The Third World Debt Crisis:

Can't Pay or Won't Pay?

Peter Bauer

occasional papers

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Foreword

THE Third World Debt problem has plagued official discussions about international banking and financial arrangements since the early 1980s. Market participants have been much less prone to be caught in a 'debt discussion trap', however onerous the illiquid assets held by banks and others as claims on Latin American and African countries. Those participants went on in the 1980s to develop international markets in new financial instruments such as interest rate and currency swaps. Hence, the so-called crisis, whatever its significance for some banks (mainly American), did not bring stagnation to world financial markets. It is a political sideshow to the sparkling circus of international banking and capital markets.

The issues treated in this Occasional Paper, based on seminars held in Sydney and Wellington during Lord Bauer's visit to Australia and New Zealand in November 1989, go a long way to explain why the attention of the official international financial community was transfixed by this perceived crisis. No less significant are the trenchant views expressed here on the folly of that community. It is little wonder that the International Monetary Fund and the World Bank carry so little weight in international financial markets and have scant prospect of improving their standing. These institutions failed to detect the onset of the problem in the late 1970s; their joint unwillingness to analyse effectively its significance is hardly surprising.

The prime responsibility for the predicament of the heavily-indebted countries lies with their national governments. For some countries, including Brazil and Mexico, foreign funding requirements to ensure balance of payments stability were relatively lower in the 1980s than in earlier decades. Often those funding needs were smaller as a share of gross national output than those of vibrant, newly-industrialising countries such as South Korea. In other countries, such as Venezuela, substantial foreign investments were being made during the 1980s so that their net foreign liabilities were much lower than official debt figures would lead the casual observer to believe.

Lending institutions cannot escape their share of the blame in failing to assess correctly the risks of loss when funding governments and companies. These debts can be written off only at the expense of their owners in terms of lower dividends and much reduced values for the traded shares of the banks and other lenders. But the owners share the burden with the taxpayers who indirectly meet the costs in terms of lower corporate tax collections as bad debts are set off against operating profits.

However, the failures of national governments are the prime cause of the debt imbroglio. Borrowings have been used for political aggrandisement and the pursuit of military obsessions as much as for economic betterment. Little heed has been taken of the need to foster international competitiveness. Quite often, the policy signals have been perverse, as overvalued currencies encourage urban consumption at the expense of domestic and export production.

Nor can arguments about restrictions on access to markets in advanced industrial countries stand up to much inspection, There are indeed market restraints in the United States and Europe, but the countries hampered by them are the successful Asian 'dragons' (Singapore, South Korea, Hong Kong and Taiwan) rather than the indebted ones of Africa and Latin America. Moreover, the economies of Japan, the United States and the European Community have recorded sustained real growth in recent years, thus offering market opportunities to exporting countries with the capacity to seize them. Similarly, the advanced industrial countries can hardly be blamed for accepting the funds flowing from indebted countries as asset-holders try to escape the incompetence of their national authorities.

In this essay, as in many other distinguished contributions to the same broad topic, Lord Bauer has given us refreshing insights into the 'international aid business'. Fortunately, the lessons are being learned; the munificence of Western governments will be less easily tapped in the 1990s. Unfortunately, recipient governments have been slow to respond with improved policies and a greater willingness to accept the need to master their own destinies. Yet there are signs of a change of attitude, even in Africa. And in Latin America, recent decisions by the governments of Mexico, Brazil, Argentina and Chile to promote freer trade are most welcome indications of a new approach to economic strategy.

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Peter Bauer was born in Hungary in *1915,* and migrated to Britain in *1934.* He has held senior academic posts at Cambridge University and the London School of Economics, where he was Professor of Economics from *1960* to *1983.* In *1975* he was elected Fellow of the British Academy, and in *1982* he was elevated to the peerage.

His books include: *The Rubber Industry* (1948); *West African Trade (1954, 1963)*; *Economic Analysis and Policy in Underdeveloped Countries* (1958); *Dissent on Development* (1972, 1976); *Equality, the Third World and Economic Delusion (1981, 1982)*; and *Reality and Rhetoric: Studies in the Economics of Development (1984).* He is the author of the CIS Occasional Papers *Economic Control or Economic Development?* (1990), which is based on the *1989* John Bonython Lecture, and *Population Growth: Curse or Blessing?* (1990).

The Third World Debt Crisis: Can't Pay or Won't Pay?

Peter Bauer

I. INTRODUCTION

Large-scale default by governments on their debt to Western lenders constitutes the so-called Third World debt crisis. 'Crisis' is a misnomer. The defaults are a prolonged and rational response of the debtors to the reluctance of their creditors to press for payment. I shall focus on Third World debt, but the argument applies also to Polish and Yugoslav debt.

I shall try first to get out of the way some matters of terminology and statistics. I shall use the term 'debt crisis' without saying 'so-called' or using inverted commas to denote failure to honour obligations. And I shall follow the traditional practice, well-established in other contexts, of referring consistently to failure to meet contractual obligations as 'default'. In the parlance of the current debt crisis, the term 'default' is rarely employed and then only to describe formal repudiation of debt. Similarly a defaulter is termed 'problem debtor', one of the many euphemisms in this general area. Default is so rarely mentioned presumably because the term would force creditors to write off debt sooner or to a greater extent than they would wish. Western governments, the international organisations and bankers may also think that its use would offend Third World governments.

The words 'reorganisation', 'rearrangement', 'rescheduling' are commonly used to denote various forms of default. Dr Mike Faber of the Sussex Institute of Development Studies has coined the apt term 'debtspeak' for this terminology.

Apart from brief references to the debts of some of the problem debtors, I shall not review the statistics of Third World debt. The substantive argument does not depend on these statistics. Indeed preoccupation with them diverts attention from the basics. I may note, however, that the statistics often cited in public discussion are much affected by what is included. Most discussion centres on sovereign debt; sometimes the estimated total of private debt is also included. In what follows I shall focus on sovereign debt, which is at the centre of the debt crisis.

The number of indebted countries covered also varies: sometimes the discussion refers to Latin America, at other times to 15 or 17 countries regarded by the World Bank as highly indebted, at yet other times to all Third World countries; and there are many other variants as well. Again, usual practice is to exclude debts owed by one Third World government to another, that is, to measure sovereign debt to the West. Nevertheless, debts between Third World governments are sometimes included. When these are not netted out, the statistics overstate Third World debt to the West. Moreover, very different categories of debt are habitually lumped together in these figures. Thus, the large disbursements made to many governments by the International Development Association (IDA) of the World Bank are included. These 50-year loans, which are free of interest, are not indexed for inflation. In effect, they are grants rather than loans.

II. THE DEBT SERVICE RATIO: AN INADEQUATE MEASURE

One often-used statistic is known as the debt service ratio: the sum of interest and amortisation payments expressed as a percentage of export earnings. The International Monetary Fund (IMF), the World Bank and Western governments have accepted this ratio as index of debt service capacity. This ratio may appear as a sensible and relevant measure of the ability to service debt without politically and morally unacceptable hardship. But for several distinct reasons this is not so. First, this ratio does not indicate at all the relation between debt service and gross national product (GNP). Second, it takes no account of the policies of the debtor governments themselves, which often affect export earnings directly. Third, it takes no account of the liquid funds and other marketable assets of the debtors. I shall now examine these matters in some detail.

Debt Service as a Share of GNP

Seventeen countries are listed by the World Bank as problem debtors and have been aggregated under this heading since about 1985. They are Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Ivory Coast, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia. The criterion on which these countries have been chosen is not clear. They have been aggregated as the major problem debtors since the discussions surrounding the Baker Plan of October 1985. Possibly they were, or were believed to be, countries that would grow out of their indebtedness if that plan were implemented. US political concerns have presumably also affected the choice of these countries among which Latin American countries figure so prominently.

