The International Debt Crisis of the Third World

Peter Nunnenkamp

The International Debt Crisis of the Third World:

Causes and Consequences for the World Economy

Peter Nunnenkamp

Research Fellow
The Kiel Institute of World Economics

Wheatsheaf Books

DISTRIBUTED BY HARVESTER PRESS

First published in Great Britain in 1986 by
WHEATSHEAF BOOKS LTD
A MEMBER OF THE HARVESTER PRESS PUBLISHING GROUP
Publisher: John Spiers
Director of Publications: Edward Elgar
16 Ship Street, Brighton, Sussex

British Library Cataloguing in Publication Data
Nunnenkamp, Peter
The International debt crisis of the Third
World: causes and consequences for the
world economy.
1. Debts, External—Developing countries
I. Title
336.3'435'091724 HJ8899
ISBN 0-7108-0752-X

Phototypeset in 11 point Times Roman by Tradespools Ltd, Frome
Printed and bound in Great Britain by
Biddles Ltd, Guildford and King's Lynn

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Preface

The affluent, industrialised North normally seems rather apathetic to the economic difficulties of the developing South. With enough of problems of their own, politicians, the press and the public in the North do not bother much about the problems of the South. No doubt pictures of the poor faced by starvation do evoke some human cordiality in the rich, but only to the extent of writing cheques in favour of some charitable institution to appease their troubled conscience. At the same time, the rich accuse the 'low-wage countries' of the South of dumping and thus, it is said, significantly adding to unemployment in the North. In joint action, employers and employees in industrialised countries lobby for protectionism and countervailing measures, and politicians comply with these requests, although it is obvious that an artificial protection of domestic industries in the North will further aggravate the misery of the South.

The scenario seemed to have changed in the early eighties with Brazil, Mexico and some other heavily indebted Third World countries declaring that they were unable to meet their foreign debt obligations. The Third World's economic difficulties became a major issue of public debate in industrialised countries. However, this was not because of a rising interest in developing countries' well-being *per se*. It was rather the widespread fear that the debt problems of some of the Third World's major borrowers could adversely affect the economic well-being of the industrialised countries which caused considerable concern. Developing countries' defaults, when added to the repayment difficulties already experienced by Eastern Bloc nations, it was argued, could severely impede the smooth functioning of world financial markets. Widespread failures of commercial banks which were heavily engaged in lending to the Third World could even result in a collapse of the international financial system. Frequently, the threat of another worldwide depression, comparable to the one half a century ago, was conjured up.

Since then the mood of panic has cooled somewhat. Politicians, banks and international organisations, in joint effort, have mounted quick rescue operations which have provided quite a few developing countries with additional funds. The crisis management has so far succeeded in preventing the Third World's repayment difficulties from substantially affecting the world economy. However, the underlying problems have been postponed rather than solved. Major repayment difficulties are expected to recur in the second half of the eighties, when huge debt repayments, recently postponed, will fall due.

Moreover, there is still a considerable degree of confusion regarding the Third World's debt situation:

1. Notwithstanding a significant improvement in the data base, information on the external indebtedness remains far from complete.
2. Many analyses of underlying factors are rather one-sided. Frequently, debt problems are exclusively attributed to 'anonymous' world market developments. The responsibility of both debtors and creditors remains inadequately exposed.
3. Possible worldwide repercussions arising from borrowers' repayment difficulties are still heavily disputed between rather pessimistic and more optimistic observers.
4. Considerable disagreement also prevails as to how to ease the developing countries' debt burden and how to prevent international ramifications.

This list already indicates the central topics of this book. Besides presenting a short global overview on the Third World's foreign indebtedness in Chapter 1, the first part of the book endeavours to identify important differences in the debt situation of different developing country groups (Ch. 2) and eighteen major individual borrowing countries (Ch. 3). This part culminates in an attempt to discriminate between sound borrowers and problem borrowers in Chapter 4. This analysis forms the basis for the following investigation.

