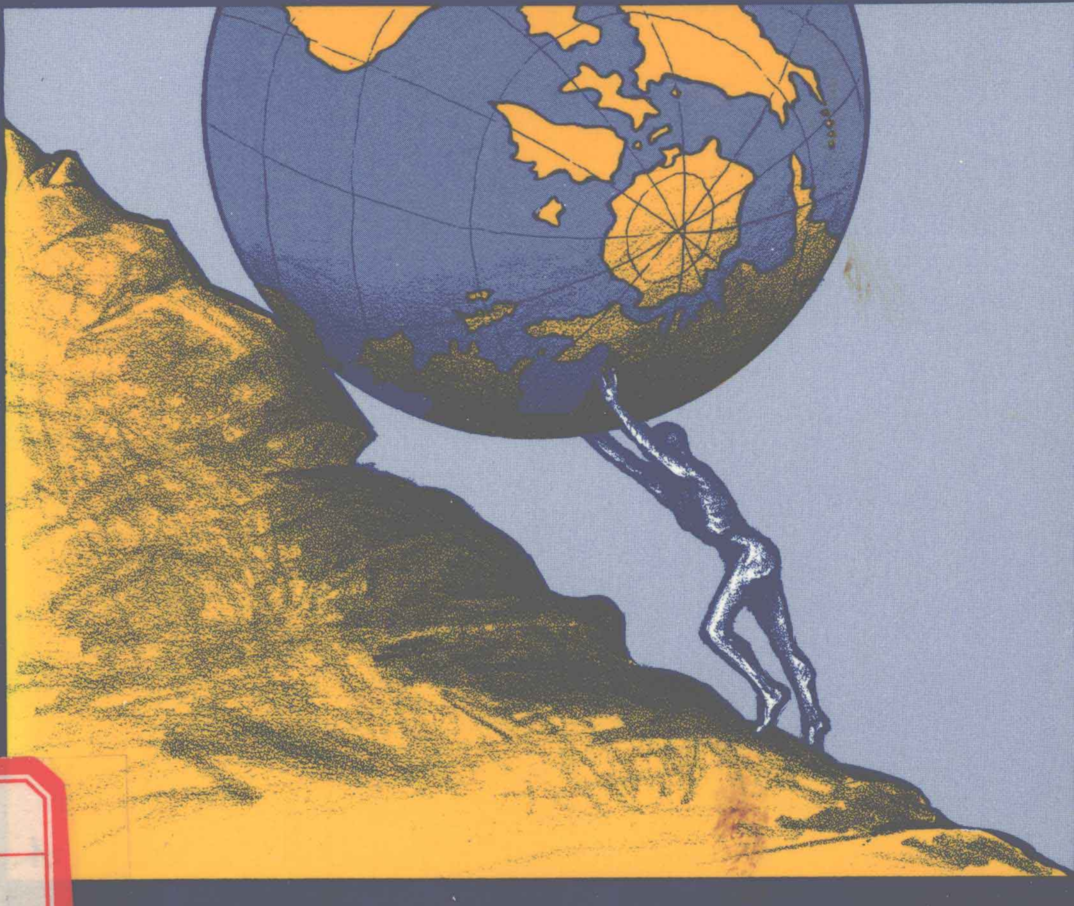
Developing Country Debt and the World Economy

Edited by
Jeffrey D. Sachs



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(Resolution adopted October 25, 1926, as revised through September 30, 1974)

Preface

This volume includes 16 papers that were prepared as part of a research project by the National Bureau of Economic Research on Developing Country Debt. These papers examine other debt crises that occurred before World War II, political factors that contribute to poor economic policies in many debtor countries, the role of commercial banks and the International Monetary Fund (IMF) during the current crisis, the effect of developed country economies on the debtors, as well as possible solutions to the debt crisis. In addition, the volume includes summaries of case studies of Argentina, Bolivia, Brazil, Indonesia, Mexico, the Philippines, South Korea, and Turkey.

The findings of NBER's Debt project were presented at a conference for government officials of lending and debtor countries, economists at international organizations, and representatives of banks and other private firms with interests in the debtor countries. The conference was held in Washington, D.C., from 21 through 23 September 1987.

