

PART II

Chapter 1

Survey of the Debt Problem

Origins of the Problem

Banks and the recycling process

1.1 The immediate causes of the present debt crisis lie in the onset of the recession from 1980 onwards in the industrial countries and the associated rise in interest rates. The seeds of the problem were already present, however, in the events following the first oil price rise of 1973–4, the explosion in the current account deficits of the non-oil developing countries and the financing of these deficits by private banks. The main burden of the counterpart deficits to the surpluses of the oil-exporting countries was shifted quickly from the industrial countries which were the major oil importers, to the non-oil developing countries. The recycling by the banks of the surpluses of the oil exporters was facilitated by the softening of the costs of borrowing by inflation and the rapid expansion of international banking; the Eurocurrency market increased from US\$300 billion in 1973 to over \$2,000 billion in 1983. The second oil price increase in 1979 and the impact of restrictive fiscal and monetary policies in the industrial countries, adopted to control inflation, together resulted in a stagnation of world trade and a sharp rise in nominal and real interest rates. The result was a substantial increase in debt-service obligations leading to arrears which precipitated a sudden reduction in net lending by banks. Debt obligations, contracted under what seemed to be favourable circumstances, ceased to be viable. The intermediation role played by the banks—which made finance easily available at low real rates of interest during the 1970s—also encouraged some debtor countries to adopt expansionary policies, albeit for investment rather than consump-

tion,¹ thus contributing to their large budget deficits and to the accumulation of debt.

1.2 This broad pattern of events can be encapsulated with the aid of a few aggregate statistics. The total long-term external debt of developing countries at the end of 1983 was around \$600–650 billion, with \$125–150 billion of short-term debt; and some 85 per cent of the total was accounted for by non-oil developing countries. The debt increased five-fold after 1973 in nominal terms, and more than doubled in real terms. It mainly accumulated over the period 1974–82 when a total deficit (and reserve increase) of \$587 billion for non-oil developing countries was financed as follows: 29 per cent by non-debt-creating flows, foreign direct investment and grants; 22 per cent by long-term capital from official sources, mainly export credits and from international institutions; and the remainder (49 per cent) by borrowing from private markets, almost all from banks (see Table 1.1). Consequently, by 1983, about half of all the long-term debt of non-oil developing countries, together with almost all the short-term debt and the rapidly increasing debt of some of the oil exporters, was owed to banks.

1.3 Various features of this private bank lending explain why serious problems arose subsequently:

- the maturities of Eurodollar loans have been typically around 8 years, which are long in relation to the liquidity of the banks' deposits but short in relation to the time periods appropriate to development financing. By contrast, the World Bank lends for over 50 years under its soft-loan International Development Association (IDA) facility and 15–20 years in its IBRD lending to middle-income countries. In the absence of well-defined measures for refinancing the Eurodollar loans as they fall due, the international financial system has operated on a false assumption that the debt would be repaid in the unrealistic time-frame of medium-term bank finance;
- much of the debt was contracted at variable interest rates; the proportion of such (non-oil) developing country debt increased from 5 per cent in 1972 to 40 per cent in 1982, and to over 75 per cent for some major debtors. This has made borrowers highly vulnerable to short-term increases in interest rates which raise the cost not only of new borrowing but of past debt too. It has been estimated that a 1 per cent rise in interest rates adds at least \$3 billion per year to interest charges on all developing countries' debt;

1. The IMF, on the basis of an econometric investigation, concluded that 'in general— it appears that increases in the indebtedness of the non-oil developing countries have reflected primarily an exchange of debt instruments for additional physical capital'. *World Economic Outlook*, 1983, p. 144.

- there has been a rise in the significance of short-term debt with an original maturity of less than one year. Countries have commonly relied on 90-day credit to finance many of their imports, but the big increases in short-term debt for some major debtors cannot be explained in terms of trade credit requirements. The increased proportion of short-term debt in total debt reflected the interest of individual banks in protecting themselves in periods of impending crisis by further reducing the maturity period of loans. But when all banks have acted together in a concerted way the effect has been to make the position of the debtors, and the system as a whole, more vulnerable.

