

Causes and Consequences of the 1982 World Debt Crisis?

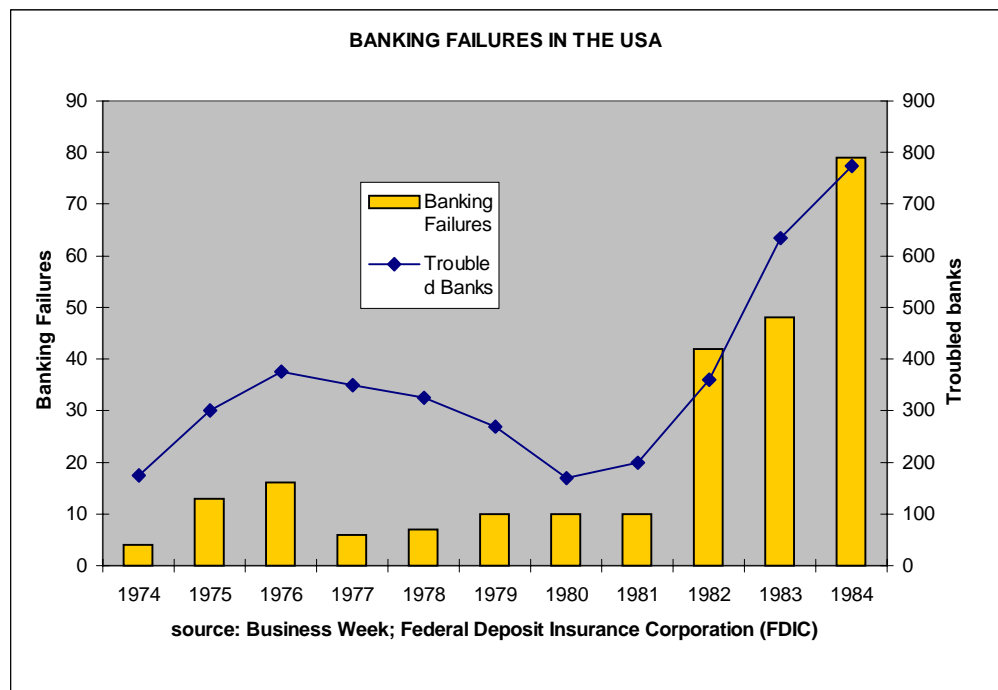
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ABSTRACT

This paper investigates underlying causes of the debt crisis that only surfaced with Mexico's unilateral moratorium on her foreign obligations in 1982. The paper investigates the evolutionary trend of LDC debt and the consequences for lenders, borrowers and the international financial system. The motivation of the research is to develop sound analytical understanding of the mechanics of debt accumulation as groundwork for further study of macroeconomics of debt and debt relief.

The paper observes that the third world's debt crisis resulted from an exponential increase in external indebtedness disproportionate to the debt service capacities of developing countries. The collapse of commodity prices, high interest rates and appreciation of the US \$ further tightened their internal fiscal positions and balance of payments, forcing them to re-finance maturing debt from fresh loans.

The paper also observes that western bankers ignored signals of an imminent debt crisis and worsened the debt portfolio of third world countries by refinancing maturing loans with shorter maturities. These countries remained on the brink of default until convergence of multiple maturities and inadequate availability of new finance caused a capital reversal.

The paper argues that although developing countries has used some of the loans to finance unproductive investments [including militarization] the lenders also brought the crisis upon themselves as a result of 'obsession' lending aimed at offloading surplus petro-dollars deposited in western banks by oil exporting countries. Although lending was justified by apprehension to fearful consequences for world trade and political stability [if the purchasing power of the third world evaporated as a result of discontinuation of lending] the paper emphasizes the role of 'uncritical herd instincts' of lenders in the debt crisis.

The paper concludes that the failure of the loans represent miscalculations on both sides of a transaction and distortions in the lending process itself, hence the debt crisis deserved mutual cooperation of the lenders and the borrowers. However, the closure of all financial markets to defaulting economies prevaricated cooperative resolution and, in fact, precipitated the crisis.

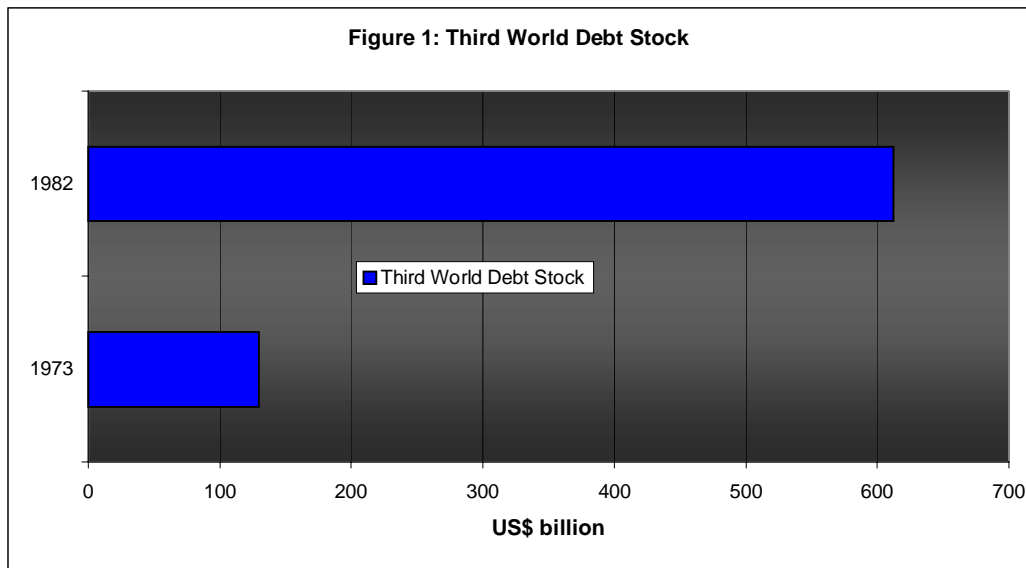
The paper emphasizes that developing country economies are fatally dysfunctional with long standing ills that are only concealed by capital inflows; hence unilateral action of lenders in halting the supply of finance while demanding repayments opens a liquidity gap resulting in consistent economic contraction.

THE DEBT CRISIS

Background

The World's debt crisis of the early 1980's was the culmination of a build up of external debt of developing countries, a large part of which was accounted by a progressively rising short-term debt. Having been triggered largely by demands from the balance of payments effects of the oil crisis that started in 1973/74, the debt build up became more apparent towards 1980 when third world borrowers resorted to rolling over their debts.

A combination of very tight internal fiscal position and increasingly fragile balance of payments, most developing countries contracted new loans to liquidate maturing loans. In some cases, entirely new loans were contracted to service interest only. At the same time bankers in the western world ignored signals of an imminent debt crisis and remained more than willing to refinance maturing loans of third world countries, but with shorter maturities. In the process, third world debt snowballed from \$130 billion in 1973 to some \$612 billion in 1982 (IMF, 1984).



Despite widespread use of various tools of risk management among bankers in the western world no apprehension existed until the Mexico unilaterally announced an immediate moratorium on its foreign currency debt in August 1982. The announcement was made after Mexico had failed to raise a large enough loan to repay external debts that were falling due.

Between 1975 and 1980 four countries had to postpone amortisation payments while servicing interest only. By 1983 the number of countries defaulting on their repayments reached twenty-one and some third world countries had instituted state criminal proceedings against public figures on account of alleged negligence and mishandling of public money.²

The snowballing of debt has drawn interest from academics and politicians alike, with one school maintaining that lenders brought the crisis upon themselves as a result of excessive lending. Another school of thought attributes the debt crisis to oil price rises and deflationary policies pursued by the developed world. This school also maintains that donors as well as recipients have a mutual duty to get the world environment right so that industrial and developing countries alike can prosper.

There is also another group of researchers who maintain that the commercial nature of the debt and the inherent instability of world capital markets are such that cycles of boom and bust should be expected to occur. Technically, this view seems to imply that there was need to monitor and regulate the flow of funds to the developing countries to match their requirements for development while ensuring that sufficient capacity is created to finance repayment of loans.

Some researchers argue that, in the first place, there was no scope for a debt crisis at all. Using arguments that have become formalised with the East Asian crisis, some researchers argue that the crisis was precipitated by irrational sensitivity of western financial institutions by virtue of the immediate closure of all financial markets to the economy of Mexico, while allowing debt rollovers to proceed with other third world countries.