The second part that focuses on the causes of the recent debt crises in the Third World comprises of three more chapters. The first (Ch. 5) questions the widely held view that difficulties in servicing foreign debt are the inevitable consequence of unforeseen external shocks which were outside the control of both debtors and creditors. This view is further challenged thereafter. Chapter 6 stresses the relevance of borrowing countries' economic policies in becoming a problem borrower or not. Chapter 7 analyses the lending attitudes of Western commercial banks, which nowadays are the most important creditors of the Third World's largest debtor nations. The question is posed whether the banks bear part of the responsibility for the borrowers' debt problems.

Turning to possible worldwide consequences of developing countries' defaults in the third part, Chapter 8 presents a comparison of economic conditions prevailing in the twenties and thirties on the one hand and in the early eighties on the other. In this way we may discover whether the Great Depression is really the relevant point on which to focus in view of the present economic tensions. Chapter 9 discusses in some more detail the probability of bank failures and possible chain reactions.

The question as to how to tackle the Third World's debt problems is dealt with in the subsequent chapters. The practice of rescheduling, and especially the role of the International Monetary Fund in it, is critically reviewed (Ch. 10). Since the success of short-term emergency programmes critically depends on an improvement in the international economic environment, Chapter 11 tries to assess whether there are reasonable prospects that debt-service obligations will become easier to handle in the near future. Even those who are rather optimistic about future developments in world markets will largely agree that debt problems cannot be solved exclusively by simply postponing the repayment of foreign loans. The short-term approach has to be supplemented. That is why the proposals which are intended to ease the developing countries' debt situation in the longer run are evaluated in Chapter 12. Finally, Chapter 13 summarises the main elements of a longer-term solution; specific reference is made to the question of defining the lender-of-last-resort function of monetary institutions.

I owe thanks especially to my colleagues in the Kiel Institute of World Economics, who gave me the chance to write this book and who contributed in various ways to its realisation. In particular, I wish to record by appreciation for the assistance provided by Kusum Ravinder Bhatia. She worked through hundreds of newspaper-cuttings in order to get a detailed impression of the different aspects of debt problems experienced by eighteen sample countries in the very recent past. This arduous task formed the basis of the summary table presented in Chapter 4. Furthermore, I am most grateful to her for reading the complete manuscript and for suggesting many improvements.

I have to apologise to Dean Spinanger for frequently disturbing him in his own work because, over and over again, I had to ask him for stylistic advice. Ulrich Lächler and Georg Junge were always prepared to discuss the different aspects of the Third World's international indebtedness. Many thanks also to them for constructive criticism after having read the manuscript.

Valuable assistance was also provided by Michaela Rank, who did most of the computational work and by Barbara Buss, who typed and retyped the whole of this book through successive drafts.

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THE SETTING

1 Developing Countries' Deteriorating Debt Situation

Twice in the last decade the non-oil developing countries (NOPECs)[1] have experienced a sharp rise in their current-account deficits. Following the oil-price explosion in 1973/74, the net total of balances on goods, services and private transfers resulted in a deficit of $46 billion in 1975, more than four times that of 1973. The NOPECs had just succeeded in improving their current-account position to some extent when the second oil-price crisis of 1979/80 occurred. Combined with economic stagnation, intensified protectionist pressures in the industrialised world and the NOPECs' own domestic policy mistakes, this oil-price hike contributed to a renewed steep rise in deficits, which in 1981 exceeded $100 billion.

