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Towards a solution of developing countries' debt crisis: Strengthening the weakest link

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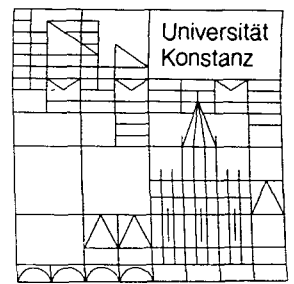
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**Towards a Solution
of Developing Countries' Debt Crisis —
Strengthening the Weakest Link**

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**TOWARDS A SOLUTION OF DEVELOPING COUNTRIES' DEBT CRISIS -
STRENGTHENING THE WEAKEST LINK**

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Abstract

All current proposals and initiatives to a solution of the debt crisis of developing countries focus on the financial problems associated with the crisis, i.e. the level of external debt outstanding or the debt service payments, respectively. The link to the real sphere of the debtor countries is given via the adjustment programs surveyed by the International Monetary Fund (IMF) and the World Bank (IBRD). On the other hand, trade relations of and especially amongst the highly indebted countries have shown to be disrupted by the debt crisis. Establishing an International Fund for Trade Adjustment (IFTA) liable for stabilizing those trade flows instead of coordinating merely financial adjustments could provide an effective assistance in strengthening the economic performance of those countries with respect to their solvency.

1. Causes and Consequences of the Developing Countries' Debt Crisis

The debt crisis of the less developed countries broke out in August 1982, with the announcement by Mexico that it would be unable to meet its debt obligations. Since then, more than 40 developing countries have been involved in debt rescheduling actions. The identification of the releases of the debt crisis leads to a division into two main categories: First, developments which were externally caused such as the rise in real interest rates in the early 1980's, and the reduction of export earnings of developing countries insofar as they can be attributed to the slowdown in world economic activity at the same time.¹ Secondly, internal structural problems of the developing countries such as large budget deficits, inadequate exchange rate policies and/or disruptions in the countries' capital markets in connection with capital flight.²

The fundamental environment which made the debt situation extremely sensitive to those developments was the voluminous lending and borrowing process in which private creditor banks and developing countries had been engaging in the 1970's in the course of the excess liquidity prevailing in world capital markets at that time.

Correspondingly, two negative effects of the debt crisis on the world economy can be separated: The first is the fact that a default of large credits to developing countries poses a direct threat to the world financial system via the subsequent default of major creditor banks involved in the borrowing.³ The second strain imposed by the debt crisis on international economic relations is the possible restriction of economic growth in developing countries implied by the necessity to transfer resources to their creditors in order to service and pay back the debts.⁴

¹ See Dornbusch, R. (1987), Debt Problems and the World Macroeconomy, NBER Working Paper #2379, Cambridge.

² See Dornbusch, R. (1985), External Debt, Budget Deficits and Disequilibrium Exchange Rates, in: Smith, G. and Cuddington, J., eds., International Debt and the Developing Countries, Washington.

³ See Eichengreen, B., Portes, R. (1986), The Anatomy of Financial Crisis, Institute for International Economic Studies, Stockholm, Seminar Paper # 375.

⁴ See Feldstein, M. (1986), International Debt Service and Economic Growth: Some Simple Analytics, NBER Working Paper #2076, Cambridge.

2. Solvency vs. Liquidity

In order to evaluate the debt situation of a country, two benchmark conceptions are to be considered:⁵

Solvency. Judging the solvency of a country is basically equivalent to contrasting the level of the country's external debt with its expected ability to pay back the debt. If, to illustrate one operationalization, the transfer of a country's resources to foreign lenders is confined to the trade account, it can be considered solvent if the discounted present value of the future export surpluses exceeds the current value of its debt. Furthermore, assuming that imports on the one hand diminish the resources to be transferred, but in the long-run contribute to the country's ability to realize the export earnings necessary to pay back the debt, the decisive factor for this future transfer of resources are the projected exports. Then, with the current level of exports as the main indicator for future exports (export surpluses), the ratio of debt to exports becomes the appropriate measure of the country's solvency. If the debt-export ratio exceeds a certain (country specific) critical value, the country is considered not to be able to raise and transfer the resources necessary to fully pay back its debt via future export earnings and thus has a solvency problem. Table 1 provides the development of the debt-export ratios for the heavily indebted countries of the Western Hemisphere.