Sachs and Radelet (1998) argue that unilateral action of creditors arises because when a debt crisis takes place it is the debtor who is asked to take blame. They argue that the failure of a loan usually represents miscalculations on both sides of a transaction or distortions in the lending process itself. Hence, a debt crisis requires mutual cooperation of the lenders and the borrowers.

These arguments recognise the fact that developing country economies are fatally dysfunctional with long standing ills that are concealed by capital inflows. The unilateral action of lenders in closing the tap on Mexico while demanding repayments amounts to a capital reversal as later experienced in Argentina in 1995 and East Asia in 1997. It is the behaviour of lenders that displays elements of a self-fulfilling crisis because the withdrawal of

² In 1985 Brazil instituted state criminal proceeding against Delfim Neto former Minister of Economic Planning who was accused of mishandling of public money.

one lender results in a characteristic withdrawal of overall creditor involvement resulting in consistent contraction.

Sachs and Radelet recognise the financial panic that arises in the banking community [as a result of such withdrawal] as rational on the part of each lender seeking to protect their interests but the collective effect is to prolong the economic contraction. Based on this description of events, Sachs and Radelet (1998) settled to define an international financial crisis as the outcome of sudden demands for repayment of outstanding loans at a time when an economy that has been a recipient of large-scale capital inflows has stopped receiving such inflows.

The above analysis appears more consistent with the fact that the first ever-recorded financial crisis in 1929 occurred when the flow of bond financing from US to Latin America because of boom conditions in US financial markets which tightened conditions for new international bond issuance. Of course the falling international commodity prices also called into question the ability of commodity-exporting countries in Latin America to service their debts.³

The analysis of Sachs and Radelet (1998) also typifies the financial crises in Chile, Uruguay and Argentina in early 1980's (Diaz-Alejandro, 1988). As a result of financial deregulation in late 1970's these economies experienced a surge in capital outflows hitherto restricted by regulations on capital exports (Edwards, 1996).

The fact that the 1982 crisis occurred when there was a steep rise in interest rates in the US underscores the significance of the capital outflow element of a financial crisis. The appreciation of the dollar at this time also means that repayments magnified the capital outflow in domestic currency terms. At the same time, the accompanying drop in dollar prices of internationally traded commodities undermined inflows derived from exports.

The typology outlined above is also reflected in the 1994 financial crises in Mexico, Turkey and Venezuela equally attributed to dramatic reversal of large scale lending to emerging markets, as well as the experience of Argentina in 1995 and East Asian economies in 1997. It is the argument of Sachs and Radelet that most of these crises large amounts of international loans to forestall default, hence the rebuke of Mexico at the onset of the 1982 crisis worsened a financial condition that was potentially manageable.

³ Cessation of bond financing worsened global conditions at the onset of the depression and the rise in protectionism in countries throughout the world

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DEMAND SIDE OF DEBT

Non-productive Investments

An essential starting point of this analysis is the demand for credit by developing nations. This involves identifying pressures that compelled poor nations to accumulate borrowed capital. Technically, this involves examination of the uses to which borrowed funds were applied.

The General Agreement on Tariffs and Trade (GATT) has attributed the third world debt problem to the fact that the loans contracted were not matched by a corresponding rise in real investment. This would seem to suggest that a large proportion of borrowed funds either went into the unproductive sector or by-passed economies of poor countries altogether. A common factor to the two arguments is that third world countries did not devote the funds towards increasing their own capacity to service loans.

Debt for Military Expansion

The International Monetary Fund and a number of researchers have attempted to establish this fact from empirical research, tracing commercial credits to investments in developing countries, and the most influential finding is that the build up of foreign debt coincided with political decisions that resulted in a build up in military supplies. This was reflected in the trebling of arms imports in real dollar terms between 1962-71 and 1972-81, to the equivalent of \$74 billion at 1975 prices (SIPRI, 1982).

This build up of military ware is taken as a reflection of a combination of increased demand for latest military technology by third world regimes, especially those under military rule and the willingness of arms suppliers who were ready to supply with the backing of their governments.

Another view is, of course, that exports of military equipment largely served the interests of the developed vendor-countries in terms of budgetary savings and income, balance of payment and employment security. A clear example was the purchase of 200 aircraft by the French airforce at a discount of 25%, after Dassault had sold 350 Mirage III's abroad (Rich, Stanley, Birkler and Hesse (1981)).

The extent to which arms imports contributed to debt build up among third world countries is still dubious. The link between the two appears to be very weak when we consider that – in 1975 dollars - third world debt expanded by some \$200 billion between 1961-72 and 1972-81,

while the increase in military spending during the same period was only \$51.1 billion (SIPRI, 1982).

The charge of 'non productive investment' or 'militarization debt' becomes controversial upon discovery of the fact that developed countries have actually been involved in granting soft loans for arms imports. Brzoska (1981) has also argued that less than 25% of the debt accumulated in third world countries is linked to arms imports.

Rand Corporation estimated at 8% the debt build up attributed to military expenditure. This figure is obtained from soft loans that developed countries specifically offered third world countries to finance arms imports. A conclusion of the Rand Corporation is therefore that arms imports may have had a major impact on third world debt, but only up until 1979.

The charge of 'militarization debt' also remains inconclusive because there does not appear to be any consistency between areas where debt build up occurred and the areas where the arms went. It has been reported that the Middle East alone absorbed 46% of arms sales to the third world between 1972 and 1981, but one wonders how arms sales to the Middle East could have caused a rise in third world debt when the majority of these countries belong to OPEC whose member countries enjoy large amounts of net foreign assets.⁴

The range of conflicting conclusions on the ultimate uses of foreign debt in recipient countries only confirms the fact that money is fungible, and foreign exchange is particularly more fungible. Economic systems have the ability to bring into the country and utilise funds on a project very different from the particular project for which the funds were intended. At the hands of less honest leadership economic systems also have the ability to divert funds to destinations outside the country for personal uses.

Bearing in mind the above observations and experiences in a large number of third world countries, foreign currency lending would be rightly viewed as general lending aimed at either financing the deficit on the current account of the balance of payments, offsetting drainage caused by capital outflows or contributing to the build up of external reserves.

As a corollary to the above observation, foreign currency loans would trigger economic boom if it were used to sustain higher levels of demand and imports, a process through which real investment would be encouraged. The predicament of third world countries would therefore seem to be explained by the weak links between foreign currency lending and domestic

⁴ It is possible that the Middle East was a mere conduit, but this is difficult to establish from currently available data

investment, especially the type of investment necessary to generate additional foreign exchange to meet arising debt obligations and buttress the country's reserve position.

According to the basic macroeconomic model of national output and national consumption, if an increase in demand occurs in an economy – without a corresponding increase in output – a rise in imports becomes the natural result, a factor which is directly associated with increased utilisation of foreign exchange. There are of course exceptions where expansion in demand can be accompanied by stagnation in output while demand driven inflation compensates for the potential increase in imports.

The non-productive investment factor could be translated to mean that, contrary to foreign borrowings translating into increased real investment in the export oriented sector to generate economic growth and strengthen capacities for foreign exchange generation, the pace of economic growth in most third world economies has been dependent on expansion of imports. This confirms the weak link between foreign loans and real investment among a majority of the third world countries.

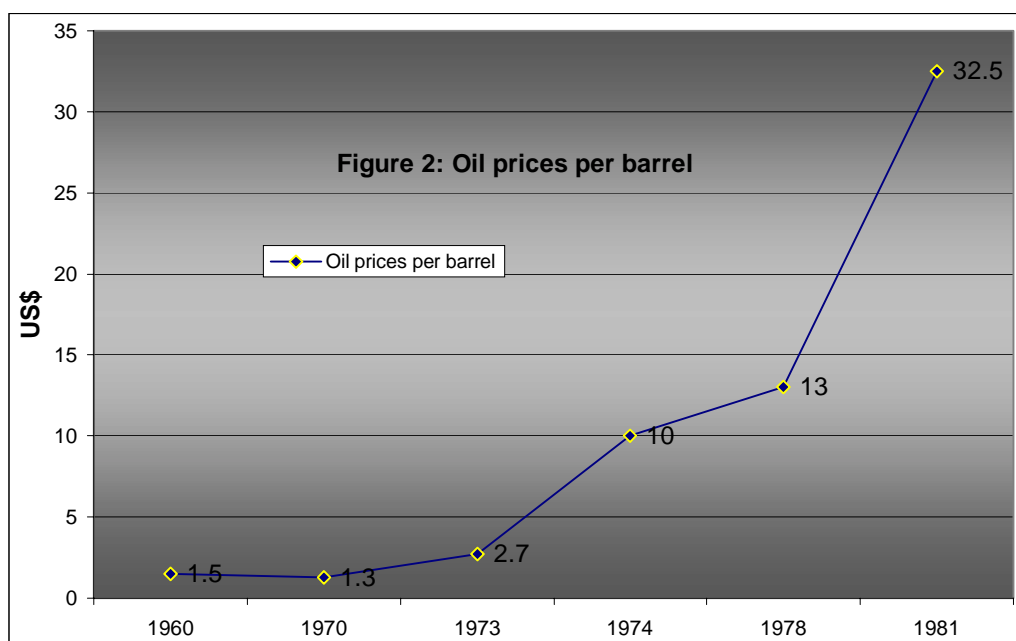
Of course, it can be argued that the weak link does not apply to all imports, but imports of consumption as opposed to imports of intermediate or investment goods that have the proven capacity to promote the supply response of an economy. During much of the 1970's and 1980's more than half of all imports to Latin America consisted of raw materials and intermediate goods for the industrial sector (Leven and Roberts, 1983).

