The Debt Bell Tolls Again

by Catriona Purfield

On August 20th 1982, Citibank's Vice Chairperson, W.R.Rhodes cut short his summer vacation, with the announcement of Mexico's president, Lopez Portilla and his finance minister Jesus Siliva Herzog ringing in his ears. It was on this date that the Mexicans announced to the world that they would no longer be able to meet their debt service obligations. The shock to the world's financiers was a large one, but then again so was Mexico's foreign debt, (80 billion dollars to be precise,). The bulk of this debt was borne by American banks. In fact Americas nine largest banks were owed $12 billion, (roughly 40% of their capital reserves). In many cases the banks' exposure exceeded their capital giving rise to fears of a run on the system.

However more bad news was to follow. 26 countries were reported to be late on their debt repayments. Quick to follow the Mexican announcement were Argentina and Brazil. Many sub-Saharan countries were also in severe difficulties. The world braced itself for the sinking of the international financial system.

This was how the world debt crisis came to the fore of the world headlines. I hope to trace the trail of events in the crisis to the present by firstly presenting the package which helped save the Mexicans, and which was later formulated into a rescue package which was implemented in other debtor countries. I then intend to cover the origins or roots of the crisis in the 1970s. This analysis of the past will be followed by an evaluation of the present, showing how despite the apparent calm the crisis still exists in its most potent form for those in the sub-Saharan countries which are the poorest in the world. These countries are bearing the full brunt of the recommended IMF adjustment policies with little or no assistance from First World nations. In order to suggest ways of relieving the human suffering in these countries, a brief outline is given of possible policy instruments which could be implemented in both Third and First World nations.

The Initial Crisis and its Solution

The disaster did not happen to the financial system despite the fears of many. All parties to the debt problem worked to maintain the stability of the system. Jesus worked miracles in conjunction with the Americans (for it was they who after all had the most to loose financially). Credit was advanced to the Mexicans and advance payments were made by US authorities for shipments of Mexican crude oil. The IMF negotiated a loan of $4.8 billion and at a meeting with the commercial banks in New York, Herzog negotiated a 90 day moratorium on principal repayments for public sector debt. Soon after, the Mexican survival plan was formulated into a world strategy in response to difficulties being experienced in various countries. There were three main stages.

a) DEFENCE: This consisted of the formulation of emergency short- term packages and the rescheduling of debt due within the next 2 years, in order to overcome short-term problems.

b) OFFENSIVE: The IMF entered the battle for the maintainence of the financial system. They negotiated stabilization policies in debtor states. Countries were advised to remove exchange and import controls, to devalue official exchange rates and to implement stringent anti inflationary policies such as cut backs in public sector spending and borrowing, and controlling wage increases. In return the commerical banks would agree to reschedule debt.

c) THE CONDITIONALITY TRUCE: The Baker Plan, by which commerical banks would make new loans available on the undertaking by debtor countries that they would implement certain growth-oriented structural reforms, was formulated. The abyss had passed..... or so it seemed.

Origins of the Crisis

Despite the rather abrupt emergence of the "debt-crisis" onto the world's headlines, the problems roots stem right back to the 1970s, with the occurrence of the world oil price shock.

In order to maintain their previously high growth rates many of the now present debtors sought loans from commercial banks. These private institutions were only too willing to lend in order to recycle their surpluses of petro-dollars which had been accumulated by the Arabs after the 1973 oil price hike. Often these loans were made without proper assessment of the project being funded or of the risk involved. Such commercial debt carried with it shorter maturity and more variable interest rates than what was available on official loans. A favourable economic climate from 1974-1979 meant that third world debtors had little difficulty in meeting their debt service obligations. The 1970s were a period of high inflation. Real interest rates were low or negative. Commodity prices were also high.

This bubble burst with the second oil price shock of 1979. Faced with high oil bills, large trade deficits and a global recession (resulting from the price stabilization policies of industrial nations), debtors saw real interest rates rise from a negative 3-6% to a positive 16-20% by 1982 (Kruger,1987). Primary product prices plummeted by around 20% (Todaro,1989). These external conditions were aggravated by the domestic mismangement of economies and the flight of private capital from these countries. In Mexico, the main cause of the debt crisis was a highly expansionary macroeconomic policy financed by external borrowing, $65 billion of which was at variable interest rates and capital flight (accounting for about

71% of Mexico's debt growth (Todaro,1989)). Under such tremendous pressure, both internal and external, it is little surprise that Mexico, and many other Third World debtors could no longer meet their repayment deadlines.

The Situation Today

It is now over ten years since the Mexicans broke onto the news headlines.These days media coverage on the subject has waned considerably. Where do we stand now?