These 16 papers will also be published in longer and somewhat more technical versions. One volume will contain the eight papers on selected topics. Another volume will include studies of the four Latin American countries, while a final volume will have the studies of the other four countries.

We would like to thank the Agency for International Development, The Ford Foundation, Mr. David Rockefeller, the Rockefeller Brothers Fund, and The Tinker Foundation for the financial support of this work. The success of the project also depended on the efforts of Deborah Mankiw, Yasuko MacDougall, Kirsten Foss Davis, Ilana Hardesty, Robert Allison, and Mark Fitz-Patrick.

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1 Introduction

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1.1 Introduction

The Project on Developing Country Debt undertaken by the National Bureau of Economic Research in the past two years seeks to provide a detailed analysis of the ongoing developing country debt crisis. The focus is on the middle-income developing countries, particularly those in Latin America and East Asia, though many lessons of the study should apply as well to the poorer debtor countries in sub-Saharan Africa.

The urgency of the NBER study should be self evident. For dozens of developing countries, the financial upheavals of the 1980s have set back economic development by a decade or more. Poverty has intensified in much of the developing world as countries have struggled under an enormous external debt burden. Moreover, the world financial system has been disrupted by the prospect of widespread defaults on the foreign debts of the developing world. More than six years after the onset of the crisis, almost all of the debtor countries are still unable to borrow in the international capital markets on normal market terms.

Table 1.1 shows several aspects of the economic crisis of the major debtor countries in recent years. Since the dramatic outbreak of the crisis in 1982, economic growth has slowed sharply or has been negative. Per capita incomes in the most indebted countries are still generally well below the levels of 1980. And ominously, dept-export ratios are higher in 1986 than at the beginning of the crisis.

Future growth prospects are clouded by a sharp drop in the share of capital formation in GNP. At the same time, inflation has risen to remarkable levels throughout Latin America. The mechanisms behind the epidemic of high inflations are basically the same that caused the

Table 1.1 The Economic Crisis in the Heavily Indebted Countries

	Average 1969–78	1979	1980	1981	1982	1983	1984	1985	1986
Per capital GDP (annual change)	3.6	3.6	2.6	−1.6	−2.7	−5.5	−0.1	0.9	1.4
Inflation (annual rate)	28.5	40.8	47.4	53.2	57.7	90.8	116.4	126.9	76.2
Gross capital formation (percent of GDP)	n.a.	24.9	24.7	24.5	22.3	18.2	17.4	16.5	16.8
Debt-export ratio	n.a.	182.3	167.1	201.4	269.8	289.7	272.1	284.2	337.9

Source: All data refer to the fifteen heavily indebted countries: Argentina, Bolivia, Brazil, Chile, Columbia, Ivory Coast, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, Yugoslavia. Data are from the IMF *World Economic Outlook*, April 1987. Inflation refers to the consumer price index.

n.a. = not available.

hyperinflations in Central Europe after World War I, with foreign debts now playing the role that reparations payments played in the post-World War I crisis.

The NBER Project analyzes the crisis from two perspectives, the individual debtor country, and the international financial system as a whole. A major goal of the country studies is to understand why some countries, such as Argentina or Mexico, succumbed to a serious crisis, while others, such as Indonesia or Korea, did not. Another important goal is to understand why most of the debtor countries have been unable to overcome the crisis despite many years of harsh economic adjustments.

To analyze such questions, the NBER commissioned eight detailed country monographs, covering four countries in Latin America (Argentina, Bolivia, Brazil, and Mexico) and four countries in the Middle East and East Asia (Indonesia, the Philippines, South Korea and Turkey). Each study was prepared by a team of two authors: a U.S.-based researcher and an economist from the country under study.