This serves to confirm that import led growth is not sustainable if it is merely supported by foreign borrowings. However, a sustainable import led growth strategy can be pursued with the support of high export growth achievable with supporting policies of devaluations, fiscal stability and an industrial revitalisation policy.

The oil price factor

The debt crisis can also be explained – in part - by deterioration in the world economic environment caused by the oil price rise that began to escalate in 1971; after the oil price had dropped from \$1.50 a barrel in 1960 to \$1.30 a barrel in 1970 (IMF, 1984). Much of the blame for the oil price rise is attributed to the collapse of the innovation of the Bretton Woods system of fixed exchange rates that had allowed governments to liberate themselves from limitations imposed by a fixed parity. Despite its weaknesses, the fixed parity system had been intended to ensure that domestic demand was properly managed to safeguard against indiscriminate rises in imports that would open up trade imbalances and weaken the domestic currency.

The breakaway from the fixed parity, which coincided with the election of new governments in several parts of the developed world between 1972 and 1973 triggered gradual overvaluation that resulted in expansion in demand in the developed world (Tufte, 1978). Because of the supply inelasticity of primary commodities in the short-term commodity prices rose by 13% in 1972 and a further 53% in 1973 (IMF, 1984). These price rises are attributed to the demand-pull inflationary effect of strong markets in the developed world. These developments also triggered a price rise in oil to \$2.70 in 1973, which was partly supported by formation of an effective OPEC cartel as a result of the Yom Kippur war around the same period.



Further oil price rises to \$10 per barrel in 1974 resulted in accumulation of current account surpluses among oil exporting countries from \$7 billion in 1973 to \$68 billion within one year. This occurred simultaneously with severe deterioration of current accounts of oil importers. By 1974 the current accounts of industrial countries had deteriorated to a deficit of \$24 billion, from a surplus of \$12 billion.

The industrial countries were – at least - able to counteract the declining trend through a combination of policies that included increased exports targeted at the oil exporting countries while pursuing contractionary fiscal and monetary policies that helped to slow down the level of domestic aggregate demand. As result industrial countries managed to achieve a swift turnaround to a current account surplus of \$6 billion in 1975.

While the developed nations managed to cushion the effects of oil price rises, third world countries suffered devastating losses on their current accounts, the consequences of which became embedded in their economic systems. Initially deterioration in the external account was mild as the deficit on current accounts of developing countries rose from \$11 billion in 1973 to \$37 billion in 1974. This was attributed to the relatively larger content of crude oil in oil imports of developing countries.

In the absence of counteractive measures adopted by developed countries, third world countries resorted to foreign borrowing to meet obligations for expensive oil imports. In 1975 economic conditions among third world countries worsened as the slow down in industrial country demand resulted in a decline in commodity prices by 19%. The combined impact of high-energy prices and adverse terms of trade was a major slow down in the growth of developing countries and a widening current account deficit to \$46 billion.

Although a relatively stable atmosphere emerged during 1976 and 1977 resulting in reduction of current account deficits of non-oil developing countries, economic conditions in the developing world worsened again in 1979 by a second round of energy price rises which took Saudi crude from \$13 a barrel in 1978 to \$32.50 in 1981. As a percentage of the total import bill among non-oil exporting developing countries, oil imports rose from 5.9% of GDP in 1973 to 21% of GDP in 1981.

In his determination of the influence of oil price rises on third world borrowing behaviour, Professor William Cline has showed that developing countries had incurred an additional cumulative \$260 billion by 1982 (SIPRI, 1982). This estimate excludes interest charges on debt incurred to finance oil imports.

Apart from explaining the borrowing behaviour of developing countries, the oil factor also explains the starting point of a virtuous cycle that explains the supply side of the credit equation. Because oil-producing countries earned foreign exchange faster than they needed it to finance immediate imports, they resorted to accumulating savings in the western world. The western banks in turn used the savings to advance loans to third world countries to meet their outstanding bills for oil imports. These developments also undermined the value of the US dollar in which currency all the massive lending took place.

The interest rate factor

Despite their adverse effects of weak investments on national solvency, the tendency for developing countries to apply large proportions of borrowed capital to unproductive uses do not seem to conclusively explain the accumulation of foreign debt by third world countries.

In fact, the ultimate effect of the oil price rises of the 1970's is still subject to debate because Mexico and Venezuela which featured quite highly as debtors during the crisis period were actually net exporters of oil. Given that the two countries had actually benefited from the oil price rises, alongside other oil exporting nations of the world the case for debt explosion deriving from the oil crisis becomes weaker.

Another potential cause of the crisis that warrants investigation is the interest rate factor associated with monetarist influences for lenders in the western world to maintain the real value of the yield on loans by pegging interest rates above inflation. The new policy was intended to ensure that interest payable on loans sufficiently compensated lenders for the erosion to the real value of the original loan caused by price escalations elsewhere on the marketplace.

This approach meant that new loans contracted to repay maturing loans carried a higher rate of interest, a factor that progressively raised the average interest obligation on the portfolios of developing countries. This was also aggravated by the fact that existing loans contracted at a fixed premium above the base rate – for example the London Inter-bank Offer Rate – were subject to upward revision as the base lending rate was increased to counter the effects of inflation.

The first shock transmitted to the developing world from surging inflation in the US after 1976, pushing with it the average rates of interest. The choice to third world borrowers was either to increase debt to keep inflation-adjusted debt stock constant or borrow less to avoid high rates of interest and consequently experience a reduction in the real value of the inward transfer.

This phenomenon was repeated from 1979 onwards as nominal interest rates in the developed world continued to rise to offset the effects of high inflation originating from the second round of the oil crisis. As a result, total outflows of dividends, profits and interest payments rose from \$15 billion in 1978 to \$44 billion in 1981 (Lever and Huhne, 1982). UNCTAD has calculated that between 1976-79 and 1980-82, the rise in interest rates added \$41 billion to the stock of third world debt (Inter-American Development Bank, 1985).

There are, however, questions regarding the reliability of the view that interest rate increases could have caused the rapid debt build up on its own. If such a view was to be sustained it would imply that the debt stock would have slowly evaporated if interest rates had remained at pre-1970 levels. This fails to hold because available statistics show that the level of debt was already rising during the period before the rise in interest rates.

A relevant feature of developing country macroeconomics is that fiscal and monetary restraint adopted by the developed world [to neutralize inflationary pressures originating from the second round of the oil crisis] was tantamount to industrial nations exporting deflation to the developing world. The ensuing contraction resulted in a further drop of 25% in third world export prices (IMF, 1984; pp 133). This affected the entire developing world including the upper middle-income countries of Latin America, which also relied on primary commodities for their export receipts.

Despite their relatively more advanced levels of economic development, Brazil, Argentina and Chile had remained heavily dependent on exports of primary agricultural produce during much of the late 1970's and early 1980's. In Brazil, Soya beans, coffee and iron ore accounted for 83% of merchandise exports in 1981-2 (IMF, 1984; pp 133), while wheat, corn and beef accounted for one third of export receipts in Argentina. In Chile copper accounted for 50% of export receipts.

The debt build up in third world countries is therefore a combined result of rising oil prices, higher interest rates, sluggish markets in the developed world, falling commodity prices and appreciation in the value of the dollar, the currency in which most of the debt was denominated. The effect of these developments was to constrain the ability of developing countries to generate foreign exchange while at the same time creating conditions that raised their demand for foreign currency.

