A Survey of Current Debt Crisis in LDCs

by

QING JIAN FU

B.A., Xiamen University, Fujian, China, 1985

A MASTER'S REPORT

Submitted in partial fulfillment of the

requirements for the degree

MASTER OF ARTS

ECONOMICS

KANSAS STATE UNIVERSITY
Manhattan, Kansas

1989

Approved by:

Patrick J. Gormely

Major Professor

ACKNOWLEDGEMENTS

I would like to take this opportunity to express my deep gratitude to my major professor, Dr. Patrick J. Gormely, for his continuous help and guidance throughout my study program. My sincere thanks also go to Dr. E Wayne Nafziger and Dr. Yang-Ming Chang for servicing as my graduate committee members. Their support and encouragement are highly appreciated.

I would also like to share my warm feelings with the faculty and staff in this department, my fellow students from the attic, and my close friends all over the world. The memory of their kindness and friendship will be a part of my future life.

Finally, I am greatly indebted to my parents and the Chinese State Education Commission (SEC) for their moral and financial support. Without their support, it would have been very hard for me to finish this report and my study program.

TABLE OF CONTENTS

LIST OF TABLES

Page

LIST OF FIGURES

I. Introduction

Six years have passed since the outburst of the debt crisis in LDCs in August 1982. While the topic is not as hot now as it was several years ago, this by no means suggests that the debt problem is over. For the past six years, some of the efforts to cope with this problem have been successful, but in other areas the progress has not been satisfactory. The dangers of disruption to the international financial system clearly have been reduced, but systematic risks are still present in the overall debt situation. The economic development of LDCs is still hanging on the continuous efforts to manage and ultimately resolve the debt problem. In this regard, a retrospective review of the problem may be helpful.

Debt crisis refers to the period of widespread inability of debtors to meet their obligations (Dornbusch & Fischer, 1986, p. 836). It is not a new phenomenon at all. Ever since the emergence of money economy, it has been a recurrent event in the financial history. However, it was not until the 1970s when LDCs accumulated such a huge external debt which imposed tremendous threat to the world economic stability that this momentous problem became a topic attracting considerable attention. Since then numerous studies on this topic have been done. It is difficult to add anything new, and even more difficult to think out practical and effective policy recommendations in such a complex, interrelated world economic and political environment. In this paper, however, I do attempt to play a kind of synthetic or integrative role and provide a survey of recent studies on current debt crisis in LDCs.

II. Review of the Debt Problem

Economists agree that the first "oil price shock" contributed to the recession in the industrial world in mid 1970s. However, not until the early 1980s did they realize that LDCs suffered more seriously. It can be traced back to this oil price increase that the seeds of current debt problem in LDCs were sowed. The first oil price increase in 1973/74 forced most LDCs to borrow heavily to finance their huge current account deficits. This financing was mainly in the form of loans from private creditors, unlike the previous financing which was mainly direct investments, short-term trade related credits and long-term loans at concessionary interest rates from official creditors (IMF, 1981, p. 4). Until 1980, however, high inflation rates and low interest rates kept the growth in LDCs' real debt and debt service manageable, and the international financial community celebrated its success in recycling petro-dollars.

This happiness disappeared when the bright debt picture was damaged by a series of world economic events in the early 1980s. The 1979-80 second oil price shock contributed to the 1980-82 world recession which jeopardized both the terms of trade and the export volume of LDCs. Tight monetary policies and huge fiscal deficits in some major industrial economies led to rising nominal and real interest rates which increased LDCs' cost of servicing new and existing debts (Hallberg, 1986, p. 10-11). Finally, in late 1981 Poland announced its inability to pay its debt obligations. Roughly eight months later Mexico experienced a financial crisis and rescheduled its debt repayments to foreign banks (Zloch-Christy, 1987, p. 29). Since then, similar financial difficulties have spread to other capital-importing LDCs.

Total external debt is defined as the amount of disbursed and outstanding contractual liabilities of one country to other countries (IMF Survey, May 16, 1988, p. 148). The large magnitude and rapid growth of LDCs' external debt from 1979 to 1988 is shown in table 1. The total external debt of capital-importing LDCs increased from $505 billion in 1979 to $1140 billion in 1987, and was projected to reach $1177 billion in 1988. Compared to Gross Domestic Product (GDP), total debt rose from 26.4% of GDP in 1979 to 42.7% in 1987.

The real problem, however, is reflected in the recent trend in and composition of the service payments on the debt. Debt service payments consist of interest and amortization payments. The increase in the debt service burden has been dramatic since the late 1970s. Total debt service payments more than doubled from $80 billion in 1979 to $163 billion in 1987.

Table 1: Capital-importing LDCs'[1] External Debt and Debt Services (in billion US $)

	1979	1980	1981	1982	1983	1984	1985	1986	1987*	1988*
Total External Debt	505	603	708	803	850	895	961	1049	1140	1177
Short-term Debt	90	124	151	171	150	155	135	129	139	148
Long-term Debt	415	479	557	632	700	740	826	920	1001	1029
From Official	160	184	208	236	264	287	327	384	441	471
From Private	255	295	349	396	436	453	499	536	560	558
Debt/exports Ratio	123	114	129	156	165	158	173	187	177	166
Problem Borrowers[2]	165	152	186	241	255	246	267	310	313	295
Debt/GDP Ratio	26.4	26.8	30.4	34.7	36.9	37.7	40.1	42.0	42.7	40.9
Problem Borrowers	32.5	32.5	37.6	43.7	47.6	47.6	49.1	51.3	53.9	52.1
Debt Service Payments	80	97	122	133	124	135	139	153	163	167
Interest	33	50	68	76	72	80	78	75	73	78
Amortization	47	47	54	57	52	55	61	78	90	89
Debt Service/Exports	19.5	18.2	22.2	25.7	24.0	23.9	25.0	27.3	25.4	23.6
Interest/Exports	8.1	9.3	12.3	14.7	14.0	14.1	14.1	13.3	11.3	11.0

Source: IMF, World Economic Outlook, October 1987, p. 106, 109-113.
* Data for the years of 1987 and 1988 are projections.

