Chapter 18 The Third World Debt Crisis & the International Financial System

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Introduction: The phenomenon of Third World debt

To even the most uninformed observer the Third World debt crisis represents nothing short of a global economic crisis. This crisis, which was recognized as such only six years ago, originated merely fifteen years ago. The accumulation of a large external debt is a common phenomenon among Less Developed Countries (LDCs) which are at the stage of economic development where the supply of domestic savings is low, the current account deficit on the balance of payments tends to be large and imports of capital are vitally needed to augment the rather scarce domestic resources.

Despite the contemporary populist belief that foreign borrowing is a disease rather than a cure,theoretically such borrowing can be beneficial. It can provide much needed resources to promote economic growth and development. But the debts incurred in Latin America and sub-Saharan Africa were often used to finance status projects which brought few benefits in terms of economic growth. Moreover, the costs of borrowing are very considerable. The servicing costs represent a contractually fixed charge on domestic real income and savings. Such servicing charges can only be made with foreign exchange and can therefore only be made through export earnings, curtailing imports and further external borrowing. Under normal circumstances most of a country's debt service obligations are met by export earnings. However, if the composition of a country's imports or exports change, or rate of interest rises, realistic prospects in the dynamic world economy of the 1980's, a corresponding increase in debt service payments will result. The vicious circle of Third World debt is already apparent.

Origins: The global debt crisis in perspective

The global debt crisis represents a very recent phenomenon, originating a mere fifteen years ago. Before the 1970's the external debt of LDCs was relatively small and the majority of creditors were foreign governments and international financial institutions such as the International Monetary Fund, The World Bank, and other regional development banks. Most loans were made on concessional rather than commercial terms and were extended primarily for the purpose of implementing development projects and expanding the importation of capital goods. However, since then the size, form and composition of Third World debt has been transformed. From 1971 to 1983 the total external debt of LDCs has risen from \$90bn to \$817bn, a rise of over 900%. Debt service payments have accelerated at an even faster rate of over 1000%, jumping from \$11bn in 1971 to \$131.3bn by the end of 1982. The seeds of this debt crisis were sown during the 1974-79 period, a period in which there was a virtual explosion in international lending precipitated by the first O.P.E.C. oil price increase in 1973. The spiralling of debt stems directly from the simultaneous need for funds to sustain growth and the extreme eagerness of the international financial system to provide such funds from the bank deposits of their O.P.E.C. clients.

In the years 1967 to 1973 developing countries experienced high growth rates. To some it seems that they were indeed at last 'catching up' with the industrialized world. In particular, newly-industrialized countries such as Brazil, Mexico and Argentina experienced very high growth rates. So they began to import heavily, particularly capital goods, oil and food. The outward looking development strategies that such countries adopted led them to promote their exports aggressively; this occurred, however, on the eve of the first oil price shock, a world recession and, hence, a fall in growth rates in industrialized countries. As a result many developing countries sought to sustain their high growth rates by increased borrowing. Lending from unofficial sources increased considerably, particularly non-concessional lending; official agencies lacked the funds to meet the growth needs of many middle-income and newly-industrialized countries. Additionally, many countries facing balance of payments problems involving an excess of import payments over lagged export revenue were reluctant to approach official sources who might have forced painful policy adjustments upon them. As a result of these factors, numerous developing countries turned increasingly to commercial banks and other private lenders to provide the funds needed for balance of payments support.

This outward shift in the demand curve for international funds was simultaneously matched by a corresponding outward shift in the supply curve for such funds held by commercial banks who during the 1970's held the bulk of the O.P.E.C. oil revenue surplus, a surplus which grew from $7bn in 1973 to $68bn in 1974 and peaked at $115bn in 1980. The commercial banks, flush with such funds and facing low demand for capital from the slower growing industrialized countries, aggressively competed against each other in lending to LDCs.

Herein lies the explanation for the meteoric rise in the total external debt of such countries. However, more significant perhaps than the rise in the absolute size of the debt was the change in the form and composition of the debt. An increasing portion of the debt was made on non-concessional terms - 77% of total debt in 1979, compared to 40% in 1971 - such terms being less benevolent, involving shorter maturities and charging market rates of interest which were often variable. It is not surprising therefore that due to the large rise in the size of the debt and the larger proportion of the debt scheduled on harsher terms, the debt servicing payments of all LDCs trebled from 1975 to 1979, from $25bn to $75bn.

However, despite this large increase in debt servicing obligations the ability of most developing countries to meet their debt service payments remained largely unquestioned due to the international economic climate prevailing in the late 1970's. The combination of a fall in real oil prices due to high inflation, low or negative real interest rates and a rise in export earnings which narrowed the current account deficits of many developing countries allowed such countries sustain relatively high growth rates, averaging 5.2% from 1973 to 1979, through massive borrowing.

