest rates caused a serious strain on the borrower countries which had to make loan repayments annually. The burden became more acute with the constant rescheduling of existing debts.

- Between 1978 and 1983, Latin America's total interest payments rose by 360%. By 1984, every one per cent rise in interest rates was adding $700 million to the annual payments of Brazil alone.

- President Obasanjo of Nigeria, speaking in 2000: *"All that we had borrowed up to 1985 or 1986 was around $5 billion and we have paid about $16 billion yet we are still being told that we owe around $28 billion.* ***That $28 billion came about because of the injustice in the foreign creditors' interest rates. If you ask me what is the worst thing in the world, I will say it is compound interest****."*

- The share of export earnings which had to be diverted to service the debt for all developing countries together rose from 16% in 1977 to 25% in 1982.

16.3 Reduced Export Earnings for Developing Countries

- Due to the effect of the oil shock, a global recession happened from 1981 to 1982.

- The global demand for exports, especially from the developing countries plummeted, which put even more strain on the Third World economies.

- The cumulative effect on the Third World countries was truly devastating: commodity prices dropped 28% in the period, while interest payments on loans increased by 50% in nominal terms and 75% in real terms.

- This created a problem for debt servicing because the developing countries tended to have soft currencies (meaning that the values can fluctuate); paying off loans therefore depended on the ability to earn foreign exchange in hard currencies.

- But with the falling export prices, debts became harder to pay off.

16.4 Mismanagement of Loans

- Besides the external factors, internal developments contributed to the debt spiral for the Third World.

- The money that was borrowed by these developing countries were not all being spent on economic development.

- When the first oil crisis broke out, much of the loans were spent on buying oil at the new inflated prices. According to one estimate, the extra cost of this oil was $260 billion, out of an increased debt of $482 billion between the years 1974 to 1982.

- By the late 1970s, a large amount went to repaying the interest which soared on the loans.

- Between 1978 and 1983, Latin America's total interest payments rose by 360%. By 1984, every 1% rise in interest rates was adding $700 million to the annual payments of Brazil alone.

- Money was also stolen by corrupt leaders and stashed away in their bank accounts in Switzerland, New York or Miami. The Financial Times estimated that between $150 billion and $200 billion disappeared in this way between 1974 and 1985.

- About 20% of the loans were also spent on weapons and military use.

- Little went to economic development, which was why First World countries were reluctant to write off the loans.

16.5 Explosion of Debts Due to Unchecked Lending and Borrowing

- Although saddled with huge debts, the developing countries continued borrowing at first, just to get cash to pay the interest on their debts.

- Loans were also easily acquired, due to the growth of the money market in Europe. A vast amount of dollars was circulating in the European financial markets, as governments placed minimal regulatory restrictions on banks to prevent irresponsible and indiscriminate lending.

- There had been no coordination between the banks and so no one knew how serious the overall problem had become and the banks themselves continued to lend at higher and higher interest rates and so reaped higher and higher profits.

- In an increasingly frenetic atmosphere, loans were made which were increasingly dubious. Basically, the banks assumed that sovereign debt was a good risk since there was a belief that the countries would not default.

- So, elementary precautions which any domestic bank manager would take before lending a private customer were thrown out of the window on the grounds that 'countries could never go bust'.

- A time-bomb was waiting to explode, with total outstanding external debt of the developing countries increasing inexorably from $636 billion in 1980 to $1,017 billion in 1985 to $1,601 billion in 1993.
- To put things in perspective, in 1990, debt and interest payments due from the Third World were three times more than all the aid they received; the poorest people in the world paid the richest people in the world $42.9 billion more in debt repayment than they received in aid.

- What seemed bizarre about the situation was that in the last years of the Cold War era, flow of capital was from the poor world to the rich and not the reverse as one would expect!

17. Default on Loans in Latin America and the Impact on the Global Financial System

17.1 Default on Loans in Latin America

- The debt crisis had its centre in Latin America. Unlike some other countries, especially in the Far East and Europe, which reacted to the oil crisis by tightening their belts, the Latin American governments did not cut back on consumption, but instead borrowed more to keep going at the old rate.

- The external debt of the government sector in all Latin American countries together rose tenfold between 1973 and 1983, while that of their private sector rose fourfold.

- Hyperinflation followed in several of the larger countries in the region, with a massive flight of capital as the consequence.

- On 13 Aug 1982, something which no one thought possible happened—a default. The Mexican government announced that it had run out of cash and could borrow no more and was going to default on its debts.

- Up until then, Mexico was considered one of the safest debtor countries. A major country had gone bust, and this threatened the stability of the financial system of the whole world.

- In Feb 1987, Brazil also announced that it could no longer meet its debts. Brazil was the world's largest debtor, so its cessation on repayments of both interest and capital sent shock-waves through the world financial system.

17.2 Impact on the Global Financial System

- At the start of the debt crisis, the banks that had so irresponsibly lent all this money did not suffer. On the contrary, while debtor nations continued to borrow to finance their payments, the banks just made even higher profits.