Most of these problem debtors are so-called middle income countries with recorded per capita GNP of well over $US1000; and the GNP figures are in many cases almost certainly substantially understated. The aggregate debt service payments of these 17 countries in 1986 represented about 3 per cent. Debt servicing of this magnitude could not have affected living standards substantially.

It is also relevant that in 1986 debt service as percentage of GNP was less for these highly indebted countries in total, and for the principal problem debtors, than it was for South Korea. For the 17 countries it averaged 4.9 per cent of GNP; for Brazil it was 3.1 per cent, for Mexico 7.2 per cent, for Venezuela 6.5 per cent. For South Korea it was 7.6 per cent.[1] It is worth noting, in passing, that according to Professor Deepak Lal (at the time Research Administrator at the World Bank) the burden of debt service of the problem debtors after the onset of the debt crisis was far from exceptional by historical standards. It was appreciably lower than it was at times in the past for Argentina (now one of the seventeen) when that country was rated as a first-class debtor.[2]

Preoccupation with the debt service ratio, that is debt service as percentage of exports, or with debt service as percentage of GNP suggests that capacity to pay depends critically on external factors outside the control of the debtors. This ignores key questions relevant to the ability to pay. Do the policies of the debtors affect export earnings? What assets do the debtors have?

Government Policy and Export Earnings

Export earnings depend critically on government policy. Some widely adopted policies directly and promptly affect export earnings adversely. Obvious examples include restrictions on certain exports, underpay-

1. World Bank, *World Debt Tables 1987-88*, Vol.I, p. xlviii.
Sometimes only 15 countries are included in the list but the difference does not affect the argument.

2. Deepak Lal, *The Wall Street Journal,* 27 April, 1983, and *The Times* (London), 6 May, 1983.

ment of farmers of exportable crops, suppression of private trade and over-valuation of the exchange rate. Other policies and government conduct also damage export earnings, though the effects are not so direct and evident. These include maltreatment of productive groups and provocation of civil conflict, neglect of public security, expensive import substitution, and other measures that divert resources from export to domestic use.

Government policies largely explain differences in the export performance of different countries. For example, in 1940 the Gold Coast (now Ghana) supplied over one-third of world demand for cocoa. By 1987, its share had fallen to under 15 per cent. The tonnage exported from Ghana was lower than in 1940. World consumption had more than doubled; and exports from other countries had more than trebled. The principal factor has been the sustained and severe underpayment of farmers in Ghana.[3] The importance of government policies is also indicated in the very different export performance of major debtors and other Third World countries such as the Far Eastern economies, including both industrialised countries (Hong Kong and Taiwan) and primary producers (Malaysia and Thailand).

Restrictions on Capital Inflow

Restrictions on the inflow of equity capital deserve special notice. Most debtor governments, possibly all, restrict the inflow of equity capital. They reserve for themselves or their nationals the major part or the whole of the equity in large sections of the economy. This policy reduces the resources available to debtor governments and also inhibits the inflow of enterprise, know-how and skills that often accompanies the inflow of equity. By reducing the economic capacity of a country it also reduces the capacity to export. The policy is also notably anomalous when shortage of capital is the argument for debt relief and other forms of aid. The restrictions on the inflow of equity are maintained or even extended amidst rescheduling negotiations or the pleas of debtors for further support.

The restrictions on inward foreign investment are a major factor behind Third World debt. They have encouraged reliance on other forms of foreign capital, notably bank finance and official aid. Bank finance and concessional borrowing involve interest obligations while

3. For cocoa statistics, see FAO, ***International Yearbook of Agricultural Statistics 194142 to 1945-46,*** Vol. II, 1947, and FAO, ***Trade Yearbook 1987,*** Vol. 41, 1988.

equity finance carries no such obligation. The effects of the restrictions on equity are reinforced when foreign investment is deterred by fears of expropriation or other official policies adverse to foreign investors.

Restrictions on the inflow of equity diminish the supply of capital available to debtor governments. The same applies to the flight of capital from the major debtors as a result of political uncertainties, inflationary policies and over-valued exchange rates. This is a familiar phenomenon though its magnitude is sometimes difficult to estimate.[4] Exports of capital account for the large liquid external funds of residents of debtor countries, a matter to which I return shortly.

Borrowed Funds Wasted

What has happened to the borrowed funds? If loans are used productively, servicing them should not be a burden in the sense that the recipients are worse off then they would be if they had never borrowed the money.

However, much of the money, possibly most of it, has been used in directions which have not yielded income or improved economic and social conditions in the recipient countries. Third World debtors have spent hugely on prestige projects, unviable industries and politically-motivated subsidies, including subsidies to the urban population, to relatively well-off people and to other politically-effective groups. The countries of the defaulters are littered with monuments and relics of unviable and grandiose schemes undertaken for the political and personal purposes of the rulers and their local allies, often promoted by Western commercial interests. This is such a well-worn and well-documented theme that details would be otiose.

The major debtors also spend heavily on armaments for use almost entirely against other Third World governments, many of them also debtors, or against their own citizens. Large-scale expenditure on weapons, including often highly-sophisticated, expensive, up-to-date weapons, is commonplace by debtor governments including relatively rich countries such as Venezuela and Argentina and very poor ones such as Ethiopia and Sudan.

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4. Some observations and statistics on this subject are in Ramon Diaz, 'Capitalism and freedom in Latin America', in Michael A. Walker (ed.), *Freedom, Democracy and Economic Welfare*, Vancouver, 1988.

Assets Unused

Possession of assets is always pertinent to ability to pay. Estimates differ widely of the external liquid assets of the governments, central banks and para-statal organisations of the major debtors and those of their private citizens. The latter are also pertinent since the external assets of a country's citizens can be requisitioned, as was done by the British government in two world wars. Reliable information on the external assets either of Third World governments or of their subjects is not readily available, as the information is often confidential.[5] However, the sums involved are undoubtedly large in relation to debt service and also as a means for securing bridging finance to overcome liquidity problems.

Some of the particularly recalcitrant debtors have been notably unwilling to use available liquid assets to make even token payments. Thus in 1987 the government of Peru had foreign exchange and gold reserves of about $1.3 billion at the time it refused to pay a few million dollars on debt service. In 1987 the government of North Korea was reliably reported to have significant gold and foreign exchange reserves in the West when it had not serviced its sovereign debt for some three years.[6] It is worth noting, more generally, that according to the annual report for 1988-89 of the Bank of International Settlements, the increase in liquid external assets of the citizens of eleven major Latin American debtor countries 'over the ten years up to and including 1987 may have amounted to a very large proportion of or even exceeded their present debts to commercial banks'.[7]

The major debtors also have command over other readily marketable assets. The large state-owned oil enterprises of Mexico, Venezuela, Brazil, and Nigeria are only the most conspicuous examples among

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5. At times the volume of the currency reserves of the debtors are not disclosed, or diminish in rather mysterious ways. Reported reserves occasionally show substantial declines over a period when a country ran surpluses on external transactions and also received new loans from Western banks. These declines tend to further concessional finance. Reports on such developments appeared in The Financial *Times,* 21 January and 25 January 1989 for Brazil and Mexico respectively. These uncertainties reinforce the argument of the text.

6. The Financial *Times*, 25 August 1987; *Neue Zürcher* Zeitung, 27 August 1987.

7. Bank of International Settlements, *Annual Report*, 1988-89, p. 135. The eleven countries are Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico, Peru, Uruguay and Venezuela.

many others.