Therefore on the evidence presented so far, the surge in international lending following the first oil price shock could be largely termed a success because in an economic atmosphere that could be described as congenial to developing counties, such borrowing allowed these countries to maintain high growth rates with few servicing difficulties by facilitating the recycling of huge surpluses from oil exporters to oil importers through the lending activities of private international banks. This cheerful picture is completed by the fact that such massive lending/borrowing helped dampen the recession in industrialized countries post 1973 by boosting export demand from LDCs seeking Western goods and services.

However if the surge in international lending in the period 1974 to 1979 was to sow the seed, the harvest that was reaped post 1979 was a very bitter one indeed. The second oil price shock in 1979 was to lead to a complete reversal of economic conditions that had been so conducive to the success of international lending in the previous decade. LDCs suddenly faced an abrupt increase in oil prices which added considerably to their oil import bills and affected the prices of industrial imports on which they so vitally depended. The second oil crisis coincided with, or perhaps was the cause of, the emergence of deflationary economic policies in the Western World. Such policies affected LDCs in two critical way. Firstly, the stabilization policies of the Western powers led to a hike in interest rates which led to a similar increase in debt service obligations, obligations which were made harder to meet by the bunching of short maturities arranged during the 1970's. Secondly,a deflationary policies in the West led to a collapse in the major markets for goods exported by LDCs resulting in a decline of over 20% in primary commodity export prices during the period. Therefore the present-day crisis is due to these two vital factors: a sharp rise in the cost of debt servicing and a sharp fall in export revenues to pay such servicing charges.

Faced by this critical situation, Less Developed Countries faced two rather unsavoury policy options: the imposition of fiscal and monetary measures that would curtail imports but restrict growth and development objectives, or finance the widening current account deficits through more external borrowing. Being either unable or unwilling to accept the first option, many LDCs continued to borrow heavily, sinking further and further into a massive debt trap. Alarm bells began to ring in the financial capitals of the world as the impending crisis increasingly came to light. By 1983 the two largest borrowers, Brazil and Mexico, had a total external debt of $93.5bn and $86.6bn respectively. When one considers the export earning of the two countries stood at $17.5bn and $22.2bn respectively, the crisis becomes all the more stark. In August 1982 Mexico informed its creditors that it could no longer keep up its interest payments. Other major debtors followed their stance. The debt crisis had begun in earnest.

The present dilemma: crisis or consolidation?

It was Mexico's shock announcement in 1982 that confirmed the debt crisis as a global problem. Since then numerous solutions have been proposed and the collapse of the world financial system predicted by many has been averted or deferred. However the debt crisis still continues to act as a constraint on development and on poverty alleviation. By the end of 1987 (the most recent figures available) the total external debt of LDCs stood at $1,217bn, an increase of 43% over the total external debt of 1982. Despite a slowdown in the rate of increase of some indicators such as the ratio of interest service payments to export revenue, the situation still remains critical. Any rise in LDCs' exports has just offset the fall in export prices. The real cost to developing countries of their external debt rose from 8.1% of G.D.P. in 1986 to 10% in 1987, while the average growth rate of real G.D.P. in all LDCs fell from 4.2% in 1986 to 3.4% in the following year.

The 'Financial Times' recently predicted that the third phase of the debt crisis was at hand. The first phase, lasting from August 1982 until 1985, was one of crisis management, the main concern being the stability of the world financial system. James Baker, the recently appointed U.S. Secretary of State and then U.S. Treasury Secretary proposed a plan in 1985 that ended the first phase of the debt crisis. Baker argued that debtor countries would never be able to meet their commitments unless they were able to export more and grow economically. The Baker plan set the agenda for the second phase of the crisis. It involved a large increase in loans to LDCs, a greater application of I.M.F. conditionality, and more case by case rescheduling of loan commitments. However, by the end of the second phase the net outflow of funds from LDCs continued. The third phase of the debt crisis, which we are currently experiencing, aims at limiting the net cash outflow from developing countries and encouraging development in such countries by allowing debtor countries greater access to financial markets and by the enunciation of long-term development strategies for these countries. The success of this current phase of the crisis will ultimately depend on stemming the cash outflow.

Recent initiatives to solve the stalemate have experienced varying degrees of success. A five year recovery programme launched by the U.N. in 1986 has had little success in sub-Saharan Africa where debt service payments are projected to reach $45bn per annum by 1995. At the Washington meeting of the I.M.F. and World Bank in September 1987, Nigel Lawson proposed that Western governments write off some past loans to African debtors, a significant shift in emphasis. James Baker echoed Mr Lawson's views in a speech to the African Development Bank in June 1988. In the same month the Toronto Summit of the seven leading industrial nations agreed to a package of rescheduling and the partial writing off of debt to sub-Saharan African countries. In September 1988, UNCTAD (United Nations Conference on Trade and Development) proposed that the debt relief way was the only means of reviving growth and alleviating the debt crisis and called for a once and for all cut of 30% in commercial bank debt which they predict will lead to a 100% fall in the debt to export ratio of developing countries within five years.

