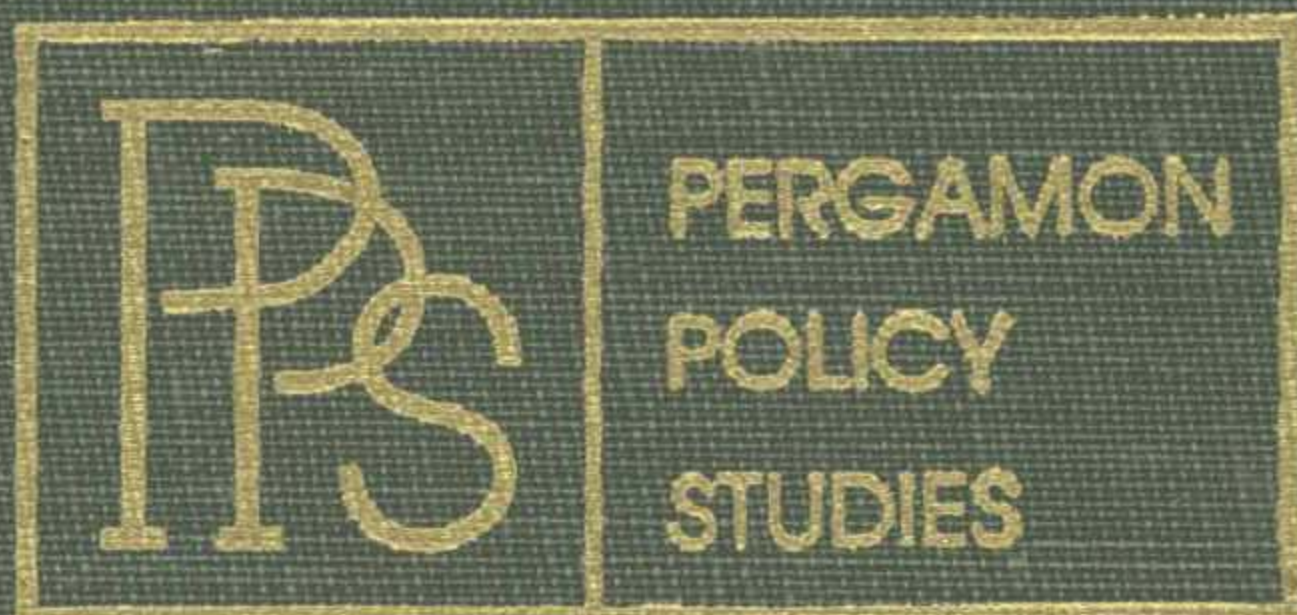
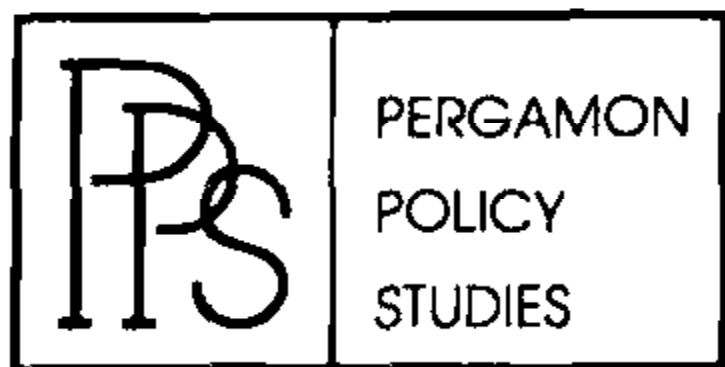


Developing Country Debt

Edited by
Lawrence G. Franko
Marilyn J. Selber





ON SOCIO-ECONOMIC
DEVELOPMENT

Developing Country Debt

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Foreword

The world is very different now. For man holds in his mortal hands the power to abolish all forms of human poverty and all forms of human life.

John F. Kennedy
January 20, 1961

Eighteen years ago John F. Kennedy's belief in the unlimited power of the United States to determine the future course of world economics, as well as world politics, was shared not only by the nation he sought to lead, but also by the world he aspired to mold. Two and one-half decades of unrestrained expansion had resulted in the unquestionable superiority and dominance of American economic system. The world then stood on the threshold of the "last frontier." All that was required to establish a world order of economic health was the exercise of the tremendous power of the United States with wisdom.

