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# Loans to LDCs and Massive Defaults

by Ramesh C. Garg, Ypsilanti, Michigan\*

**The quadrupling of oil prices since the end of 1973 was accompanied by a rapid increase in the borrowings of developing countries. A global view of their external debt situation reveals some alarming realities.**

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According to the World Bank's estimate<sup>1</sup>, the total external public debt<sup>2</sup> of developing countries increased more than 36 times from the beginning of 1956 to the end of 1978 (from \$ 9.7 bn to \$ 352 bn, respectively). However, the increase has been more dramatic during the last few years. The total debt outstanding almost tripled from \$ 116 bn at the end of 1973 to \$ 352 bn at the end of 1978. Debt service payments (interest plus amortization) also increased by more than 47 times, from \$ 0.8 bn in 1956 to an estimated \$ 37.6 bn by the end of 1978. Debt service ratios<sup>3</sup> have risen significantly and, in some cases, have exceeded 30 %. Understandably, individual countries have varying debt situations and the capacity to handle debt problems differs a great deal from country to country. It is, however, possible to generalize about certain debt characteristics of developing countries when classified on a regional basis which also seems to coincide with categories based on average per capita national income.

Table 1 gives the summary of debt burden on a regional basis<sup>4</sup>. The data cover the latest available statistics for the period 1976-1978. The dollar amount of 1978 data has been further classified into official and private categories to reflect the sources of borrowings. The official source includes borrowing from various foreign governments and international organizations. The private source, on the other hand, includes suppliers credits, and borrowings from private financial

markets, including overseas private banks. The 96 developing countries are classified into 87 non-oil exporting and nine oil-exporting countries. The total debt outstanding for the nine oil-exporting countries<sup>5</sup> was approximately \$ 65 bn at the end of 1978; up from approximately \$ 41 bn in 1976. These countries, taken together, had current account surpluses during the last several years. The future outlook for some of them, however, particularly the larger and poorer ones like, for example, Indonesia, does not look materially different from those of many non-oil-exporting developing countries. Algeria, Ecuador, Indonesia, Nigeria, and Venezuela had all experienced substantial current account deficits in 1978.

## Regional Analysis

The 87 non-oil exporting countries are further classified into various regional groupings. As mentioned earlier, this regional classification also seems to coincide with classification based on average

<sup>1</sup> IBRD: World Debt Tables, Washington, D. C., various issues.

<sup>2</sup> External public debt is defined as the debt incurred or guaranteed by governments repayable to non-residents in foreign currency, with an original or extended maturity of more than one year.

<sup>3</sup> The debt service ratio is defined as total debt service payments (amortization plus interest) on external public debt as a percentage of exports of goods and non-factor services.

<sup>4</sup> This regional analysis is based upon the presentation given in IBRD: External Public Debt of Eighty-four Developing Countries, Washington, D. C., September 1977, pp. 3-6; World Debt Tables, October 20, 1978, pp. 4-9; and World Development Report, 1980, pp. 134-135.

<sup>5</sup> Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Nigeria, Trinidad and Tobago, and Venezuela.

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per capita income. The developing countries in the *Mediterranean*<sup>6</sup> region of Europe enjoy a relatively high per capita income among the developing world. The combined external debt of these countries, expressed as a percentage of GNP was only 6 % in 1975<sup>7</sup>. Prior to the end of 1975, the Mediterranean developing countries had relied less on external public borrowings and used alternate sources, including reserves, to finance their current account deficits. Since 1976, however, these countries have increased their reliance on external borrowing and the ratio of their external debt to GNP rose to 9 % in 1976. The total outstanding debt of Mediterranean countries was approximately \$ 41 bn at the end of 1978 of which about 42 % came from private sources.