Economic mismanagement factor

The main indictment on governments of poor countries is that should have optimised the presence of debt by focussed their policies towards increased generation of foreign exchange to meet future obligations for debt service. On the contrary most developing countries adopted Marxist style government focussing on comprehensive ownership of the means of production that resulted in expanded public sectors. Existing research also suggests that financing of loss making state enterprises was one of the sources of external debt accumulation.

A large number of developing countries also adopted inward looking industrial strategies, aiming at domestic production of previously imported goods as a means of saving foreign exchange. Most such enterprises augmented demand for foreign exchange to finance their imports resulting in import driven economic growth without accompanying enhancement in foreign exchange earning capacities.

However, developing countries argue that the links between poor countries and developed countries have never been reciprocal, and that irrespective of the commitment of the poor countries to sound economic management and reform there are profound structural distortions of the international economic system that will notoriously hold down poor countries from becoming full partners in the international economy.

They argue that the award of subsidies to western producers is forcing developing country exporters to accept lower prices that result in losses thereby killing off the ailing export commodities sector. They also charge that preferences awarded under concessionary schemes like the Lome Convention have also been faced thus placing middle income and low-income countries neck on neck competition in developed country markets, as underdogs to local producers. Developing country exports also faced competition from synthetic substitutes of their products.⁵

Policymakers accuse third world countries of refused to devalue in order to regain competitive markets. They argue that despite higher domestic inflation than their main trading partners most developing countries have allowed their nominal exchange rate to remain stable thus resulting in real exchange rate over-valuation which has contributed to further deterioration in non-oil exports while raising attractiveness of imports.

The argument of most developing countries is that devaluation is synonymous with government losing control over the domestic inflationary policy. This is because by devaluing a currency at every instance of inflation, it implies that the exchange rate is indexed to the domestic price level via the balance of payments and money supply. Given that government is the largest consumer of foreign exchange [in the context of debt service payments], this means that exchange rate depreciation magnifies the public sector net cash requirement and leads to a faster rate of monetary growth, thus resulting in further cyclic inflation.

Another argument is that since developing country banks carry a significant amount of unhedged foreign currency liabilities, the effect of devaluation is to compromise bank balance sheets and lead to contractions in bank lending capacities, which also affect the real economy. The fact that banks hold open speculative positions in foreign exchange, which increase vulnerability of the entire financial system, which works against the private sector, is also used to rationalise objection to real exchange rate rules.

The other argument is also that devaluation would cause price increases for imported fertilisers, insecticides and modern seeds were equally embedded in agricultural exports. This

would accentuate the effects of high interest costs associated with financial sector reforms and thereby squeeze the maximum conceivable profit that could be generated from export sales from developing countries.

Since devaluation acts as a 'conveyor belt' transmitting imported inflation faster into structures of production, the scope for diversification into manufactured exports also diminishes.

There is some credence, however, to the charge that macroeconomic policies of poor countries have made foreign goods cheaper than locally made goods. This derives more from the desire – among most third world countries – to acquire the image of modernisation that resulted in rapid foreign exchange utilisation in consumer imports. That compelled developing countries to increase recourse to foreign borrowing to safeguard their reserve positions.

This is very true of Chile where, between 1979 and 1982, the Central Bank had allowed free exchange of the peso for the dollar while the local currency was kept unrealistically overvalued (Susan George, 1984). The level of distortion was compounded by government's decision to peg local salaries to domestic inflation, which had risen to rampant levels while the peso remained overvalued. This resulted in astronomical increases in Chile's purchasing power in US dollars. As a result, Chile spent most of her foreign borrowings on current consumption; especially imported electronic gadgets and consumables for the middle and upper classes.

The double tragedy is that such laxity in wage policy against a background of currency overvaluation [at a time when inflation was running higher; in double digits] resulted in Chileans going on international spending spree while local firms collapsed in large numbers due to weak domestic demand and non-existent foreign demand.

As a result, both the trade deficit and employment soared, while government resorted to foreign borrowing to finance the deficit resulting in the highest per capita debt level in Latin America at \$1,540 per head. It is estimated that \$11 billion of the \$19 billion debt Chile owed to the Banks is closely related to Chile's international spending spree (Dornbusch, 1984).

⁵ Sisal exports from Tanzania suffered from innovation of twine rope while cocoa suffered from instant coffee

SUPPLY SIDE OF DEBT

The Loose lending factor

At the embryonic start of lending to developing countries in the early 1970's, banks had merely experienced a normal increase in deposits associated with underlying growth in the western world. However, towards the late 1970's, it was noticeable that banks in most of the developed world were reporting net average annual growth rates of deposits of between 25-30%. Most such deposits originated from excess foreign assets of oil companies in the gulf region, a reflection of export price impacts of oil revenues on their balance of payments.

The rapid increases in deposits in the banking systems is also notable for creating additional financial capacity that enabled Banks to commit higher amounts in loans to the borrowing public in the own countries most of whom deposited their money back in the banking system. At every stage of the lending process the banks created more deposits with the final result that the original loans were multiplied several times as lending continued.

One characteristic of financial systems in most countries at the time was the existence of liquidity requirements for banks and other deposit taking institutions to hold a prescribed percentage of their deposits in liquid assets like cash or tradable government bills. There were also similar rules the ratio of lending to assets, the ratio lending to capital, which altogether had the effect of lowering the magnitude of each successive round of lending.

However, the main weaknesses of financial systems in Europe at that time – which was construed as an advantage by the lenders was the absence of regulations limiting the ability of banks to lend from deposits. The rate of credit expansion each bank would achieve depended upon the definition of capital and reserve requirement by each bank. For most banks that had confidence in their assets, the money-go-round continued unabated.

One of the reasons for the debt build up from \$260 billion in 1975 to \$ 1,265 billion in 1984 is the administrative complacency among monetary authorities that turned a blind eye to the unprecedented expansion of credit to the third world (OECD, 1984). Technically, this was because deposits of foreigners held in a third country often did not feature elsewhere in the monetary aggregates on the basis of which interest rate policy was determined. Besides the sluggishness of authorities in keeping up with a rapidly changing world, there was little incentive to regulate or constrain capital of the Euro-market in London that was clearly a viable source of foreign exchange earnings, especially that the rate of expansion of international debt was at a rate far in excess of any measure of international inflation.

One aspect that featured prominently in the business culture among financial institutions in Europe was that lending to the third world was considered to be 'the business' and the belief that there was no risk involved in lending to the third world. The advent of the syndicated loan led to the belief among financial institutions that they could minimise their credit risk by spreading loans to a variety of countries across the third world among several banks, in such a way that the exposure of each bank was minimal (Sampson, 1981).

Such comfort was buttressed by the move from fixed interest-rate loans to variable interest-rate loans. Since the former meant that banks took the risk of loans becoming unprofitable as a result of a rise in interest rates, the variable interest brought some comfort in that the obligation of the borrower included a margin above the basic rate, thus guaranteeing profit.

Ideological Miscalculations

Chief Executives and politicians also had a hand in supporting the euphoria of lending to the third world. Walter Wriston, who served as head of Citibank Corporation that was still a leading financial institution in the USA - around 1967 - was one of the proponents of the 'sovereign risk hypothesis'. Wriston contended that a country '...how badly off, will "own" more than it "owes"'. He maintained that countries could not go bankrupt, nor could they disappear and that even if they had short-term cash flow problems, the cure would be 'sound programs and time to allow them to work'.

Wriston whose views were supported by Brazil's planning Minister, Delfim Neto, believed that more debt was required to facilitate repayment of existing debt while countries moved to a higher level equilibrium. He likened lending to third world countries with every new and subsequent issue of the Treasury bill that got repaid with the issue of another Treasury bill.

Although Wriston sounded logical and received widespread support from the rest of the Banking world, there were already several examples that falsified the applicability of his arguments. Among trained bankers a case was well known of the Florentine Bankers who had little difficulty recovering money from King Edward III in 1327, although two banks collapsed (Dammers, 1984). In total contrast, the state of Mississippi is still in default on debt that it repudiated in 1875. Similarly there are very few of the bonds that South American governments failed to repay in the 1930's that have ever been paid back at par.

These two examples challenge the notion of 'bankruptcy' advanced by Wriston who believed it was a process of recovering a debt. On the contrary bankruptcy is an instance that involves recovery of a debt through confiscation of assets a measure that cannot practically be undertaken against countries.