Two decades later it is again valid to observe that "The world is very different now." No longer do economists, politicians or world opinion believe that our world is approaching a final era of economic harmony and stability. The events of the past twenty years have again altered the political and economic structure of the world as profoundly, if not as cataclysmatically, as the two world wars which fashioned the American empire of 1960. The proliferation of nation states and nationalism, the insatiable energy consumption of the Western industrialized countries, and the dramatic demonstration in 1973 of the helpless dependence of the United States upon OPEC have created the new realities which now confound the world order.

The chapters in this volume present the most comprehen-

sive and cogent analysis of the revolutionary effects of the post-1973 OPEC oil pricing structure on the world's economic system. The authors have dramatically demonstrated that the problem of developing country debt is no longer the limited concern of multilateral lending institutions and the various organizations and scholars concerned with the economic development of less developed countries, but is now inexorably involved in the successful functioning of any future world economic system. For the first time in history, the successful management of lesser developed country debt is essential to the successful functioning of the world economic order. Because of the unparalleled growth of debt due to the imperative of recycling post-1973 petrodollars, the poor countries of the world have now become full partners of the rich. This critical new reality so insightfully detailed by the authors of this volume has gained only creeping cognition of the world's bankers, politicians, and policy makers. Familiarity with the facts and policy alternatives contained in this volume will be essential to the proper fashioning of future public policy.

The essential reality which the people of the United States and their government must acknowledge is the altered role of the United States from that of the determining force of the world economic system capable of working its will; to that of the major but limited partner in a vastly more integrated and complex system. The authors have invaluabley detailed the structure of the new system and more importantly provided the insights necessary for the future policy decisions needed to accommodate that structure.

The most important lesson to be learned from these brilliant authors may well be that the emergence of the phenomena of large debt among the developing countries of the world has at least created the imperative necessary for the creation of an economic system both committed and capable of achieving the ageless goal "to abolish all forms of human poverty...."

The Honorable John J. Cavanaugh

U.S. House of Representatives
January 1979

Preface

A decade ago, the phenomenon of developing country debt would have been thought an improbable international economic issue. Even the most astute observers of the global economy did not contemplate the emergence of the less developed countries (LDCs) as large-scale borrowers in international capital markets. But by 1976-77, developing country debt had taken on sizable and unprecedented proportions. Moreover, it was accompanied by unprecedented controversy.

The immediate concern, especially within the framework of a "stagflationary" world economy, was whether the high indebtedness of developing countries was dangerous to the solvency and stability of the lending banks and thereby the international financial system. Thus, developing country creditworthiness, bank risk analysis, and the size of LDC debt became central issues of debate. Those who were not so pessimistic - notably creditor bankers - hastened to assure and persuade those with alarmist views that no "debt problem" existed. Indeed, no major developing country had defaulted, nor did a massive chain reaction of defaults occur.

Out of this controversy grew many articles, pamphlets, and pages of congressional testimony. But few books, if any, comprehensively examined this phenomenon. Developing Country Debt attempts to fill this gap. This collection of articles presents a variety of views and perspectives on the topic of developing country debt. As the biographical notes for this book point out, the contributors have academic, business, and government backgrounds. Many have been participants in the operational and policy processes related to LDC debt. More than gathering a variety of views, however, we also have assembled serious analyses of LDC debt and presented the range of proposed solutions to debt servicing problems.

Our chosen route has been to begin with an overview,

followed by disaggregated country analyses and a review of proposed solutions to debt relief and their constraints. We conclude with an examination of the debt issue as it relates to the world economy and public policy.

First, in Part I, Neil J. McMullen presents historical perspectives on developing nations' debt starting with the debt experiences of the now developed countries prior to World War I. He then reviews the external debt picture of the 1920s and 1930s, and brings the debt experience to post-World War II. Next, Robert Solomon provides an aggregate analysis of recent LDC debt since the 1973 OPEC price increases and of the developing countries' abilities to carry debt. His conclusions are optimistic. Developing countries' ventures into the Euro-currency market and the consequent ballooning of private debt are then presented by Marilyn J. Seiber. And, finally, in this section, Charles S. Ganoe offers a banker's view on the myths of debt.

