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The Debt Crisis and Structural Adjustment in Developing Countries

A fundamental change is emerging in the World Bank's perception of the problems of the debt overhang and in its ideas for development strategies. The author examines the implications for debtor countries.

A change of emphasis is evident in the World Bank's 1988 World Development Report. As the year before, it expresses considerable optimism about the solution of the Third World's debt problems through growth and an expansion in exports and reiterates the view that the debtor countries could again achieve the high growth rates of the fifties and sixties by adopting rigorous structural adjustment measures. Given that objective, the role of public finances in the development process constitutes the main theme of the report.

However, the World Bank also analyses the constraining influence of the debt overhang and points to the need to reduce the cost of debt servicing for heavily indebted countries. It considers measures based on a market valuation of the debts of middle income countries to be an appropriate starting point, alongside further concessions to the poorer debtor countries as agreed at the Venice Summit in 1987. The World Bank has thus added its weight to a demand made by the Group of 24 at the 1988 spring meeting in Washington. On that occasion the Development Committee of the IMF and World Bank also declared that the international organisations should support methods of reducing outstanding debt where loan packages between commercial banks and middle income countries were concerned.

This indicates a fundamental change in the perception of the problem of the debt overhang. The World Bank is relying on faster economic growth in debtor countries

and a reduction in debt servicing costs, simultaneously, i.e. independently, so to speak as the two basic components of a new development strategy. This article examines the implications of these ideas for the debtor countries.

Changed Nature of the Debt Crisis

There has been talk of a debt crisis since 1982, when many Third World debtor countries got into balance-of-payments difficulties as a result of the excessive and unsustainably rapid expansion in credit in the seventies, the subsequent steep rise in interest rates and stagnation in demand in world markets. The crisis broke in spectacular fashion when Mexico, one of the large debtor countries, suspended payments to its creditors. At that time the prime objective of the International Monetary Fund was to provide debtor countries with liquidity through short-term balance-of-payments assistance in order to avert an international financial crisis that could have led to the collapse of major banks in the creditor countries. The Fund granted the crucial assistance under its then President Jacques de Larosière, but in the years that followed it became clear that this had only postponed the problems. In March 1987 it was the turn of Brazil; in the face of serious liquidity problems, it could see no solution but to suspend its debt servicing despite the threat of a boycott by the banks.

The true nature of the crisis, namely the overindebtedness of many Third World countries, became abundantly clear in 1985. Since then the

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developing countries have been in the position of a net payer both to the IMF as well as to private creditor banks. The flow of debt service payments from the Third World to lenders has exceeded the inflow of new capital. This was criticised as an unsustainable situation at the spring meeting of the IMF in Washington. Being a net payer requires a country with no foreign exchange reserves to achieve trade surpluses in order to finance interest payments and debt redemption. The developing countries therefore find themselves in a situation that conflicts with their development needs and their economic position in the world market.

The net transfer of capital from debtor to creditor countries reflects the following development trends:

□ The debtor countries have clearly succeeded in their efforts to reduce their balance-of-payments deficits, although over the short term this could only be achieved by curbing imports; a durable expansion in exports would necessitate a drastic improvement in their competitive position and a reduction in protectionism in industrial countries. Their trade surpluses are therefore the result of an austerity policy impeding growth. At the same time, the improvement in their trade surpluses has not been accompanied by an improvement in creditworthiness, since the indicators of a country's credit standing are based on export performance. In fact, the indicators for many developing countries have actually deteriorated, mainly as a result of valuation effects caused by the depreciation of the dollar since 1985.¹

□ In addition, the net flow of capital out of developing countries shows that the willingness of creditor countries to lend fresh money has not increased. The crisis management by the IMF and the World Bank since 1982 may well have encouraged this wait-and-see attitude on the part of the banks.

□ From the point of view of the industrial countries, an increase in the trade surplus of developing countries signifies that important export markets of the industrial countries are stagnating or shrinking.

New Programme Structure

The IMF and the World Bank have adapted to the changed nature of the debt crisis since the beginning of the eighties by modifying their programme structure. As a result, the traditional division of tasks between the two institutions, whereby the IMF was responsible for short-term balance-of-payments assistance and the World

Bank for project financing, was also abandoned in the course of the crisis.

