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Lessons from the Debt Crisis

Although rescheduling negotiations with Argentina are still in progress there can be little doubt that this financial rescue operation will also be brought to a successful conclusion. The outcome of the presidential elections in Argentina has certainly helped pave the way for a solution in this case. The huffing and puffing displayed by both sides in such negotiations has become as much a matter of routine as has the restructuring of billions of dollars of public and private external debt via the joint or coordinated action of commercial banks, central banks and governments as well as the International Monetary Fund (IMF) and the Bank for International Settlements (BIS).

However, even before the final signature has been put to this particular deal it is fair to assert the following: the institutions responsible have the international debt crisis firmly under control. The danger that cumulated defaults on the part of highly indebted developing countries might lead to a collapse of banks triggering a worldwide financial breakdown, has been averted for the time being. A repetition of the events which occurred during the early 1930s need no longer be feared as soon as Argentina, the last tough nut among the major floundering debtor countries, has been cracked. The amounts of debt still to be dealt with will then no longer be so large as to be able to shake the foundations of the international financial system.

Although this observation may seem most comforting at first glance, the question arises as to how such a critical situation could come about in the first place and whether international financial problems have in fact been fundamentally solved or merely bridged for a short spell. A further question is who is to foot the bill. After all, the fear of an international financial collapse is not purely a product of the imagination of oversensitive newspaper readers. Anyone taking the time to read between the lines of statements and proposals made by the decision-makers in this crisis could not fail to detect a note of grave concern. Even without such signs it is easy to appreciate that the price to be paid for deferring millions of dollars of interest and redemption payments and the subsequent rescheduling operations is a high one.

When after the first oil price crisis public doubts were raised on how a long-term financing of the resultant current account deficits of oil-importing countries – not just of developing countries – could be guaranteed, the international banks had already taken action. The recycling of petrodollars appeared to function extremely well. The international banking community had the necessary tools at its disposal. Variable interest rates facilitated the adjustments of payment deadlines and passed the risks of interest-rate changes on to the debtors. The setting up of consortia enabled high sums of money to be provided whilst the individual country risks were initially kept low. Much to the delight of the debtor countries, western private-enterprise management practices guaranteed speedy decisions.

The world therefore seemed well equipped to cope when, towards the turn of the decade, the OPEC countries brought about a second oil price shock. This time the shortcomings of the much-acclaimed banking policy tools became apparent. It was not merely as a result of the longest period of international economic stagnation in post-war history, marked by a decline in demand for exports, a plummeting of raw materials prices and a resurgence of protectionism, that many highly indebted developing countries found themselves faced by liquidity problems. It also became obvious that the investment programmes pursued in a number of countries were the result of prestige-mindedness rather than profitability

considerations. Moreover, instead of being used to extend productive capacities, foreign savings were frequently used to maintain a given consumption level. International banks had been indiscriminate in their financing of such programmes. Apparently relying too much on one another, the members of the banking consortia had largely failed to carry out the necessary assessments of the debt-paying ability of the borrowing countries in question, assessments which are a matter of course in the private sector. This was not all that was brought into the open by international economic stagnation and the growing number of rescheduling cases. It also became clear that, although variable interest rates pass the burden of the risk of interest-rate changes on to debtor countries, creditors, especially in times of continued interest rate increases, are faced with higher solvency risks; for, the higher the interest rates, the lower the number of profitable projects.

The restraint shown by international banks in their lending policy in response to the new international economic situation aggravated the situation even more. The banks were now just as indiscriminate in their restraint as they had previously been in their willingness to lend. This led to a situation in which those countries which had been seriously shaken by the external shocks of oil price increases and stagnation but which had adopted new economic policies to cope with the changed framework, also found themselves facing severe balance-of-payments difficulties. The subsequent cumulation of debt crises threatened to overtax and even break up the international financial system.

The collaps could be prevented. This was not least a success of the long-standing communication network within the afore-mentioned system, including the governments of western creditor nations, the IMF and the BIS. However, there is no way of ensuring that such a situation will not occur again in future. The fact that the repayment periods agreed upon in rescheduling packages are relatively short and that the necessary processes of adjustment may not have been concluded before these periods expire, is not the problem. In fact this may prove to be a positive aspect, since the already foreseeable renegotiations will compel the countries in question to comply with the conditions agreed upon. It is the emerging distribution of burdens that gives cause for concern.

The events described are only then unlikely to recur if those causing the crisis are also obliged to take the consequences, i.e. to bear the costs of remedying the damage done. Otherwise, moral hazard will be encouraged. In fact, by involving the IMF those countries guilty of plunging too readily into debt were compelled to accept economic policy conditions which on the whole seem appropriate for providing a basis for orderly economic growth in future. The conditions laid down by the IMF make sure that the scope of economic and social activities is a realistic one and help remove price distortions. As these conditions are "painful" for the countries concerned and give rise to economic costs, the debtor countries do have to bear their share of remedial costs.

However, what about those guilty of indiscriminate lending? During the joint rescheduling operations they were forced to grant a respite for the repayment of interest and redemption and to grant new loans. Of course this was not done free of charge, but special fees and risk charges on interest were demanded. In addition, the fact that these operations restored the solvency of debtor countries meant that the need for value adjustments for losses on loans was less than originally expected. This led in most cases to lower profits rather than losses. What is more, at least in some countries there are grounds for suspecting that restraint of competition has allowed banks to keep their interest margins at a high level. The profits thus gained have enabled the necessary value adjustments for losses on international loans without leaving the shareholders empty-handed. The burden of rescheduling has thus been socialised via tax savings and higher charges for domestic customers.

In their fear that the international financial system might collapse, the governments and central banks in the creditor countries as well as the IMF and the BIS have probably overdone matters somewhat. They must now give serious thought to the mechanisms via which they can return the credit risks to the banks so as to prevent thoughtless international lendings in future.

Manfred Holthus