- However, with the loan defaults in Latin America, the problems engulfing everyone else finally caught up with the banks.

- The value of several major banks fell on the stock markets of the world. Behind the scenes, bankers began to stop the practice of lending new money to debtor nations to help them pay the interest on the first loans.

- Then, out of the blue, the world's biggest bank, Citicorp, suddenly announced that it was to register a $2.5 billion loss in order to put money (which should have been profits) on one side in case some of its Third World debts were never repaid.

- This move took the banking community by surprise, but soon other banks were obliged to follow its lead and within two months all the major US and British banks had increased their loan loss reserves by 25% to 30%.

- Finally, the banks acknowledged that the enormous debt might never be repaid, but the amount of debt, and the repayments expected from the Third World, remained the same.

- Unlike lending by states, private commercial banks do not simply write off loans as a gesture of political goodwill.

18. Attempts to Resolve the Debt Crisis

18.1 The Need for a Solution

- Third World debtors could not simply refuse to pay what was regarded as an unfair debt because a whole barrage of crippling economic and political reprisals would be directed against the defaulter.

- For example, financial institutions would cut off any defaulter from the short-term credits a nation needs for buying the products necessary for daily survival.

- While immediate help to debtor nations was offered by the IMF, in the longer term, the problem of the debt crisis was solved by 'rescheduling'.

- 'Rescheduling' usually meant a reduction in the interest rates payable and a lengthening of the repayment period so that the annual burden was lightened. It also commonly involved new lending to get through a critical transition period.

- The threat of instability to the whole world's financial situation also led Western politicians to suggest more structured solutions.

18.2 'Bail-Out' Loans from IMF

- In 1982, over twenty countries affected by the debt crisis were frantically renegotiating with banks and the IMF to find suitable repayment solutions.

- A debtor nation would go to the IMF to plan a programme of macroeconomic stabilisation and economic adjustment. Both would agree on targets for inflation, government spending, budget deficits.

- If the IMF was satisfied that the government was going to change policies, the fund would lend a small amount of money, in instalments, which could be halted if the government failed to meet its commitments.

- In effect, this forced Third World governments to be more accountable for their own economic management policies as well as assume greater responsibility for debts contracted by private commercial firms in their countries.

- Private international bankers regarded an IMF agreement as a seal of approval and required debtors to go to the fund before they would renegotiate debts.

- By the end of 1983, 17 Latin American countries had adjustment agreements with the IMF. Mexico was bailed out by a package agreed between the US government, the banks and the IMF. This was regarded as a model to be replicated for other countries.

- The IMF emerged more and more as the world's financial policeman, the guarantor of the creditworthiness of the countries. In the past, it had used its 'own' money to assist countries with balance of payment problems, but now the emphasis was also on creating conditions to assure continued payments to private lending institutions.

- Austerity drives were introduced in indebted countries—these included measures such as reducing subsidies on basic foodstuff and other necessities as well as restraining wages.

- For example, in Santo Domingo, people found that the price of cooking oil doubled overnight. In Manila, bus drivers had to greet their customers one morning with the news that fares had risen in one leap by 30%. In the northeast of Brazil, peasant farmers arrived to collect their credit payments for fertilisers, only to find that they had been abolished in an IMF programme. In Mexico, accidents and injuries increased substantially as the oil industry was put into overdrive to produce exports to pay debts.

- While austerity drives seemed like a sound solution in theory, the criticism of such 'bail-out packages' are as follows:
  - Acceptance of IMF packages involved drastic cuts in the living standards of the poorest citizens of the world;
  - Commercial banks which had contributed to the situation through sheer greed and abdication of responsibility simply made more money from the rescheduling.

18.3 The Baker Plan

- As the world economy's most influential player, the USA also tried to come up with alternative solutions to complement the work of the IMF. In 1985, US Treasury Secretary James Baker tried to persuade commercial banks to begin making loans to debtor nations again.
- Banks were hesitant to do so following the massive defaults but Baker argued that if lending did not continue at a minimum level, the debtors would not even have the ready cash to pay interest on what they already owed and the whole international banking system would collapse.
- In addition, Baker suggested the World Bank and IMF should lend another $10 billion and the commercial banks another $20 billion to the 15 largest debtors who, in return, would accept IMF monetarist adjustment policies.
- The Baker Plan also advocated a policy of 'structural adjustment' which would entail structural reforms like a shift towards export-led growth, reduction of the state's role in the economy and public sector reforms.
- Unfortunately, the plan foundered for two reasons: the debtor nations refused to submit to the even stricter adjustment conditions and the banks would not come up with the cash.

18.4 The Brady Plan

- Nicholas Brady, the next US Treasury Secretary, suggested that the banks should write off large amounts of the debt (which was unlikely ever to be repaid) in return for smaller amounts of debt- bonds which would be underwritten by the IMF and the World Bank.
- He also suggested changes to US banking regulations to remove existing disincentives to debt reduction.
- The Brady Plan, however, still insisted that countries benefiting from the plan should agree to implement IMF adjustment programmes—a

major stumbling block for the Third World countries.