1. Capital-importing LDCs comprise all developing countries except eight capital-exporting LDCs which recorded a current account surplus during 1979-81.

2. Problem borrowers are defined as those capital-importing LDCs which incurred external payments arrears during 1985 or rescheduled their debt during 1983-86.

Since exports are a major source of foreign exchange to service the payment, it is useful to express the debt service payments as a ratio of the value of export of goods and services. The debt service/exports ratio increased from 19.5% in 1979 to 25.4% in 1987. This is equivalent to saying that over one fourth of the total export earnings of capital-importing LDCs is required for debt service payments.

Figures 1 and 2 show that the interest payment ratio was relatively stable during 1973-77 period, after which it started climbing until 1981-82 when it reached its peak, and was more than double its 1973 level (from about 6% to 14.7%)[1]. During 1980-85 interest payments exceeded amortization, and the interest payments alone increased from $50 billion in 1980 to nearly $80 billion in 1985. This sharp upturn in interest payments generated most of the current concern about the severity of LDCs' debt problem (Cline, 1984, p. 11-14). When one considers the cases of those countries with debt-servicing difficulties (or "problem borrowers" as they are called sometime), the situation must be even worse than the one shown by the aggregate data in table 1.

It was not only the huge external debt but also the changes in debt structure that caused concern. Table 1

[1] Data for years before 1978 are drawn from IMF <u>World Economic Outlook</u> (1983), and data for years after 1978 are from 1986 edition. There may be some disparities between these two sets of data because of statistical error. However, the trend shown in figures 1 and 2 remains appropriate.

Figure 1: Debt Services

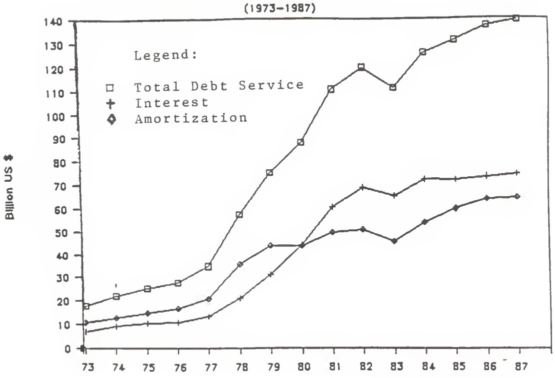
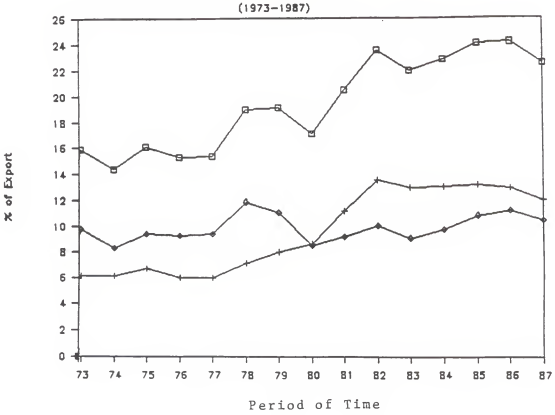


Figure 2: Debt Burden



indicates that LDCs' long-term debt has increased continuously since 1973, but their short-term debt, however, changed dramatically before and after the outburst of the crisis in 1982. Short-term debt had increased systematically since 1973 but decreased after 1982 when the infamous "Mexican Weekend" made creditors lose their confidence in LDCs' debt-servicing capacity and become unwilling to roll over LDCs' short-term debt. The rapid growth of short-term debt before 1982 contributed to the deterioration in LDCs' average debt terms since it increased the pressure on the LDCs to find lenders willing to roll over debt (Dale and Mattione, 1983, p. 12).

An examination of the sources of LDCs' external borrowing reveals that LDCs' debt from private sources outpaced the debt from official sources before 1982, but decreased dramatically afterward when commercial banks began contracting their exposure to foreign risk (see table 2).

Griffith-Jones and Sunkel (1986) argued that in each of the decades after World War II there was one actor who was willing and able to play a dynamic role in generating financial flows to LDCs, such as foreign private investors in the 1950s, official aid agencies in the 1960s, and commercial banks in the 1970s. Until the late 1960s, capital flows to LDCs were mostly in the form of foreign direct investment and official development aid, and the small amount of LDCs' external debt was almost evenly divided between official and private creditors. The first and second oil price shocks

Table 2: Capital-importing LDCs' External Financing (in billion US $)

	1979	1980	1981	1982	1983	1984	1985	1986	1987*	1988*
Current Account Deficits	61.6	76.1	116.6	107.4	64.4	38.3	41.5	44.1	32.1	36.3
Non-debt Financing	24.7	23.8	25.2	23.8	23.0	23.8	32.4	30.6	29.8	31.1
Official Transfer	11.6	12.6	13.6	13.1	13.8	14.1	16.6	17.3	17.9	17.9
Direct Investment	10.0	9.2	13.3	11.8	8.9	10.1	10.1	10.1	10.9	12.7
Other	3.1	1.9	-1.8	-1.1	0.2	-0.4	5.7	3.1	1.0	0.4
Net External Borrowing	76.3	104.8	129.5	103.9	72.8	52.9	44.3	42.3	39.6	44.1
From Official Creditor	29.5	23.7	31.4	34.6	31.8	32.7	24.0	29.6	35.6	28.0
From Private Creditor	46.8	78.4	85.8	42.7	17.1	11.3	17.5	5.6	14.3	9.3

