The Middle-income Developing Countries

A dramatic increase in commercial bank lending to Third World countries took place in the 1970s. Contrary to popular belief, this increase was not initially associated with the sudden rise in OPEC oil prices in 1973-74 but with a major commodity price boom in 1972-73. A similar pattern of expanded bank lending appears to have been followed in 1976-78, also in the context of higher commodity prices and prior to the second oil price rise of 1979.

Nonetheless, despite evidence that the spectacular increase in bank lending to developing countries was not actually triggered by the actions of the OPEC oil cartel following the 1973 Yom Kippur War, there is no doubt that the climb in oil prices resulted in very heavy borrowing by many developing countries. For the non-oil-exporting developing countries, it has been calculated that from 1973 to 1982 the extra cost of imported oil amounted to $260 billion.* To cover the large balance-of-payments deficits that developed, countries needed foreign exchange in substantial amounts. Once they had run down the balances accumulated during the 1972-73 commodity boom, developing countries from all parts of the world, but most particularly those in Latin America, turned increasingly to foreign commercial banks for their external financing needs.

Many borrowing countries failed to follow prudent monetary and fiscal policies. At a time when they needed to encourage domestic savings and inflows of foreign or repatriated capital, many actually discouraged such developments by implementing policies that resulted in price controls, subsidies, and overvalued exchange rates. These policies in turn caused increased balance-of-payments pressures that were kept from becoming problems by more borrowings from foreign banks.

In the circumstances that prevailed at the time, however, it was easy for borrowing countries to obtain credit and credit was cheap. Inflation was in the main growing faster than the interest rates charged on borrowed funds. In fact, from 1973 to 1979 real interest rates were close to zero and sometimes even negative. It was the low real interest rates and the falling dollar that made borrowing advantageous, which explains in part why even some oil-exporting countries such as Venezuela and Indonesia became heavy borrowers in the latter part of the 1970s. The high cost of imported equipment associated with energy and infrastructure development was also a factor in the debt build-up of these oil-exporting countries.

For the commercial banks, the decision of the OPEC cartel to exploit its power and escalate oil prices, thereby amassing huge surpluses of what became known as petrodollars, created a new situation. Major oil-exporting countries deposited a large portion of their massive surplus revenues in the banks of the industrialized countries and bankers were faced with the challenge of "recycling" these new funds. The bankers, in turn, loaned many of these deposits to oil- importing countries of the Third World, who were faced with growing oil costs. As the decade progressed, such loans increased heavily. From the banks' perspective, the commodity price boom, the steady growth in the economies of most developing

* William R. Cline, *International Debt: Systemic Risk and Policy Responses.* The $260 billion figure does not include the interest charges on the amounts borrowed to pay for each year's imported oil.