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Consequences of the Debt Crisis

by Anton Konrad, Munich*

The indebtedness of the developing countries to foreign creditors which has expanded rapidly over the past few years rose by a further 18 % last year and by the end of the year had reached the estimated level of \$626 billion. The debt servicing for this sum amounted to \$131 billion.¹ The rescheduling operations required as a result of the accumulating payment difficulties reached a volume of \$40 billion. According to the Mexican Minister of Finance, the restructuring of Mexico's foreign debts alone was the largest multilateral support operation in modern financial history.²

It is generally agreed that the only real solution to the present debt crisis lies in an economic upturn in the industrialised nations which would again improve the developing countries' export earnings. One difficulty is, however, that this upturn is in fact impeded by the debt crisis itself because the nations facing payment problems have to limit their imports from the industrialised countries in order to restrict their own net borrowing and service their present debts and this produces a decline in the urgently needed export demand. To avoid a reciprocally induced paralysis of the industrialised and developing nations the IMF obliged the banks involved in the rescheduling operations not only to extend existing credits but also to grant new loans. This could not, however, prevent a drastic fall in the volume of new lending to developing nations. In the third quarter of 1982 there was in fact a drop in absolute terms in the international banks' total claims deriving from loans to the non-OPEC developing nations.

The banks involved in international syndicate loans are obviously themselves under some pressure to adapt. Although it was possible to avoid a serious crisis of confidence in the banking system by means of close cooperation between the IMF, the central banks and a large number of creditor banks, certain indications of increasing caution and restraint on the part of private and official investors towards the international banks did become evident. These indications include, in particular, the fact that since 1979 the OPEC nations have been investing only a rapidly contracting proportion of their current account surpluses in the western banks and instead have preferred the newly-established Arab banks in the Euro-markets which in turn adopt a very cautious attitude towards loans to oil-importing developing nations. Traces of a switch in

preference away from the banks on the part of both official and private institutions can also be perceived in the brisk demand on the gold market until other influences predominated at the beginning of March 1983. As regards the private sector, the persistent heavy demand for diamonds can perhaps also be construed as a search for alternative stores of value. Yet if the banks restrict their lending to the Third World because of their own views of the risk involved and also the behaviour of their depositors, this also impedes the drop in interest rates which is so urgently needed.

Causes of the Crisis

The worsening of the debt situation is a bitter disappointment for those economists, bankers and persons concerned with economic policy who believed that the balance of payments problems arising since the oil crisis had been solved by the apparently smooth functioning of the recycling process. The critical situation is still sometimes described as the result of a coincidental occurrence of adverse circumstances, such as high interest rates, high oil payments, declining raw material prices, stagnant foreign aid from the industrialised nations, excessive investment programmes and inefficient debt management by the developing nations. All these elements can, however, be directly or indirectly linked with one causal factor, i.e. the rise in the real interest rate – based on the London interbank rate (LIBOR) and the growth rate of the US national product deflator – from 0.9 % for the period between 1973 and 1979 to 5.2 % for 1979 to 1981. This reflects an analogous swing from largely negative to high real interest rates in the leading industrialised nations.

¹ Cf. IMF Survey, 10 January 1983.

² Interview with the Mexican Minister of Finance, Jesus Silva Herzog, in: Handelsblatt, 28/29. 1. 1983.

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V E R L A G W E L T A R C H I V G M B H - H A M B U R G

Another method of calculating real interest rates is even more informative with regard to the developing nations: since they usually have to pay their interest in dollars which have to be earned from exports, we obtain a suitable yardstick for real interest rates by deducting from the nominal rates the rate of increase in the export prices of the countries in question. In the first of the above periods world inflation fuelled by the oil price explosion and a permissive monetary policy caused a boom in raw materials so that, when calculated in this way, the real interest rates of the developing countries were largely negative. The debt service ratio, defined as the ratio between debt service payments and export earnings, could thereby be stabilized at 14 % despite rapidly increasing foreign indebtedness. The switch to a more restrictive control of the money supply, especially in the USA, caused a rapid upturn in nominal interest rates, deceleration of the price upcreep and a drop in raw material prices as a result of the recession; when calculated on a dollar basis this drop was particularly affected by the dollar's revaluatory tendency. These factors combined to produce a situation where the real interest rates applicable for the developing countries and which had formerly been between -7 % and -11 % rose to between +7 % and +10 % in 1981.³ Since the periods to run of the loans were shortened at the same time, a dramatic increase in the debt service ratios occurred, particularly in those countries which had contracted variable-interest loans from the international banks; in Brazil, for example, this ratio rose to more than 60 %.

Different as the course of the two periods before and after 1979 may have been, taken together they indicate that the oil-producing countries' attempt to accumulate an enormous volume of foreign assets by means of a monopolistic pricing policy is coming up against firm limits: either the foreign assets accumulated by net exports and interest earnings are reduced by world inflation or the generation of further surpluses is restrained by a recession. One essential future task will be to restrict the monopoly power of the oil exporters in a different, less painful manner than by world inflation or world recession, that is to say by reducing dependence upon oil.