Liquidity. Whereas the issue of solvency is a concept rather evaluating the long-run debt situation of a country, the short-run aspects are determined by the country's ability to raise and transfer resources to service its debt at the present point in time. As for an illustration, assume that the country considered spends a certain share of its export earnings on debt service and principal payments to its foreign lenders. Imports then are financed by the rest of the export earnings, and by additional net borrowing. If this share given by the debt-service-to-exports ratio increases due to a rise in interest rates or a decline of exports, for instance, the country has to reduce imports or to acquire additional loans in order to meet its payment obligations. With the degree of substitutability imposing a lower bound on the import reductions, the increase in the debt-service-to-exports ratio may exceed a (country specific) critical value, where the country has to finance its debt service payments via new loans, and thus the country is

⁵ For definitions and descriptions of various debt concepts see World Bank (1989), World Development Report, p. 18, Eaton, J., Gersovitz, M., Stiglitz, J. (1986), The Pure Theory of Country Risk, NBER Working Paper #1894, Cambridge.

liable to run a liquidity problem. Table 2 illustrates the liquidity situation as given by the debt-service-to-exports ratios for the heavily indebted countries of the Western Hemisphere.

Basically, both indicators - the debt-export-ratio and the debt-service-to-exports ratio - contrast the developments of financial variables with those of real variables; they comprise causes of the debt crisis, such as the rise in interest rates and the reduction of export earnings of indebted countries, as well as the consequences, insofar as they identify possible threats to the financial and to the real spheres of the world economy. Any comprehensive initiative to a resolution of the debt crisis must therefore aim at reducing liquidity and solvency problems of heavily indebted countries; equally important, however, is an intrinsically balanced treatment of the financial and the real disruptions as consequences of the current and as possible causes of a future debt crisis.

3. Management of the Crisis

The management of the debt crisis since 1982 has shown a certain asymmetry in dealing with the causes and consequences of the debt situation of developing countries: with regard to the consequences, the main emphasis has been on rescheduling the debt via case-by-case negotiations or market-based debt reduction schemes, thereby accentuating the financial links between creditors and debtors and the necessity to avoid a major financial crisis by maintaining the stream of interest payments, i.e. solving the liquidity problems.⁶ As for the causes of the crisis, the remedy was based on the fact that the infusion of "fresh money" to the debtor countries or the conduction of a debt reduction scheme was in general made conditional upon adjustment programs to be adopted by those countries. These programs surveyed by the International Monetary

⁶ See for an early paper Dornbusch, R. (1984), On the Consequences of Muddling Through the Debt Crisis, *The World Economy*, Vol. 7 N° 2, or Fischer, S. (1987), Resolving the International Debt Crisis, NBER Working Paper #2373, Cambridge.

Fund and the World Bank then were intended to resolve the structural problems of the indebted countries.⁷

The immanent problem associated with these financial schemes is that they imply merely a transfer of domestic corporate debt management to the resolving of (sovereign) developing countries debt problems,⁸ i.e. they lack the explicit acknowledgment of the trade and growth disruptions incurred by the debt crisis on the developing countries' economies. The link to these issues has been a rather indirect conception, expressed by the projection that the reduction of the interest burden in combination with the internal adjustments would help the countries to extricate themselves out of their debts.

Then, with these adjustment programs taking effect rather slowly (if at all), this kind of management suffers from the problems incurred by the attempt to take care of short-run problems with long-run solutions and vice versa. Not only that in the course of the adjustment process the indebted countries are still highly vulnerable with regard to external shocks such as an increase in world interest rates, there arises also a conflict between the liquidity and the solvency issue: since easing a country's current liquidity problems via rescheduling is generally accomplished by "rolling-over" current obligations into the future, for a given ability of the country to transfer resources to its lenders in the medium-run, the country's solvency is immanently deteriorating with the corresponding increase of its total debts. Thus, liquidity is attained at the costs of diminishing solvency, which can be indicated by a comparison of the developments outlined in Tables 1 and 2:

In 1981/82, four countries exhibited a rather high debt-service-to-exports ratio (Brazil, Chile, Mexico, Peru). Over the following years, none of these countries experienced a significant increase in these ratios, in the case of Peru it even dropped from 44 in 1981 to 12 in 1987. The average of the region fell from 52 in 1982 to 38 in 1987. Yet, all these countries showed a significant increase in their debt-service-to-exports ratios, with again Peru showing a ratio of 503 in 1987 versus 243 in 1981. The average of the region increased from 273 in 1982 to 341 in 1987.