Source: IMF, World Economic Outlook, October 1987, p. 89-90.
* Data for the years of 1987 and 1988 are projections.

resulted in dramatic changes in the level and forms of financial flow from developed to developing countries in the 1970s and early 1980s. While developing countries incurred larger current account deficits, developed countries shifted from a combined current account surplus to a combined deficit. The slow increase in official development assistance (ODA) and official non-concessional flows from industrial economies could no longer match the sharp increase in LDCs' financial needs (Hallberg, 1986, p. 8-10). Developing countries turned more to private creditors (mostly commercial banks) to finance their current account deficits. Private creditors have played an increasingly important role on the stage of international debt since the first oil price shock. By 1982, private creditors accounted for $400 billion of the $632 billion LDCs' long-term debt. Table 2 also indicates that private creditors accounted for about two-third of LDCs' net external borrowing during the late 1970s and early 1980s. The increasing reliance on private sources of credit was accompanied by an increase in the interest rate on LDCs' debt. While the cost of loans at fixed interest rates (mainly from official creditors) increased from 4.4% in 1972-73 to 6.7% in 1983, the cost of loans at floating rates (mainly from private creditors), rose tremendously to about 17% in 1981-82 (Hallberg, 1986, p. 12).

III. The Origin of the Debt Problem

An international debt crisis occurs when important debtor countries declare their inability to continue debt service payments as contracted. Such a crisis may be the result of unfavorable global economic conditions or inappropriate domestic policies or the combination of both (Dornbusch & Fischer, 1986, p. 836). Numerous studies suggested that the current debt crisis was rooted in LDCs' internal policy mistakes, fostered by the external economic environment, and fertilized by imprudent lending policies of the international financial community. Although disputes concerning the relative weight of each factor still exist, an increasing agreement has been reached that all these three factors played a role.

1. External shocks triggered the debt crisis

The world economy has been hit by various shocks since 1973. The sharp increases in oil prices, by 400% in 1973-74 and by 165% during 1979-81, had disastrous effects on developing countries (Loxley, 1986, p. 12). Rising oil prices pushed many LDCs to increase their foreign borrowing to finance imports and current account deficits. These sovereign borrowers assumed that industrial economies would deal with the oil-price induced inflation gradually, without severe impact on interest rates and world trade. Unfortunately this optimistic assumption turned out to be wrong. Industrial countries such as U.S. actually attacked inflation vigorously through restrictive monetary and fiscal policies (see table 3). These strong measures did ultimately put the inflation under control, and inflation rates decreased steadily. But they also contributed to a worldwide recession in the early 1980s. Unemployment rates rose to a high level. Growth of real GNP and real domestic demand of major industrial countries were reduced.

It is widely recognized that recessions in industrial countries have strong impacts on developing economies. According to the IMF, "every reduction of 1 percentage point in the growth of the industrial countries for a one year period typically reduces the exports of the non-oil developing countries by about 1.5% or more than $2 billion" (IMF, 1980, p. 8). World trade was hit by the effect of recession in industrial countries. The impact on LDCs was devastating. For many LDCs, as market demand for their exports fell, their export volumes contracted and prices of exports collapsed, their terms of trade worsened by 1.5-2% annually, and their current account deficits grew substantially to over $100 billion in the early 1980s (see tables 2 and 4).

Even more important was the significant increase in real interest rates. The decline in the inflation rates in industrial countries, combined with the rise of nominal interest rates resulting from restrictive monetary policies, produced unusually high real interest rates by 1981-83 (see

Table 3: Major Industrial Economies' Performance (annual percentage change)

	1979	1980	1981	1982	1983	1984	1985	1986	1987*	1988*
Fiscal policy										
Fiscal Balance	-1.8	-2.5	-2.7	-3.9	-4.1	-3.3	-3.3	-3.3	-2.6	-2.7
Fiscal Impulse	-0.4	-	-0.4	-0.1	0.2	0.2	0.2	-	-0.7	0.1
Monetary Growth										
Narrow Money	10.0	5.7	6.5	6.7	10.0	7.0	8.5	11.5	-	-
Broad Money	10.8	9.5	10.1	9.5	10.6	7.8	9.2	8.5	-	-
Interest Rates										
Short-term Rates	9.8	12.7	14.2	11.8	9.3	9.8	8.5	6.9	-	-
Long-term Rates	9.4	11.3	13.2	12.5	10.9	11.2	9.8	7.5	-	-
Inflation										
GNP Deflator	8.2	9.3	8.7	6.7	4.7	3.8	3.5	3.0	2.9	3.3
Consumer Price	9.3	12.1	10.0	7.1	4.5	4.5	3.9	2.0	2.9	3.4
Real Domestic Demand	3.6	-0.1	1.0	-0.3	2.9	5.3	3.3	3.8	2.6	2.6
Unemployment Rates	4.9	5.5	6.3	7.8	8.2	7.5	7.4	7.4	7.1	7.0
Real GNP Growth	3.4	1.2	1.7	-0.5	2.8	5.2	3.2	2.8	2.5	2.7

Source: IMF, World Economic Outlook, October 1987. p. 40, 43, 48, 53, 54, 56.
* Data for the years of 1987 and 1988 are projections.