Mexico provides an informative instance. The debt crisis erupted in August 1982 with the refusal of the Mexican government to service its external debt. At the time this debt was around $80-85 billion. The capital value of PEMEX, Mexico's state-owned oil monopoly, was then around $35 billion if valued conservatively on the basis of six or seven times earnings.[8]

The para-statal corporations of the major problem debtors represent assets that could be sold or pledged as a whole or in part. In fact the opposite has been happening. In the course of the debt crisis some of these para-statals bought heavily into large Western enterprises. For instance, in 1986 and 1987 Petroleos de Venezuela invested heavily in oil refineries and related enterprises in the US, West Germany and Sweden. In 1987 it announced that it planned to invest $11 billion in such enterprises between 1988 and 1993.[9] In November 1988, Petrobras of Brazil acquired a substantial stake in the North Sea Magnus oil field originally developed by BP.[10] These various transactions took place at times when it was widely asserted that these debtors could not service their debts without hardship.

It is widely believed that the sale or pledging of state-owned or controlled assets for debt servicing is politically impossible. In Latin America it is widely regarded as demeaning and incompatible with national sovereignty. But there is no basis for this opinion. In both world wars, the British government sold or pledged its own securities or those of its nationals without this being regarded as infringing sovereignty. **And** in the 1980s the New Zealand government sold off state-owned enterprises explicitly in order to reduce its external indebtedness. Even the use of gold and foreign exchange reserves for debt servicing has at times been deemed politically impossible. An article in The *Financial Times,* April 1987, reported that Mexican foreign exchange reserves were then at the record level of $16 billion. The article considered whether part of the reserves should be used to buy up government debt in the secondary market. According to the

8. The earnings would have been considerably larger if PEMEX had been in the private sector and therefore would not have had to carry heavily inflated personnel for political reasons.

9. Reports on such transactions appeared in *The* Financial Times, 16 April 1986; 24 December 986; 26 March 1987; 20 May 1987; 10 December 1987; in International Herald Tribune, 19 January 1988; and *The* Economist, 14 May 1988.

10. The Times, 22 November 1988.

article, this appeared especially appropriate because the reserves could well be dissipated in unproductive spending, or in the financing of capital flight. The use of reserves for these purposes was dismissed in the article as politically impossible. This was not an isolated instance. The use of gold reserves of Latin American countries for debt service has often been opposed as being inconsistent with national sovereignty.

Sovereign debt can always be paid, but never needs to be paid. It can always be paid because governments determine the volume and pattern of their spending and they can tax their citizens.[11] Governments normally also have substantial marketable assets and can requisition those of their citizens. On the other hand, sovereign debt repayment cannot be enforced in the courts. Payment is therefore at the discretion of the debtor government.

III. EXPLAINING THE DEBT CRISIS

The Rationality of Default

Servicing of sovereign debt involves economic and political costs. It reduces money available for other purposes; and payment to external creditors is unpopular. Governments will try to avoid these costs unless the consequences of default outweigh these costs. Much the most important adverse consequence would be the drying up of new external flows of finance which could result in an economic crisis sufficiently serious to undermine the position of the government. In the absence of this threat there is little incentive to honour sovereign debt.

Whether a defaulting government can expect further external funds depends on external forces, external climate of opinion and the commercial interests of the suppliers of new funds. These have only rarely been affected by past default. There have been many instances of default on sovereign debt for at least six centuries. In the 1950s and 1960s a number of governments of less developed countries (LDCs) defaulted, including those of Argentina, Chile, Brazil, Peru and Turkey. Debt cancellation as a form of aid was already canvassed in the 1970s. There was no foundation for the belief, much publicised in the 1960s, that sovereign lending was riskless because 'countries do not

11. There are instances when the government cannot pay sovereign debt, notably war, external aggression and boycott. These exceptions are not relevant to contemporary Third World debt.

go broke'.

The present debt crisis dates from August 1982 when Mexico suspended servicing its sovereign debt. Since then the great majority of Latin American and African governments have defaulted, as have a number of Asian governments including those of the Philippines, Sri Lanka and North Korea.

There are certain novel features in the recent wave of defaults: the scope and scale of the defaults; the readiness to default when the ability to pay without hardship is often evident; the systematic avoidance of the term 'default'; and most significantly, the reluctance of creditors to press their claims. Indeed, default is regarded as less reprehensible than attempts by creditors to make the debtors pay.

There has been no such drying up of funds to the debtors which would undermine the position of the governments. Indeed the major debtors, such as Mexico, have been receiving much increased flows of official aid. There has also been some new lending by banks, partly as a result of pressure by Western governments and partly because this accords with the interests of the managements and executives of the banks. Substantial further increases in the inflow of funds to the debtors from the IMF, the World Bank, Western governments and the commercial banks are envisaged in the discussions surrounding the Brady Plan and canvassed at the IMF/World Bank meetings in March/April 1989.

In these conditions it is quite rational for the debtors to default. It is a rational response to the reluctance of the creditors to press their claims and to apply the only effective sanction, namely, to refuse further funds.

Why Default is Partial

Indeed, it may be asked why debtor governments have continued in most cases to pay some part of their obligations rather than default completely.

There may be several reasons for this. Some time had to pass before the debtor governments could be reasonably confident that the major creditors would be accommodating in the face of de facto default and not react by discontinuing further flows. Again, a debtor government could have considered itself at risk if it had for a period ceased servicing its debt completely, unless there were domestic economic or political events which could provide an excuse for its behaviour. The validity of the excuse was less important than its superficial plausibility and acceptability to influential opinion in the

West. Further, a government might have believed that demonstration of a willingness to meet some of its obligations could elicit larger current and prospective flows of funds than would have been forthcoming with a more complete default. Each debtor government might have considered itself as being in competition with other governments in securing further funds. The formation of a debtors' cartel, if effective, would of course remove this limited incentive which at present may serve to contain the number and extent of defaults.

The arrangements of official and commercial creditors with the defaulting debtors exhibit considerable differences in detail. But in major respects the arrangements are broadly similar. The standard procedure usually includes deferment of payment of interest and amortisation beyond the due date; extension of the period of repayment; and provision of substantial new funds to the debtors. The new monies may come from the World Bank, the IMF and Western governments or from commercial banks which are under strong pressure from their governments to maintain or extend their exposure in the debtor countries. The new money is then added to the total debt. Some of it is used to pay interest on the outstanding debt, including arrears of interest. In the negotiation of debts due to official creditors there is often some formal debt cancellation and reduction of already concessional interest rates. Such arrangements are often made for the same debtor several times within a few years.[12] When commercial banks are involved in these procedures they often receive substantial fees for their services.

Provision of new money is usually an integral element of these arrangements. Indeed in the course of these discussions debtors often urge that they will not pay at all unless the new funds exceed debt service payments.

Related policies involve increases in official bilateral and multilateral aid to debtor governments. In return the debtors undertake not to repudiate their debt formally, at least for the time being. They may also promise to reduce government spending and fiscal deficits and to devalue officially prescribed nominal exchange rates. They may also undertake to pursue more market-oriented policies. The performance of the debtors under these arrangements is rarely enforced or even monitored effectively with the exception of the undertaking not to repudiate their debts formally and also to devalue the nominal exchange rate.

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12. According to *The **Financial Times,*** 26 January 1989, the official creditors were then rescheduling the debts of Senegal for the sixth time.

Most debtors, especially major debtors, rarely change their policies significantly under these arrangements. Policies such as the maintenance of a large state sector, extensive control over economic activity, state export monopolies and the like accord with their interests and may even be necessary for their political survival. They will abandon them only if continued pursuit would result in economic breakdown threatening their own position. If they are rescued they will persist in their policies, though they may pay lip service to the market and effect some changes in their exchange rate policies.