The developing countries of the *Sub-Saharan African* region<sup>8</sup> and those of *South Asia*<sup>9</sup> have a few common characteristics with respect to their debt situation. A large proportion of their external public debt is owed to official creditors. By the end of 1978, 69 % of the total external public debt of approximately \$ 33 bn for the Sub-Saharan African countries came from official sources. The countries of the South Asian region owed a total of approximately \$ 40 bn at the end of 1978, of which 97 % came from official lenders. Countries in these two regions were able to borrow on

concessionary terms from national and multilateral agencies, particularly because of their very low per capita income. With limited or almost no access to the private international capital markets, these countries have not been able to borrow large sums from private lenders. Among the Sub-Saharan African countries which borrowed from private sources, four countries – Ivory Coast, Sudan, Zaire, and Zambia – accounted for 69 % of such borrowings in 1978. One of them, Zaire, encountered severe difficulties in servicing its external debt in 1975 and 1976<sup>10</sup>.

Countries in the *East Asia and Pacific*<sup>11</sup> region had an outstanding debt of approximately \$ 40 bn at the end of 1978, an increase of 66 % since the end of 1976. South Korea has been the major borrower in this region. It owed approximately \$ 18 bn, or 45 % of the total regional debt outstanding at the end of 1978. Other major borrowers in the region have been the Philippines and Malaysia who owed approximately \$ 7.3 bn and \$ 4.3 bn, respectively, at the end of 1978. Thailand owed approximately \$ 3.7 bn at the end of 1978<sup>12</sup>. Because of the relatively higher economic growth rates of the countries in this region, the role of private lending has been very significant. At the end of 1978, 49 % of the total external debt was provided by private sources. Korea, the largest and the most

<sup>6</sup> Cyprus, Greece, Israel, Malta, Portugal, Spain, Turkey, and Yugoslavia.

<sup>7</sup> IBRD: External Public Debt of Eighty-four Developing Countries, o.p. cit., p. 3.

<sup>8</sup> Benin, Botswana, Burundi, Cameroon, Central African Republic, Chad, Congo, Ethiopia, Gambia, Ghana, Guinea, Ivory Coast, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Niger, Rwanda, Senegal, Sierra Leone, Somalia, Sudan, Swaziland, Tanzania, Togo, Uganda, Upper Volta, Zaire, and Zambia.

<sup>9</sup> Afghanistan, Bangladesh, Burma, India, Nepal, Pakistan, and Sri Lanka.

<sup>10</sup> Cf. IBRD: External Public Debt of Eighty-four Developing Countries, o.p. cit., p. 4.

<sup>11</sup> Republic of China, Fiji, Republic of Korea, Malaysia, Papua New Guinea, Philippines, Singapore, and Thailand.

<sup>12</sup> Cf. IBRD: World Debt Tables, Volume II, Washington, D. C., December 28, 1979.

**Table 1**  
**External Public Debt of 96 Developing Countries by Regions, 1976-1978**  
(in mn US \$)

Regional Distribution	Debt Outstanding as of December 31st			Source of Borrowing: 1978 (Percent Distribution)	
	1976	1977	1978	Official	Private
Africa South of Sahara	23,154	28,499	33,087	69	31
East Asia and Pacific	23,948	30,239	39,818	51	49
Latin America and Caribbean	67,623	80,429	99,671	36	64
North Africa and Mid-East	20,131	28,265	32,820	78	22
South Asia	31,136	35,635	39,936	97	3
More Adv. Med. Countries	28,881	34,296	41,272	58	42
Total 87 Non-Oil Countries	194,874	237,363	286,604	58	42
Total 9 Oil Export Countries	41,173	52,369	65,266	35	65
Total 96 Countries	236,047	289,732	351,870	54	46

Source: IBRD: World Debt Tables, Volume I, Washington, D. C., December 28, 1979.

rapidly growing economy in the region, accounted for 50 %, or \$ 9, 935 mn, of the total private lending for the region<sup>13</sup>. Large and growing Korean exports provided the necessary resources required to service the country's debt.

The outstanding public debt for the developing countries of the *Middle East and North Africa*,<sup>14</sup> excluding the oil-exporting countries, was \$ 32,820 mn at the end of 1978, an increase of 63 % since the end of 1976. Egypt has been a major borrower in this region which owed 43 %, or \$ 14,127 mn, of the total debt outstanding in 1978. Most of the borrowing for the non-oil producing countries of the region came from official sources. At the end of 1978, only 22 % of the total outstanding debt was owed to private sources. This situation is due to the existence of relatively poor countries in the region.