**Table 1.1: Non-Oil Developing Countries:
Financing of Current Account Deficits
1974-82 Cumulative Totals**

	\$ billion	per cent
Current Account Deficits	531	90.5
Increase in Official Reserves	56	9.5
Total	587	100.0
Financed by:		
(a) Non-debt-creating flows (net)	172	29.3
(b) Long-term capital from official sources, net	128	21.8
(c) Borrowing through private markets	278	47.3
Of which: Banking	255	43.4
(d) Others	9	1.5

Source: Computed from IMF, *World Economic Outlook*, 1984 and *International Capital Markets, Developments and Prospects*, 1983.

1.4 It will be clear from the above that we regard the current debt crisis as having largely originated in the weakness of the financing mechanism itself which evolved to meet developing country external deficits in the 1970s. The recession and the rise in real interest rates precipitated the crisis in 1982, but the inherent vulnerability of the system would have been exposed sooner or later.

The impact of recession

1.5 The first major impact of recession was on developing country export earnings. Between 1973 and 1980 the export earnings of the

non-oil developing countries roughly kept pace with the growth of debt. But between 1980 and 1983, the total debt of the non-oil developing countries increased by an amount close to \$200 billion, while their total export earnings increased by only about \$20 billion. The weakness in export earnings has arisen from the low volume of growth and the depressed prices of commodities, and also from difficulties in exporting manufactures because of protectionism and slow market growth. While the tentative recovery in growth in the industrial countries in 1983 began to suggest that a revival in commodity prices was under way, these have dropped again in 1984. At mid-July, the dollar index for all items had fallen by 3 per cent from a year earlier and by 17 per cent from 1980 levels; for non-food agricultural items the falls were 19 and 22 per cent and for metals 16 and 33 per cent, respectively.

1.6 The second influence has been that of high interest rates. For example, the six-month Eurodollar rate payable on variable debt rose from an average of 8.3 per cent in the period 1972-78 to 17.2 per cent in 1981, descending again to 9.8 per cent in 1983. The trend this year is, once again, upward, with the rate reaching 12.8 per cent in mid-July 1984.

1.7 Annual interest payments for all non-oil developing countries have risen from \$13 billion in 1977 to over \$60 billion since 1982. Between 1980 and 1983 the increase in annual interest payments on outstanding debt was about \$20 billion, absorbing the entire increase in export earnings. For the 25 major debtor countries, interest payments now absorb over a fifth of all export earnings, and for some individual countries the position is considerably worse (see Table 1.2).

1.8 Although nominal interest rates are now at lower levels than in 1981, real interest rates remain high. If rates of interest are adjusted for changes in the export unit values of developing countries, it becomes clear that the real interest rate, which remained largely negative in the 1970s, rose to over 20 per cent in 1981-82 in respect of the non-oil developing countries, and has not fallen significantly since.

1.9 High international interest rates have another, negative, impact which exacerbates the liquidity problem faced by debtors. They precipitate outflows of private capital. The opportunity of earning high real rates of return on dollar deposits in overseas accounts encourages capital flight from developing countries, thus forcing governments, in effect, to choose between debilitating capital outflows and domestic interest rates which are at a level that chokes off investment.

1.10 We shall pursue in Chapter 5 the future implications of the debt problem based on different assumptions about growth and interest rates

Table 1.2: Developing Countries: Debt-Service Payments as per cent of Export Earnings, 1973-83

	Interest Payments Ratio					Debt Service Ratio		
	1973 ^a	1977	1980	1983	1973 ^a	1977	1980	1983
(1) All Developing Countries ^b	n.a.	5.7	9.1	13.2	n.a.	15.3	17.1	22.5
— 25 Major Borrowers ^c	n.a.	7.2	11.9	18.6	n.a.	19.1	21.5	29.9
(2) Non-Oil Developing Countries	6.1	5.7	9.1	13.2	15.9	14.8	17.2	21.6
— Low-Income Countries	6.1	4.7	4.4	5.4	14.6	12.1	10.3	13.3
— Excluding China and India	n.a.	5.1	6.1	9.3	n.a.	13.2	14.3	22.4
(3) By region								
— Africa	2.9	5.0	8.1	10.8	8.8	11.9	17.4	25.1
— Asia	3.9	3.1	4.4	5.9	9.6	7.9	8.4	10.8
— W. Hemisphere	11.1	10.0	18.9	32.2	29.3	28.2	34.1	44.0

Notes: ^a Figures for 1973 do not include China in any category and are not strictly comparable with the figures for later years. Regional figures for 1973 refer to non-oil developing countries only.