⁷ See Krugman, P. (1988), Market-Based Debt-Reduction Schemes, NBER Working Paper #2587, Cambridge, Sachs, J. (1988), Conditionality, Debt Relief, And the Developing Countries' Debt Crisis, NBER Working Paper #2644, Cambridge.

⁸ See Bulow, J., Rogoff, K. (1988), Sovereign Debt Restructuring: Panacea or Pangloss? NBER Working Paper #2637, Cambridge.

In 1987, with respect to the debt-service-to-exports ratio, only one country (Argentina) ranged above the average of the region, and thus could be considered to run a serious liquidity problem, whereas the debt-service-to-exports ratios of four of the countries considered (Argentina, Brazil, Mexico, Peru) were higher than the region average.

Though part of the development of the debt-service-to-exports ratios may be attributed to the corresponding decline of world interest rates over that period, the strong divergence between the solvency and the liquidity indicators cannot be explained without relying on the debt rescheduling measures.

Nevertheless, more recently a new quality has entered the management of the developing countries' debt crisis: Whereas according to previous proposals to a solution of the debt problem including the plan of the former American Secretary of the Treasury, James Baker, provided the international institutions International Monetary Fund and World Bank with a rather supplementary if important role in the adjustment process, the new initiative by Baker's successor, Nicholas Brady, assigns a direct engagement to those institutions: The administrative assistance to the indebted countries of International Monetary Fund and World Bank implied by the Baker plan would be accompanied by the provision of direct financial assistance in the context of the Brady plan.⁹ Furthermore, this assistance should not merely set off a new round of rescheduling old debts, but amount to a significant reduction of debt.

The new quality as compared to former proposals can be attributed to the perception that the benefits of a solution of the debt crisis will accrue to the debtor as well as to the creditor countries, and that the latter therefore might contribute their share in providing incentives to such a solution. Yet, there are some arguments hindering a possible success of the initiative:

The direct linking of financial assistance to debt reduction

- implies a redistribution of income from the taxpayers of all industrialized countries via the international institutions to the main creditors of the indebted countries, i.e. the major U.S. banks,

⁹ For a description see for instance Frenkel, M. (1989), *The International Debt Problem: An Analysis of the Brady Plan*, *Intereconomics* Vol. 24, No. 3.

- merely focusses on the causes of the debt internal to the indebted countries via the adjustment programs surveyed by International Monetary Fund and World Bank, and on the consequences of the crisis which may arise from the level of the debt respectively the interruption of the debt service payments.

Though providing the international institutions with an active role in resolving the debt problems, the new initiative as well as its predecessors puts direct emphasis only on the financial side of the crisis by linking the institution's assistance merely to the reduction of debt. Although, on the one hand, the conflict between the liquidity and the solvency issue is being moderated, the plan still fails to represent a comprehensive solution mainly to the solvency problems of the indebted countries by neglecting any direct link to the trade and growth disruptions as causes and as consequences of the crisis.

4. The Need for Trade Stabilization

The indicators for evaluating the debt situation as illustrated for the liquidity and the solvency issue contrast the development of financial variables with those of real variables. Furthermore, it is commonly understood that the exports of indebted developing countries play a key-role for their economic development; their level determines whether a country

- is able to service and pay back its current debt without recurring on reschedulings,
- has to finance imports and development projects by new loans and thus increases the future level of foreign debt,
- has acquired a sufficiently robust economic structure to absorb future external shocks.

The crucial point in assessing the need for a direct stabilization of indebted developing countries' exports as opposed to stabilize the countries' economic performance in general is the question, if their level is mainly determined by developments internal or external to the countries. In the latter case, export promotion via internal adjustment programs cannot suffice to remedy the countries' solvency (and liquidity)

problems. Moreover, this inadequacy could even be accentuated if the development of those countries' exports were impaired as a consequence of the debt crisis.

Table 3 shows the exports for the three developing countries with the largest level of external debt outstanding (Argentina 54.5 billion US-\$, Brazil 116.9 billion US-\$, Mexico 105.6 billion US-\$, each at the end of 1987).