The choice of countries was dictated by several considerations. First, the project aimed to include the countries with the largest external debt, since their behavior is most important from a global economic point of view. Second, the project was designed to investigate both successes and failures in external debt management. Thus, we have countries that succumbed to serious crisis, and have so far not recovered (Argentina, Bolivia, Brazil, Mexico, and the Philippines); a country which succumbed to crisis but has recovered in substantial part (Turkey); and two countries that did not succumb to an external debt crisis (Indonesia and South Korea). Third, the project aimed to compare countries that varied widely in economic structure, particularly in the structure of international trade. Thus, as shown in table 1.2, our case studies include countries heavily dependent on primary commodity exports (Argentina, Bolivia, Indonesia); countries with a mix of commodity and manufactured exports (Brazil, Mexico, the Philippines, and Turkey); and a country almost wholly dependent on manufactured exports (South Korea).

The economic performance of the eight NBER countries is summarized in table 1.2. The table shows the very broad range of experiences. Economic growth is strong, and inflation relatively low, in South Korea, Indonesia, and Turkey. The Latin American economies all have low growth (negative in per capita terms), and very high inflations. The Philippines has low growth but also low inflation. The external debt burden, measured by the debt-export ratio, is heaviest in Latin America and the Philippines, and relatively light in Indonesia and South Korea. Turkey is ranked in the middle. As shown in the final column of the table, two countries (Indonesia and South Korea),

Table 1.2 **Economic Performance in the Eight NBER Countries**

	GDP 1980–85	Inflation 1980–85	Primary Share of Commodities in Exports, 1985	Debt-Export Ratio, 1985	Debt Rescheduling 1975–86
Argentina	−1.4	342.8	82	576	Yes
Bolivia	−4.5	569.1	94	601	Yes
Brazil	1.3	147.7	59	417	Yes
Indonesia	3.5	10.7	89	191	No
Mexico	0.8	62.2	73	445	Yes
Philippines	−0.5	19.3	49	563	Yes
South Korea	7.9	6.0	9	156	No
Turkey	4.5	37.1	46	315	Yes

Source: World Bank, *World Development Report, 1987*. GDP and inflation measures are annual rates of change.

escaped a debt crisis altogether, though Indonesia's debt position remains somewhat precarious. Turkey's crisis came in the late 1970s, before the onset of the global crisis. The Latin American economies and the Philippines have all been engaged in repeated reschedulings since 1982–83.

The individual country studies can answer only some of the questions about the crisis, since global factors have undoubtedly been key to many of the developments in the past few years. Indeed, as Lindert and Morton stress, international debt crises have been a recurrent part of the international financial landscape for at least 175 years, in the 1820s, the 1870s, 1890s, and 1930s. It is important to understand the fundamental properties of the international macroeconomy and global financial markets which have contributed to this repeated instability.

The NBER studies in this project that take a global or "systemic" perspective cover several important topics, including: the history of international sovereign lending (Eichengreen, and Lindert and Morton); the nature of negotiations between the commercial banks and the debtor countries (Krugman); the role of the International Monetary Fund and World Bank (Sachs); the global linkages between debt and macroeconomic policies in the industrial countries (Dornbusch); the appropriate role for long-term structural adjustment policies in the debtor countries (Edwards); the political factors within the developing countries that contribute to economic crisis versus stabilization and growth (Haggard and Kaufman); and possible new approaches to the global management of the crisis (Fischer).

1.1.1 The Creditor and Debtor Views of the Crisis

The international debt crisis has already given rise to many oversimplified interpretations, most of which can be dismissed on the basis of the studies in the NBER project. Simple ideas abound on this topic, often because they serve particular vested interests. Creditors want to blame the crisis on the policy mistakes of the debtor governments. Debtors want to blame the crisis on the macroeconomic and trade policies of the creditor governments. Both sides are keen to neglect the more nuanced historical record.

The mainstream creditor interpretation (as expressed variously by the United States government, the international institutions, and the commercial banks) can be summarized as follows. The debt crisis emerged largely because of the policy mistakes of the debtor governments. Loans were wasted by inefficient state enterprises, or were squandered in capital flight. "Successful" governments were those like South Korea, which pursued free-market economic policies, while unsuccessful governments smothered economic growth with government regulations. With sufficient economic reforms, including trade liberalization and an encouragement of foreign direct investment, the debtor countries will be able to grow out of the current crisis.