^b Excluding eight oil-exporting countries: Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia and United Arab Emirates.

^c The 25 developing countries with the largest total external debt at the end of 1982. In order of the amount of debt, they are: Brazil, Mexico, Argentina, Korea, Indonesia, Venezuela, Israel, India, Chile, Egypt, Yugoslavia, Turkey, Algeria, Philippines, South Africa, Portugal, Nigeria, Thailand, Malaysia, Peru, Pakistan, Morocco, Romania, Colombia and Hungary.

Source: IMF, *World Economic Outlook*, 1983 and 1984.

in the industrial countries. Suffice it to say here that since work on this report was initiated the prospects for both now look considerably less promising.

Major debtors and other developing countries

1.11 Up to now we have dealt with the developing country debt problem as an undifferentiated whole. There is, however, an important distinction to be made between the small number of major debtor countries which are critical to the viability of the international banking system and the many small debtors for whom the burden of external debt is also a serious problem but who are less central to the system as a whole.

1.12 As far as the international financial system is concerned, the debt problem would appear to centre on a handful of countries. Brazil, Mexico, Argentina and South Korea account for more than 45 per cent of total non-oil developing country debt, about two-thirds of the debt owed to private creditors, and 62 per cent of the gross exposure of banks to the non-oil developing countries. If we take account of the deposits of these countries with the banks, and exclude officially guaranteed export credits, they account for nearly 95 per cent of the net exposure of banks to all developing countries.

1.13 By contrast, low-income developing countries (on the IMF definition)² account for a total of \$88 billion, short- and long-term, 13 per cent of the total for all non-oil developing countries. Their outstanding debt to all private creditors is \$15.4 billion, under 5 per cent of the total of such debt for all non-oil developing countries (most low-income developing country debt being official rather than private). Yet these countries have collectively experienced serious problems of indebtedness. Between 1980 and 1983, their total debt (excluding India and China) increased by about \$14 billion, while their annual export earnings declined by \$1 billion. At the same time, their debt-service payments increased by about 50 per cent over a period of three years. Over a fifth of their export earnings are now absorbed in debt-service payments; for Africa, the share is over a quarter.

1.14 The distinction between the problems of major middle-income debtors and those of the low-income countries is sufficiently important for us to treat them separately in Chapters 2 and 3. In Appendix 1.1 we show for a range of mainly Commonwealth countries how the debt problem varies in scale and type.

2. See Annex for country groupings.

Implications of the Debt Problem for Developing Countries

Economic impact of negative resource flows

1.15 The main impact of the debt crisis on the major debtors has been the rapid forced transition from trade deficits financed by net capital inflows to net capital outflows made possible by running trade surpluses. The process by which growing interest charges are being met through surpluses elsewhere on the current account is shown in Table 1.3.

1.16 Gross new medium- and long-term Eurocurrency bank credits to developing countries fell from an average of over \$40 billion in the five years 1978-82, to \$33 billion in 1983 and \$18.8 billion in the first six months of 1984 (against \$23.1 billion a year earlier). As a result of the mounting debt-service payments on the one hand and reduced loan disbursements on the other, all medium- and long-term loans (net of repayments) to all developing countries declined by \$41 billion between 1981 and 1983 and by \$38 billion for the thirteen major borrowers.³ During 1983, these thirteen suffered a net outflow of resources of \$21 billion as compared with \$11 billion for developing countries as a whole. This outflow was augmented by private capital flight, amounting to an estimated \$45-70 billion from four Latin American countries in 1982 alone.

1.17 Developing countries have been required, as a consequence of lack of financing sufficient to pay the interest charges, to achieve surpluses on trade in goods and services. Deflationary policies have been the main instrument used to create these surpluses. As a consequence, their imports fell by some \$60 billion between 1981 and 1983, much of this being concentrated on the major borrowers. In order to achieve this degree of import contraction, the ensuing deflation has been sufficiently large to induce not merely lower growth but also cuts in per capita income. In Latin America there was a decline in real per capita incomes in 1983 of 5.6 per cent, a fall for the third year in succession. Of developing countries as a whole, the IMF has commented: 'in 1982 and 1983 the entire GDP growth of 1½ per cent in the non-oil developing countries was needed to improve the foreign balance. Thus, real domestic demand in these countries in 1982 and 1983 was at best stagnant in aggregate terms and declined by a wide margin in per capita terms'⁴. The cutback has affected not just personal consumption but also investment, with adverse implications for future growth.