Table 4: Capital-importing LDCs' domestic performace (annual percentage change)

	1979	1980	1981	1982	1983	1984	1985	1986	1987*	1988*
Fiscal Balance(% of GDP)	-3.2	-2.9	-4.8	-5.7	-5.2	-4.2	-4.0	-4.8	-4.6	-
Problem Borrowers	-2.3	-1.7	-5.6	-6.1	-5.6	-4.0	-3.8	-4.8	-4.4	-
Broad Money Aggregate	35.5	36.8	37.4	39.0	43.3	57.2	53.8	39.1	-	-
Problem Borrowers	41.3	42.3	50.0	55.5	66.4	88.5	93.6	60.6	-	-
Consumer Prices	23.1	28.9	28.4	29.1	38.1	44.4	46.5	32.9	40.0	25.6
Problem Borrowers	32.6	37.5	43.4	49.2	69.0	83.2	90.1	61.1	80.0	46.8
Capital Formation	27.2	26.7	26.2	24.7	22.8	22.6	22.3	22.9	22.9	-
Problem Borrowers	26.1	25.4	25.3	22.8	19.6	18.9	18.3	19.2	19.6	-
Real GDP Growth	4.7	4.5	2.4	2.0	2.0	4.9	4.2	4.5	4.1	4.7
Problem Borrowers	5.3	4.2	0.1	-0.3	-1.9	3.0	2.7	3.5	3.2	4.3
Per Capita GDP	2.6	2.3	0.5	-0.2	-0.7	2.9	2.3	2.6	2.2	2.7
Problem Borrowers	2.9	1.9	-1.9	-2.6	-3.9	0.9	0.7	1.5	1.2	2.2
Export Volumes	6.4	3.8	1.5	-0.8	8.0	11.0	3.9	7.5	7.6	6.3
Problem Borrowers	4.4	3.1	-4.5	-4.0	6.0	8.3	1.5	-3.0	1.1	6.1
Import Volumes	4.9	6.5	5.7	-6.1	-1.7	4.7	3.3	0.6	4.1	6.7
Problem Borrowers	1.5	3.8	3.1	-14.1	-13.8	2.9	-1.5	-3.9	-0.2	6.5
Terms of Trade	2.8	3.7	-1.5	-2.1	-1.4	1.7	-1.8	-8.3	-1.2	0.2
Export Unit Values	21.8	23.6	-0.2	-5.7	-5.6	0.2	-5.6	-7.4	8.0	4.3
Import Unit Values	18.5	19.2	1.4	-3.7	-4.3	-1.4	-3.8	1.1	9.3	4.1

Source: IMF, World Economic Outlook, October 1987, p. 44-46, 50, 57, 59, 65-69.
* Data for the years of 1987 and 1988 are projections.

table 3). High interest rates impelled the debtor countries to borrow more heavily than ever before, in part to meet the higher interest payments, and in part to finance the increasing current account deficits. The new borrowing was mostly contracted at floating market rates (i.e. LIBOR or US prime rate which measure the cost of funds to the banks, plus a spread or margin which reflect both the market liquidity at the time and the creditworthiness of the borrower) which reached record-high level at that time (Griffith-Jones & Sunkel, 1986, p. 75-78).

The unfortunate consequence of these unexpected external shocks was that LDCs incurred more debt than they would have otherwise. Nunnenkamp (1986) set up mathematical models and provided a quantitative analysis. He concluded that the combined effect of negative external shocks on the debt situations of capital-importing LDCs during 1974-82 was $570 billion.

External factors did matter a great deal. However, the deteriorating debt situations of many developing countries cannot be explained by only referring to the unfavorable world market conditions which are outside of the control of borrowers. The debt problem is a consequence of a complex array of interconnected trends and events. The external shocks alone did not cause the debt crisis. Rather, they were triggers of a problem which became a crisis because of policy mistakes made by sovereign borrowers and international financial institutions.

2. Domestic policy mistakes in LDCs contributed to debt crisis

Developing countries have quite a few instruments at their disposal to reduce the unfavorable effects of adverse external shocks. It is governments' failure in implementing relevant domestic policies that posed major difficulties in debt service. This can be seen by the comparison of the contrasting performances of those capital-importing LDCs with and without debt-servicing difficulties, because both of them faced similar external environments (IMF, 1987, p. 25-26).

(a) Imperfect external financing

Of the huge LDCs' accumulated external debt, official lending at the concessional interest rates reflected only a small portion, and even less took the form of private fixed-rate financing in the bond market. Instead, most private debt, whether long term or short term in maturity, was negotiated at floating market rates (Davis, 1979, p. 143-145). One implication of this is that debtor countries became increasingly vulnerable to the increase in interest rates that occurred after 1978.

In addition, too much of the debt, particularly in Latin America, was contracted in U.S. dollars rather than over a range of international currencies. By failing to diversify, debtor countries exposed themselves to tremendous risk and bore heavy costs when the U.S. dollar became exceptionally strong in early 1980s. If capital-importing LDCs had diversified their new and maturing bank debt between 1979 and 1982, Mohl and Sobol (1983) estimated that the combined savings from lower interest costs and exchange rates gains could have amounted to over $30 billion.

Finally, LDCs seemed not to have considered the optimal allocation of external financing between debt and equity investments (see table 2). Visions of national ownership and control of industries prevailed instead. LDCs thus eliminated or reduced opportunities for foreign direct investments at the very time when increasing direct equity investment would have been more appropriate. Bank debt is an inappropriate form of financing for LDCs in many ways. One of them is that the short maturity of such debt usually does not match the long time requirement of many investment projects (Mattione, 1986, p. 45-46, and Cline, 1986, p. 4).

