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Mark Leddy
South Dakota State University

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by

Mark G. Leddy
Former Graduate Assistant
SDSU Economics Department
Brookings, SD 57007

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INTERNATIONAL LENDING TO THE THIRD WORLD

By Mark G. Leddy

Introduction

The main emphasis of this paper is on the debt repayment difficulties experienced by the Less Developed Countries (LDCs) in the 1980's. These difficulties are a result of a combination of factors which have led to large accumulations of debt in these countries. The outstanding debt of the LDCs increased from $152 billion in 1975 to $850-$875 billion in 1985 (Meltzer, 1987).

According to Dale and Mattione (1983), the major reasons country borrowers pursue foreign loans are: (1) Such loans allow both governments and companies to finance investments that will increase income or exports; (2) Foreign loans offer countries flexibility in their attempts to smooth the adjustment to permanent or temporary changes in economic conditions; and (3) Governments may borrow for political reasons, such as to retain or consolidate power.

In all these cases, these countries can borrow against the capacity to pay out of future income and exports.

Historical Development

International capital flows between developed and developing nations have fueled the engine of economic progress over most of the last two centuries (Clausen, 1983). In the nineteenth century, developing countries normally borrowed internationally by selling bonds. This bond finance was characterized by fixed interest rates and long maturities, with most of the bonds being sold to individual investors. During this period of history, the United States borrowed heavily to finance the rapid economic growth which was taking place in this country.

With the onset of World War I in the early twentieth century, there was an increased demand for credit from the European countries. This increased demand for credit along with the rapid economic development in the United States, catapulted the U.S. from the largest debtor nation into the number one creditor position.

The 1930's world wide depression led to large defaults by Latin American governments and some European governments on their international debts. This was the first experience with widespread defaults on international debt. There had been defaults prior to this period, but they were on a much smaller scale than that which was seen in the 1930's.

The post-World War II period brought about a demand for large amounts of financing to fund the relief and reconstruction of Western Europe. The U.S. addressed this need for financing with the adoption of the Marshall Plan, which called for reconstruction on a regional basis. Also, during this time period two major international institutions were established: The International Monetary Fund (IMF) and The World Bank. These organizations were formed out of the Bretton Woods Conference of 1944.
The IMF was formed to assist countries who are experiencing short-term to medium-term balance of payments problems. IMF lending is not designed for development financing. The World Bank was designed to focus on longer-term economic development and project financing. The World Bank borrows on capital markets and lends to creditworthy countries.

In the early 1960's, the United States began giving aid to Third World countries to thwart the spread of communism. Much of the U.S. aid in the early 1960's was directed by the Agency for International Development (AID), which was established during the Kennedy Administration.

The early 1970's brought about the emergence of bank lending to the LDCs. Prior to this, the majority of lending to these governments was by developed-country governments and by multi-lateral agencies, such as the World Bank Group, the United Nations and its specialized agencies, and Regional Development Banks. Bank lending to the developing countries increased at an annual rate of 20 to 25% throughout the mid 1970's and early 1980's (Dale and Mattione, 1983). With the emergence of this bank lending, there came a conversion from long-term fixed rate funds to short- and medium-term lending with floating interest rates. This effectively shifted the interest rate risk from lender to borrower.

Causes Leading to The Crisis of the 1980's

External shocks were a leading cause of the debt crisis of the 1980's. The major external shocks were: (1) the oil shock of 1973, (2) the oil shock of 1979-1980, and (3) the world wide recession of 1980-1982. Domestic factors of the developing countries also played a role in the debt crisis of the 1980's. The major domestic factors were: (1) overvalued currencies and (2) inadequate domestic interest rates (Cline, 1985). These causes will be covered in the following discussion.

The oil shock of 1973 caused a huge surplus of funds to accrue to the oil exporting countries, while oil importing countries were running current account deficits. The large deficits in the oil importing countries made borrowing necessary to smooth the adjustment to the new situation with higher oil prices.

The major sources of funds for this borrowing were banks who were "recycling" the petrodollars of the oil exporting countries. Many of the banks which entered this international lending environment had no real long-term interest or expertise in the market. Between 1973 and 1980, an average of 66 new banks per year entered international lending (Johnson, 1987). This large increase in participants contributed to the problem of resolving the repayment difficulties of the LDCs.