The external public debt of the 20 non-oil exporting countries in the *Latin American and the Caribbean* region<sup>15</sup> was approximately \$ 100 bn at the end of 1978, or about 35 % of the total for the 87 non-oil exporting countries. Brazil and Mexico have been the major borrowers in this region. These two countries

together accounted for 59 % of the total debt outstanding for the region at the end of 1978. A distinctive characteristic of this region has been the predominance of private capital in the total lending. Private sources accounted for 64 % of the total external debt outstanding at the end of 1978. The private sector in several countries of the region has been very active in borrowing from the international money market primarily because of its superior credit rating. Other major borrowers in the region include Argentina, Chile and Colombia who owed \$ 8,403 mn, \$ 5,756 mn, and \$ 4,402 mn, respectively, at the end of 1978<sup>16</sup>.

### Recent Trends

Lately, the external debt situation has caused considerable anxiety among members of the international financial community. Opinions on the issue vary a great deal, from the horror story of a possible domino effect caused by defaulting developing countries, to the emergence of a new international economic order systematically recycling the petro-dollars<sup>17</sup>. There are several reasons for the

<sup>13</sup> Ibid., p. 96.

<sup>14</sup> Bahrain, Egypt, Jordan, Lebanon, Morocco, Oman, Syria, Tunisia, Yemen Arab Republic, and People's Democratic Republic of Yemen.

<sup>15</sup> Argentina, Barbados, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, and Uruguay.

<sup>16</sup> IBRD: World Debt Tables, Volume II, op. cit.

<sup>17</sup> For two contrasting opinions on the external debt issue, see Charles S. Gano: Loans to LDCs: Five Myths, in: The Journal of Commercial Bank Lending, November 1977, pp. 18-27; and United States Senate: International Debt, The Banks, and U.S. Foreign Policy, U.S. Government Printing Office, Washington, D.C., August 1977, Part. III, pp. 43-58.

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**Table 2**  
**96 Developing Countries: Capital Inflow, Service Payments and Resource Transfer Analysis**  
(in mn US \$)

Year	Debt Disbursement during the year	Debt Service			Net Flow	Net Transfer	In % of Debt Disbursement	
		Amortization	Interest	Total			Net Flow	Net Transfer
1970	11,113	4,275	1,883	6,159	6,838	4,955	62	45
1971	12,305	4,880	2,160	7,041	7,425	5,264	60	43
1972	15,514	6,006	2,605	8,610	9,508	6,904	61	45
1973	21,769	8,184	3,559	11,743	13,586	10,026	62	46
1974	26,236	9,533	4,624	14,157	16,703	12,079	64	46
1975	35,800	9,990	5,908	15,897	25,810	19,903	72	56
1976	41,646	11,575	7,191	18,766	30,070	22,880	72	55
1977	50,835	15,608	8,993	24,601	35,228	26,234	69	52
1978	69,869	25,000	12,641	37,642	44,869	32,227	64	46
1970-78	285,087	95,051	49,564	144,615	190,037	140,472	67	49

Note: Total may not add up due to rounding.

Source: IBRD: World Debt Tables, Volume I, Washington, D.C., December 28, 1979, and October 20, 1978.

extreme concern over the external debt situation of developing countries. Some countries have borrowed very heavily and the ratio of their total debt outstanding exceeds 50 % of their annual gross national product and more than double of their export earnings. A global view of the debt situation reveals some alarming realities, which are the subject-matter of the following discussion.

### Low Resource Transfer

The transfer of resources on account of external public debt has been very low for all developing countries. As it stands now, it takes almost two dollars of fresh borrowings to realize one dollar of resource transfer. The resource transfer analysis provides a suitable mechanism to ascertain the extent of resource transfer that a country has obtained over a period of time. Literature pertaining to the field of international capital movements generally discusses the concept of resource flows. Three variations of capital flows are involved: gross capital inflow, net capital inflow, and resource transfer. Gross capital inflow is defined as all receipts on capital account, without any offsets. Net capital inflow is defined as gross inflow less amortization of loans in the case of external debt. Resource transfer on account of external public debt is defined as net capital inflow less interest charges on such debts. The resource transfer concept essentially indicates how much of the gross capital inflow is left over to the borrowing country after it pays for the service items<sup>18</sup>.