Part II provides a disaggregated analysis of debt and is introduced by Ganoe's commentary on risk analysis - a process, he advises, that is more than a numbers exercise. Then a series of case studies reports the economic and political conditions of selected countries with substantial debt and varying degrees of economic difficulty. The analysis of the Philippines by Seiber and of Jamaica by J. Daniel O'Flaherty demonstrates the wide differences that can exist among debtor nations; and the "package picture" of Turkey, Portugal, Peru, and Egypt by Robert N. McCauley points out the often critical role of the IMF when debt problems, among others, arise.

Part III follows with an examination of proposed solutions to debt burden problems by Seiber, and an examination by Jane D'Arista of United States congressional attitudes toward developing nations and United States economic assistance to them. D'Arista's appraisal indicates that congressional commitment to support developing countries' objectives has not strengthened in recent years. Third in this section is Carl R. Neu's response to the proposal that the International Monetary Fund take on greater direct responsibilities - perhaps as a lender of last resort - when emergency debt problems occur. He makes clear that neither the IMF's purpose nor resources would enable it to assume such a function.

Finally, the concluding section, Part IV, places the analysis of developing country debt in a broader, global context. First, Robert W. Russell presents the differing perspectives on debt of the borrowing LDCs, the lending banks, and the national interest of the United States. William A. Noellert then assesses debt in a framework of the global economy and international adjustment problems rather than the traditional framework of "development" or "financial stability." Last, Lawrence G. Franko concludes by examining what could be done about LDC debt in the context of global problems of

growth, trade, and energy.

One fact will become apparent to the reader. The current and increasing magnitude of developing countries' external indebtedness has become an important international policy issue with major implications for both developed and developing countries. The World Bank estimates that developing countries' demand for external financing will increase from \$63 billion in 1975 to \$276 billion in 1985, and half of these funds would be used in repayment of loans and interest to developed countries. As various contributors to the book point out, such external financial requirements have significant effects on policies concerned with such issue as trade, economic growth, multilateral financial institutions, resource and technology transfers, and domestic regulation of international banking activities.

The specific stimulus to gathering the collection of works contained in this book came from the International Studies Association which asked the editors to organize a panel on developing country debt for the association's Annual Meetings in February 1978. Thanks are therefore due to the International Studies Association for triggering the actual production of this work. Also, our thanks and appreciation go to the contributors for lending their expertise and efforts to this project.

As the reader will see, countries always have borrowed externally to supplement their capital resources. However, in recent years developing country debt has come to public attention because of its magnitude, rate of growth, concentration, the condition of the world economy, and the increased participation of LDCs in international fora. The exact amount of debt is not known - as varying figures throughout these pages illustrate. Yet it is widely agreed that the economies and policies of the industrial countries, the petroleum pricing policies of OPEC members, and the character of growth and development in the developing countries will largely determine how much debt is too much.

Lawrence G. Franko
Geneva, Switzerland

Marilyn J. Seiber
Washington, D.C.

January 1979

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I

An Aggregate Analysis of Developing Country Debt

1

Historical Perspectives on Developing Nations' Debt*

Neil J. McMullen

THE EXPERIENCE OF THE UNITED STATES, CANADA, AUSTRALIA AND NEW ZEALAND IN THE ERA BEFORE WORLD WAR I

It is sometimes forgotten that foreign investment played a large role in the economic development of the United States in the nineteenth century. Canada, Australia and New Zealand are additional examples of successful development, and these countries were even more dependent on foreign investment inflows than the United States. Typically, a developing nation lacks capital relative to its endowment of labor and natural resources, including arable land. Under these circumstances, successful economic development along a noncommunist pattern has implied the import of capital from abroad and the accumulation of foreign debts.

Estimates of the foreign indebtedness of the United States in the nineteenth century have been made and, when related to the size of the economy incurring the debt, are similar to the debt levels of many twentieth century developing countries. For the United States, total foreign indebtedness as a percentage of GNP is estimated to have been 40 percent in the 1830s,(1) 24 percent in 1869, 20 percent in 1899, 18 percent in 1914, and 8.5 percent in 1929.(2) This is gross indebtedness and, if foreign liabilities are offset by foreign assets, the

*From "Perspectives of Developing Nations' Debts" (Washington, D.C.: Committee on Changing International Realities, National Planning Association), forthcoming. Printed with permission.