What attitude should be adopted towards future current account deficits of the developing countries and what past errors must be avoided in the process? These questions can be discussed more expediently if the current account deficits are broken down into the

categories applied for budget policies, namely normal indebtedness and cyclical and structural deficits, to which we should add deficits caused by expansion.

Normal Indebtedness

The developing countries' normal indebtedness to industrialised nations results from the fact that in mature economies there is a long-term tendency for savings to exceed investment whereas in the developing countries the saving capacity lags behind the investment opportunities. Any imbalance in the current account can indeed be construed as a discrepancy between saving and investment. Without allowing a certain latitude for using one's own discretion it is hardly possible to decide which proportion of the imbalance can be considered normal and long-term, especially since this depends not only on the long-term growth trends but also on the transfer of resources which the industrialised nations are prepared to make, by dispensing with internal absorption, in the form of official development assistance. In practice it would be possible to refer back to empirical values taken from several base years which can be considered normal and to extrapolate this "normal" current account deficit in line with the growth in exports which has occurred in the meantime. Apart from the yardstick it provides, the value of such a model computation lies in the fact that it enables us to appreciate that no net redemption of such normal indebtedness is necessary but only redemption with the help of new loans, following the system used for our internal public debt. If the interest is regularly serviced, the necessary gross borrowing requirement should be able to be met on the capital markets or by foreign aid. Only the interest due and not the total interest plus redemption would then need to be included in the debt service ratio. Although the volume of foreign indebtedness rapidly increases with such a system, the ratio between debt service and export earnings tends towards a stable marginal value which will be the lower, the lower the interest rate and the higher the growth rate of exports.⁴ This assumes that the foreign loans are efficiently used so that they cause a steady improvement in production and exports.

From the creditor nations' point of view it is not only feasible to maintain this type of normal indebtedness on the part of the developing countries for the foreseeable future but actually desirable as a means of supporting demand. A net redemption by successful developing

³ Cf. J. de Larosière: The Impact of Interest Rates on International Finance and Trade, in: IMF Survey, 15 November 1982, p. 360f.

⁴ This view is based on the results of applying the Domar Model for the public debt to the problem of foreign indebtedness. As the reference figure for the national debt or debt service, exports replace the national income. Cf. E. D. Domar: The 'Burden of the Debt' and the National Income, in: Essays on the Theory of Economic Growth, New York, 1957, p. 35ff.

countries is of course welcome but only so that the returning funds can be re-lent abroad. On the other hand, a global net redemption of foreign loans would result in the industrialised nations having a current account deficit with the developing countries which, from the point of view of total demand, would be as inappropriate as internal budget surpluses for the net redemption of the public debt.

The Cyclical Component of Indebtedness

The cyclical component of the present deficits is a consequence of the lasting recession in the industrialised nations as a result of which the oil-importing developing countries have been witnessing a decline in their volume of exports and a fall in their export prices. In addition, the developing countries had a higher average growth rate than the industrialised nations and this was maintained even in the period of recession. Whereas economic growth in the industrialised nations fell from 4.5 % to 3.1 % between 1968/72 and 1973/80, the developing countries experienced only an insignificant drop from 5.8 % to 5.2 %.⁵ This ability to resist the recessionary trends in the industrialised nations meant support to the demand for the latter's output and thus acted to some extent as an automatic stabilizer, comparable to the situation in the domestic economy when public expenditure is maintained in the event of revenue shortfalls caused by cyclical factors.

Yet the supply of official foreign assistance from the OPEC nations has declined since 1975 while the same trend has occurred in the industrialised nations since 1981. Faced with their own budget problems, the industrialised nations have been tending to intensify the effects of the cycle instead of increasing their foreign aid and thus funding the developing countries' demand-supporting behaviour. Since, however, official financial assistance accounts only for the smaller part of the flow of capital to the developing countries, even if the donor nations adopted an approach more appropriate to the cyclical trend the main burden of financing the deficits caused by that trend would fall upon the banks or the International Monetary Fund which has a special fund for this purpose in the form of the compensatory financing facility.

The concept of the cyclical deficit implies automatic reversibility; in other words, the deficit is automatically reduced when the cyclical situation in the industrialised nations returns to normal. The higher level of foreign indebtedness, however, continues to exist for the time

being. Only when the developing countries are able to achieve surpluses in the course of the cyclical upturn in the industrialised nations is it possible to reduce the volume of debts to their original level prior to the recession. Otherwise, a "residual burden" remains in the form of the debt service for the obligations contracted during the recession and this necessitates a continuing reduction of imports for a longer period. It would be entirely proper, if necessary, for the industrialised and oil-exporting nations which enjoyed the benefits of continuing demand during the recession to help to spread the burden by providing more foreign aid or remitting part of the debt. This would belatedly produce a similar result as an anti-cyclical allocation of funds in the first place, as the concept of "global Keynesianism" requires. A number of industrialised nations may, however, have already made their contribution in real form by exposing themselves to competing imports and import substitution from the more advanced developing nations when they kept their markets open even in times of economic difficulties.