Table 2 provides the data on resource transfer for a total of 96 developing countries. On an average, it may

be observed that the developing countries have realized a net transfer of resources in the magnitude of 49 % of their total borrowings during 1970-78. There have been some modest increases in the transfer of resources from the years 1975 through 1977. However, this increase may not represent any long-term trend indicating an improvement in the debt situation. The increase in the resource transfer in the short-run has come about because of the necessity to borrow excessively to pay for the oil imports during this period. Developing countries borrowed more than \$ 128 bn in only three years, from 1975 to 1977. As a matter of fact, the net resource transfer shrank again to 46 % despite a fresh borrowing of nearly \$ 70.0 bn in 1978. The debt service payments increased to \$ 37.6 bn in 1978. This seems to suggest a long-term declining trend in the extent of resource transfer to developing countries.

### Declining Share of Official Sources

In recent years, the share of official capital has been consistently declining. Table 3 provides the percentage distribution of debt outstanding between official and private sources for the years 1970 to 1978. The data show that the share of official lending has declined from 70 % in 1970 to 54 % in 1978. Should the trend continue in the future, we may see some definite structural changes in the flow of debt capital to developing countries, with private capital playing an increasing role.

<sup>18</sup> For a detailed understanding of the concept of resource transfer, see D. Avramovic: Latin American External Debt, in: Journal of World Trade Law, March-April 1970, pp. 134-136; and Ramesh C. Garg: Debt Problems of Developing Countries, in: INTERECONOMICS, March-April 1977, pp. 95-96.

### High Average Cost of Private Capital

The ratio of debt service payments to debt outstanding signifies one of the major indicators for the terms of lending<sup>19</sup>. In general, the average cost of borrowing for the developing countries from all sources has been 8.9 % during the period 1970 through 1978. The cost of private lending, however, has been very high – almost three times that of official lending. The average costs from the official and private sources have been 5.2 and 14.7 %, respectively, during the period 1970-78 (see Table 3). On an average, it took 35 % of the total debt service payments to service the 61 % share of official debt capital. The remaining 65 % of the total debt service payments was utilized to service the 39 % share of private debt capital.

With the increasing share of private capital in the external debt structure along with its higher cost of financing, a continuing unfavourable shift in the debt structure of developing countries is likely to occur in the near future. If the trend is allowed to continue, it is estimated by the author that in approximately another 20 years, i. e., by the end of the year 2000, the net transfer of resources to the developing countries will become zero.

### Danger of Massive Defaults

Given this situation, massive default will surely occur by many developing countries who are going to be fast experiencing diminishing levels of resource transfer on account of external public debt. Debt service payments

currently reflect the terms of lending prevailing 10 to 15 years ago when the share of official capital was significantly higher than it is today. With a marked deterioration in the debt structure in recent years, the burden of debt service payment has increased considerably and the terms of borrowing have become much harder. According to Gamani Corea, Secretary General of the United Nations Conference on Trade and Development, debt servicing for non-oil exporting developing countries currently absorbs an average of 25 % of their export earnings<sup>20</sup>.

Another unfavourable element which has emerged because of the recent shift in borrowings to private sources relates to the maturity of loans. The ever-increasing share of private capital in the total debt outstanding did, indeed, shorten the overall average maturities for these loans. Nominal interest rates rose for most types of financing. Inflation during the decade of 1970s reduced the effective debt service burden for loans made at fixed interest rates. A large proportion of private loans, however, was contracted at variable interest rates so that changes in interest rates affected debt service payments on past loans as well. It is widely feared that developing countries are going to face serious debt service problems in the next few years and may already have reached their borrowing limits. Many developing countries were borrowing in recent years to cope with the higher oil prices or to make allowances for their falling exports due to recession in the industrialized countries. However, if this phenomenon continues in the 1980s, the adjustment process will not only be more painful but it

<sup>19</sup> For a detailed study on various terms of lending, see Clive S. Gray: *Resource Flow to Less Developed Countries: Financial Terms and Their Constraints*, New York 1969, pp. 48-55.