The apparent similarity in Wriston's view of third world debt and the bond issued by the US government is equally flawed because the American government was able to radiate confidence on the treasury bill because its obligation is denominated in its own currency. On the contrary third world countries required to generate an export surplus in order to service debt while the US government could simply raise taxes or print dollars to repay its debt.

Despite the technical flaws and proven inapplicability of the arguments of Wriston, his views on the doctrine of sovereign loan safety were widely supported. The commonly held view in official circles was one of apprehension to the fearful consequences for world trade and political stability if the purchasing power of the third world evaporated as a result of discontinuation of lending.

There was no attempt to intelligently address the anxiety of the character and sustainability of the continued adherence to such principles in the realm of commercial lending. This would seem to suggest that continued third world lending was aimed at satisfying the tastes of public policy and not the merits of sound economics, while western policymakers seem to have run away from the task of introducing safeguards that would render the process of third world lending safer.

Mr Johannes Witteveen, who preceded De Larosiere as managing director of the International Monetary Fund, also explicitly supported the policy of Euro-market credit expansion towards third world countries (IMF, 1974). In the wake of the 1973-74 oil price rises Witteveen supported lending to third world countries as a means of offloading surpluses accumulated in the external accounts of oil exporting countries to overcome prospective balance of payments disequilibria, sentiments which were repeated in 1977.

Political Miscalculations

Speaking at the annual meeting of the IMF in September 1977, Mr Dennis Healey, Britain's Chancellor of the Exchequer also commended the commercial banking system for successfully financing deficits of the third world. At a 1979 annual meeting of the IMF, his conservative successor Sir Geoffrey Howe, also expressed the hope that flows from the commercial banking system to the less developed countries would continue to grow. The US Secretary of the Treasury Mr G William Miller made similar encouraging remarks at the 1979 annual meeting of the IMF.

It cannot be denied therefore that the build up of third world debt had assent from the highest levels of policy making in the developed world. In 1979 British Prime Minister Margaret Thatcher was signatory to a communiqué issued at the end of the Tokyo summit of the seven

leaders of the biggest market economies in the world. The communiqué specifically “...recognised the need for the flow of financial resources to the developing countries to increase, including private and public, bilateral and multilateral resources.”⁶

As close to the world debt crisis as nine months, in autumn of 1981, Sir Geoffrey Howe once again praised the virtues of private banks in recycling funds to the third world countries. He described lending to the third world as “..the best form of recycling” on account of the fact that external loans “...enabled them (developing countries) to finance their external payments and to raise their living standards”.

In a speech that was later to raise more questions on the subject third world debt, in March 1980 Mr Paul Volcker, chairman of the Federal Reserve Bank of the USA also endorsed the rise in third world bank lending. He dismissed fears of a debt crisis arguing “The impression I get from the data I have received is that the recycling process has not yet pushed exposure of either borrowers or lenders to an unsustainable point in the aggregate”⁷

In a rejoinder, however, Paul Volcker made reference to problems that were beginning to rear with third world debt at the time but played down the incidents. These sentiments suggest that the western policymakers had dismissed credit problems that led to near insolvency of Turkey and Zaire in the 1970’s as trivial and transitory.

The strong belief that debt default was inconceivable had also led to increased lending to eastern European ostensible under a guarantee that Russians would not jeopardise their pride and credibility by allowing their satellites to fall into arrears. When Poland fell into arrears in 1981 the western policymakers viewed the whole incident as an isolated and temporary event, insufficient to pose as a warning.

Bank Euphoria

The banking sector in the western world also contributed to the debt crisis through the application of methods that were outdated and insufficient for measuring credit risk. With the benefit of hindsight there is reasonable ground to perceive naivety among the banks in the consideration of single country loans as well as the aggregate level of their portfolios to the third world countries.

One of the innovations of the banking systems that was developed around 1979 was the use of the selective premium rates applied in accordance with what was perceived to be a realistic

⁶ Press Release, Published in Financial Times, 30th June 1979 as Communiqué

⁷ ‘The Recycling Problem Revisited’, Challenge, vol. 23, July-August 1980, p 13

risk profile of each debtor country. In addition to the cost of funds to the commercial bank lenders, countries like Argentina and Mexico paid premium rates of just under 1%, while Poland paid 1%. Hungary and France paid just over 0.5% while Sweden paid 0.5%⁸

In reality these differentials did not reflect the true risk attached to each country and it is for this weakness that when the debt crisis began to develop the response was not the widening of spreads but an outright halt to the process of lending. The fact that France's debt attracted a premium of only 0.25% above that of Argentina suggest that the use of spreads was a mere pretence at risk management.

Increased debt of the third world has an element of careless obsession with third world lending which had become the fashion in the western banking system. In terms of career development in the banking system, a position in international lending was the ultimate expected of the brightest bankers. It was the section that management would not hesitate to authorise air tickets for international travel and hotel rooms in the third world.

Third world lending was simply the fashion in the high street banking sector as a successful deal was often followed by a lavish cocktail in the most of expensive of Ritz or Claridges. The Press also maintained league tables ranking banks reflecting on their exposure to the third world countries as a measure of their outward strategy. Small banks often craved for inclusion in syndicated deals contributing smaller proportions though while seeking an opportunity to rub on the international glory that went with lending business.

The reckless nature of lending is apparent from the fact that where a borrower was well known it simply became the practice for banks to accept parts of a syndicated loan over the telex; without the necessity a new credit analysis. Bank applied immense efforts selling loans to the developing world and went to the extremes of borrowing dollars on the international markets if or when their own central banks failed to provide them as lenders of last resort.

There is an outstanding example of a joint venture involving an American Bank and French Bank that opened representative offices in Gabon in the mid 1970's. At the end of one year the office had advanced \$600 million in officially guaranteed export credits and \$679 million in syndicated loans. The projects undertaken included a highway linking the airport and the Presidential palace, a flurry of hotels with occupancy below a seaside resort in mid-winter, a fleet of commercial jet aircraft, enlarged government buildings and one of the world's least economic railways constructed against the advice of the World Bank (Lombardi, 1985).

⁸ Roland Plan, 'External Debt Rescheduling: Repercussions on and attitudes of the Lending Banks (mimeo) Institut d' Administration et de Gestion, Universite catholique de Louvain, Louvain 1984

Whether rightly or wrongly, the implied view of the lenders was that sovereign debt was safe irrespective of what the loans were used for. On their part the western governments maintain that they did not have information with which to assess the full extent of indebtedness of the third world. The Washington based Institute of International Finance created after the debt crisis has added its professional weight to this view despite the fact that the Bank of International Settlements published figures on the commercial banks' exposure to individual countries although the information was six months behind.

The strongly held view is euphoria in the banking system translated into an 'uncritical herd instinct' whereby banks felt a false sense of comfort lending as a team and sharing the risks. At the time banks were always willing to refinance debt including interest due to a bank that was pulling out, compelling banks to hold on to their clientele, rolling over debt as the borrower country wished.

Portfolio Mismanagement

In reality, some developments in the third world countries were sufficient as warning signals to the western lenders. Towards the 1980's there was a marked change into the portfolio structure of loans to third world countries towards shorter maturities for debt that had been rolled over. A build up of new loans contracted for periods not exceeding one year further accentuated the concentration of shorter maturities in the portfolios of poor country.

Technically, the banks' preference for short maturities was sufficient to signal their unwillingness to extend the period of their exposure to lenders into the medium to long term period. As banks collectively switched to shorter maturity lending became hectic, while individual third world borrowers became gradually squeezed to meet repayments at shorter intervals. Six months before August 1982 crunch Mexico actually borrowed \$6.4 billion (Bank for International Settlements, International Banking Developments: 4th quarter, 1984).

Under the pressures of hectic lending US banks also increased their exposure at the annual rate of 34% (Cline, 1984; pp113). Pressures mounted on third world borrowers, sometimes drawing down on their reserves to repay a loan only to find another loan was due for repayment, while banks became increasingly hesitant about extending new loans. Through repetition of this process, third world debtors collectively experienced a liquidity gap and became unable to repay loans as and when they matured.

The final result was that all measured that brought comfort to the western financial systems failed to serve their intended purpose: the premium on high risk loans shifted the ultimate burden to the borrowers who were technical insolvent, while the syndicated loan that which

had been designed to safeguard each individual bank from excessive exposure to any one country actually ensured that the entire financial system was unduly exposed and every bank was at the mercy of another bank.