Structural Component of Indebtedness

Unlike the cyclical deficit, the structural deficit does not have a self-correcting tendency; instead an expansive force is often inherent in it. Since by definition it exceeds the level fundable in the long-term, efforts must be made to reduce it. One principal component, i.e. the high oil bills of the oil-importing developing countries, is often cited as an example to show that this reduction is impossible in the short term. To maintain the current level of production additional expenditure is required for the necessary oil imports even if it is not always possible to observe the fundamental rule that foreign credits must be accepted only for investment purposes.

This view should, however, be modified in the light of recent experience. It has been found that the ample flow of funds through the banks and, to some extent, through the public institutions has in the final analysis helped to ensure the sales of the higher-priced oil. Combined with other demand-reducing factors, a contraction in the available funds – a situation which has now arisen owing, for example, to the international banks' increasing caution in granting credit to developing countries – was a quite suitable way of putting pressure on the monopolistic pricing policy of the OPEC nations. This raises a question which has already been discussed in connection with American foreign aid in the post-war period: is the need for funds dependent on a structural deficit on current account or is the latter determined by the availability of funds? One particularly

⁵ Cf. IMF Survey, 5 April 1982, p.98.

unsatisfactory aspect of recycling was that the western banks were responsible for transmitting the petrodollars accumulated by the oil exporters and thus had to assume the country risk instead of the oil nations having to bear this burden themselves.

On the other hand, a straightforward cut in oil imports without any prior measures for oil conservation and substitution would cause unreasonable hardship to the population. These measures require either a reallocation of investment funds or extra investment and thus extra capital. In cooperation with the World Bank the IMF has taken this need into account by means of so-called structural adjustment credits. This involves, however, not simply the problem of capital supplies but also of incentives. Since the increase in oil prices also raised the general level of prices through cost inflation, the change in the relative prices was often too slight to stimulate a search for alternative sources of energy.

Oil-exporting Debtor Nations

Yet the oil deficits have not played the crucial role in the present crisis, as is proved by the fact that the countries with high levels of indebtedness do include oil-exporting nations such as Mexico, Venezuela, Algeria and Indonesia. In these cases, over-ambitious development programmes have obviously been responsible for the payment difficulties. Here again, it is indeed quite possible that as part of those investment programmes projects were implemented which were appropriate for improving the current account by exports or import substitution. Yet realization of that potential often requires a corresponding demand in the industrialised nations which would in turn be generated only by a cyclical upturn. In that respect the border line to the cyclical deficit is fluid.

If the investment programmes are considered extravagant after the event, we must remember that initially the negative or very low real interest rates also gave misleading signals for their go-ahead. Projects which seemed profitable with low interest rates proved to be no longer viable after the rates had been adjusted. In this way it was sometimes impossible to ensure the profitability of the invested capital even in terms of domestic currency; the transfer problem was certainly intensified by the adjustment of interest rates.

Involvement of the IMF

The IMF loans subject to conditionality are a suitable means of funding those deficits resulting from a policy of forced growth. As the recent spectacular rescheduling operations have shown, the IMF's conditionality

includes not only global restrictions on the expansion of the money supply and budget deficits but also the methods for consolidating the budgets and measures for influencing relative prices, e.g. removal of subsidies, increases in taxes and tariffs and currency devaluations.

To allow the IMF to carry out the tasks incumbent upon it in the imminent and anticipated cases of rescheduling the Group of Ten have increased the funds available to the IMF under the "General Arrangements to Borrow" from 6.4 billion to 17 billion SDR (approx. \$19 billion). The IMF Interim Committee also agreed to a general increase in quotas from the present 61.03 billion to 90 billion SDR (approx. \$98.5 billion). This operation will certainly maintain the continuing functional capacity of the international credit system. Yet one still has the uneasy feeling that involvement of the IMF and the central banks in the rescheduling operations can only result in reorganisation through the printing press!

The fact that the most serious payment difficulties occurred precisely in the relatively wealthiest developing countries which had relied mainly upon bank loans for funding their economic expansion programmes, proves that those were right who had for years been calling for stricter control of the international banks. Voluntary measures, such as the establishment of an evidence centre for country risks, can no longer be an adequate substitute for bringing the foreign subsidiaries of domestic banks under national bank supervision nor for more stringent regulations with regard to equity requirements and risk-spreading.

Even more importance attaches to the need for the leading countries, and especially the USA, to avoid in future the extreme levels and fluctuations in real interest rates which have been experienced over the past decade. This is all the more important in view of the fact that most of the international bank loans are granted at variable interest rates so that the long-standing loans feel the full brunt of any fluctuations in the rates. Any approximate stabilization of real interest rates does not necessarily conflict with the control of money supply which is still applied in varying degrees. Only if the growth rate of the money supply is significantly reduced to remedy current inflation does a period of high interest rates occur, whose length depends upon the obduracy of inflationary expectations and the resultant behaviour. The reduction of inflation which has now been achieved in the USA should, however, increase the likelihood of more steadiness regarding both control of the money supply and real interest rates even if the budgetary policy still offers considerable risks in this respect.