<sup>20</sup> Cf. "UN Official Asks an Easing of Debt for Poor Countries", in: *The Wall Street Journal*, January 14, 1978, p. 1.

**Table 3**  
**96 Developing Countries – Debt Structure Analysis**  
(Percentages)

Year	Outstanding Debt		Debt Service <sup>1</sup>		Debt Service in percent of Debt Outstandings		
	Official	Private	Official	Private	Total	Official	Private
1970	70	30	46	54	8.2	5.4	14.7
1971	69	31	45	55	7.9	5.2	14.2
1972	69	31	43	57	8.3	5.3	15.1
1973	66	34	39	61	9.3	5.5	16.8
1974	64	36	37	63	8.8	5.1	15.4
1975	62	38	38	62	8.3	5.1	13.5
1976	59	41	36	64	8.0	4.8	12.4
1977	56	44	33	67	8.5	4.9	13.1
1978	54	46	27	73	10.7	5.4	17.0
1970-78 <sup>a</sup>	61	39	35	65	8.9	5.2	14.7

<sup>a</sup> Weighted average based on original data.

<sup>1</sup> Debt Service is defined as "Percentage of Total Debt Service Payments required to service official and private debts".

Source: IBRD: World Debt Tables (calculations made by the author).

may also prove to be totally ineffective. Any further increase in the price of oil would further deteriorate the situation for developing countries regarding their ability to repay the loans. The world oil supply situation has been further disrupted by the recent turmoils in Iran and Iraq.

With the maturities falling due on recent borrowings, many developing countries will be forced to roll-over or reschedule their debts in coming years. In the past, the debts of several countries including Argentina, Chile, Brazil, Peru, Uruguay, and Zaire have been rescheduled. Indonesia has already fallen behind in its debt payments. Recently, Sudan has defaulted on its foreign-bank debts. These are the known cases with public knowledge. There might be other cases which have not yet become public knowledge. The process of rescheduling the debt with repayments stretched out over a longer period invariably results in higher interest costs to the borrower. In any event, such types of stop-gap arrangements will merely postpone the impending defaults on the part of many developing countries.

### Heavy Borrowing Requirements

With the oil crisis still going on, developing countries shall be continually in need to borrow hard currency to meet their trade deficits. UNCTAD indicates that the current account deficits of the non-oil developing countries will deteriorate sharply in 1980 and 1981. Their combined deficit amounted to \$ 45.5 bn at the end of 1979 and will swell to \$ 67.6 bn in 1980, reaching \$ 73.1 bn by the end of 1981<sup>21</sup>.

Since 1973, most developing countries have managed to achieve moderate levels of economic growth by way of financing their essential imports through substantial borrowings from private sources. Typically, loans from the private sources carry much shorter maturities than from the official sources. Most of the development projects are heavily weighted by infrastructure investments. On an average, these investments are unlikely to have a life span of less than twenty-five years.

The average financial returns on such investments can hardly be expected to exceed 10 % per annum. If this reasoning is accepted, the average service payment in the tune of 15 % in the case of private sources would consist mostly of interest payments with very little allowance for amortization. Consequently,

the amortization component of the service payment is assumed to be rolled over for a long period. This practice will lead to an increasing level of outstanding debt for indefinite time, until some countries start defaulting on their loans.

### Faster Increase of Official Assistance

The outlook for the future seems gloomy unless new approaches to finance development in the Third World economies are adopted. This requires concerted efforts on the part of both official and private lenders. At the March 1978 meetings of UNCTAD held in Geneva, representatives of rich industrial countries agreed to seek measures for the adjustment of terms of loans to the poorest developing countries. According to Gamani Corea, "Quite a significant step" was taken at the session to soften the terms of lending. Mr. Corea estimated that the rich countries would have to give up, at most, \$ 600 mn a year of principal repayments and interest in order to do so. Since most of the Western countries ruled out any across-the-board debt relief promises, it was further estimated that the sum would be between \$ 300 mn and \$ 400 mn annually. Some 30 to 40 poor countries would stand to benefit from such debt relief.