Financial cycle Theory

The sequence of events in the lending process and problems of debt typifies stages of the financial cycle - from boom to bust - as prescribed in Minsky's theory of financial instability (Minsky, 1979). From the mutual euphoria that characterised the build up of third world borrowing that was supported by over-trading in the western banking systems, the process descended into a phase of hesitation and finally total revulsion.

Perhaps the only successes that would be claimed from the point of view of growth of the world economy and public policy in developed countries is the fact that western financial systems played a very important role in private financing of third world deficits during the decade towards 1982. The level of debt or its results is not so much an issue, but the nature of lending.

On their part, non-oil developing countries derived some benefit as they were able to achieve higher rates of growth than could have been achieved, and the fact that they were able to make up for depressed export receipts on account of the depressed economic atmosphere among the developed countries. Non-oil developing countries also managed to sustain their import capacities and prevent devaluation that could have made imports more expensive and the consequential effects of high inflation.

Economic growth in the non-oil developing countries averaged 5.1% during 1973-81 compared with 5.8% during 1967-72 (IMF, 1981; Table 1, pp112), while growth among the developed nations slowed down from 4.4% to 2.8%, during the same period. Although the non-oil developing countries are projected as the beneficiaries of the debt build up the interrelationships between developed and developing countries actually suggest that growth the growth in the developed countries would have been more constrained if developing countries had not taken up the loans which not only spurred growth but secured jobs throughout the developed world.

Schools of thought developed by pro-LDC extremists actually identify the third world debt overhang as the cost of keeping jobs in the developed world, and attribute the debt crisis to the unsupported and insufficiently regulated banking system of the western countries. This school accuses the western banks of tempting third world countries with loans when the times were good and refusing to absorb the deficits when times turned bad. As a result of such

character the west is believed to be the inherent source of balance of payments problems for the developing world.

The view that western banks tempted third world countries with loans would seem to be supported by the fact that the total amount of debt rose from \$169 billion in 1973 to \$294.7 billion in 1979 (at 1975 prices) while the third world experienced sustained increases in foreign currency earnings (William Cline, *International Debt: Systemic Risk and Policy Response*, Institute for International Economics, Washington DC, 1984, Table 1.1, p.2).

Thus despite the oil price rise, third world countries would not have needed that much foreign exchange loans while their own reserves were rising. This is reflected in the drop in the debt to export ratio from 130.2% in 1978 to 119.2% in 1979, although it had previously risen from 115.4% in 1973.

In addition the proliferation of commercial loans towards the developing world is seen as a deliberate attempt by western governments to step down from their social responsibility towards their own former colonies which they were compelled to assist at concessional rates of interest. Evidently the share of outstanding commercial debt in total loans rose from 11.6% in 1973 to 37.5% in 1982.⁹ In the case of the upper middle income countries in Latin America the proportion of commercial debt had risen from 23.8% to 62%.

⁹ see 'Overview Paper on debt' (mimeo) background Papers for the Commonwealth expert group on debt, CDG/LComsec, April 1984.

THE DEBT PROBLEM

The gravity of the Debt Problem

The precise level of third world debt has been the subject of controversy among various sources. However, data from the IMF, World Bank, Organisation for Economic Co-operation and Development (OECD) and the Bank for International Settlements seem to vary within a narrow range around \$895 billion in 1984.¹⁰ The debt was classified as follows:

Table 3.1:

	Total	Public sources	Private sources
Short term debt	\$142 billion	\$ 49 billion	\$ 93 billion
Long term debt	\$751 billion	\$279 billion	\$472 billion

This structure shows an extremely high concentration of debt from private commercial banking sources, while the short-term component remained disproportionately high for development debt.

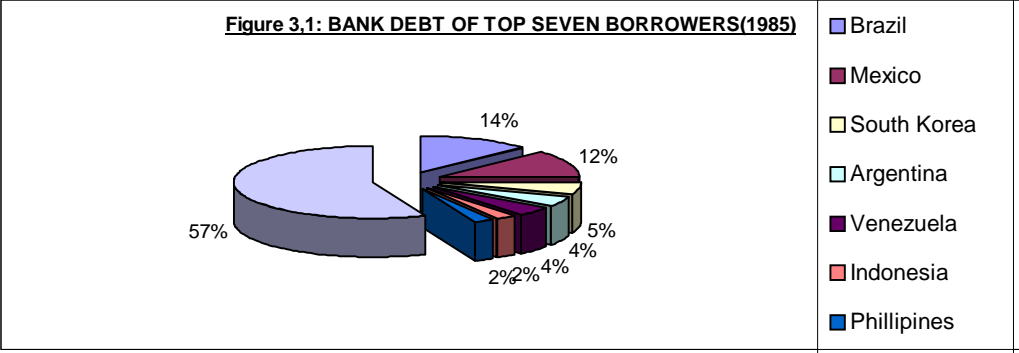
Top Borrowers

According to the IMF, thirty-three countries accounted for 42 per cent of total debt contracted by all the 123 indebted developing countries in 1984.¹¹ The fact that most of the debt was from private banks, [and was also concentrated among very few countries, as in Latin America and the Caribbean] presents the financial crisis as one involving western commercial banks and state treasuries in the west Indies.

Only seven large borrowers in the developing world accounted for 44% of commercial third world debt. These countries include Brazil, Mexico, South Korea, Argentina, Venezuela, Indonesia and the Philippines as reflected in Figure 3.1.

¹⁰ World Bank, World Debt Tables 1984-5, Washington DC, 1985, p ix

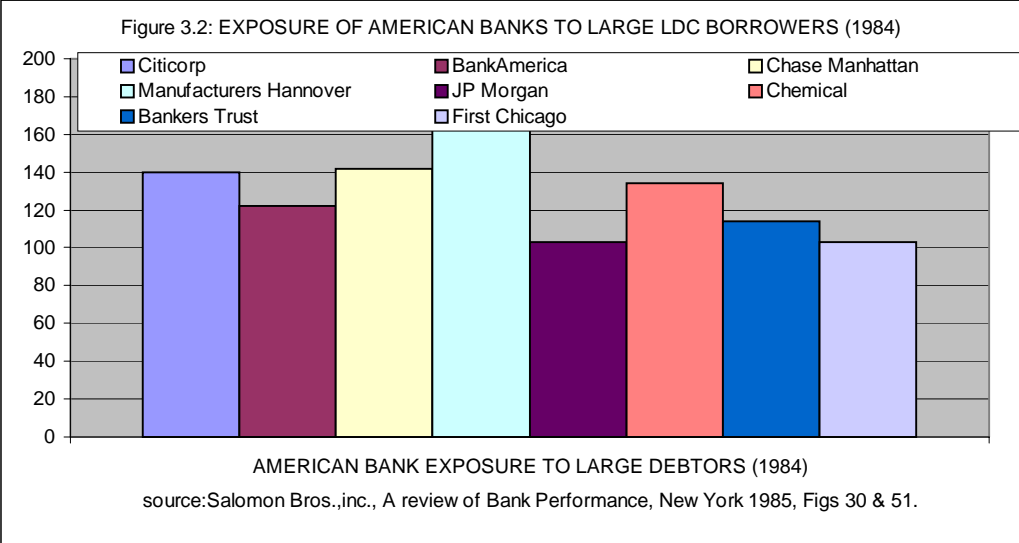
¹¹ IMF, World Economic Outlook, , Washington DC, April 1985, Tables 45 and 46, pp. 262-3



Interest payments escalated from 10 per cent as a proportion of export receipts in 1977 to 32 per cent in 1983, reflecting both the expansion of international commercial debt to these countries and rising interest rates. Other less developed countries with a larger proportion of bilateral and multilateral loans experienced a modest increase in the ratio of interest payments to exports from 4.7% in 1977 to 5.4% in 1983.¹² This would lead to the conclusion that the debt crisis is more of a problem of the bigger borrowing nations.

Top Lenders - USA

The gravity of the debt problem to the banking system can be discernible from the high percentage of commercial bank debt to developing countries in relation to the capital and reserves of the Banks. As at 1984, the 209 American banks covered by the Federal Financial Institutions Examination Council had lent out a total of \$132.6 billion against their capital of only \$85 billion.¹³ This represents a loan to capital ration of 156%.