It was not only the large financial needs but also some obvious structural changes in their capital account that caused concern for the NOPECs' balance of payments situation (Table 1). The extent to which current-account deficits were matched by non-debt-creating capital inflows diminished significantly. Whereas in the period 1970–73 net external borrowing could largely be used to fill up international reserves (as about 60 per cent of the annual average deficit of $10 billion was financed by official transfers and direct investment flows), this proved impossible later on. In the periods following the first oil-price shock, non-debt-creating inflows barely covered 40 per cent of capital requirements. Their share further declined to about 27 per cent at the beginning of the eighties. After 1979, development assistance in the form of outright transfers stagnated in nominal terms; the industrialised donor countries, themselves confronted by severe economic difficulties, were increasingly reluctant to grant non-repayable aid to the Third World. The record of direct investment flows was

Table 1: Current-Account Financing by Non-Oil Developing Countries, 1973–83 (in billions of US$)[a]

	1970–73[b]	1974–78[b]	1979	1980	1981	1982	1983[c]
Current-account deficit	10.2	37.2	61.0	89.0	107.7	86.8	67.8
Use of reserves[d]	−5.1	−8.8	−12.6	−4.5	−2.1	7.1	−7.2
Non-debt-creating flows, net	5.9	14.3	23.9	24.1	28.0	25.1	24.2
Official transfers	3.0	7.9	11.6	12.5	13.8	13.2	13.1
SDR allocations, valuation adjustments, gold monetisation	0.6	0.6	3.4	1.4	0.3	0.5	0.2
Direct investment flows, net	2.3	5.7	8.9	10.1	13.9	11.4	10.9
Net external borrowing	9.3	31.8	49.7	69.3	81.8	54.6	50.8
	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)
Long-term borrowing, net	7.6	27.0	36.5	47.2	62.7	41.0	64.0
	(81.7)	(85.0)	(73.4)	(68.1)	(76.7)	(75.1)	(126.0)
From official sources	3.7	10.8	13.3	17.6	23.0	19.5	23.8
	(39.8)	(34.1)	(26.8)	(25.4)	(28.1)	(35.7)	(46.9)
From private sources	3.9	16.2	23.2	29.6	39.7	21.5	40.2
	(41.9)	(50.9)	(46.7)	(42.7)	(48.5)	(39.4)	(79.1)
Financial institutions	2.6	13.7	21.7	28.4	35.7	18.5	39.1
	(28.0)	(43.3)	(43.7)	(41.0)	(43.6)	(33.9)	(77.0)
Other lenders	1.4	2.4	1.5	1.2	4.0	3.0	1.1
	(15.1)	(7.7)	(3.0)	(1.7)	(4.9)	(5.5)	(2.2)

Table 1—continued

	1970–73[b]	1974–78[b]	1979	1980	1981	1982	1983[c]
Use of reserve-related facilities	0.1	1.9	0.4	1.8	5.9	10.7	10.8
	(1.1)	(5.9)	(0.8)	(2.6)	(7.2)	(19.6)	(21.3)
Other short-term borrowing, net,	1.6	2.9	12.8	20.4	13.2	2.9	−24.1
including errors and omissions	(17.2)	(9.1)	(25.8)	(29.4)	(16.1)	(5.3)	(−47.4)
Exceptional financing	n.a.	0.9	−0.4	4.1	6.7	14.4	−7.6
	(n.a.)	(2.7)	(0.8)	(5.9)	(8.2)	(26.4)	(−15.0)
Payment arrears	n.a.	0.4	0.8	1.1	2.4	7.1	−5.0
	(n.a.)	(1.2)	(1.6)	(1.6)	(2.9)	(13.0)	(−9.8)
Other short-term borrowing,	1.8	6.1	14.6	20.8	10.1		
net	(19.4)	(19.3)	(29.4)	(30.0	(12.3)	−11.5	−16.5
Residual errors and omissions	−0.2	−4.1	−1.4	−4.5	−3.7	(−21.1)	(−32.5)
	(−2.2)	(−12.9)	(−2.8)	(−6.5	(−4.5)		

[a] In parentheses: shares in net external borrowing
[b] Annual averages
[c] Projection
[d] A negative sign indicates an increase in reserves

Sources: IMF, *World Economic Outlook*; IMF, *Annual Report*.