In 1970 the developed nations had agreed to contribute 0.7 % of their GNP to the Official Development Assistance (ODA) by 1980. But the target has not nearly been reached so far, and there are no indications presently that it will ever be met. The outgoing President of the World Bank, Mr. Robert McNamara, reported in his thirteenth, and final, address to the World Bank forum that the situation is clearly unsatisfactory with respect to the ODA. The current level of the average ODA for the OECD countries is only 0.34 % of their GNP. He proposed that the lagging countries – in particular, the United States (0.18 %), and Japan (0.27 %) – should consider increasing their ODA flows faster than their GNP growth. Every other country, at the very minimum, should maintain its ODA at the same percentage of its GNP as it did in 1978, and thus should increase the real level of its ODA as quickly as its GNP increases<sup>22</sup>.

### Diversification of OPEC Aid

With the emergence of the Organization of Petroleum Exporting Countries (OPEC) as a class of prosperous nations, some sort of proportional sharing of the development assistance burden would seem a fair and equitable approach. The official assistance capacity depends upon per capita GNP and its growth

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<sup>21</sup> Cf. "Developing Countries Without Oil had had Debt of 330 Billion in 1979", in: The Wall Street Journal, March 24, 1980, p. 10.

<sup>22</sup> IBRD: Address to the Board of Governors by Robert S. McNamara, Washington, D. C., September 30, 1980, pp. 12 and 46.

rate. As the GNP of OPEC nations increases with the increase in their oil export earnings, they may also want to subscribe to some accepted assistance targets similar to other developed nations. It may be important to note that OPEC nations did increase their official lending to developing countries since 1972 and became more important as a source of external finance in recent years. The total disbursed debt owed to OPEC nations by the 96 developing countries increased from \$ 668 mn in 1972 to \$ 10,786 mn in 1978<sup>23</sup>. However, 79 % of the total commitments by OPEC governments in 1975 was restricted to only five countries: Egypt, Syria, Indonesia, Yugoslavia, and Zaire<sup>24</sup>. So, there is a strong need to diversify the OPEC nations' disbursements.

### Participation of the Eastern Bloc

The centrally-planned economies (CPEs) of Eastern Europe, including the USSR, have not subscribed to the UN's assistance targets. Assistance from these countries is usually on a bilateral basis. Notwithstanding their economic potential and GNP growth rates, only 12 % of the total disbursed debt owed to all governments was provided by the governments of the CPEs in 1978<sup>25</sup>. Inasmuch as these countries may not be obliged to accept the UN targets for assistance, some formula should be worked out to seek greater participation of the CPEs to provide aid on a multilateral basis. It should be noted that the loans from these countries are provided at a very concessional interest rate of less than 3 % but have shorter maturities. They are heavily project-oriented and the technical assistance for the project usually comes along with the loan.

### Extended Risk Analysis

While it is encouraging to note that the private banking system is supplementing development assistance at an increasing rate, there is a strong need to reassess its terms of lending. The cost of borrowing should be compared with the expected "financial" return of the development project which the loan is purported to finance. No loans should be extended to finance poor projects. The private banks should not only evaluate the credit-worthiness of the borrowing country but also examine the economic potential of the project for which a loan is being granted. It seems that the current lending practices of the banks limit their

exposure analysis to evaluating the riskiness of the borrowing country alone, and do not go far enough to evaluate the economic potential of the development project.

In this context, it should be noted that these loans are guaranteed by the host governments. By extending their risk analysis, private banking systems will make their loans project-oriented. This procedure will prevent the leaders in developing countries to borrow for projects which may be politically motivated or perhaps meant for conspicuous consumption with little economic sense. The maturity structure on private loan should be made consistent with the economic life of the development project. Only when the private multinational banks follow such guidelines can we minimize the probabilities of defaults by developing countries.

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<sup>23</sup> IBRD: World Debt Tables, Vol. I (1979), *op. cit.*, p. 178.

<sup>24</sup> IBRD: World Debt Tables, Vol. I (1977), *op. cit.*, p. 36.

<sup>25</sup> IBRD: World Debt Tables, (1979), *op. cit.*, p. 178.