The second oil shock of 1979-80 also resulted in a large current account surplus accruing to the oil exporting nations, while the oil importing nations experienced current account deficits. Borrowing was again necessary to smooth the adjustments to the higher oil prices. However, the situation had changed dramatically since the first oil shock, with large debt accumulations in the developing countries. Between 1972 and 1979, the indebtedness of the LDCs increased at an annual average rate of 21.7% (Bogdanowicz-Bindert, 1986).

The new borrowings by the developing countries were at dramatically increased interest rates. This increase in cost of funds was a result of
the restrictive monetary policy undertaken by the industrialized nations to address the problem of double-digit inflation which existed in these countries. This restrictive monetary policy was one of the factors which led to the global recession of 1980-1982.

The global recession of 1980-1982 resulted in a decrease in demand in the industrialized nations for commodities, which are the main source of export earnings for the developing countries. This decrease in export earnings along with increased interest payments brought about by the higher interest rates contributed to the repayment problems experienced by many of the developing nations.

The two domestic problems which were cited earlier, overvalued exchange rates and inadequate domestic interest rates, led to capital flight from the developing countries. Overvalued exchange rates encouraged imports by the developing countries, which led to an outflow of capital. Inadequate domestic interest rates caused an exodus of capital to countries where a higher return could be earned on investment than that which was available in the developing countries. This capital flight was estimated by the World Bank to be more than $70 billion between 1979-1982. This capital flight resulted in less investment undertaken internally, which increased the need for external borrowing.

The culmination of these causes of the debt crisis occurred on August 12, 1982, when Mexico announced that it could not meet its external obligations.

**Strategies for Solving The Debt Problems of the LDC’s**

The strategies which may be pursued by the LDCs to deal with their repayment problems range from the timely repayment of the debt to repudiation of the debt. Repudiation is defined as the explicit refusal by the borrower to pay interest and/or principal as originally agreed (Eaton and Gersovitz, 1981).

The most common solution utilized so far in dealing with the debt problem has been rescheduling. Rescheduling is an explicit agreement between lenders and borrowers to modify the schedule for payments of interest or principal. According to the World Bank (1986), 14 developing countries rescheduled their debt in 1983 and another 20 did so in 1984.

Rescheduled loans and advances of new money have been arranged in response to the implementation of austerity programs by the borrowing governments worked out with the IMF. Austerity programs which have been implemented include: reductions in current expenditures, adoption of exchange rate policies which reflect present realities, expanded domestic savings, and increased export revenues (Bolin and Del Canto, 1983).

Rescheduling of debt has been favored by the lenders, because these reschedulings have not generally involved reductions in principal due or interest rates charged. Losses to the banks have been limited to not receiving payments as soon as originally agreed. The borrowing nations receive the benefit of deferring payments over a longer period of time, but no reductions in payments have been negotiated.
When rescheduling has been used, it has generally not resulted in economic recovery in debtor nations. According to Sachs (1986), of the countries who rescheduled bank debt between 1978 and 1981, before the onset of the global debt crisis, only one country, Turkey, has experienced increased per capita Gross Domestic Product (GDP). The remaining countries have experienced decreases of 5.8% to 28.2% in GDP and do not have access to capital markets. This is compared to a 7.8% decline in GDP for all countries with debt servicing problems between 1981 and 1986. Also, many of these countries have been forced to reschedule debt more than once.

Another solution being considered is debt-equity swaps. This involves the exchange of debt for equity in corporations in the debtor countries. The normal procedure is for a bank holding LDC debt to sell it to a broker who in turn sells the debt to a multinational firm that wishes to begin or expand production in a particular debtor country. Currently, the debt-equity swap market is not of great size or breadth. Chile, with swaps approaching $750 million in 1986, has been the most active debtor country in the debt-equity swap market. Other active countries are Mexico, Argentina, and the Philippines.