Therefore debt cancellation is firmly on the agenda as a means of solving the global debt crisis. This policy is justified on four counts: historical experience of past debt crises; fairness; efficiency and, lastly, considerations of political stability. It is in the interests of all LDCs that this policy is adhered to.

The international financial system: a wolf in sheep's clothing?

To many observers the burden of guilt for the present debt crisis lies not with the economic policies of the borrowers but with the profit motives of the lenders, i.e. the international financial system. By the 'international financial system' we are referring to the institutional arrangements ensuring the world's surplus funds flow to countries in deficit, the rule governing the international exchange rate regime and the mechanisms for creating and distributing liquidity. The arrangements for channelling funds to LDCs involve a wide range of participating entities including international financial institutions, governments, commercial banks and industrial companies.

As already discussed, the range of maturities, currencies and financial instruments offered to LDCs has changed. In general the 1970's was an era of financial liberalization. Deregulation and increased competition led to the increasing globalization of banking. The O.P.E.C. surplus added to the above factors and resulted in the increased involvement of the international financial system in the financial and economic affairs of LDCs. Indeed in the 1970's the desire of the international financial system to lend to them became a stampede. With the benefit of hindsight we can see that the creditors did not question their ability to pay sufficiently.

The second oil crisis led many debtor countries to renegotiate their loan commitments with private international banks in the hope of either stretching out the payment period for the principal and interest and/or obtaining additional finance or more favourable terms. However, most debtor countries have typically been obliged to deal with the I.M.F. as an indication of the debtors' willingness to impose policies to tackle the crisis before a consortium of international banks would agree to refinance or reschedule a loan.

Such stabilization policies tend to be politically very unpopular because they strike at the heart of development efforts by disproportionately hurting the lower- and middle-income groups and because such policies are imposed by an international agency and are therefore perceived by many, particularly those in the Dependency School of Development Economics, as measures primarily designed to maintain the poverty and dependency of LDCs while preserving the global market structure for industrial countries. Cheryl Payer, an economist of the Dependency School, viewed the I.M.F. functions as "the chosen instrument for imposing imperialist financial discipline on poorer nations" (quoted in Todaro, 1986, p557), a system which creates a form of "international peerage" or debt slavery whereby the I.M.F. offers additional funds which will ultimately perpetuate rather than solve the debtors' balance of payment problems. As the debt burden increases the debtor countries are 'blackmailed' into anti-development stabilization policies thus creating a vicious circle of debt in which LDCs must run faster simply to stand still.

The alternative view sees the I.M.F. not as a development or anti-development agency but simply as one fulfilling its original mandate of holding the global capital market together by the pursuit of short-term orthodox counter-cyclical stabilization policies. However such a mandate may perhaps be outdated in the dynamic, international, increasingly global economy of the 1980's. Also the balance of payments problems of many LDCs may be structural and long-term in nature and therefore the adoption of short-term stabilization policies may lead to long-term debt crises. There is no doubt that the I.M.F.'s policies of severe financial regression of debtor countries, whether just or unjust, do impose a harsh and perhaps unnecessary economic burden on countries that can ill afford it.

Therefore the greater flexibility and willingness to modify its prescribed medicine to fit the varied illnesses of its patient is perhaps the most logical and humane course of action for the I.M.F. to take to help it shed its 'wolf in sheep's clothing' image that many people hold of it.

Conclusion: A Third World problem; a global crisis

The Third World debt problems has thus truly become a worldwide problem. The debt crisis of the 1980's has called into question the very existence, stability and validity of the international financial system. Ironically, fears that the imminent collapse of this system in the early 1980's led currency speculators to purchase large quantities of the dollar which inflated its value and added further to the dollar-denominated debt burdens of LDCs.

The debt crisis has underlined the tremendous interdependence of the international financial and economic systems, an economic domino effect with frightening consequences.

Although many LDCs are at least partly responsible for the massive accumulation of debt, the adverse economic conditions they face, in part precipitated by the industrialized countries own stabilization policies, are often beyond their control. Cline has estimated that 85% ($401bn) of the total increase of $480bn in external debt of the non-oil producing LDCs from 1973 to 1982 can be attributed to four factors beyond their control:

1. O.P.E.C. oil price increases;
2. rises in dollar interest rates;
3. a decline in developing countries exports due to the worldwide recession;

4. the dramatic decline in commodity prices and the consequent worsening in the LDCs terms of trade.

Therefore the burden of the global debt crisis must be shared by all. While many debtor countries must undergo a period of painful adjustment, industrial countries must relax their restrictive monetary policies and encourage imports. International organizations such as the I.M.F. must provide sufficient financial liquidity until the economic climate changes and LDCs can make the necessary adjustments. A global crisis requires a global solution.

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