percentages decline more sharply after 1869. Net indebtedness as a proportion of GNP is estimated to have been 15 percent in 1899, 10 percent in 1914, and -7.9 percent (foreign assets exceeding liabilities) in 1929.(3) This sharp decline in the net foreign indebtedness of the United States was a result of successful development and indicates the increasing financial maturity of the United States. By the end of the nineteenth century, the United States was lending abroad and repaying foreign debt faster than new foreign capital was flowing in. The big turnaround in America's foreign position occurred during World War I. In 1914, foreign obligations totaled \$7.2 billion, with assets equal to \$3.5 billion for a net liability of \$3.7 billion. By 1919, this situation had reversed itself; assets rose to \$7.0 billion, liabilities fell to \$4.0 billion, and the net position was \$3.0 billion of foreign holdings.(4)

Foreign loans to the United States in the 1800s were not without risk. Though data is fragmentary and incomplete, it is well known that there were periods in which American states, local governments and private borrowers defaulted on foreign loans in sizable numbers. Large borrowings by American states for canal and railroad construction in the 1830s were defaulted in 1841 and 1842 as the price of cotton collapsed and foreign exchange was not available to make debt payments. Nine states in all defaulted but, by 1845, with a revival of cotton prices, all but two states resumed payment, effecting settlement on all or part of their debts.(5) In the 1870s and 1890s, there were some defaults on foreign bonds by railway companies and municipalities and, as late as 1915, a French loan to the New Haven Railroad was in default. On balance, however, foreign investors as a whole derived gains from their American investments that made their losses through default seem insignificant.(6)

In reviewing the trends of investment flows into Canada and Australia, the pattern is similar, but the timing is somewhat different. Foreign capital flows into these areas reached a peak in the years prior to World War I. The total amount of British foreign capital invested in the Dominions rose from \$11 million in 1830, to \$63 million in 1854, \$450 million in 1870 and \$7,400 million in 1914.(7) Of this, \$2,778 million had been invested in Canada up to 1914. Foreign capital invested in Canada totaled \$1,200 million in 1900, \$2,480 million in 1910 and \$3,700 million in 1913.(8) About 20 percent came from the United States, 75 percent from the United Kingdom and 5 percent from elsewhere.

Comparing estimates of Canadian GNP with net foreign indebtedness in the years of the twentieth century shows a very high level of debt. In 1900, net foreign debt totaled 114 percent of Canadian GNP; in 1910, this ratio was 111 percent; and, by 1920, the proportion of debt to GNP was 88 percent. By comparison, the figure had dropped to 42.7 percent in

1960. These figures are higher than those for the United States, indicating a greater dependence on foreign capital inflows throughout the Canadian growth process.

Australia and New Zealand followed the Canadian pattern of economic development with strong emphasis on foreign capital inflows. Up to 1914, Australia and New Zealand had together received some \$2,435 million(9) in foreign investments, which represented about \$400 of external debt per person. The comparable figure for Canada in 1914 was about \$500 per person.

These figures shows that Canada, Australia and New Zealand were heavily dependent on foreign capital for their development and growth in the early 1900s. The ratio of external debt to GNP exceeded 100 percent for Canada and was probably close to 100 percent for Australia and New Zealand. By comparison, none of the key nonoil developing countries had a ratio of foreign debt to GNP that exceeded 45 percent in 1976. Two important qualifications must be considered. The first relates to the external debt that is being compared; the Canadian, Australian and New Zealand figures include direct investment in local firms, whereas the external debt of the nonoil developing nations generally does not. Thus, there is an incongruity in definition which would reduce the difference between the ratios compared. A second important difference relates to the nature of the economies being compared. Canada, Australia and New Zealand were sparsely populated lands with vast amounts of underutilized natural resources and unsettled arable lands in the early 1900s. Development strategies would be expected to be more capital-intensive for these countries than for nations that had large supplies of labor available for employment in mining, manufacturing and agriculture. From this perspective, it is not surprising that, relative to output, external capital was larger for the newly settled British Dominions in the early twentieth century than for the developing nations in the last half of this century.

The experience of the British Dominions shows that very high foreign debt levels can be sustained and are compatible with long-term economic growth. Where foreign loans are utilized productively, where their repayment is properly planned, and where world trade continues to expand, historical experience shows that it is possible to service very high levels of external debt. Nonetheless, there are enough important differences between historical events and current conditions to make past experience an imperfect predictor of the features.

Experience prior to World War I indicates that, in an expanding world economy, foreign lending is both remunerative to the creditor and productive for the borrower. There are clearly risks to be faced and, on occasion, repayment may be tardy or partial but, over the long haul, there are tremendous gains to be made by both sides.