Most creditors have also maintained that the only proper way to manage the current crisis is to insist that the debtor governments honor their debts in full, since to do otherwise would threaten the international financial system. To grant debt relief to the debtors, they also suggest, would hurt the debtors more than it would help them, because it would cut the debtors off from future borrowing from the world financial markets, and thereby hinder their economic growth.

The debtor perspective, of course, differs at key points. Debtor governments hold that the crisis erupted because of the rise in world interest rates, the fall in commodity prices, and the collapse of world trade at the beginning of the 1980s. They blame the macroeconomic policies of the creditor governments, particularly the U.S. fiscal policies, for many of the global shocks. Debtor governments typically downplay the role of debtor country policies in the crisis, and often state that advocates of "free-market policies" in response to the crisis are simply serving foreign interests (e.g., multinational firms) at the expense of the domestic interests. Many debtor governments argue that successful adjustment will require some debt relief. One reason for this pessimism is the view that attempts to honor the debt burden through increased exports would simply promote offsetting protectionist pressures in the creditor economies.

The evidence from the NBER study belies many of the points commonly made by both the creditors and the debtors. The historical record and the recent experience certainly call into question the creditors' optimism with respect to rapid adjustment with growth in the debtor countries, but also the debtor's pessimism about the *long-term* results of adjustment policy. The historical record is rather clear on the long-run benefits of macroeconomic stabilization and a shift towards outward-oriented trade policies (though the studies by Edwards, Sachs, Collins and Park, and Celâsun and Rodrik, make clear that outward orientation is not the same as trade liberalization, a point sometimes missed in the current debate). The country experiences also suggest, however, that outward-orientation requires a sustained period of heavy investment in the export sector, as well as a sustained period of macroeconomic stability, both of which are difficult to achieve under conditions of financial crisis.

Both the historical record and the recent difficulties of short-run adjustment in the countries under study highlight the debtor countries' need for a financial "time out" from the crisis, in the form of a sustained reduction in the debt-servicing burden as a prerequisite to economic recovery. The historical cases studied by Eichengreen, and by Lindert and Morton, show that such a financial time out has often come in the form of a unilateral reduction of debt payments imposed by the debtor country, followed by a renegotiation of the terms of the debt contract that results in a measure of debt relief (we will use the term debt relief to signify a reduction in the contractual present value of debt repayments).

The NBER study offers fresh evidence on several important issues, in addition to the ones just mentioned: the sources of the debt crisis (and of debt crises in the past); the patterns of economic adjustment in a debtor country after a debt crisis gets underway; the nature of bargaining between debtors and creditors; and the role for public policy in easing or eliminating the global crisis. These subjects are now taken up in detail in the following sections.

1.2 Origins of the Debt Crisis

The debt crisis arose from a combination of policy actions in the debtor countries, macroeconomic shocks in the world economy, and a remarkable spurt of unrestrained bank lending during 1979–81. The "unsuccessful" adjusters (all but Indonesia and South Korea among the countries in the NBER study) fell prey to a common pattern of policy actions: chronically large budget deficits; overvalued exchange rates; and a trade regime biased against exports in general, and agriculture in particular. These policies would have hindered economic performance in most circumstances, but they provoked a deep crisis when combined with severe shocks to world interest rates, exchange rates, and commodity prices, in the early 1980s. The crisis was greatly exacerbated because the commercial banks provided copious financing for the bad policies of the developing countries for many years, particularly during 1979–81, and then abruptly withdrew new credits starting in 1982.

1.2.1 The Role of Global Shocks

The importance of global macroeconomic changes in provoking the debt crisis have been widely noted (see Sachs 1987 for a review of this issue). As is well known, the growth of the eurodollar market and the OPEC price shocks of 1973–74 put in motion a period of rapid bank lending to the developing countries. During the period 1973–79, the export proceeds of the developing countries boomed, while nominal interest rates on the loans were low, contributing to the happy state of affairs that debt-to-export ratios remained modest despite heavy borrowing by the developing countries. Indeed, for the non-oil LDCs as a whole, the debt-export ratio was lower in 1980 than in 1973, while for the Western Hemisphere LDCs, it was only marginally higher in 1980 compared to 1973 as can be seen in table 1.3.