If major changes in the domestic policies of the debtors, such as substantial dismantling of the state sector or reduction in the scope of economic controls or in the underpayment of farmers are introduced at all, they are likely to continue only as long as the inflow of new money under these arrangements substantially exceeds debt service. Indeed it is often urged in the West that it will be politically impossible for the debtors substantially to reform their policies and that they should not be pressed to do so either in the course of debt service negotiations or in other contexts.

The Rhetoric of 'Burden Sharing'

The standard procedures and arrangements between creditors and problem debtors are usually termed 'burden sharing'. Western taxpayers and bankers assist the debtors by agreeing to postponement of payment, by scaling-down debt and debt service, and by providing new money. *As quid pro quo* the debtors do not repudiate their debts formally and promise vaguely to pursue more market-orientated policies.

'Burden sharing' is thus a euphemism for the acceptance of default coupled with virtual assurance of further default through the use of some of the new money to pay interest on past debt. Burden sharing also suggests that the debts were somehow imposed on the debtors, somewhat like reparations or tribute, rather than loans contracted voluntarily for the benefit of the economy, or at any rate of the government.

Under these arrangements the debtors are treated leniently. Indeed the arrangements encourage and reward default. The favourable treatment of defaulters is especially evident when they receive large official funds as part of debt renegotiation or as supplement to it. Thus the Mexican government has received substantial official funds on favourable terms since the default of 1982; the announcement in October 1988 of a new US government loan of $3.5 billion was but one example.

The creditors treat defaulters more favourably than they do; debtors who honour their obligations. This was put succinctly in an article in *The Financial Times*, 21 January 1984, entitled 'No rewards for being good':

> The debtors getting the worst treatment from Western Bankers are actually those who have not asked to reschedule their debts at all ... for Senor Edgar Guttierrez, the Colombian Finance Minister, the message is clear, If he really wants a good deal from his bankers, he should spend Colombia's remaining reserves ... then he should stop paying Colombia's foreign debt... In the question of sovereign debts, virtue will tend to go unrewarded.

IV. WHY ARE CREDITORS SO LENIENT?

According to widely canvassed arguments in the West, if Third World governments were to pay more than they do now or, indeed, if they continued with current payments, this would inflict morally unacceptable hardship on their people, especially the poorest, and would also go counter to the economic and political interests of the West.

Debt Service No Cause of Third World Poverty

It has now become received opinion that debt service is a major cause of Third World misery. Destitution, unemployment, low real wages, inflation, malnutrition (even child mortality), population pressure and deterioration of the environment have all been attributed to debt service. Received opinion was epitomised by Mr Jaime Lusinchi, when he was President of Venezuela: 'The problem of foreign debt today strangles the economic and social development of the great majority of the world's peoples'.[13] According to these opinions, without debt relief Third World misery must continue and indeed will be exacerbated.

These are fantasies. To begin with, the beneficiaries of debt relief are not the poor but Third World governments, chiefly governments of middle-income countries. Thus in 1986 per capita income in Mexico was $1860, in Venezuela $2920. The comparative prosperity of major Latin American debtors is reflected in such indices as the

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13. *International Herald Tribune, 2 January* 1989.

ubiquitous six or eight-lane highways, high-rise buildings and the sales of durables such as automobiles which continued at record or near record levels throughout the debt crisis.

Moreover, the debtors could readily find resources for debt service in ways which would involve no austerity at all. These include the sale or pledging of state-owned or controlled companies, often loss-making enterprises, in their entirety or in part; the lifting of restrictions on the inflow of equity capital; a reduction of the more extravagant forms of public spending; and withdrawal of some of the most harmful policies. Under these various headings there is ample scope for finding resources without hardship. Indeed, the population would benefit from these measures. The governments may, of course, arrange their finances and other policies so as to impose hardship on the poor and rationalise this by reference to the need to pay their creditors. But this does not affect the substance of the matter.

According to another contention related to hardship, some debtors may now pay out more in debt service than they receive in new funds and this is said to represent a perverse, immoral transfer from poor to rich. This argument ignores the initial transfer of resources which underlies the debt. It is usual, indeed standard practice that debtors, whether governments, companies or individuals, pay more in interest to their creditors than they receive in new funds, whether in any one year or over the life of the debt. There have been substantial new inflows of funds to several of the problem debtors in recent years. When there has been a reverse transfer from some debtors to creditors this reflects the reduction in the inflow of new money as a result of the conduct of the debtors.

According to another argument for favourable treatment of defaulters, such treatment is justified because their problems are the result of unavoidable adversity, namely deterioration in the external economic environment. This argument is both patronising and insubstantial. It is patronising because it implies that Third World governments can be expected to behave like children with no thought for the morrow, or pop stars who promptly spend all they earn. If the difficulties of the debtor governments are genuine and the results of adverse external change, why have they not set aside the reserves in good times to provide against adversity?[14] Their citizens are clearly capable of taking a long view in economic affairs as is shown by their

14. Balance of payments crises have indeed often served as an effective argument for obtaining more foreign aid from Western donors, thereby discouraging the setting aside of prudential reserves.

readiness to plant tree crops which mature only years after planting.

Besides being patronising, the argument is also insubstantial. Whatever the real or alleged payments problems of the debtors, they do not derive from external conditions but are of their own making. As I have already insisted, exports and export earnings of the debtors depend critically on domestic conditions, especially government policies.

Because the debt crisis is not the result of external adversity, it will not be resolved by changes in external conditions such as, for instance, even faster growth in the West, the economies of which have grown greatly since the eruption of the debt crisis in 1982. Western prosperity did not make the debtors any readier to pay.

Debt Relief Not in the West's Interest

By 1989 it has become very clear to debtor governments that the flow of funds required to sustain them will not depend so much on their readiness to service debt but on the play of political forces in the West and on the interests of the managements of the international banks. On this last subject, it is often said nowadays that the banks need the debtors more than the other way round.

The argument for supporting the debtors in the economic interests of the West invokes the stability of the financial system and the maintenance of employment. It is argued that without substantial assistance, the debtors would openly default and this would endanger the Western financial system. This argument is less often heard since 1987 when the banks began to make large provisions against their Third World loans. It raises the obvious question of how the banks can declare large profits and pay substantial dividends if their solvency is threatened by bad or doubtful Third World debts. And if their capital base were really threatened by Third World default, this would call for measures to strengthen this base rather than for assistance to the debtors. If banks have to be rescued this would need to be done directly, rather than by channelling taxpayers' money through debtor governments who may not even use the money to pay debts, and certainly will not use all of it for this purpose.

However, even acknowledged default on Third World debt would not threaten the Western financial system. The Western governments can ensure that bank losses should not endanger depositors as distinct from stockholders or management of the banks, let alone the financial system. They could insist that the banks should build up their capital base by reducing dividends and seeking new capital. They could also purchase loans at market value and/or take over some of the banks and sell them as going concerns after writing down the balance sheets.

The argument that support of the debtors is necessary to protect activity and employment in the West is also insubstantial. If more spending by the West prompted more activity and jobs, this could be achieved much more effectively by more domestic spending. Exports bought with money provided by the exporting country are in fact given away.

The last argument for supporting defaulting debtors is political. It is that without debt relief and new money, extensive hardship in the debtor countries would bring to the fore nationalist, populist or communist governments hostile to the West, especially to the US. By the late 1980s, this had become the most loudly, widely and persistently-canvassed argument for debt relief and for new money for the debtors, especially in the US, particularly with reference to Latin America.