- Some attempts were made—after lobbying by aid agencies—to make these adjustment programmes more acceptable to the Third World by introducing compensatory programmes to soften the blow on the poorest and weakest sections of the community.

- The Brady Plan proved to be fairly limited in its application but the important thing about it was that, for the first time, it implicitly acknowledged that the Third World debt crisis was not solely the fault of the world's poor.

- Western banks and governments had played a part, too, in creating the problem and, appropriately therefore, it suggested a solution which required banks to shoulder some of the burden by taking losses just as they had earlier taken the profits.

- They were to be assisted in this by Western taxpayers whose money would provide relief for the banks and also funds for the IMF and the World Bank to underwrite the new guaranteed debt- bonds.

19. Impact of the Debt Crisis

19.1 Economic Slowdown in Debtor Nations

- Mexico and other debtor nations had to adopt IMF strategies for reforming their economies.

- For instance, they had to abandon old practices like the import-substitution industrialisation model and adopt the export-oriented industrialisation strategy favoured by the IMF.

- Severe structural adjustment problems resulted. Production levels dropped, while unemployment levels rose.
- Furthermore, continued debt servicing according to IMF-recommended loan repayment schedules resulted in massive amounts of money flowing out of these countries.

- The cumulative effect of all these measures was a decline in average growth in the Third World, from 6.3% a year to 1.7% a year, comparing the period 1965-1980 and 1980-1990 respectively.

19.2 Socioeconomic and Political Problems Caused by Austerity Drives

- By 1989, some 70 countries were struggling under the burden of IMF demands.
- Forced to squeeze domestic consumption in order to free the resources needed to satisfy the debt burden, governments adopted austerity measures that invariably led to the decline in basic standards of living and increase in cost of living.
- Food prices skyrocketed everywhere. In Brazil, the price of beans rose 769% and rice 188% in one year. In Bolivia, the price of bread quadrupled and bottled gas for cooking rose twenty times. Soon, half of Bolivia's children were malnourished.
- Education was also badly hit. In Zaire, 7,000 teachers and in Ghana 4,000 were sacked in order to save money.
- Medical services were worst hit by the austerity programmes as weak embattled governments usually put these on low priority. In Senegal, there was only one doctor for every 20,000 people because newly qualified medical students had to wait four to five years for a job, owing to the axing of medical budget by the state. In Chile, typhoid and hepatitis began to increase due to cut backs in state provision of clean water and sanitation systems.
- After decades of slow but steady improvement in levels of child nutrition and literacy, the situation in much of the Third World in the 1980s began to decline.
- The United Nations children's organisation, UNICEF, estimated that as a result of these budget cuts, a total of one million African children died in the 1980s. Furthermore, throughout the whole of the developing world, an additional 500,000 children died as a result of this in 1988 alone.
- On top of that, there was a rise in the potential for political violence. Many protests against the IMF austerity measures were witnessed and where governments struggled to maintain control, people were killed.
- The debt crisis thus engendered social and political instability in many countries, such that between 1985 and 1992, 56 major 'IMF riots' broke out in various developing countries around the world. Popular demonstrations were common in countries in Latin America, Asia and Africa.

- Political instability also made it harder for democratic governments to survive and this could account for the prevalence of authoritarian governments in Latin America.

- Worse still, such regimes may turn away from market economies, thus putting pressure on the relationship between the debtor countries and the IMF.

20. Conclusion

- As the dominant global economic and political superpower, the United States played a crucial role in bringing about a resolution to this crisis.

- Had the U.S. government not intervened, most economists of the time recognised that the consequences could have been far more severe.

- Additionally, the regulatory forbearance granted to large banks in terms of establishing reserves against nonperforming developing countries' loans proved crucial in averting the possible insolvency of 7 to 8 of the 10 largest U.S. banks—an outcome that would have triggered an economic and political upheaval.

- Notably, no major U.S. bank failed due to these nonperforming loans, underscoring how the crisis, with government assistance, spared the U.S. financial system. Banks consistently managed to secure funding and were granted ample time to rebuild their capital, swiftly returning to normalcy.

- The IMF and the World Bank also played crucial roles in the resolution process. The IMF's role was particularly pivotal in forging a coalition of creditors.

- By establishing clear connections between commercial bank loans and IMF loans, the problem of "free riding" was curtailed.
- This united front enabled creditors to reward cooperative governments with fresh financing while denying additional funds to governments that refused to comply with creditors' terms.

- Furthermore, the intensity of the crisis was somewhat mitigated because debtor governments never collectively threatened default. No single government owed such a substantial amount that a unilateral default would inflict severe damage on U.S. banks or the economy.

- With the exception of Argentina for a brief period, they all maintained a cooperative stance. Substantial funds were raised from the IMF, the World Bank, and other sources to facilitate debt reduction, contingent upon developing countries implementing domestic economic reforms to stimulate growth and bolster their debt-servicing capacity.

- The resolution of the debt crisis stands as a noteworthy achievement in History—a testament to bold decisions, cooperative efforts, and the resilience of nations determined to reclaim their economic stability.