□ In 1980 the World Bank followed the trend of conservative economic policy in the industrial countries by shifting the accent of its policy away from targeted project financing aimed at combating poverty (the main emphasis of the McNamara era) towards financial assistance for the implementation of economic reforms. For this purpose it introduced structural adjustment loans (SALs) to add to its existing project loans and sectoral loans. SALs are longer-term balance-of-payments assistance for countries with high structural current account deficits; they are granted on condition that the debtor country implements a comprehensive programme of structural adjustment. The conditions are laid down in consultation with the IMF. In 1987 SALs already totalled \$ 4.4 billion out of total lending of \$14.1 billion. Since the mid-eighties the World Bank has also again stepped up its special programmes to combat rural poverty.

□ The IMF also geared itself to tackle the medium-term problems of debtor countries and for some years has offered medium-term facilities to counter "structural balance-of-payments disequilibria". In addition, it introduced various facilities tailored to the particular problems of developing countries, contrary to its principle of rejecting any linkage between liquidity assistance and development aid. These facilities comprise: (1) the structural adjustment facility, which was introduced in 1986 and extended to the benefit of the poorest developing countries in 1987; it is not subject to the usual conditions and is financed from special resources; (2) the external contingency mechanism, consisting of special credit lines to cope with unforeseeable developments (only fluctuations in export earnings until 1987) that jeopardise the implementation of an adjustment programme that is already in progress.

These programmes have a strong development content. The Fund's supervisory function in the context of "enhanced surveillance" is also important for development strategy. In this exercise, in which the Fund plays a catalyst role, the debtor countries' sole concern is to acquire the Fund's "seal of approval" for their adjustment programmes for the purposes of negotiations on debt rescheduling.

Joint crisis management by the IMF and the World Bank had two direct consequences for debtor countries:

□ On the one hand, the chances of successfully carrying out stabilisation programmes and political

¹ Cf. World Bank: World Development Report 1988.

reforms improved, because the time-scale of adjustment was lengthened, co-operation between the IMF and the World Bank made it easier to meet the conditions and because the policy-based loans could be disbursed more quickly than project loans. Another important aspect for the World Bank was that the improved general setting enhanced the prospects for successful project financing.

□ On the other hand, co-operation between the IMF and the World Bank with regard to structural adjustment greatly increased the incursion into the economic autonomy of debtor countries. Admittedly, World Bank representatives generally regard structural adjustment measures as marginal measures rather than fundamental reforms. Hence land reform cannot be subject to conditionality, but conversely policy-based lending requires closer surveillance than project financing since there are practically no criteria for evaluating such programmes.

Strategy of Long-term Structural Adjustment

The structural adjustment assistance from the IMF and the World Bank is aimed at instigating fundamental structural change in debtor countries and hence above all improving their competitive position in world markets. The basic objectives of this strategy of long-term structural adjustment are:²

- reform of public budgets, with the prime aim of reducing deficits;
- reform of foreign trade, aimed at switching from a domestic orientation of the economy (import substitution) to an external orientation;
- reform of the price structure, especially the liberalisation of agricultural prices;
- the privatisation of state enterprises and hence at the same time a slimming-down of the public sector.

High Social Costs

As to the role of fiscal policy, the World Bank recommends a cautious budgetary policy, tax reforms aimed at increasing the efficiency of the tax system, more effective public expenditure, a devolution of government power through decentralisation and government measures to combat poverty. Long passages of the analysis in the 1988 World Development Report read like a textbook on public finance. There can be no doubt that the action

recommended by the World Bank is urgently needed in many debtor countries, but implementation requires tenacity and patience and it is not apparent how such measures might help ease the problem of the debt overhang even over the medium term.

According to the World Bank, a key element of the reform of foreign trade should be to remove the protection for domestic industry that debtor countries have erected in the course of industrialisation. Typically, this consists in overvaluation of the currency, which reduces the cost of intermediate products needed to build up domestic industry, combined with direct import restrictions on competing goods (quantitative restrictions and tariffs). In such a market situation the competitiveness of the protected domestic industry remains permanently low, while at the same time the overvaluation of the currency induces persistently high import demand and impedes the development of an export sector. For many developing countries, the reform of foreign trade coupled with devaluation is therefore an important prerequisite for improving their international competitiveness.

However, in many cases an improvement in export capability also requires a reorientation of domestic industry towards internationally tradable goods. This is a process entailing high social costs, particularly since structural change cannot be regarded as a once-and-for-all event. The extent to which structural adjustment leads to volume effects and to an improvement in the trade balance will depend ultimately on conditions in the world market. A decisive factor is the price elasticity of demand for internationally traded goods. Others are whether developing countries are supplying internationally expanding or stagnating markets (income elasticity of demand) and not least the degree of protection in those markets. In these circumstances it is not surprising that the tremendous export success of the newly industrialising countries in East Asia cannot simply be attributed to trade liberalisation (the "new orthodoxy" hypothesis) but to a policy of vigorous export promotion and a fundamental change in the structure of industry.