(b) Overvalued domestic currency

Countries are well advised to avoid overvalued exchange rates, namely official rates that do not reflect the true value of domestic currency on the free market. But, for reasons of political expediency or national pride, many LDCs overvalued their currencies in the 1970s and early 1980s (Hallberg, 1986, p. 11). Overvalued exchange rates discourage exports by making them relatively unprofitable for domestic exporters and encourage imports by making them less expensive for domestic consumers. The end results were worsened trade and current account balances. Overvalued exchange rates also encourage capital flight. If a country's currency is not really worth the official rate, its citizens will have an incentive to try to convert their money into hard currency.

(c) Market distortions

Economic theory strongly suggests that small LDCs reduce or eliminate special subsidies, state-enterprise deficits and trade restrictions, since these grant excessive benefits to some particular interest groups and reduce the overall welfare of the nation. Moreover, they impede the operation of free markets and efficient allocation of productive efforts (Enders & Lapan, 1987, p. 133). Huge subsidies may also increase government budget deficits which must be financed either through printing or borrowing (internally or externally) money. Printing money exacerbates the inflation that already plagues many debtor countries. Borrowing money, on the other hand, directly increases the debt burden on the government.

(d) Uncontrolled budget deficits and inflation

Developing countries need to minimize public sector deficits and restrain the expansion of money supply to control inflation. However, many LDC governments have run huge budget deficits and have been financing much of their deficits through external borrowing. This makes budgetary programming vulnerable to shifts in foreign credit availability and tempts governments to rely on inflationary financing. Inflation, like overvalued currency, tends to harm the terms of trade by rendering exports more costly abroad and imports less expensive at home. If exchange rate changes do not keep pace with the differences between domestic and foreign inflation, the real effective exchange rate tends to appreciate when domestic inflation is relatively faster. Hence budget deficits, inflation and real effective exchange rates may rise together (Khan & Knight, 1983, p. 4).

Moreover, if domestic interest rates are lower than the rates of inflation (i.e. negative real interest rates), the incentive for domestic saving disappears and capital flight into overseas dollar accounts may actually occur. Some studies suggest that perhaps 40% (or about $40-50 billion) of all bank loans to Latin America from 1979 to 1982 ended up as capital outflows from those countries.[2] The consequences are obvious. Much of the money on loan to these countries has not been invested productively. Had it contributed to productivity, the countries would now be better able to generate the exports (and foreign exchange) needed to service their debts.

[2] For more detailed discussion, see Deppler and Williamson (1987).

3. Imprudent lending by international commercial banks contributed to the debt crisis

The unfavorable global economic environment has posed a major threat to future development of LDCs. Their adjustments to worsening world market condition have often been impeded by inappropriate domestic policies. Their mounting demands for foreign funds have not been matched by a sufficient supply of official development aids in the form of outright grants or subsidized credits (Hallberg, 1986, p. 8-10). Accordingly, capital-importing LDCs have had to rely heavily on international capital market.

The accumulation of LDCs' huge debt and the outburst of the debt crisis afterward would have not become a reality if international commercial banks had adopted a more prudent lending policy when facing substantial demand for their loans. International financial institutions are responsible for their lack of concern for the quality or riskiness of their loans.

The development of international bank lending to capital-importing LDCs was the result of a combination of demand and supply factors (Llewellyn, 1979, p. 40-43). After the first 400% rise in oil prices in 1973-74, most OPEC countries were unable to spend total extra oil revenues for additional imports immediately. Attracted by higher profitability in foreign financial markets, they were reluctant to channel the funds back to capital-importing LDCs. The international banking system reacted and accepted its role as financial intermediary between capital exporters and importers.

Although in late 1970s the OPEC surplus was reduced, market liquidity never dried up. The supply of funds was fuelled by the liquidity-creating effect of soaring U.S. trade deficit and the accompanying U.S. Federal Reserve's interventions in support of the U.S. dollar. Unlike the deficits in other countries which lead to a higher absorption of funds from international capital market, U.S. deficit actually provided additional funds because of the unique role of the U.S. dollar as a commonly held reserve currency (Fleming, 1981, p. 14-15).

A number of financial innovations, such as the introduction of roll-over credits on a large scale and the development of syndicated loans, have significantly strengthened the recycling of petro-dollars. The term "roll over" reflects the fact that the loan can be renewed and the interest on loans changed in line with the London Inter-bank Offer Rate (LIBOR) every roll-over period. Syndicated loans provide economies of scale which allow commercial banks to raise very large amount of funds at comparatively low cost. These new techniques improved risk-sharing among commercial banks, and permitted the participation of even smaller creditors who otherwise would probably have faced severe constraints in entering the international-lending market because of their lack of experience and expertise (Seiber, 1979, p. 44. Davis, 1979, p. 145-150. and Fleming, 1981,

p. 18).

Finally, the relaxation of formerly prevailing national restrictions on capital movements encouraged the process of portfolio internationalization by commercial banks. This allowed, for example, an expanded international engagement of Japanese banks in late 1970s. The effect of the removal of U.S. capital controls in early 1974 was perhaps even more significant. The U.S banks' external engagement has ever since expanded rapidly (Llewellyn, 1979, p. 30-33).