3. These are countries with disbursed and outstanding long-term debt of over \$13.5 billion in 1982 (World Bank classification).

4. IMF, *World Economic Outlook*, 1984, p.3.

1.18 In this report, we have endeavoured, with the help of a linear model of the world economy, to demonstrate the costs of trying to achieve trade surpluses by demand-reducing measures.⁵ Our estimates are that for Latin America as a whole to generate \$1 of additional foreign exchange it is necessary for it to reduce its GDP by \$8; for Africa and Asia the reductions are respectively \$5-6 and \$6-7. Using the same model we also estimate that if growth rates are held back by the need to achieve trade balance (or a small positive resource transfer), then, even if growth in industrial countries averages 3 per cent (which was the average for the period 1970-81), growth in Latin America will average only 1.4 per cent, in Africa 2.1 per cent and in Asia 3.2 per cent. Except in Asia, per capita incomes will fall continuously.

1.19 The impact of the enforced contraction of incomes in developing countries has been felt in industrial countries also. In the case of the United States, for example, the drop in exports to Latin America

**Table 1.3: Non-Oil Developing Countries:
Balance on Current Account and Interest Payments,
1973-84 (\$ billion)**

Year	Balance on Current Account Excluding Interest Payments on External Debt and Official Transfers (1)	Interest Payments on External Debt (2)
1973	- 4.4	6.9
1974	- 27.7	9.3
1975	- 35.8	10.5
1976	- 21.7	10.9
1977	- 17.7	12.7
1978	- 24.2	18.1
1979	- 36.1	25.9
1980	- 48.7	39.0
1981	- 54.4	54.7
1982	- 19.2	63.0
1983	+ 2.8	59.2
1984 ^a	+ 13.7	63.7

Notes: China is not included in the years up to 1977.

^a Projections.

Source: IMF, *World Economic Outlook*, 1983 and 1984.

5. This exercise was carried out in collaboration with Martin Weale of the Cambridge University Department of Applied Economics. The model is described in 'Quantity and Price Effects in an Analysis of World Trade Based on the Accounting Matrix', *Review of Income and Wealth*, March 1984.

accounted for almost half of the \$33 billion decline in total exports between 1981 and 1983, and may have cost the American economy some 400,000 jobs. Clearly, the debt problem has affected industrial country growth. It is estimated that 3 per cent growth would have been achieved in 1983, instead of the 2.3 per cent actually achieved, if the developing countries had been able to continue importing at 1982 levels—which were already below those of 1981. This linkage is especially important for industrial countries which have a high share of their exports directed to developing countries: the US (40 per cent), Japan (43 per cent), the UK (29 per cent) and West Germany (22 per cent).

Export growth prospects

1.20 Negative net transfers entail trade surpluses on goods and non-factor services. These will be achieved either by further suppressing imports through low levels of domestic activity or by rapid export growth, which will in turn permit faster growth of imports and of the domestic market. Improved trade performance can come in part by removing any bias against traded goods and services, and in particular exports, which exists at present in some of the seriously indebted countries. But it will also be necessary for developing countries to achieve improved returns from their traditional commodity exports and better market access in industrial countries for an expansion of non-traditional exports, mainly manufactures.

1.21 Improved access to industrial country markets requires a reversal of protectionism. At present about a third of the exports to industrial countries of six of the most heavily indebted countries consist of highly sensitive items (meat; dairy products; cereals; animal feedstuffs; fats and oils; textiles and clothing; footwear; ships; and steel). Ever since the onset of the debt crisis, additional restrictions have been imposed on steel and textiles, and on many lesser items.

1.22 While the issue of protectionism is crucially important, it should not be forgotten that half the exports of non-oil developing countries—and a much higher proportion of those of the low-income developing countries—are primary commodities whose earnings have been depressed in respect of both price and volume since the start of recession in 1980. Indeed, in 1982, commodity prices achieved a post-war low in terms of manufacturing prices. Little progress has been made on the various proposals to improve developing country terms of trade, a consequence of which has been a weakened ability to service debt.