Price reform, especially the freeing of the prices of agricultural products, triggers strong impulses, as the examples of Ghana and Nigeria show. The removal of price ceilings for farm produce creates economic incentives for agricultural production, which has a foreign trade effect by reducing the demand for imported food.

As far as the privatisation of state enterprises is concerned, closer examination shows that the efficiency

² Cf. World Bank: World Development Reports 1987 and 1988; and IMF: World Economic Outlook, April 1988.

of the enterprise is determined more by the terms of its statutes and the way in which it is run than by its ownership status. Moreover, the scope for privatisation is extremely limited in many developing countries because of the lack of a developed capital market in which the enterprise's shares can be placed.³

Given that a strategy of long-term structural adjustment is subject to severe constraints even under "normal" conditions, the crucial question remains how such a strategy can enable debtor countries to cope with their excessive debt. The World Bank's confidence is based on the expectation that an outward-oriented growth strategy will mobilise domestic resources by reducing budget deficits and generate an export surplus by shifting the emphasis towards the production of internationally tradable goods.⁴ The World Bank is using a simple model here,⁵ whereby the increase in domestic savings or the reduction in budget deficits solves the problem of capital mobilisation and the export surplus makes the transfer of capital possible (debt repayment). The mobilisation and transfer problems are therefore at the heart of the development strategy.

The Dilemma of the Debt Overhang

If one regards the problem in terms of net income flows one loses sight of the fact that the debt overhang, which additional investment and additional exports are supposed to reduce, itself prevents these stimuli from developing in a money economy. There are cogent reasons for this:

- Growth presupposes investment and hence new borrowing (growth-cum-debt); if capital goods have to be imported, external indebtedness will increase in any case. Rising indebtedness need not impair the country's creditworthiness, for the country's ability to service its debts grows as national product and exports rise.
- This is not the case if the economic development that a structural adjustment programme is supposed to set in motion is burdened from the outset by a mountain of existing debt, in other words if it is first a question of restoring creditworthiness. In this instance a development strategy based on new borrowing is

blocked, because banks are not prepared to provide fresh money, since the new creditors are bound to fear that their money will be used to settle past debts.

This paralysing conflict between old and new creditors cannot be resolved unless there is provision for giving precedence to the claims of new creditors, as in composition proceedings.⁶ This casts a fresh light on the current assertion that a cancellation of debts would be to the detriment of debtors because they could no longer bank on receiving new money. There is indeed a problem of incentive here, but the decisive point remains the fact that it is the debt overhang itself that is deterring new lenders, as events in the international financial markets in recent years have confirmed. Devaluing existing debt to a market-oriented level therefore emerges as the central prerequisite for the new development process to be financed externally. Since the Third World debtor countries have borrowed in foreign currencies, they cannot achieve this devaluation through inflation. A reduction in the nominal value of debt in one form or another is therefore unavoidable, for only this will give the holders of new claims an assurance that the risk of non-redemption has been reduced to normal levels. The 1953 London Agreement on German External Debts is an historical example in which creditors, albeit sovereign creditors, fulfilled these prerequisites and hence greatly improved the growth prospects of the Federal Republic of Germany.

The debt overhang also creates a dilemma for lending countries. If it were demanded that debtor countries restored their creditworthiness by mounting an export drive, the hard-currency countries would have to be prepared to accept trade surpluses by debtor countries amounting to a substantial part of the Third World's total outstanding debts of more than \$ 1,200 billion (private bank loans \$ 320 billion). If this is thought through properly, it will be seen not only that a transfer of resources on this scale is likely to exceed the developing countries' capacity to handle but also that the industrial countries are not prepared to accept such a transfer and the consequent structural change in their domestic economies.

In any case, the restoration of a debtor country's creditworthiness does not require a trade surplus at all. Import surpluses during the development process are no impediment to creditworthiness, provided the debt/export ratio remains reasonable. An export surplus is therefore not a necessary condition for creditworthiness. As the years since 1985 have shown, it is not a sufficient condition for the restoration of creditworthiness either, since it may reflect a restrictive policy reducing imports and hence impairing investment

³ Cf. J. Aylen: Privatization in Developing Countries, in: *Lloyds Bank Review*, No. 163, 1987.