It was argued that there was an inverse relationship between lending to industrial economies on the one hand and to capital-importing LDCs on the other. Interbank competition was considerably strengthened just when the demand for credits in recession-hit industrial countries was rather weak. This may have induced a switching of lending by commercial banks from advanced to developing countries. Therefore, even while facing serious debt mismanagement in the debtor countries, commercial banks stepped up their rates of lending. Their own governments' direct or indirect encouragement of loans to LDCs made them undoubtedly believe that their governments effectively stood behind them, and that "they were too big for their governments to allow them to fail" (Dornbusch & Fischer, 1986, p. 837).

Another imprudence was that the banks' lending was heavily concentrated on those developing countries which declared financial difficulties later. The vast majority of banks' claim were held on Latin America. Four Latin American countries (Argentina, Brazil, Chile and Mexico) accounted for 69% of bank lending to top ten borrowers and 51% of bank lending to LDCs in 1977 (Seiber, 1979, p. 56). The lending share to these problem countries increased further in the late 1970s. Even more astonishing is that banks continued to lend to capital-importing LDCs on a large scale in the early eighties when these countries had been hit by a new series of external shocks and when their domestic policy failures had become evident.

In short, LDCs' domestic policy failures, together with imprudent lending by international commercial banks, had a chance encounter with extraordinarily unfavorable world economic conditions in the early eighties. Undoubtedly, the acute Mexican debt crisis in mid-1982 contributed to bank skepticism about their international lending and marked a milestone in banks' lending policies toward developing countries. Many banks reconsidered their exposure to the risk of international lending, and decided to cut the expansion of their credit engagement dramatically. Developing countries, especially Latin American borrowers, without adequate new money to roll over their maturing short-term debts, had nothing to do but declare their inability to service their debts. The international debt crisis actually broke out.

IV. Solution to the Debt Problem

The question about what is the best solution to the international debt problem is clearly generating widespread debate. Much of the conflict and disagreement over what should be done center on the difference between "illiquidity" and "insolvency". A country is illiquid if it temporarily cannot meet its debt service obligations on existing terms but is financially sound in a longer term; on the other hand, a country is said to be insolvent if its debt service payments not only cannot be met in the short run but will never be sustained in the long run (Cline, 1984, p. 39). It is argued that illiquid countries should be given sufficient financial assistance to keep them from becoming insolvent, otherwise there will be involuntary defaults and bank failures, trade cutbacks, lost jobs, and increased protectionism.

The conceptual distinction between illiquidity and insolvency can be unambiguously displayed in the case of domestic firm (Dornbusch & Fischer, 1986, p. 838). When applied to countries, however, the distinction is less clear and absolute. Accordingly, the distinction cannot be made by a well defined classification which can be measured precisely, but rather by examining whether the debt trend is toward improvement or deterioration.

The ability to meet debt service payments essentially means that in the long run the growth of a country's external debt can not exceed its growth rate of income. Since the external debts in LDCs are typically less than their annual income, it is logical to say that the debt problem in LDCs is one of illiquidity, not insolvency (Dornbusch & Fischer, 1986, p. 838). Cline's trend-projection model analyzed the nineteen largest debt countries, which account for two-third of total external debts of LDCs. The central result of his analysis is that the debt problem is manageable (Cline, 1986, p. 39-69). Thus, the view that the debt crisis is one of illiquidity is basically accepted.

We should keep in mind that the conclusion that the debt problem is one of illiquidity is based on assumptions that the world economic condition is becoming favorable, as recovery in industrial economies spreads to the developing countries, and that the debtors are taking and will continue to take consistent, strong adjustment measures. But will the debt problem gradually disappear and insolvency be ruled out as soon as recovery spreads to LDCs? The answer depends in part on the willingness of debtor countries to implement appropriate domestic policies to help bring about an adequate and sustainable growth rate, and in part on the domestic macroeconomic and foreign lending policies of creditor countries. It is evident that the debtors themselves had an interest in adopting adjustment programs and were willing to maintain debt services to preserve their future access to the international money market. Actually, a large number of debtors have continued to service their debts without interruption throughout the entire difficult period. The question thus now turns to whether it is feasible, economically and politically, to further extract the debt services largely by austerity measures as it was done during the early years of the crisis. To reduce their outstanding debts rapidly, the debtor countries have had to run large trade surpluses with creditor countries by increasing exports and by reducing imports. Capital-importing LDCs' exports jumped from a decrease of 0.8% in 1982 to an increase of 8.0% in 1983, but their imports showed a 6.1% decrease in 1982 and a further decrease of 1.7% in 1983 (see table 4). For problem borrowers the figure was more remarkable. However, belt-tightening alone is not a sustainable solution. The strong emphasis on demand control without adequate supply-side measures has led to acceleration in domestic money growth and inflation, decreases in real wage and living standards, and suspension of essential investments which have severely restrained the future growth in these countries (Dornbusch & Fischer, 1986, p. 839).

The disappointing growth performance in a number of debtor countries has led to the increasing recognition that easing debt problems through growth is a more promising alternative, and that restoring growth in debtor countries is a political as well as economic necessity. It was under this circumstance that the 1985 Baker Initiative was brought about.

The Baker proposal contains three essential and mutuallysupporting elements: (1) the adoption by debtor countries of comprehensive macroeconomic and structural adjustment programs to improve growth and reduce inflation; (2) a continued central role of the IMF and World Bank and an enhanced role for other multilateral development banks; and (3) increased lending by commercial banks in support of debtor countries' policy efforts (Dornbusch & Fischer, 1986, p. 839).