By comparing the export levels of 1987 with those of 1981, Argentina's total exports dropped by 30%, Brazil's increased by 14%, and Mexico's by 35%. During that period, world exports rose by 27%, and those of Industrialized Countries by 41%. Though the bad Argentinian performance is mainly due to a drop of exports to the U.S.S.R. by about 70%, and the Mexican increase in exports comes close to that of Industrialized Countries, in general the development of exports has shown to be rather unstable for all three countries over the period considered. Moreover, there is also a common feature to the exports figures of the three highly indebted countries: While their exports to Industrialized countries remained relatively stable or could even be increased by about 50% as for Brazil and Mexico, exports to Developing Countries experienced a significant reduction (Argentina: -15%, Brazil: -24%, Mexico: -31%). Even more marked was the decline in exports to countries of the Latin American region (Argentina: -25%, Brazil: -24%, Mexico: -35%). Argentinian exports to Brazil dropped by 12%, and to Mexico even by 80%. Brazilian exports to Argentina decreased by 24%, to Mexico by 78%, Mexican exports to Brazil also declined by 70%. These reductions in intraregional trade were not only more pronounced than the reductions in trade between Industrialized Countries and Developing Countries (-2% for exports of Industrialized Countries to Developing Countries, -14% for exports to Western Hemisphere), they point also to the conjecture that adjustment problems internal to those economies cannot be blamed for this development. An explanation would rather be that the debt situation of these countries in connection with the resulting import reductions set off a vicious circle of trade contractions, with the export reductions resulting in an aggravation of the debt situation especially in this region. The existence of these multiplier effects also pronounces the need for an exogenous stimulus in order to break that vicious circle. The question is, if such an approach should be directed towards debt reduction, or should it aim at directly promoting the real part of the solvency problems of the indebted countries, i.e. their export revenues.

While there is certainly no single conclusive answer to this, it should be considered that debt reliefs - aside from the problems mentioned above - bear the disadvantage

of being linked to the real spheres of the economies only via the surveillance of the adjustment programs. The benefits of such a debt relief could

- amount to a mere reversal of the rescheduling having taken place in former years, with the benefits accruing solely to the creditor banks instead of the debtor countries,¹⁰
- remain in the financial sphere of the economies, as would be the case with an occurrence of additional capital flight,
- be used to finance projects without any stabilizing effect on the export sectors of the indebted country.

Promoting exports of indebted developing countries, on the other hand, shows the disadvantage of distorting the relation of comparative advantages in international trade, or, to put it in political terms, threatening the current account situation of Industrialized Countries directly or indirectly. Yet, if the former export reductions were caused by import disruptions of other indebted countries, stimulating those exports by removing the import restrictions incurred by the debt crisis could prove to be beneficial to all partners in international trade.

To summarize, any approach to accomplish such an outcome should be directed towards

- establishing a direct link between international financial assistance and the real spheres of the indebted countries,
- breaking the vicious circles of trade reductions between indebted countries.

The main steps to be undertaken would be to

- evaluate which export sectors in indebted countries were injured by the decline of intraregional trade,
- constitute which countries were impaired to import those good due to external payment obligations in the course of the debt crisis,

¹⁰ For the description of such a result in the case of Bolivia see Bulow, J., Rogoff, K. (1988), Sovereign Debt Restructurings: Panacea or Pangloss? NBER Working Paper #2637, Cambridge.

- establish an institutional setting to provide financial assistance and to distribute it to the sector of the exporting respectively importing economy.

The basic idea would be to induce additional demand for the exports of one country and thus stimulating growth via international fiscal policy measures. Furthermore, those export goods should be directed towards those countries which are most heavily restricted from importing them by their payment situation, which would mean a net transfer to these countries analogous to financial aid. While the first two steps may look rather complicated, yet, they imply no additional efforts to the surveillance of adjustment programs conducted by the international organizations: Evaluating the economic situation of an exporting industry is by no means different from evaluating the prospects of an investment project to be financed with foreign loans; determining which importing economy should benefit from the import gift is basically equivalent to determining which country should obtain a debt relief.

The third issue, however, seems to be the most critical point. And yet, despite all technical concerns, it might be the crucial step in adding a new dimension to a solution of the debt crisis.