⁴ Cf. C. Michalopoulos: World Bank Programs for Adjustment and Growth, in: V. Corbo et al. (eds.): *Growth-Oriented Adjustment Programs*, Washington 1987.

⁵ Cf. World Bank: *World Development Report 1988*.

⁶ Cf. M. Nitsch and A. Malagardis: Mit souveränen Schuldern leben. Verschuldungskrise und Insolvenzregelungen, in: *Interdependenz*, No. 2/1988.

opportunities and the prospects of a restoration of creditworthiness.

Devaluation of Existing Debt

The secondary market indicates the scale of the need for adjustment in the valuation of claims on the major debtor countries that has accumulated as a result of the debt overhang. In this market Third World debt is traded among banks at discounts of more than 50% to its face value. If secondary market valuations are considered realistic, a large share of the outstanding debt of developing countries (estimates say \$ 300 to 400 billion) should be ascribed to the debt overhang and considered as having no economic value.

Why are the debtors not allowed to benefit from these valuation adjustments so that they too can straighten out their accounts and escape from the dilemma of being unable to restore their creditworthiness? The reason is that there is no international law on bankruptcy and composition that could allow debts to be devalued according to predetermined rules. Perhaps that is why the banks wrongly assumed that there would be no defaults, and undoubtedly it is the reason why the suspension of payments by Mexico in 1982 and Brazil in 1987 appeared so scandalous since it broke the rules. In fact, these countries were only attempting to invoke rules that do not exist simply because they would not be accepted. Since then, the introduction of such rules has been discussed within UNCTAD.⁷

Lack of an Institutional Mechanism

The nature of the debt involved illustrates the point. During the phase of debt expansion in the seventies the debts were not issued in the form of fixed-interest bonds, as would be normal with long-term borrowing. An important reason was probably that such bonds, which are placed in international financial markets, must meet high rating requirements. Instead, the debts were concluded as loans at adjustable interest rates so that the debtor bore the interest rate risk. A risk premium was built into the interest rate to cover the risk of non-redemption and to compensate for the lack of rating. Debtors accepted these terms in the seventies, when real interest rates were low and sometimes negative. Since the beginning of the eighties they have been paying the price of the worldwide battle against inflation. There has been much speculation as to why interest rates remained so high in the further course of the eighties after inflation had been successfully curbed. It is conceivable that the banks, as price setters,

postponed the decline in interest rates in order to offset the now far greater risk of default.

The decisive factor continues to be the lack of an institutional mechanism for devaluing the debt overhang. What is possible are negotiations between the debtor country and the creditor banks, which must solve the difficult problem of free riders. Since the debtor country generally stands alone in such negotiations, there is a danger that solutions will be adopted that will give it only brief respite. Negotiations usually range over a number of measures, with non-concessionary debt remission beginning to appear in arrangements such as debt-equity swaps, securitisation or certain forms of interest capitalisation. However, it must be obvious that the success of more far-reaching measures to reduce the debt overhang depends less on the goodwill of the parties involved or the progress of the negotiations than on economic imperatives. The question is what forces, in the sense of a competition mechanism, influence the negotiations. Since the danger of a collapse of the international financial system has been banished for the time being, the banks can play for time and keep open the option of repayment of their claims at face value in more favourable world market conditions. Such a policy of muddling through would be fatal, because it could induce a tendency towards permanent stagnation that would cripple world trade. The only economic incentive that may be effective in these circumstances in the sense of prompting the banks to act is therefore the interest of producers from industrial countries in long-term financing for their exports to developing countries. In this connection, it has been seen that state export credit guarantees are a two-edged sword, since although they safeguard exports they may contribute to postponing a solution of the debt overhang problem.

On closer examination, the World Bank's optimism that the problems of the debt overhang can be solved by increased growth efforts and an export drive by debtor countries proves to be an illusion, first because it orientates the debtor countries' development strategy towards repayment of the debt overhang, which in economic terms is neither justified nor desirable, secondly because it again gives the development strategy a one-sided emphasis on achieving export surpluses, and thirdly because it frustrates all efforts to induce the banks to adopt a market-oriented approach to negotiations on overcoming the debt overhang. It would be highly desirable if those within the World Bank and the IMF who consider a solution to the debt overhang to be a precondition for structural adjustment measures by debtor countries and a successful development strategy were to win the day.

⁷ Cf. UNCTAD: Trade and Development Report, Autumn 1988.