It is often urged that the misery caused by debt service is behind political instability and the fragility of the nascent Latin American democracies. Senator Bill Bradley's remark that it's 'debt v. democracy' epitomises this opinion.[15] Latin American and other Third World politicians understandably promote this opinion by vocal sabre-rattling. They make out that their peoples are both martyrs of Western financial manipulation and a menace to the international position of the United States. The politicians act simultaneously as victims and as bullies. In July 1989, African and Asian leaders warned the Group of Seven of the danger of revolution if Third World economic sufferings were not alleviated.[16]

As is evident from what has gone before, support of defaulting debtors is not necessary either to raise living standards or to obviate austerity; in fact it often achieves their opposite by propping up governments pursuing extremely damaging policies. Moreover, the rise of anti-Western governments does not depend on local living standards as is clear from Latin American experience ranging from Mexico to Argentina, as well as from experience elsewhere in the Third World. The argument that debt relief and new funds to the debtors are necessary to sustain Western political and strategic interests encourages both financial irresponsibility and political blackmail. By providing a sufficiently frightening scenario of political uncer-

15. *The Financial Times, 24* January 1989.

16. *The Financial Times,* 14 July 1989.

tainty and unrest, governments of LDCs can demand both the complete cancellation of their debts and further aid as well.

Vivid illustrations are provided by the demands for debt relief and for further aid following the presidential elections in Mexico in 1988 and the disorders in Venezuela in 1989, both relatively prosperous middle-income countries where poverty cannot be reasonably attributed to their modest debt service obligations.

The Debt Default Industry

Familiar elements of the contemporary climate of opinion are helpful to the arguments for preferential treatment of the defaulters: de-emphasis on responsibility for one's conduct; widely-articulated feelings of Western guilt; greater sympathy for debtors rather than creditors; and the influence of some Marxist-Leninist ideas on exploitation. But the arguments might not have been accepted so readily if the policies they support did not benefit powerful interest groups who are the most active participants in dealing with Third World debt.

They include the World Bank and the IMF, which seek to expand their roles when the grounds for their existence are increasingly questionable; Third World governments that understandably press for more resources; the banks that wish to avoid or postpone overt losses on their portfolios and wish also to continue or extend their activities with least risk; the aid departments of Western governments and the aid lobbies who support any transfers. This is so because help to governments of middle-income countries and to Western banks can be adduced readily in support of further aid to governments of poorer countries, especially in Africa and South Asia. These interest groups, although mostly of recent origin, are extremely powerful taken singly, and in combination are well-nigh irresistible.

V. CONCLUSIONS

Favourable treatment of defaulting governments politicises life and also enables defaulters to continue with damaging and destructive policies. It also rewards the profligate, incompetent and dishonest and thereby encourages attitudes and conduct harmful to emergence from poverty, notably beggary and blackmail compared to self-reliance.

Lenient treatment of defaulters also discourages the inflow of productive investible funds into their countries and possibly other LDCs as well. It makes it easier for debtors to restrict the inflow of private capital. Effective reward of default also increases the moral hazard of lending to the Third World, which again inhibits the inflow of commercial funds into LDCs. The aggregate inflow of investible funds, that is, officially supplied funds and commercial funds, may well diminish as a result of such a policy. This applies particularly to commercially supplied funds, whether to governments in the form of portfolio investment or to enterprises as direct or portfolio investment. Such commercial funds are less likely to be wasted or used to support damaging policies than are official funds. They are therefore more likely to be productive and to improve the lot of the people, especially of the poorest.

The participation of Western governments and international organisations in debt negotiations simultaneously encourages favourable treatment of defaulters and further politicisation of life in the Third World, which is notorious for damaging economic conditions and prosperity in LDCs. The message and conclusions of the debt negotiations in the 1980s are likely to continue or even expand in scope. This will encourage those who disregard their obligations; increase the moral hazard of lending to Third World governments; enhance the role of the World Bank and the IMF; and lead to further waste of resources and to further politicisation of life in LDCs.

Commentary

Wolfgang Kasper

SINCE I found nothing with which to disagree in Lord Bauer's analysis, permit me to use the allocated time to elaborate on a few aspects and to add some quantitative dimensions.

We owe Professor Bauer thanks for casting a clarifying intellectual light on to what I would call the '500 billion dollar misunderstanding'. Give or take a few billion, that is currently the external debt of defaulting developing countries. In other words: we really begin to talk about genuine sums of money!' It is a misunderstanding because many citizens and many of the leaders of the defaulting countries consider repayment unlikely, even undesirable, whereas the lenders have been expecting all along to be repaid the credit they extended!

Third-world debt is an issue where politics, emotion and guilt are threatening to crowd out cool, rational economic analysis. Let me quote from a widely distributed recent statement on the 'debt crisis':

> Fallen bodies, pillaged shops, massive police retaliation: the scenes of violence in Venezuela ... The hundreds who died were overwhelmingly poor Venezuelans protesting the sudden and unendurable increases in their cost of living. They fell victim to the continuing crisis which has already claimed over three thousand lives in riots in 23 countries .... The same crisis, according to UNICEF, is responsible for the deaths of 500,000 children every year. (George, 1989)

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1. For a reliable, comprehensive overview of global debt figures, see International Bank for Reconstruction and Development, ***passim,*** and Institute of International Finance, 1989.

Whilst some policy mistakes by the developing countries are acknowledged, the paper goes on to advocate debt forgiveness in the name of democracy in the LDCs. This is not the place to elaborate on my serious doubts as to whether the repudiation of debts, which the rich and corrupt elites of LDCs have raised, is at all likely to weaken their grip on power and to bring about genuine democracy, including for the poor.

Let me, instead, confine myself to a few economic fundamental principles and a few basic facts. A first fundamental principle of any economic system is that credits must be repaid, if credit — a fundamental ingredient in economic progress — is to remain available. A second basic economic fact is that it does not matter how much debt a firm or a country has incurred, but whether the efficiency with which the borrowed capital is used exceeds the real interest-rate cost. Since world interest rates are largely given, it seems not very profitable for Third World debtors to concentrate on obtaining interest concessions. Instead, they should aim to raise the efficiency of capital.

Every entrepreneur knows what economists and politicians often overlook: the efficiency of capital is not absolutely given, but can be greatly improved by better management, a clever use of skills, the agile pursuit of new market opportunities, technical innovation, effective work practices and the like. This also applies to developing nations: they can lift the return on capital by making their economies work better and more innovatively. But governments are also quite capable of depressing the return on capital by bureaucratic interventions in markets and enterprise, by distorted international trade, by large, loss-making public sectors, by a well-connected, repressive, corrupt priviligentsia that pretends to be motivated by that familiar mix of foreign-capital xenophobia and economic-industrial cringe which is known in Latin America as the 'Gringo syndrome' (and which Australians, incidentally, can readily observe at home).

What I have just described seems to me to summarise the common traits of the 'economic culture' in the original 15 defaulting debtor countries that come under the Baker plan. More than the other LDCs (outside sub-Saharan Africa), the 'Baker group' has suffered from big, intrusive government and inward-looking, discriminatory policies that depress capital productivity. Not repaying what one has borrowed is only another aspect of pervasive economic irrationality.

The developed industrial countries can of course also make a contribution to raising the efficiency of capital invested in the developing nations:

- Our lending institutions have a shared obligation to scrutinise investment projects and should simply refuse to fund projects with a low rate of return. The 'categorical imperative' of banking (that you should not invest your depositors' funds where you are not prepared to invest your own money) has not always been strictly enforced by market competition. Instead, many of the big Western banks have been able to pass the cost of bad debts on to all their customers in the form of higher interest rates; and very few of the bankers who initiated bad LDC loans have lost their jobs.