The strategy requires close cooperation between debtors and creditors. The pursuit of effective adjustment policies in debtor countries is the basis of the strategy. It is essential to help restore their credit standings and to lay the basis for future growth. Coordinated financing packages from creditors are important features of the strategy. It is essential to facilitate economic adjustment, supplement the domestic resources for productive investments and make market-oriented adjustment measures more attractive to debtors (IMF, 1986, p. 91-92). The success of this strategy not only depends on the close relation between debtors and creditors but depends, to a large extent, on the maintenance of a favorable external environment, that is, on the sustained growth in industrial economies, liberal trade arrangements, and favorable terms of trade and interest rates. It is estimated that each 1% slowdown in the GNP growth in industrial economies will result in a 1.5% decrease in LDCs' export earning growth, and most of the losses will be born by countries encountering debt problems (IMF, 1987, p. 27).

The cooperative efforts of debtors, creditors and international organizations have achieved a considerable degree of success, not only in maintaining a viable international financial system but in reviving economic growth in debtor countries and restoring normal debtor-creditor relations (IMF Survey, March 21, 1988, p. 89). Real GDP growth has returned to the pre-crisis level (see table 3). Nevertheless, the debtor countries remain, on the whole, highly vulnerable to the unstable global economic development. For many of these countries, debt and debt service ratio have been brought down only slightly. In fact, due to the weakening terms of trade, high real interest rates and the effect of exchange rate valuation adjustment on non-dollar debts, total debt and debt service payments of LDCs continued to increase during the last a few years (IMF Survey, Feb. 22, 1988, p. 53-55). A heavy debt burden acts like a high marginal tax rate on economic adjustment. A big proportion of LDCs' output gain was channelled into debt repayment, rather than into development.

The weak progress on the debt problems has caused skepticism about the effectiveness of the Baker Initiative and led to continued suggestions for new approaches to international debt management. However, many of these suggestions are rather one-sided: either crying for extensive debt relief or stressing harsh adjustment by debtor countries alone.[3] The adjustment-and-growth approach remains appropriate in that it is mutually beneficial to and acceptable by both debtors and creditors. Its basic weakness is not in its design but in implementation. What is needed to yield a satisfactory outcome is a stronger implementation of this reinforced debt strategy and the differentiated approaches within this strategy for highly indebted low- and middle-income countries (IMF Survey, April 18, 1988, p. 125). Further progress on the debt problems depends crucially on each of the major parties pulling their weight. Therefore co-responsibility must remain the cornerstone on the way to the conclusion of this world-wide debt crisis.

VI. Summary and Conclusion

External debt has always been an instrument with both positive potential for economic development and associated risk of financial strain. The economic rationale for countries in their early development stage to engage in external borrowing is to raise their rates of investment and economic growth to levels that otherwise would not be possible (IMF, 1986, p. 89). Hence, in the normal course of world development, capital should flow from industrial countries where it is abundant and its return is relatively low to

---

[3]For a reference to these two contrasting views, see Group of 7 Statement and Group of 24 Statement in IMF Survey, April 18, 1988, p. 116 and p. 118 respectively.

developing countries where it is scarce and its return high. While these flows have contributed to development, they have also meant increasing financial dependence and rising debt-servicing obligations of borrowing countries.

External debt finally set the stage for financial strains when debtors' domestic failure to control adequately the growth, structure, and terms of external borrowing had a chance to encounter the extremely unfavorable world market conditions and the creditors' mismanagement of their international lending during late 1970s and early 1980s. The volume of external debt has reached such magnitudes that disruption in debt service would pose a considerable threat to the world development as a whole and to the stability of international financial system in particular. Actually in 1981-82 the growth of debt outpaced the growth of exports which sustain the debt, and the debt crisis became manifest and widespread.

The public have kept a wary eye on the growing external debt of developing countries since last decade. The reason for the enormous attention to this problem is that the participants in the international debt drama are sovereign. International debt problem is an economic problem as well as a political one, and indeed the economic and political dimensions of the crisis tend to merge. The debt issue has added a wholly new dimension to the effects of world economic interdependence and played an increasing role in domestic as well as international public policy formation. The present debt crisis is likely to recede as world economic recovery proceeds. However, it continues to pose a severe challenge to policy-makers in both industrial and developing countries for judicious economic management. In short, the debt crisis is far from over. The "best solution" to the debt problem lies in concerted, coordinated actions by all key players on the international debt stage.

References

Barth, James R. & Joseph Pelzman (eds.). International Debt: conflict and solution. Fairfax, Virginia: Gorge Mason University, 1984.

Carvounis, Chris C. The Debt Dilemma of Developing Nations. Westport, Connecticut: Quorum Books, 1984.

Carvounis, Chris C. The Foreign Debt/National Development Conflict. New York: Quorum Books, 1986.

Cline, William R. International Debt: Systemic Risk and Policy Response. Cambridge, Massachusetts: MIT Press, 1984.

Davis, Steven I. "Techniques in international banking", in Stephen F. Frowen (ed.). A Framework of International Banking. Guildford, England: Guildford Educational Press, 1979.

Dale, Richard S. & Richard P. Mattione. Managing Global Debt. Washington D.C.: The Brookings Institution, 1983.

Delamaide, Darrell. Debt Shock: the full story of the world debt crisis. New York: Anchor Books, 1985.

Deppler, Michael & Martin Williamson. "Capital Flight: Concepts, Measurement, and Issues". IMF, World Economic Outlook, August, 1987.

Dicke, Detlev (ed.). Foreign Debt in the Present and a New International Economic Order. Boulder, Colorado: Westview Press, 1986.

Dornbusch, Rudiger & Stanley Fischer. "Third World Debt", Science, Vol. 23, November 14, 1986, pp. 836-841.

Ebinger, Charles & Hartland-Thunberg Penelope (eds.). Banks, Petrodollars, and Sovereign Debtors. Lexington, Massachusetts: Lexington Books, 1986.