At the end of the 1970s, therefore, the pace of international lending did not seem to pose a serious danger to the commercial banks or to the world economy. But few observers fully appreciated how much this happy state of affairs depended on nominal interest rates remaining below the growth rate of dollar exports of the borrowing countries (put another way, *real* interest rates remaining below the growth rate of *real* exports). Even worse, almost nobody properly understood that the era of high export growth and low interest rates would come abruptly to an end at the end of the 1970s.

In the happy case that interest rates are below export growth rates, borrowers can borrow all the money needed to service their loans without suffering a rise in the debt-to-export ratio (since exports will grow faster than the debt). In other words, the borrower does not have to contribute any of its own resources to servicing its debts. Once the interest rate rises above the export growth rate, however, then the country cannot simply borrow the money to service its debts without incurring a sharply rising debt-to-export ratio. Sooner or later, the country will be cut off from new borrowing, and it will have to pay for its debt servicing out of its own national resources, i.e., by running trade surpluses vis-à-vis the rest of the world.

The remarkable fact is how abruptly the interest rate–growth rate relationship was reversed as of 1980, as shown in figure 1.1. Extremely

Table 1.3 **Debt-Export Ratios, 1973 to 1986 (selected years)**

(percent)	1973	1980	1981	1982	1983	1984	1985	1986[P]
Non-oil LDCs	115.4	112.9	124.9	143.3	152.8	148.3	162.0	162.2
Western Hemisphere	176.2	178.4	207.9	273.1	290.4	275.2	296.2	331.3

Source: International Monetary Fund, *World Economic Outlook*, April 1986 and October 1986 editions.

[P]Preliminary.

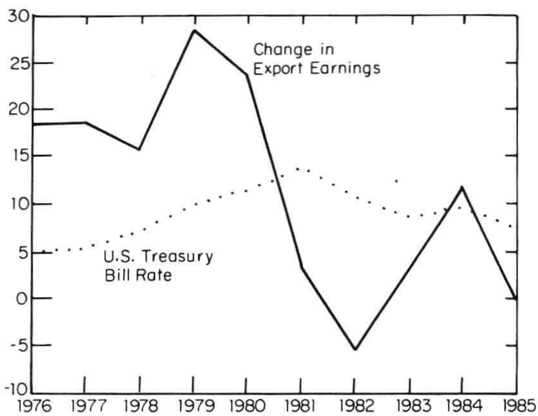

Fig. 1.1 Interest rates and annual change in non-oil export earnings

tight monetary policies in the industrial countries, designed to fight inflation, provoked a sharp rise in interest rates, an industrial country recession, and a steep fall in the export prices and terms of trade of the developing countries. The debt crisis followed relentlessly upon the resulting rise in interest rates and the collapse in developing country export earnings. All of a sudden, all of the debt warning signs started to fly off the charts, as seen by the rapid increase in the debt-export and debt-service ratios after 1980. Commercial bank lending dried up once the debt-export ratios started to soar. Total gross bank lending to the non-oil developing countries rose by 24 percent in 1980 over 1979, 18 percent in 1981, and only 7 percent in 1982.

1.2.2 The Role of Bank Lending Behavior

Few observers perceived the risks of international lending as of the end of the 1970s, least of all the lenders themselves. Lindert and Morton, as well as Eichengreen, suggest that in earlier historical experiences as well, lenders lost sight of the inherent risks of cross-border lending. In the late 1970s, bankers adopted the credo of the worlds' leading international banker, Citicorp Chairman Walter Wriston, who justified the heavy international lending with the declaration that "countries never go bankrupt." In the mid- and late 1970s, the commercial banks were making enormous profits on their cross-border lending to the developing countries. In Citicorp's case, overall international operations accounted for an astounding 72 percent of overall earnings in 1976, with Brazilian operations alone accounting for 13 percent of the bank's earnings (Makin 1984, 133–34).

The banks had the recent loan experience to back them up. As already pointed out, the combination of high export growth rates and low interest rates meant that debt-to-export ratios remained under con-