The value of the LDC debt to be swapped is determined in a well functioning secondary market in which banks can sell loans in their portfolios. LDC loans sell at discounts to their value. Values range from 7 cents per dollar of loan value for a Bolivian loan to 85 cents per dollar of loan value for a Colombian loan (Dornbusch, 1987).

Advantages of debt-equity swaps cited by de Vries (1987) include: (1) Developing countries gain through increased domestic investment and reduced external debt; (2) Banks are able to work down their LDC exposure-capital ratios; (3) Smaller banks can obtain a means for graceful exit from international lending, although at a charge to their earnings; and (4) Confidence in the LDCs could be enhanced as they convert debt obligations to equity finance.

A problem of debt-equity swaps is that this may discourage private investment which may have otherwise occurred. Also, some countries may be fearful of the foreign control of corporations which is implied with debt-equity swaps. However, the benefits of rapid debt reduction could possibly outweigh these negative factors.

Two solutions which have been proposed by United States government officials to deal with the debt crisis are the Baker Plan and the Bradley Plan.

The Baker Plan was proposed by Treasury Secretary James Baker III in October 1985 at the IMF meeting in Seoul, Korea. He called upon the banks to put up $20 billion in new money lending to the LDCs over a three year period. He also called upon the multi-lateral institutions to supply an additional $9 billion in new loans in return for policy adjustments in the debtor governments. Debtor nation governments were also expected to continue to meet interest obligations on a timely basis.

The goal of the Baker Plan was to promote a growth oriented strategy in the LDCs. Whereby, the LDCs could use this new money for productive investments in an attempt to grow themselves out of their debt problems. However, Baker's call for new credit has gone largely unheeded, with banks unwilling to extend additional credit to countries perceived as bad credit risks.
The Bradley Plan was proposed by Senator Bill Bradley of New Jersey. This plan is based upon debt relief rather than debt rescheduling and full interest servicing. The exact nature of the debt relief would be determined by negotiations on a case-by-case approach, with debt relief being conditional on economic policy reforms in the debtor nation. The plan also calls for an annual debt summit which would be part of the General Agreement on Tariffs and Trade (GATT) process.

The Bradley Plan is unique in that it endorses the use of debt relief rather than rescheduling. This shift toward debt relief has the advantage of allowing the most severely affected debtor nations an avenue of escape from their heavy burden of debt. However, debt relief must be targeted toward the most severely affected countries in order to protect the integrity of the international financial system.

Underlying all these solutions to the debt crisis are the benefits which will accrue to the debtor nations through open access to international trade. Foreign trade opportunities are the only way debt-laden developing countries can earn their way out of their predicament and expand their domestic economies again (Clausen, 1983). This access to foreign trade will allow the debtor nations to earn the foreign exchange needed to pay their debt obligations. Increases in foreign exchange earnings will also allow these countries to address the poverty problems which are prevalent in many them.

The large United States trade deficits which have occurred in the past few years have greatly benefited the developing nations. Virtually all the increase in exports from Latin America between the first quarter of 1983 and the first quarter of 1985 went to the U.S. (Bogdanowicz-Bindert, 1986). However, the protectionist sentiment which is emerging in the U.S. would greatly restrict the flow of goods from these developing countries, which would further dampen the ability of these countries to meet their foreign debt obligations.

Conclusion

The current debt problem is solvable, but it will require a concerted effort between industrialized nations and debtor nations to find a workable solution. The current solution of simply rescheduling the debt does not appear to be working. Therefore, there may need to be some selective debt relief offered to the most severely affected countries. Debt relief is justified in some instances by the fact that in some cases, the banks involved in international lending were guilty of lending for other than productive purposes. Loans were issued for unproductive purposes and an adequate examination of the repayment capacity of many countries was not made.

The realization that loans may need to be written down or written off is shown by the recent action taken by many of the major banks to establish loan reserves in the event of further repayment difficulties. Citicorp was the leader in this action, when they announced their intentions in May 1987 to add $3 billion to their loan reserves to offset potential losses on loans to the LDCs.
Whatever solution to the debt crisis is eventually pursued, whether it be continued rescheduling or some other method, the ultimate goal should be to restore the debtor countries' open access to the international financial markets.

Bibliography