- More important, our trade policies should be liberalised to admit more freely the products of the new industries which our capital helped create. Many investments in the LDCs would be viable if we dropped our, often petty, trade barriers. Put bluntly: we will in future have to decide whether we want secure overseas investments and viable banks, or a protected shoe, steel and car industry! We cannot have both. It is illogical to deplore the fact that the earnings from foreign investments (now about $US30 billion per annum) lead to a transfer problem and to the need for adjustment by some industries in the affluent lender countries.[2]

But the main burden on raising capital productivity is with the borrower countries. Although individual country cases might prove the point better, let me show you the effects of anti-entrepreneurial policies by comparing two groups: (i) the 'Baker's dozen' (the defaulters) and (ii) the many LDCs and NICs that have serviced their loans during the 1980s (see Table overleaf).[3]

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2. C. F. Bergsten (1988) is typical of the school of thought that is not quite consistent in deploring the 'reverse transfers' that create an adjustment problem for certain US industries and aggravate the US external deficit. When interest is paid on foreign loans, that income has to be transferred by net imports. If the transfer is perceived to be too demanding of structural adjustment, then interest-earnings can be re-lent overseas.

3. The grouping together disguises important differences within each country group. Thus, Brazil borrowed heavily to develop infrastructural mega-projects, but also built up much productive industrial capacity. Official borrowing by Brazil was not 'recycled' by large-scale private capital outflows. By contrast, Argentina or Venezuela built up little productive

DEBT REPAYMENT, EXPORT PERFORMANCE AND GROWTH				
	15 Baker Plan countries		**LDCs without debt problems**	
	Argentina, Bolivia, Brazil, Chile, Colombia, Ivory Coast, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, Yugoslavia		LDCs and NICs outside sub-Saharan Africa, e.g. Hong Kong, Singapore, Taiwan, South Korea, Thailand, Algeria, Indonesia	
	(Population approx. 580 million)		*(Population approx. 2500 million)*	
Year	1980	1988	1980	1988
External debt ($US billion)	271	499	217	451
Increase in debts (%)		+ 84		+ 100
Debt service (% of export receipts)	--	39.6	--	17.6
Growth in export receipts (1980 to 1988) (%)		0		+75
Current account deficits (US$ billion)	- 50	- 9	- 30	- 0.5
Growth of imports (%) (nominal terms, 1980 to 1988)		- 27		+ 50
Investment share in gross national expenditure (%)	23	16	30	30
Growth in real per capita income (approx. %)		- 13		+ 40

- Whilst all LDCs increased their indebtedness, the defaulters have managed to obtain lesser credit increases during the 1980s. This is understandable, since the average price of their sovereign debt has, on average, now fallen in the secondary market to 35 cents in the dollar, and keeps falling.

- Whilst most of the Baker countries persisted with their policies of productivity destruction and blamed their predicament on external factors (foreign banks, the IMF, a drop in their terms of trade), many of the other LDCs adjusted. They

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capacity at home, but large private bank balances abroad. Between 1980 and 1988, Brazil managed a growth rate of per capita incomes of 1 per cent p.a. and of exports ($US values) of 4 per cent p.a., whereas Argentina's per capita incomes shrank by 2 per cent p.a. and exports by 4 per cent. The corresponding rates for Venezuela were: - 2.3 per cent (per capita incomes) and - 10 per cent ($US export values).

developed new export products and export markets in response to prices on the world market. Amongst them, heavily indebted countries like South Korea, Malaysia, Thailand and India managed to repay.[4]

- The Baker group did not earn more from exports in 1988 than in 1980 (blaming this on worse terms of trade), whereas the others set out to improve their terms of trade by active productivity- and export-oriented supply-side policies. As a group, they managed to raise their export values by no less than 75 per cent.

- The supply-side policies of the non-defaulters also induced private capital to return, whereas the Baker countries lost about $US300 billion between 1980 and 1987 through private capital flight.[5]

- Both groups of developing countries felt compelled to reduce their current-account deficits. The Baker group did so by austerity and cutting imports (-27 per cent), whereas the export-oriented control group was able to increase imports (+50 per cent), and still reduce their external deficits.

- The non-defaulters, who could raise their imports and continued to attract foreign capital, managed to keep up their investment shares at a respectable 30 per cent on average, whereas the defaulters had to cut investment drastically.

- As a consequence, real per capita incomes dropped by 13 per cent on average in the defaulting Baker group, whereas the good creditors and adaptable, export-oriented developing countries increased per capita incomes by an impressive 40 per cent over the eight years under review. It is worth comparing the 13 per cent drop in real per capita incomes in

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4. The assumption in 1982 that the heavily-indebted LDCs were illiquid but not insolvent 'appears to have been a fiction'. The Baker countries, supported by further foreign loans, have sent themselves flat broke (A. J. Schwartz, 1989).

5. 'A Survey of the Third World', *The Economist*, 23 September 1989, pp.52-3.

the Baker group with Lord Bauer's estimate of the **3** per cent of GDP debt burden in those countries!

My reading of the Third World debt problem (which will soon have urgent relevance for Australia) suggests:

- First, the debt crisis is in reality just one aspect of a 'crisis of poor economic management' and of an economic and social order in many LDCs that hampers productivity growth. In any event, foreign capital is only marginal to financing overall capital formation (in a sample of 14 LDCs, domestic saving amounted to 11 times as much as foreign loans).[6]

- Second, the fault for the debt crisis (and the dying babies) lies not — as suggested in the quotation cited above — primarily with the loan-givers, but with meddlesome governments and rent-seeking elites that repress productivity-raising enterprise and individual initiative.

- Third, it does most decidedly not pay for a nation to default on international loans. Contrary to what Lord Bauer appears to have implied in his speech — namely, that defaulters tend to get away with it — at least the average citizen suffers from losses in living standards. The populace of Argentina and Peru who applauded their populist presidents when they campaigned for debt repudiation now sadly have to face poorer life opportunities for it.

Finally, let me make a very basic point. Discussing the debt crisis and debt rescheduling schemes is, at the moment, a very fashionable growth industry. And populist, rent-seeking elites in LDCs can derive political gain from blaming foreign debt burdens for poor economic performance.

But this is a distracting diversion from the essential tasks of (a) not lendingsupport to corrupt interest groups, and (b) raising the productivity of production factors. These tasks are difficult; but without tackling them the shocking misery in the Third World will not be overcome. If history is any guide, the Baker and Brady Plans are weirdly reminiscent of the innumerable, failed debt-rescheduling plans which commemorate the names of all US Treasury Secretaries of

6. *idem*, p.55.

the 1920s, but which ended in the demise of the Weimar democracy and, eventually, in Hitler's debt repudiation (Schuker, 1988).

Developing nations will thrive, irrespective of indebtedness and regardless of debt plans à la Baker or Brady, as long as they pursue the right policies. And if they interfere with the law, with enterprise, markets, trade and innovation, no amount of debt rescheduling, however cleverly designed and genuinely supported, will make much difference.

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Helpful comments by *several friends* are appreciated, but all blame for *errors of fact* and judgement is resewed by the author.

Commentary

Ray Block

WE owe a debt of gratitude to Lord Bauer for his commentary on the Third World debt crisis. 'Can't pay or won't pay' neatly sums up the dilemma of Third World debt. As he says, 'sovereign debt can always be paid, and never needs to be paid'. One might infer from this that the debt is unlikely ever to be repaid.