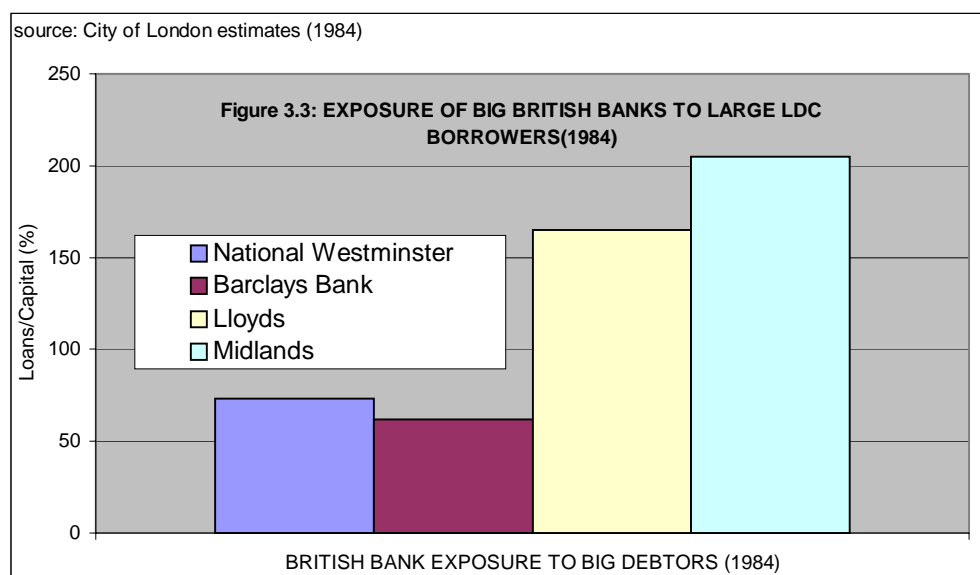
¹² Rudiger Dornbusch, 'The Debt Problem: 1980-84 and Beyond' (mimeo), MIT, Boston, January 1985, p 4.

This ratio represents a very high concentration of risk that is puzzling because US banking laws restricted both the mobilisation of deposits in their resident state only. In fact a large majority of the banks had very limited involvement in foreign lending. However in the event that their deposits exceeded advances, the state banks resorted to lending the surplus to the inter-bank market where the large banks obtained their resources. Thus, out of the total loans of \$132.6 billion advanced by American banks, at least 84% (equivalent to \$110.7 billion) had been advanced by only 24 American Banks who accounted for 63% of all the financial assets of reporting American banks. The debt crisis therefore not only tied large US banks but depositors' money belonging to US individual savers.

The pattern of concentration is more skewed when the analysis takes into account the prominent role of 'money centre' banks – based in New York and dealing in wholesale deposits – which accounted for 63% of all America's bank loans to the third world. The 'money centre banks accounted for only 43% of financial assets of the reporting banks and 59% of all foreign loans from the USA (as in Figure 3.2).

Top lenders - UK

In the British Isles, the pattern of concentration was along the same levels as the America's. The four largest clearing banks were estimated to have the same levels of exposure to Brazil, Argentina, Mexico and Venezuela as the twenty-four American banks. These banks included Barclays, National Westminster, Lloyds and the Midland. Midland topped the list with a debt to capital ratio of 205%, followed by Lloyds at 165% (Figure 3.3).



¹³ Federal Financial Institutions Examination Council, E.16 (126) Washington DC, October 1984; Board of Governors of the

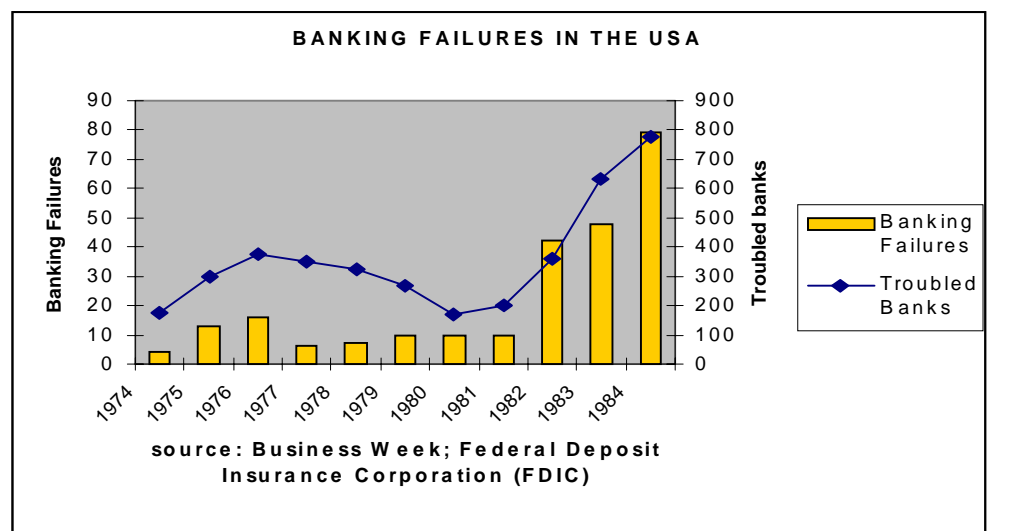
Apart from the American banks, other western lenders had a peculiar portfolio in that their lending to the third world was in US dollars while their capital was held in local currencies. This was common among Banks in Germany, Italy, France, and Britain. In terms of risk rating the position was more precarious as the banks would not have met a sudden recall of deposits since they did not have adequate dollar reserves to convert into local currencies. At the same time, their respective central banks did not have sufficient dollars to meet the contingency, either.

In Britain, for example, foreign currency deposits were 35 times the dollar reserves in the Bank of England.¹⁴ This meant that the US Federal Reserve would be relied upon as the only source capable of providing adequate dollar liquidity, a prospect that would have been brought further complication, as the Fed did not have the power to rescue banks outside its jurisdiction.

Bank Failures

The build up of highly risky third world debt to near crisis proportions also coincided with the 1982 recession, which was already having its toll on the banking system. The initial collapse of Continental Illinois was attributed entirely to domestic bad debts and it took a large injection of federal funds to keep the bank afloat. Chances of a take-over of the bank were, however, diminished by the bank's lending to Latin America.

The combination of precarious domestic and cross border credit transactions troubled US financial markets undermining the values of bonds of the major money centre banks (see 1982 Moody's bond survey) resulting in the loss of AAA status - and access to funds at



Federal Reserve System, Washington DC

¹⁴ Bank for International Settlements, International banking Developments: 4th quarter, 1984, Basle, April 1985.

preferential rates - by the most important market economy in the world.

As a sign of commitment to the rescue of key financial institutions on its soil the fed opted to pay much higher rates for treasury paper in the process widening the gap with the rate paid by banks on equivalent paper.

DISCUSSION

From the foregoing analysis, there are apparent similarities between the third world debt crisis of the 1980's and the world debt crisis of the 1930's, which strengthens arguments for the existence of the financial cycle, as described by Minsky. After the 1982 crisis, there was also the all-important question of the likelihood for recurrence of the debt crisis in future, especially that the greatest debtors of the world - after the crisis of the 1980's - are the same as those of the 1920's.

The defaulting countries are also recorded to have defaulted repeatedly throughout the nineteenth century and the nature of the predicament is also similar in that defaulters are relatively poor countries confronted by economic forces beyond their control and facing huge claims of the western banking system.

But unlike the debt crisis of the 1980's, the world debt crisis of 1931 had been preceded by a gradual decline in trade, output and employment, which had resulted from the Wall Street crash of 1929, itself a product of hectic speculation. Unlike the debt crisis of the 1980's that is largely attributed to the nature of the lending, the crisis of the 1930's resulted from Wall Street crash as well as the economic depression.

While the crisis of the 1980's came almost abruptly, the earlier crisis developed in instalments through an agonising process of writing down of foreign bonds.¹⁵ To some degree, therefore, the debt crisis of the 1980's would appear to be more man made than the crisis of the 1930's, which encompassed the gradual effect of a coincidence of adverse economic forces.

There are clear similarities however in that protracted negotiations with bondholders and their representatives that took place as economic conditions deteriorated during the 1930's could be likened to the process of rescheduling payments that occurred during the late seventies. In each case these processes rejuvenated hopes of the banking side that repayments would be forthcoming while the borrowers hardly anticipated an abrupt end to credit supply.

It came so much as a surprise in 1933, that while the world economy was picking up from the catastrophe of 1929-31, Mexico announced a unilateral moratorium on all foreign debt. Brazil followed in 1937, while in Argentina a military government that took over power in 1943 overturned all treaties that had guaranteed sterling bondholders a preference in foreign exchange.