5. Institutional Environment

Corresponding to the prominence of the financial sphere in the proposals to a solution of the debt crisis is the current disposition of international institutions. The International Monetary Fund and the World Bank are constituting and surveying the international financial and monetary relations, with the IMF being assigned rather to market based adjustment processes, whereas the IBRD plays the role of a fund in directing structural support and development aid to developing countries. With respect to trade relations, the GATT might be considered as the respective counterpart to the IMF in the real sphere of the international economy, with the task to provide that trade relations are conducted along market based schemes (see Figure 1). Yet, there exists no international institution of an equal importance which is assigned with the function of supporting international trade relations in the course of an adjustment to structural disruptions. Currently, the support of trade relations especially among developing countries is apportioned to a variety of institutions, such as the Trade Negotiating Committee (TNC) of the GATT, the Economic Cooperation Among Developing Countries

(ECDC) Committee of the UNCTAD, and the Compensatory Financing Facility (CFF) of the IMF. Though each of these institutions contributes to a stabilization of trade flows of developing countries, there seems to be neither a sufficient coordination of policies, nor an adequate acknowledgement and funding as compared to that of the IMF or the IBRD themselves. Though especially the UNCTAD stresses that the "... debt crisis has clearly inflicted such severe damage on the economic structures of developing countries that growth must be promoted without waiting for macro-economic stability to be achieved"¹¹, and also states "that South-South trade ... is still the weakest link in the network of international economic relations"¹², it also resumes that "finance made available under the existing facilities ... averaged about US-\$ 0.8 billion"¹³, the latter for compensatory financing of export shortfalls over the period 1984-86. Correspondingly, the UNCTAD's Common Fund to finance International Commodity Organizations (ICOs) was established in summer 1989, yet, with a contributed capital of a mere 700 million US-\$.¹⁴

Under these circumstances it seems obvious, that the establishment of a single international institution of a size and importance comparable to that of the IBRD, for instance, is liable to concentrate efforts towards a more significant structural support of trade adjustments of developing countries. If it is acknowledged that "the efforts of these countries to invest and grow out of a state of macro-economic disorder cannot succeed without the support of an external financial and trade policy package"¹⁵, because "a dramatic reversal in the growth of South-South trade ... largely attributable to the stagnation, sometimes the contraction, in the economies of developing countries resulting from an unfavourable external environment and debt problems"¹⁶ has taken place, it seems not enough to note "... that the technical and political feasibility of such a facility deserves further study".¹⁷ In order to approach towards a medium-term or long-term solution of the solvency problems of developing countries it is rather high time to

11 UNCTAD Bulletin N°. 254, July/August 1989.

12 UNCTAD Bulletin N°. 253, June 1989.

13 UNCTAD Bulletin N°. 252, May 1989.

14 UNCTAD Bulletin N°. 254, July/August 1989.

15 UNCTAD Bulletin N°. 254; July/August 1989.

16 UNCTAD Bulletin N°. 253, June 1989.

17 UNCTAD Bulletin N°. 253, June 1989.

establish an International Fund for Trade Adjustment (IFTA) as a counterpart to the IBRD or the GATT, respectively.

Such an institution could

- arise from merging the various facilities and committees into a single organization,
- receive its contributed capital from a diversion of (part of) the 20 billion US-\$ provided for debt reduction under the Brady plan.

Its primary tasks would be to

- constitute where indebted developing countries had to excessively reduce their imports due to debt problems,
- analyze the exporting sectors of developing countries for their capacities and capabilities to supply the respective goods,
- provide the financial resources to the importing countries conditional upon their use and contribution to strengthening the exports of other developing countries (and upon the conduction of general adjustment programs).

In such a way, an International Fund for Trade Adjustment might be able to establish a direct link from the solvency problems of indebted countries to the real sphere of those economies. Moreover, it could help to overcome the current imbalance in the setting of international institutions with their pronouncement of financial relations, especially with respect to the dealing with the international debt crisis. In a further step, it might also help the other institutions to concentrate on their ordinary tasks: The IMF could return to a surveillance of the world financial system, especially with regard to necessary adjustments between industrialized countries. The GATT institutions, on the other hand, could rather coordinate international trade in general, with an attachment to reducing protectionism and promoting market based adjustments. The exceptions to "Free Trade" arrangements in the course of structural support to developing countries could - as a counterpart to the orientation of the IBRD to capital flows - be conducted and surveyed by the new International Fund for Trade Adjustment (see Figure 1).