Pedro-Pablo Kuczynski, formerly Minister for Energy and Mines in Peru, and later a prominent figure in New York investment banking, estimated in 1987 that much of the money borrowed from the US and other commercial banks in the early 1970s fled because 'overvalued exchange rates themselves made possible by the borrowing made such flights (of capital) attractive' (1987:143). Kuczynski estimated that between $US80 and $US100 billion fled Latin America after 1974. Obviously, funds of this size could help to restore some of the external imbalance in the banana republics. But the capital will not begin to return until, as Kuczynski noted, there is a period of 'consistent and realistic policies' accompanied by visibly strong economic growth.

What irony! The Latin Americans won't reinvest the funds they took out until realistic economic policies are pursued. Their relentless game of Russian roulette in reverse with international agencies and the banks is always in the name of default or threat of default as being necessary to keep the already low living standards intact.

The phrase 'Can't Pay or Won't Pay' sums up brilliantly the losing battle of the IMF to try and keep the LDC debt boat afloat. Most of the international debt initiatives have been directed to Latin America, the area of greatest significance to the US, and the traditional destination of a sizable proportion of US exports. Given the pivotal role of the US in the IMF, even after its changed status from world's largest creditor country to world's largest debtor, it is understandable that the IMF should also share this excessive preoccupation with Latin America and apparent

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preference for handouts to LDCs.

The sadness of it all is that the LDC debt crisis has achieved so little. It certainly hasn't helped economic growth in LDC countries. All the initiatives so far employed to rein in the debt have failed, including the Program for Sustained Growth, which was initiated by James Baker, then US Treasury Secretary, in October 1985. We have also seen the stop-gap measures in the menu approach of debt buybacks, debt-for-equity swaps, debt for commodity barter deals. The Baker initiative had called for $US29 billion in new lending to LDC countries over three years, with $US20 billion coming from commercial banks. But as the IMF now acknowledges, commercial bank have come to their senses, and their claims on countries with debt servicing problems declined by some $US23 billion in 1985-88. Most of the reduction has been in the 15 heavily-indebted countries targeted in the Baker initiative.

US Treasury Secretary Nicholas Brady's plan of March 1989 has been widely advertised as a program of debt reduction. Unlike the Baker program, this plan places an emphasis on partial debt forgiveness. The idea is to put a safety net under the IMF's 39 most indebted countries, with the aim of bringing down the debt by nearly $US70 billion over three years. To be eligible for relief, debtor countries are supposed to liberalise and privatise their econornies. But you don't have to be cynical to wonder how long and effective tests of this sort would last.

The international banks were certainly foolhardy in their 1970s recycling of the oil sheiks' short-term credits into long-term LDC loans. The bank reckoning was only possible after Brazil's default in February 1987, with Citibank, the largest US bank and largest bank lender to the LDC market, forcing the beginning of the commercial banks' withdrawal of their sovereign debt exposure. In May 1987, Citicorp announced the creation of an additional loan loss provision of $US3 billion, equivalent to about one quarter of its loans to problem debtors.

Citibank's action set the pace for all other world banks, which have now broadly provided for about 50 per cent of their LDC debt exposure. Even so, the nine largest US money centre banks still had an exposure to the twelve largest developing country borrowers equivalent to 88.8 per cent of their total capital at December 1988. J. P. Morgan, which has one of the smallest LDC debt exposures, has now taken over the running from Citibank with its recent action to increase loan loss provision to 100 per cent of its LDC exposure. Other international banks have not responded, because of the considerable cost to short-term operating profits. But the writing is on the wall. The combination of the convergence to the Bank for International Settlements (BIS) capital adequacy standards and Morgan's recent move to 100 per cent has put the world banks on notice that capital adequacy is too scarce to throw new money credits on the LDC market. The Brady initiative, along with the new mood of partial debt forgiveness, is a temptation to the US banks. This is particularly so if it is spiced with a number of additional attractions that have been tentatively suggested, such as tax benefits, more liberal deductions for losses on the Latin American loans, and a relaxation of bank loan loss provisions. But it is difficult to see any of these attractions being implemented by US legislation.

In the new world of Brady, Costa Rica announced in October 1989 its agreement with commercial banks offering to buy back 60 per cent of its $US1.79 billion commercial bank debt. The debt will be purchased at around its secondary market value of 18-19 cents in the dollar, with money from the IMF, the World Bank and governments at concessional rates. There is no new money from commercial banks. The $US660 million remaining debt component, which includes $US100 million of overdue interest, will be refinanced over 15 and 20 year terms.

Just how much of the LDC debt can be massaged in this way remains to be seen, but, like the initiatives of the last five years, the Costa Rican debt reduction deal, which has been repeated a number of times so far in 1989, is a disappointing response to the LDC debt crisis. The Brady package has assembled $US16.5 billion of new funds including $US4.5 billion from the Japanese; and a further $US12 billion of IMF and World Bank funds can be set aside for debt reduction. But what happens when the funds run out, as they certainly will? How much more money is to be recycled into the permanent vortex of LDC debt?

The ultimate disappointment is the IMF itself, which has meant well but achieved little in its battle to cope with the LDC debt crisis. The IMF has a standard package of structural adjustment programs as necessary preconditions for loan assistance. These programs combine currency depreciation with wage restraint and major cuts in government expenditure. The IMF approach has made no headway in setting the ground rules for lasting economic and political reform in any region of the world. Indeed, many parts of Latin America appear to be heading for economic disaster.

But what a convenient scapegoat the IMF has turned out to be, as we saw in March 1989 in Venezuela, where 300 people died in riots opposing the IMF's restraint measures. Venezuelan President Carlos Andres Perez protested in the most bitter terms about the IMF's program. It was 'unthinkable', he said, that to 'restore the health of economies devastated by their own errors and by unjust terms of world trade, conditions be attached to loans which barely suffice to establish a precarious, inadequate, and superficial recovery of international reserves, without recognising that the growing demands of the external debt and the mounting collected interest more than wipes out whatever loans may be arranged under the signing of a letter of intent'. Can't pay, or won't pay?

The IMF's current economic model for the industrial countries assumes continuing growth over the next few years, with no faltering allowed for excessive financial market volatility and instability. But what if the US, or other majors, were to go into recession over the next two or three years? The world banks will increasingly turn their back on the LDC debts, even at the cost of writing off the whole of their problem loan exposure.

While the 1990s are likely to see rising inflation and commodity prices, this is cold comfort for the LDCs, whose economic and political stability is largely a matter of luck. Debt problems are a product of a lack of national discipline, inadequate export growth, high import demand, and above all else a fast erosion in domestic savings. Luis Tellez, Director General of Financial Planning in the Mexican Finance Ministry, says that debtors and creditors created the debt problem together, and that 'therefore, it is up to both debtors and creditors to find the way out'. Of course it is easy to find the way out in terms of debt reduction based on secondary market values of LDC debt, which can be as low as 16-16.75 cents in the dollar for Argentine debt, 4-6 cents in the dollar for that of Sudan, 3-8 cents for Liberia, and 6-8 cents for the Ivory Coast. Debtors and creditors may have been jointly responsible for the LDC mess, but are the debtor countries going to develop the discipline necessary to run their economies efficiently? The chances that they will do so are slim, and for this reason there is no solution in sight.

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Commentary

Peter Jonson

I would like in my comments to bring the discussion a little nearer home. Australia is now the third highest debtor country in the world. We have a First World morality in these matters; we've never defaulted on our debts, even in the worst days of the 1930s and the 1890s. There is a fashionable view that we don't have a foreign debt problem because most of the debt is in the corporate sector. This view raises some interesting questions, two of which I want to focus on today. First, even if it were true that the debt 'did not matter', there is a macroeconomic problem: the international capital market could decide to charge us 2 or 3 per cent more on interest rates because we are a bad risk, and that would be painful.