Ten years later, there has been only a marginal improvement in the aggregated developing countries debt service ratios (DSR). It has fallen only one percentage point from 31.8% of the value of exports in 1983 to 30.8% in 1991 (IMF,1991). This meagre improvement however, masks and is consistent with the claim that the situation is actually worse now and still remains unresolved. Nowhere is this more true than in sub-Saharan Africa (SSA), where, with a population of 464 million and a per capita income of only $330, the problem is particularly acute in human terms. After ten years of rather painful adjustment the DSR for the continent as a whole has risen from 22.7% in 1983 to 24.5% in 1992 (IMF,1991). The adjustment has been largely borne by those who can least afford it, the poor, who constitute the vast bulk of the population of these nations.

External Debt Stock of Sub-Saharan Africa

Amount (US$millions) Share %

	1985		1990	
All Sub-Saharan Africa	AMOUNT	SHARE	AMOUNT	SHARE
Total external debt	98.7	100.0	173.7	100.0
Long-term	84.4	85.5	152.8	88.0
Official	52.8	53.8	112.0	64.5
Multilateral (inc. IMF)	23.4	23.7	43.5	25.0
Bilateral	29.5	29.9	68.5	39.4
Private	31.6	32.0	40.9	23.5
Short-term	14.3	14.5	20.9	12.0
0/w interest rates	1.9	1.9	10.5	6.0

Source: World Debt Tables 1991-92

This table illustrates the fact that despite the adjustments that have taken place under IMF guidance that the level of indebtness has actually risen in Sub-Saharan Africa (SSA).

SSA Debt Policies: Hardship and Failure

Three main approaches were taken in the 1980s to reduce the DSR.Domestic consumption was choked back, with cuts being made in public expenditure levels of these countries. These cutbacks in investment and expenditure have led to the reduction of aggregate supply and this has now necessitated an even more savage depression of domestic demand on an already poverty-stricken population. Secondly, governments have sought to reduce import demand, this intertemporal trade-off is an important contributor to the present detoriation of the DSR, since by cutting imports in the 1980s the potential export capacity of these nations in the 1990s has been restricted and so SSAs export performance has been adversely affected.

The final contributing factor to this dire human situation is that, unlike in the 1980s when they received positive transfers from the rest of the world, SSA is now giving substantial sums of money to the banks of industrialised nations in interest payments. Under mounting internal political pressures, these countries have nothing to lose by defaulting on their debt repayments. This is especially true now that it is common knowledge that the banks have now built up substantial reserves for protection against default. The brunt of the adjustment has already been borne by those who can least afford it,and with little if no improvement in the situation. This is why the situation is more serious now than ever before and needs immediate attention.

The Case for Relief

Debtor countries have paid the full price in terms of low GNP growth and falls in real wages in order to service the debt burden.The price for the mistakes of both the creditors and debtors have fallen firmly on the shoulders of the debtors countries. Given high negative transfers, default seems a feasible option. In order to prevent this and to draw the "debt crisis" finally to a close, a case for debt relief can be strongly advanced on distributional grounds. Yet the banking institutions and the IMF staunchly maintain that present debts should be honoured.

Why do they persist with such a policy? Basically, they cling to the hope of making capital gains in the event of borrowers paying in full. The world's poorest people are suffering in order to provide bank shareholders with the mere hope of a profit. Such a situation can hardly be justified on moral grounds.

The case for relief can even be advocated on strictly economic grounds alone. Bird (1982) postulates a debt relief Laffer Curve. Once debt exceeds a certain point then reductions will provide the necessary incentives for paying off the remaining sum outstanding. Once debt obligations are expected to be met the value of the debt on the secondary market will rise, such relief would normalize the loans market once again. Fisher(1987) proposes that relief should only be available once IMF structured adjustment programmes have been agreed to. These would be growth-orientated and encourage investment both in private and in public sectors with the liberalisation of trade also occurring. Once this was in place, the princpal and interest would be reduced to 65% of their contractual value. Annual savings would vary between 1%-3.5% of GNP and would allow a substantial improvement in the welfare of the poor.

Conclusion

The debt crisis is still alive today in even a more potent form than it was in 1982. The "debt overhang" (Fisher's term) is preventing the progression of many countries particularly those in sub Saharan Africa. There has been a shift of the zone of danger across the sea from Latin America to the African continent. There has not, however, been the same media focus, which is needed to highlight the fact that the situation is now potentially more dangerous and of a different form than that which existed in Latin America ten years ago. The problem needs innovation and a new solution . This will require further research and attention.

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