Enders, Walter & Harvey E. Lapan. International Economics: theory and policy. Englewood, New Jersey: Prentice-Hall, Inc., 1987.

Eskridge, William (ed.). A Dance Along The Precipice: the political & economic dimensions of the international debt problem. Lexington, Massachusetts: Lexington Books, 1985.

Fleming, Alexander E. Private Capital Flows to Developing Countries and Their Determination: Historical Perspective, Recent Experience and Future Perspects. World Bank Staff working Paper #484, Aug. 1981.

Griffith-Jones, Stephany & Osvaldo Sunkel. Debt and Development Crises in Latin America: the end of an illusion. Oxford, England: Claredon Press, 1986.

Guttentag, Jack & Richard Herring. The Current Crisis in International Lending. Washington D.C.: The Brookings Institution, 1985.

Hallberg, Kristin. "International Debt, 1985: Origins and Issues for the Future", in Michael P. Claudon (ed.). World Debt Crisis: International Lending on Trial. Cambridge, Massachusetts: Ballinger Publishing Co., 1986.

IMF. External Indebtedness of Developing Countries. Occasional paper #23, May 1981.

IMF. World Economic Outlook. 1986 & 1987 editions.

IMF. IMF Survey. various issues.

Johnston, R. B. Banks' International Lending Decisions and the Determination of Spreads on Syndicated Medium-term Euro-credits. Bank of England Discussion Paper #12, Sept. 1980.

Jorge, Antonio & Diaz-Pou Frank, Salazar-Carrilo Jorge (eds.). External Debt and Development Strategy in Latin America. New York: Pergamon Press, 1985.

Khan, Mohsin S. & Malcolm Knight. "Sources of Payments Problems in LDCs", Finance & Development, IMF, December 1983.

Krumm, K. L. The External Debt of Sub-Saharan Africa: origins, magnitude, and implications for action. World Bank Stuff Working Paper, 1985.

Llewellyn, David T. "International Financial Intermediation", in Stephen F. Frowen (ed.). A Framework of International Banking. Guildford, England: Guildford Educational Press, 1979.

__________________, "International Banking In The 1970s; an overview", in Frowen (1979), P25-54.

__________________, "A Fragile International Monetary System", in Frowen (1979), P55-76.

Lomax, David F. The Developing Country Debt Crisis. London: The Macmillan Press Ltd, 1986.

Loxley, John. Debt and Disorder: external financing for development. London: Westview Press, Inc., 1986.

Makin, John H. The Global Debt Crisis. New York: Basic Books, 1983.

Mattione, Richard P. "Managing World Debt: Past Lessons and Future Prospects", in Michael P. Claudon (ed.). World Debt Crisis: International Lending on Trial. Cambridge, Massachusetts: Ballinger Publishing Co., 1986.

Miller, Morris. Coping Is Not Enough. Homeword, Illinois: Dow Jones-Irwin, 1986.

Mohl, Andrew & Dorothy Sobol. "Currency Diversification and LDC Debt", FRB New York Quarterly Review, Autumn 1983, pp. 19-20.

Noellert, William A. "International Debt of Developing Countries and Global Economic Adjustment", in Lawrance G. Franco & Marilyn J. Seiber (eds.). Developing Country Debt. New York: Pergamon Press, 1979.

Nunnenkamp, Peter. The International Debt Crisis of The Third World: causes and consequences for the world economy. Sussex, England: Wheatsheaf Books Ltd, 1986.

Seiber, Marilyn J. "Debt Escalation: Developing Countries in the Eurocurrency Market", in Lawrence G. Franko and Marilyn J. Seiber (eds.). Developing Country Debt. New York: Pergamon Press, 1979.

Smith, Gordon & John Coddington (ed.). International Debt and Developing Countries. Washington, D.C.: World Bank, 1985.

Wionczek, M. S. (ed.). Politics and Economics of External Debt Crisis: the Latin American experience. London: Westview Press, Inc., 1985.

Zloch-Christy, Iliana. Debt Problems of Eastern Europe. Cambridge: Cambridge University Press, 1987.

A Survey of Current Debt Crisis in LDCs

by

QING JIAN FU

B.A., Xiamen University, Fujian, China, 1985

AN ABSTRACT OF A MASTER'S REPORT

Submitted in partial fulfillment of the

requirements for the degree

MASTER OF ARTS

ECONOMICS

KANSAS STATE UNIVERSITY
Manhattan, Kansas

1989

Abstract

This report surveys one of the most important and complex problems facing the world economy: the current debt crisis in LDCs. Never before have so many countries owed so much money to so many banks with so little prospect of repayment. For many years the international financial system has staggered under the enormous burden of debt crisis, in which capital-importing developing countries and their lenders have struggled to prevent default on a level of external debt which is by all measures excessive.

The scope and timing of the present debt crisis result largely from the protracted unfavorable shocks that have afflicted the world economy since 1979. Weaknesses in the debtors' domestic policies and in the international financial system, however, help explain both the market's failure to adapt to the deteriorating economic conditions and the sudden breakdown of the market recycling mechanism in the summer of 1982. Since then economists, politicians, bankers and international organizations, in joint effort, have mounted quick rescue operations and generated numerous suggestions for "best solutions" to the problem. The cooperative approach to debt management has so far succeeded in preventing the LDCs' financial difficulties from substantially affecting the world economy. However, the underlying problems have been postponed rather than solved. The debt crisis continues to evolve, impinging upon the socio-economic and political dimensions of this world, and capital-importing developing countries in particular.