Despite all technical and political complications which might be connected with setting up this international institution, there is one conclusion fundamental in econo-

mics which displays the favors of such a strategic move: The first dollar spent on reducing disruptions of international trade of developing countries is liable to yield more returns, than a dollar spent on reducing financial problems of those countries, where billions of dollars have been spent on before.

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Table 1: Debt-Export Ratios of Highly Indebted Countries (percentage points)

	81	82	83	84	85	86	87
Western Hemisphere DC's	210	273	292	277	293	349	341
Argentina	286	434	461	474	470	547	660
Brazil	298	391	400	347	363	445	432
Chile	279	335	374	412	436	378	327
Columbia	170	204	273	223	301	219	220
Mexico	257	311	325	292	325	426	362
Paraguay	148	163	238	223	275	255	234
Peru	243	293	313	331	361	469	503
Uruguay	117	157	223	237	291	245	255
Venezuela	131	159	215	191	205	312	..

Source: IMF, Annual Report 1988, and International Bank for Reconstruction and Development, World Debt Tables 1988-89.

**Table 2: Debt-Service-to-Export Ratios of Highly Indebted Countries
(percentage points)**

	81	82	83	84	85	86	87
Western Hemisphere DC's	42	52	41	41	40	45	38
Argentina	17	23	24	24	40	51	45
Brazil	33	43	28	25	26	34	26
Chile	29	19	18	25	26	28	21
Columbia	13	17	21	20	29	26	30
Mexico	28	34	40	34	35	37	30
Paraguay	9	10	14	17	23	25	21
Peru	44	36	19	15	17	14	12
Uruguay	10	13	20	29	30	21	24
Venezuela	5	8	10	7	8	16	..

Source: IMF, Annual Report 1988, and International Bank for Reconstruction and Development, World Debt Tables 1988-89.

**Table 3: Exports of Highly Indebted Countries to the Countries Listed in the Sub
(million US-\$)**

Argentina	81	82	83	84	85	86	87
World	9142	7622	7835	8107	8396	6851	6401
Industrialized Countries	3389	3263	3097	3466	3525	3138	3217
Developing Countries	2638	2653	2860	3056	3224	3143	2264
U.S.S.R. and oth. Non-IMF- Members	3102	1687	1833	1557	1622	545	900
Western Hemisphere DC's	1799	1556	1103	1500	1570	1639	1345
Bolivia	125	113	56	88	69	60	87
Brazil	595	567	358	478	496	698	523
Chile	189	64	188	149	111	136	147
Mexico	275	111	33	171	255	158	57
Venezuela	101	97	58	114	72	44	53

Source: IMF, Direction of Trade Statistics, Yearbook 1988

Table 3: Continued

Brazil	81	82	83	84	85	86	87
World	23329	20168	21853	27007	25635	22405	26607
Industrialized Countries	12513	12048	13639	17107	16327	14812	18414
Developing Countries	9481	6965	6769	8650	8123	6721	7173
U.S.S.R. and oth. Non-IMF-Members	901	801	1021	870	671	483	531
Western Hemisphere DC's	4496	3140	2271	3110	2482	2774	2795
Argentina	880	650	661	853	548	682	672
Bolivia	255	80	108	141	171	204	224
Chile	641	289	208	281	238	247	292
Mexico	643	324	168	285	222	156	141
Venezuela	408	470	270	365	295	349	314

Source: IMF, Direction of Trade Statistics, Yearbook 1988

Table 3: Continued

Mexico	81	82	83	84	85	86	87
World	19381	21209	22313	24382	22105	16589	26783
Industrialized Countries	16171	17682	19080	20950	19484	14675	24406
Developing Countries	3172	3220	2744	2593	2136	1574	1887
U.S.S.R. and oth. Non-IMF-Members	37	51	109	126	92	66	76
Western Hemisphere DC's	1905	1858	1665	1652	1199	1001	1244
Argentina	35	50	37	45	37	111	145
Bolivia	3	1	..	1	..	1	1
Brazil	748	715	640	562	298	150	219
Chile	40	11	17	16	16	26	38
Venezuela	69	88	32	35	39	44	44

Source: IMF, Direction of Trade Statistics, Yearbook 1988

Figure 1: International Economic Institutions

	Market Based Adjustments	Structural Support
International Financial Relations	IMF	IBRD
International Trade Relations	GATT	(IFTA)