Second, and more fundamentally, there is a sovereignty problem. In the end, the only way to pay debts is to give up assets. This is where the analogy with a company should be further developed. A company that gets into trouble is, under our legal system, sold up, and life goes on. It's because we don't have an equivalent legal requirement in the international market place that this doesn't happen to Third World debtor countries. Yet many such countries are like badly-run companies: they have autocratic leaders, they spend too much time politicking, they overborrow and get into trouble. But we bale them out.

However, there are some historical precedents of countries being sold off, such as the Louisiana purchase and wartime reparations in the form of territory transfers. In recent years I've heard some very innovative solutions proposed, such as that the US should forgive Mexico a large portion of its debt in exchange for a Mexican guarantee to sell oil to the US indefinitely at no more than 18 dollars a barrel. (It would have been nice to have the fee for arranging such a deal.) If the rule of law applied internationally, innovative solutions of this kind would be devised.

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Another possible example relates to the Brazilian rain forests. If the Brazilians were to try to meet their obligations, they could decide to devastate their rain forests and engage in intensive agriculture, thus possibly doing damage to the world's ecology. If there were a serious risk that this might happen, why not forgive the Brazilians a large part of their debt in exchange for their leaving the rain forests intact, and let the American Parks and Wildlife Service run them? The Brazilians would of course have to give up some sovereignty, but that's a result of the position they've got themselves into.

Finally, whole countries could be sold. That sounds shocking, but how could the citizens of a corrupt Third World country be made worse off by being sold to a reasonably well-run First World country? In my view they would have to be much better off.

Something like this is already happening to Australia. Even though much of the foreign debt is private, if the corresponding investments are not sound, then one way or another we are going to have to give up assets, which involves giving up sovereignty. The alternative to selling off the farm bit by bit is to undertake structural adjustment, however painful. I hope we do the latter.

Commentary

Stephen Hoadley

I wish to comment first on several specific points that Professor Bauer makes in his paper, and then on some of his basic assumptions.

On specific points: first, I believe the potential for political disturbances occasioned by debt burden and pressure to repay debt must be given more weight than Professor Bauer assigns it. Certainly governments, and we political scientists, take it seriously.

Second, to suggest that private assets might be mobilised to meet sovereign debt is to imply government intervention and expropriation. Not only is this contrary to a market philosophy but also it is counterproductive in as much as it would stimulate flight of capital. To suggest LDCs should sell assets such as Pemex risks sale at an unadvantageous time and the realisation of less than optimum value unless carried out over a period of time. Meanwhile, a way of carrying the debt burden must be found, such as shorter-term borrowing. Asset sales are not an easy answer, as New Zealand has found out. As for the running down of reserves to pay debt, this would reduce the cushion against exchange rate and price fluctuations and reduce the country's attractiveness to overseas investors.

Third, to say that debt service ratio is 'only' 5 per cent of GNP in many LDCs is also to say that it is around 10 per cent of the budget, which is a substantial share, larger than most countries' defence budgets, for example.

Fourth, pressure from creditors on debtors to pay up might stimulate the formation of a creditors' cartel in reaction. But this would undercut the moral ground from creditors' objections to debtors' cartels. Cartels of either sort would be detrimental to free capital markets. A creditors' cartel and other forms of pressure might encourage a desperate LDC government to seek radical alternative sources of finance and aid, e.g. Iran, Libya, the Soviet Union. In New Zealand we did not take kindly to

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a cartel of Japanese banks, which was mooted momentarily, to pressure our government to take responsibility for the Development Finance Corporation's debts (following DFC's privatisation and subsequent receivership) to pay the Japanese banks. This would have been an unfriendly act which would destroy trust and disrupt commerce in the long run.

I would now like to comment on Professor Bauer's more general assumptions. First, it is not clear to me that debt always produces, or even encourages, bad economic development policies. South Korea is one of the world's most indebted countries, yet is an example of healthy growth. New Zealand has maintained a stable democracy and a high standard of living thanks, in part, to borrowing. Conversely, countries with disastrous economic policies have suffered from poor political leadership of which over-borrowing and debt burden was a symptom, not a cause: for example, Indonesia under Sukarno, and the Philippines under Marcos.

Second, strict demands for repayment of debt are risky. For example, pressure on Weimar Germany contributed to the rise of Hitler; US pressure on Latin American debtors deepened the Great Depression; and pressure on North Korea, Vietnam, and Burma has driven all three countries into defaults, and Vietnam into the arms of the Soviet Union, without doing much to change their authoritarian domestic or isolationist foreign policies. One cannot imagine Communist China responding constructively to external pressure from capitalist governments. To pressure the Philippines at this time risks destroying any chance of democracy and stability in the longer term.

Third, many countries that have received foreign aid have prospered, such as Taiwan. Those that refused or were denied Western aid, notably China, Vietnam, and Burma, have lagged.

Fourth, some countries are structurally incapable of development and must remain permanently dependent, such as the Pacific Island countries, and aid and concessional loans are the only feasible way for them to survive. In the South Pacific, this pragmatic adjustment confounds theories of economic development but it is accepted by the New Zealand and other Pacific Rim governments in the interest of political harmony. I don't believe Island governments are cynically manipulating creditors, and none has defaulted on major loans; but several, notably Western Samoa, have been obliged to seek rescheduling.

Fifth, to assert that there is little real distinction between default and rescheduling of debts seems to overstate the similarities and blur a useful distinction. To reschedule is not cynical. It signals responsibility; it protects the integrity of the larger financial system; it buys time; and it makes possible other remedial measures.

In spite of these doubts, I respect economists' logic in general and much of the argument put forward today by Professor Bauer in particular. Certainly Professor Bauer has stimulated me to look more critically at how some unscrupulous Third World leaders can manipulate First World generosity, and the peculiarities of the global banking system, to their own selfish ends. I share Professor Bauer's main thesis that borrowers should be responsible and should pay their debts. We may disagree on choice of policies by which this may be accomplished while agreeing on the ends to be sought.

I would like to take the opportunity to say that as a political scientist I have difficulty with the assumption implicit in many economists' theories that government intervention causes inefficiency. In my view, government activity in an economy, like money or weapons, is inherently neither good nor bad but must be judged on its merits. International commerce is scarcely possible without the stabilising and institutionalising contributions of governments in the nation-state system of the 20th century. Some governments are scrupulous and skilful in managing economic affairs, and some are not. Professor Bauer has concentrated on the latter, while I have concentrated on the former, and that may be the root of any differences we may have.

In conclusion, I am sure that we agree that the market is a useful standard by which to assess government performance, but it is only one measure, and we must apply others as well to reach a balanced judgment.

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Peter Bauer

In this Occasional Paper, Lord Bauer questions the widely-held belief that debt service is a major cause of poverty in Third World countries. He points out that:

- almost all debtor countries restrict direct foreign investment, so reducing their export capacity and increasing their dependence on foreign aid;
- borrowed funds have often been wasted on prestige projects, unviable industries and politically-motivated subsidies;
- many debtor countries have substantial foreign exchange reserves and state-owned monopolies, assets that could readily be used for servicing debts.

According to Lord Bauer, debt default is 'a rational response to the reluctance of the creditors to press their claims and to ... refuse further funds'. He urges Western governments and international financial organisations to abandon debt negotiations so as to encourage Third World governments to introduce rational economic policies from which their entire populations would benefit.

Peter Bauer, an authority on the economic, social and political problems of underdeveloped countries, is Emeritus Professor of Economics at the London School of Economics. His most recent books include *Reality and Rhetoric: Studies in the Economics of Development* (1984), and the CIS Occasional Papers *Economic Control or Economic Development?* (1990) and *Population Growth: Curse or Blessing?* (1990).

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