FOREIGN DEBTS IN THE 1920s AND 1930s

After World War I, the United States became the world's leading foreign investor. Net foreign assets held by Americans rose from \$3.0 billion in 1919 to \$6.7 billion in 1924, \$8.1 billion in 1929, and then declined to \$7.4 billion in 1935. The interwar period was a time of great financial and economic dislocation and provides the most recent experience of large-scale defaults of foreign debts. After the buildup of foreign lending that occurred in the 1920s, the economic depression and sharp decline in world trade in the early 1930s resulted in widespread defaults by Latin American and Eastern European nations.

By January 1932, the problem was evident as defaults on a total of \$2.6 billion had already occurred.(10) It was noted that the "income of every government has been drastically decreased, although the debt charges have remained stationary."(11) Table 1.1 demonstrates the magnitude of the

Table 1.1. Debt-Service Ratios

	Percent of Government Revenues 1931	Percent of Export Earnings			
		1930	1931	1932	1933
Argentina	36.9	18.2	22.5	27.6	30.2*
Bolivia	72.7*	13.5	24.5*	50.0*	38.5*
Brazil	25.0*	23.5	28.4*	41.0*	45.1*
Chile	32.2*	18.0	32.9*	102.6*	81.9*
Colombia	32.0	14.0	15.6	21.8*	29.6*
Cuba	NA**	6.1	13.4	18.1	22.4*
Peru	34.3*	9.5	16.3*	21.4*	21.7*
Uruguay	NA**	9.7	22.4*	36.3*	31.3*

*Years of partial or full default on outstanding foreign loans.
 **NA = not available.

Sources: Max Winkler and Maxwell S. Stewart, "Recent Defaults of Government Loans," Foreign Policy Reports 7, no. 22 (January 6, 1932): 397; and Dragoslav Avramovic, Debt Servicing Capacity and Postwar Growth in International Indebtedness (Baltimore: Johns Hopkins University Press, 1958), p. 194.

problems faced by various Latin American nations. In 1931, estimated debt service costs for principal and interest payments were running at approximately one-third of government revenues in Latin America, and totaled 72.7 percent of Bolivian government revenues.

Table 1.1 shows that, as a proportion of export earnings, debt-service costs rose sharply from 1930. This was principally because of declines in the prices of the commodities exported by these nations. Prices of coffee fell from 18.5 cents per pound in 1929 to six cents in 1931. Tin prices dropped 55 percent, from 45 cents a pound to 20 cents a pound in 1931. Sugar prices halved, going from six cents a pound in 1929 to three cents a pound in 1933. A general index of primary products indicated that prices fell 60 percent from 1929 to 1931.(12) The result was a devastating decline in the value of exports for the countries which specialized in the export of primary products. From 1928-29 to 1932-33, the value of Chile's exports fell 80 percent; Bolivia, Cuba and Peru suffered export declines of 70 percent and Argentina and Brazil had declines in excess of 60 percent.(13)

In a period of falling prices, "the burden of debts and accrued interest is much greater in terms of commodities or services than was originally intended" and debtors in effect are repaying much more than the value they received.(14) Due to depressed volume and falling prices, the value of world trade fell from \$34.3 billion in 1929 to \$27.9 billion in 1930, \$20.00 billion in 1931, and \$13.5 billion in 1932.(15) In such circumstances, governments lacked the foreign exchange to repay their debts, and, even where debtor entities set aside local currency in the amount of their obligations, there were no United States dollars available to fund the external payments.

The key elements in the series of defaults by developing countries in the early 1930s were the collapse in world trade, the decline in the prices of their exports, and the resulting unavailability of foreign currency to meet external debt payments. A crucial factor in these defaults was the rapidity with which export earnings declined and debt servicing ratios rose. It is not just a high debt-service ratio that makes a default more likely, but a sharp and unexpected rise in the ratio. Estimates indicate that, in the early 1900s, Canada, Australia and Argentina were able to service higher debt burdens than those which were in default in the 1930s.(16) In the earlier era, the debt burden had built up slowly, and was planned for by the borrowing governments and firms. Frequently, these investments were self-financing and self-adjusting in that they represented ownership in an exporting enterprise. The sales of the operation generated the needed foreign exchange and, during unprofitable years, no return on the investment was expected. This resolved problems of