Implications for the Banking System

1.23 We have already argued that bank lending was an inherently unsatisfactory vehicle to carry the main burden of recycling financial

surpluses. The consequences of this disproportionately larger role can be seen in the banks' current asset structures. In relation to their capital base, the main banks have a high degree of exposure to a small number of developing countries. The nine largest banks in the United States, for example, have a combined exposure to developing countries of over 200 per cent of bank capital and this excludes OPEC members and also offshore banking centres, many of whose funds are on-lent to developing countries. Of this figure the four major Latin American borrowers accounted for 128 per cent in December 1983. Particular banks face a much higher degree of exposure, the leaders being two British banks, Lloyds (228 per cent of shareholders' funds exposed to Latin America excluding Mexico at the end of 1983), and Midland (213 per cent), followed by Manufacturers Hanover (165 per cent) and Chase Manhattan (148 per cent). This high level of exposure in relation to capital has arisen in part because the banks, which were already insufficiently capitalised, sought in the 1970s to maximise the size of their assets and the return on shareholders' equity by gearing up with more and more marginally profitable international loans. The average capital to assets ratio for the world's leading 100 banks dropped from 4.5 per cent in the early 1970s to under 3.5 per cent at present, and of the top 34 from 5.3 per cent to just over 3.5 per cent.

1.24 Default by a small number of debtors could induce insolvency. Moreover, loans to these debtors are being kept in performance by the expedient of additional, 'involuntary', lending to maintain interest payments which in turn adds to bank exposure. Over half the \$33 billion in new credits to developing countries in 1983 was involuntary, including almost all the \$15.4 billion to Latin America, and two-thirds of the \$18.8 billion new lending in the first six months of 1984.

1.25 Vulnerability in respect of developing country lending has added to the difficulties already being experienced by banks on account of the effects of the recession and high interest rates on domestic borrowers. In the United States, 45 banks failed in 1983, a post-war record, followed by 25 up to mid-May 1984, culminating in the near collapse, and subsequent rescue, of Continental Illinois. The weakness of the banks' balance sheets is reflected in a variety of financial market indicators. Almost all the major US and European banks have lost their former triple A credit rating assessed by recognised US agencies. The recent fall in US bank share prices in the aftermath of the Continental Illinois crisis has led to some major banks being valued by the market at significantly less than their book value.

1.26 For the banks to achieve greater security will not be easy and will take time. Under pressure from the authorities they are being urged to reduce exposure to developing countries (while at the same time

being encouraged to increase 'involuntary' lending, which has the opposite effect). They are endeavouring to rebuild their capital base but against a background of market uncertainty which makes it difficult for them to raise additional finance. A crucial task to avoid the risk of insolvency is to make greater provision for losses in developing country loans. Yet the process of making such provision eats heavily into bank profits. It is estimated, for example, that if the nine largest US banks had set aside reserves equivalent to a mere 5 per cent of their outstanding loans to six of their major debtors, it would have eliminated 45 per cent of their reported 1983 earnings. A 10 per cent reserve would virtually wipe out profits. If in this year the major US banks were to miss interest payments from Argentina alone, and, in addition, if they were to set aside 10 per cent of their loans to Argentina as reserves against loss, it would cut their expected 1984 earnings by up to 40 per cent. A strong possibility is that precisely this eventuality could occur. If banks' profits were to be suddenly and severely squeezed in this way, they would seek to raise lending rates, thereby making debt-servicing problems even more acute for domestic and developing country borrowers.

1.27 Time appears to be running short. Within the last few months one major bank has come close to collapse. The experience of Continental Illinois (whose losses were domestic in origin) suggested that, at least in the United States, a damaging run on deposits could quickly be precipitated by market perceptions of impending insolvency. On that occasion, a \$5.3 billion rescue operation was launched by other banks, plus a \$1.5 billion injection to the bank's capital base by the Federal Deposit Insurance Corporation. The combination of Federal intervention as 'lender of last resort' and mutual self-help between the banks avoided a collapse. But doubts remain over the ability of the system to weather a more powerful storm. And, in the event that international lending were involved on any scale in any future crisis, there are major 'grey' areas of responsibility, notably the offshore banking centres, which could make the traditional Central Bank role of 'lender of last resort' difficult to perform.

1.28 If banks do not have time to adjust gradually to losses and to restore their capital base, then they will need large-scale long-term loans from the authorities, as has already occurred in the case of Continental Illinois. And this, in turn, raises major questions about government control over the banking system and about the scale of macro-economic management. The main point, however, is clear: the banks can only cope with the developing country problem if they are given time to adjust.