¹⁵ Carlos F Diaz-Alejandro, *Stories of the 1930's for the 1980's* in Pedro Aspe Armella et al. (eds), *Financial Policies and the World Capital Market: The Problem of Latin American Countries*, University of Chicago Press, Chicago 1983, pp. 5-35

There are also consequential differences in the impact of the crisis on western financial systems in that the potential damage - even to the largest banks - arising from the crisis of the 1980's was much greater than that of the 1930's. The crisis of 1930's culminated in reduction in the value of bonds to a fraction of their face value that became a personal calamity of millions of bondholders throughout Europe and America, without undermining existing financial systems.

The magnitude of the debt in the 1980's was such that seven of the nine largest banks in America and two of the four largest banks in Britain would have had their capital wiped out by amounts owing to Mexico, Brazil, Argentina and Venezuela. Naturally, this would have meant either total collapse of the banks, or a benevolent government take-over followed by a consequential credit contraction that would adversely affect output, hence employment.

Whether it is an instinct of excessive caution or a scientific calculation the dust does not appear to have settled sufficiently to preclude the potential recurrence of financial distress in the world financial system. The interdependence involving western financial systems, western governments, multilateral organisations, and debtor nations is still precarious, while the absence of coherent support mechanisms remains conspicuous, underlining continued fragility of the entire system. Thus the subject of financial distress in the world economy could therefore be likened to a volcano in between eruptions; it is not extinct yet.

Some views have emerged suggesting that weak productivity of investments is linked to adoption of wrong models of development from the western countries. In her radical analysis of the causes of third world debt Susan George (1994) has felled the blame onto the foreign models applied to the poor nations, which she described as 'mimicking without understanding and copying without controlling'. In her view, foreign models '...lack roots in the local culture or environments, hence they tend to droop and wither unless sustained by transfusions of foreign loans, technology and ideas'.

Another view attributes the debt problem to a failed experiment. Since the end of the Second World War most poor nations have pursued the goal of development through industrialisation, as the only feasible route to becoming 'rich' like the developed nations. However, contrary to industrial nations that developed on a very strong agricultural base, poor nations have concentrated their efforts on industrialisation through imported technologies at the expense of food security. This is true of many countries that experimented with trickle down growth, a design that was particularly scornful of small peasant farmers, the main engine for food production in poor countries.

The debt problem is therefore attributed to western models of development, which neglect locally available resources and indigenous skills and rely more on imports at escalating prices. By ignoring generic original features of poor countries, the model is also exotic; by applying the same formulas, the model fails to differentiate one country from another, attempting to mould them to the standard requirements of the world market, world capital and the tastes of international bureaucrats; all of which are inconceivable. Debt has been the obvious consequence of Mal-development models adopted by the elite in third world countries that their poor compatriots are expected to pay.

However, the debt problem has opened the doors to a more radical development to international finance as a result of efforts by policy makers and academics increasingly being preoccupied with the debate of not only what mistakes had been committed during the euphoria of third world lending, but a search for solutions that would save the international financial system from collapse.

According to figures published by the OECD, debt service payments from third world countries to both public agency creditors and private banks amounted to a total of \$1.463 billion during the ten-year period from 1982-91. This is meticulously interpreted as \$12.2 billion a month, or \$3 billion a week, or \$406 million a day, or \$17 million an hour, or \$283,000 per minute.

If account is taken for the fact that amortisation of principal does not constitute an outflow but the interest payments on long-term debt, these figures work out to \$560 billion, or \$4.7 billion as interest paid by the third world countries every month to developed governments and their commercial banks. This translates to \$155 million a day, \$6.5 million per hour, and more than \$100,000 a minute.¹⁶

Against the total outflows of \$1.463 billion [during the ten-year period from 1982 to 1991] new inflows to less developed countries amounted to \$1.065 billion, leaving a difference of \$398 billion in favour of the western countries. In Latin America alone repayments exceeded new loans by \$130 billion. If adjusted for the current value of the dollar, the net transfer of wealth from South to North is more than five times the amount spent under the Marshall Plan on rehabilitation of Europe after the Second World War.

The net difference in favour of the western world is, in fact, an underestimation because the outflows from the west include development aid, military aid, private foreign investment, new loans and grants from charitable organisations. Banks in the western world are also taking over national industries and other assets in the third world in lieu of interest payments.

¹⁶ Susan George, 'A Fate Worse than Debt', Penguin, 1994

The precise financial position of debtor countries is that since outflows from developing countries largely comprise monthly interest payments while inflows from public agencies and western commercial banks are in the form of gross lending the level of gross debt has continued to pile with a predictable consistency to a level where it rose to 67% above the level of 1984. Despite desperate efforts by sub-Saharan Africa to scrap off a billion dollars of debt per month, the region is now 123% further in debt compared to 1982.

Interestingly, when western commercial banks discovered that they had lent out much more than they should have had, a consortium of public agencies came to their rescue to evade insolvency. Jeffrey Sachs testified to congress in the late 1980's, that 'under the debt management strategy of the US administration, the commercial banks are not expected to absorb losses'.

This would lead the analysis to the conclusion that if public agencies could be prompted into action for a problem that arose from the heedlessness of the banking systems, then third world debt relief should be more deserving on account of the magnitude of human suffering in developing countries. Such argument is strengthened by the fact that since the beginning of the crisis the banks had had plenty of time to reduce their exposure to third world borrowers to less than 4%. Based on this premise third world debt should not in any way constitute a threat to the world Financial system anymore.

The most compelling argument is that although the debt figure sounds enormous it remains insignificant when compared to the western world. As at 1986, third world debt [accumulated over the previous fifteen years] was only equivalent to one eighth of the combined annual GDP of the twenty-four rich nations that belong to the OECD, which stood at an astronomical \$8 trillion.¹⁷ As at 1986, the US alone had a public debt of \$2 trillion, a level twice that of third world debt.

The level of third world debt is also insignificant when compared to the output of the top 200 Trans-national corporations, which generated a turnover of \$3 trillion equivalent to 30% of gross domestic product of the world economy.¹⁸ Third world debt is therefore equivalent to only one third of annual sales of the top 200 firms in the western world. In comparison to world annual output, third world debt is only equivalent to 10% of world GDP estimated at \$10 trillion in 1986.

Advocates of debt relief contend that debts owed by third world countries are what they are made to be because of doom-laden journalism which has constantly carried countless hand

¹⁷ Lord Lever, et al., 'The Debt Crisis and the World Economy, the Commonwealth Secretariat', London, 1984, page 10 para 23.

wringing articles on the subject of Latin America's debt. For instance, at the end of 1985, France owed over \$62 billion, much more than Argentina and the same level as the combined debt for Chile, Peru and the Philippines. Some marginal third world countries in Asia also owe substantial debt loads, but have rarely appeared in the headlines because they are servicing their loans.

Another argument is developed upon the definition of what constitutes the difference between apprehensive lending or non-performing loans and performing loans. This argument recognises that lending money is the business of banks and that there should be no fuss about outstanding loans. In that regard it should not be an issue if a borrower does not repay the principal amount because that gives the bank an opportunity to do business.

Conversely if principal amounts were repaid they would have to be lent out to maintain the business of the bank. It would seem therefore that no matter how high debt need not send jitters if it is being serviced, that is to say if interest is being paid. This view requires that banks should be magnanimous about principal as long as interest obligations are met.

This analysis is a slight modification of the approach to sovereign debt advocated by Walter Wriston but is still an attempt to lower the challenges facing third world countries the majority of who cannot even meet their interest obligations. The list of countries facing such a predicament is growing long and for the few that actually service their interest regularly have to do so by devoting new (fresh) loans to the payment of interest while existing outstanding principal is simply rescheduled.

This scenario leads to the belief that it is only the lender who can determine when a borrower should default. This is perfectly true of the relationships between lenders and Ecuador or Brazil in that many of their present loans simply transited through their books and returned to the banks as interest on previous loans.

A more radical view is expounding by a school that believes that the only reason countries cannot pay back loans or service interest is because the money was not used wisely. Since lenders naturally pay a lot of attention to the intended use of their funds the inability of third world debtors to repay should be attributed to faulty investment choices to which the lenders are a party. The advocated view should be that investments made out of the loans should have contributed to the creation of wealth part of which should have financed repayments. This should have been well known to the lenders.

¹⁸ Frederick F Clairemonte and John H Cavanagh, *Trans-national Corporations and Services – The Final frontier' Trade and Development: an UNCTAD review*, No 5, 1984.

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