

Menkhoff, Lukas; Sell, Friedrich L.

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Is a Second Debt Crisis Looming?

by L. Menckhoff and F. L. Sell, Freiburg*

The debt crisis of the developing countries, which loomed so large at the beginning of the eighties, appears for the time being to have been overcome. However, under the surface problems are growing that could give a debt crisis among the developing countries an entirely new dimension. Under what conditions can a second debt crisis be prevented?

The debt crisis that overwhelmed most developing countries in recent years is generally considered to have been defused, if not completely overcome. The apparent optimism of this view is based mainly on the debt rescheduling operations that have brought a rearrangement of repayment terms since 1982, the year in which the "first" debt crisis came to a head when Mexico declared that it was temporarily unable to meet its payment commitments. Rescheduling has essentially entailed spreading out repayments or extending the entire debt service period, thereby saving creditors, for the most part commercial banks, from incurring substantial loan losses.

However, rescheduling is designed not only to resolve the liquidity problem but also to buy time in the hope that economic conditions will change quickly enough to enable indebted developing countries once again to bear their debt burden by their own efforts without introducing adjustment programmes. Two distinct country groups are involved; one comprises the countries that have made less progress towards development and industrialisation, most of which are in Africa and are indebted mainly to public creditors, and the other groups together the economically more advanced debtor countries, which are mainly in Latin America, borrowed chiefly from private banks and, with debts currently totalling almost US \$ 400 billion, account for the bulk of the doubtful loans.¹

Expanding out of the Crisis?

This article reflects the main emphasis of the general debate by concentrating on the second group of countries, the only one with any hope of expanding out of the debt crisis. Such optimistic expectations are based primarily on three factors:

□ The relatively rapid growth in industrial countries in recent years has allowed other countries to expand their exports, so that for this and other reasons the eight largest debtor countries in Latin America recorded an aggregate trade surplus of US \$ 40 billion in 1984.

□ The anti-inflation policy in the western economies is relieving the pressure on Latin American debtors, at least as far as fresh money and floating rate loans are concerned, in that LIBOR has fallen by four percentage points since the summer of 1984.

□ The IMF's involvement in rescheduling negotiations entails the countries concerned pursuing macroeconomic stabilisation policies designed to adjust their economies to external conditions and hence to restore their creditworthiness.

Despite these developments, however, increasing concern has again been voiced in recent months about the danger of a renewed intensification of the debt crisis in the light of the latest trends. The arguments being advanced can be listed in the same order as those in support of the optimistic view:

□ In the early months of 1985 the exports of major debtors were lower than in the same period of 1984; the reduction came to 13.4 % in Argentina, 6.0 % in Brazil, 5.3 % in Chile and 11.1 % in Mexico. Moreover, despite the present growth in the volume of world trade one can observe a steady proliferation of discriminatory accords outside the GATT, thereby prejudicing developing

¹ For the figures quoted below, see A. von Bothmer: Die Verschuldung lateinamerikanischer Länder, in: G. Bruns, K. Häuser (eds.): Die internationale Finanzierungskrise, Kolloquien-Beiträge 27, Frankfurt 1985, pp. 95-118; Morgan Guaranty Trust Company: World Financial Markets, May 1985; Anon.: Lateinamerika: Explosives Gemisch, in: Wirtschaftswoche, No. 31, 26. 7. 1985, pp. 26-39; Swiss Bank Corporation: Economic and Financial Prospects, various issues.

* University of Freiburg.

countries' exports. Finally, 85 % of the growth in exports to industrial countries since the first debt crisis consisted of imports by the USA, where protectionist tendencies are strengthening appreciably and growth is slowing down.

□ Interest payments by Latin American countries still amount to around US \$ 40 billion a year and the decline in interest rates appears to have come to an end, at least for the time being.

□ A satisfactory stabilisation of the Latin American economies in the sense intended by the IMF has not been achieved nor is it within sight, despite these countries' suffering considerable reductions in real incomes.

In assessing the arguments on both sides, it is helpful to visualize the link between external indebtedness and national development, which is described in the literature as a process of "growth-cum-debt".²

The "Growth-cum-Debt" Process

The first point to consider is that in rapidly growing developing countries the propensity to invest is greater than the available investible funds or savings; one may speak of a "domestic savings gap", which can be bridged by attracting foreign capital. In that case the capital inflow, in other words the capital to supplement domestic saving, is matched by a developing trade gap, since either capital goods are imported or the importing of consumer goods makes possible the home production of additional capital goods without a curtailment of consumption. The resulting higher investment ratio should boost growth and, by generating income, ensure that saving is sufficient to finance foreign borrowing.

In simplified terms, the growth-cum-debt process is usually divided into three phases. In the first, domestic saving is less than investment, so that capital must be imported to expand the stock of physical assets and meet debt service commitments. The second phase begins as soon as domestic saving is sufficient to finance investment, so that from then onwards capital inflows are needed only to service the debt. Ignoring other factors, there will still be a balance of payments deficit on current account during this period, despite the trade surplus. The third and final phase is characterised by debt redemption, that is to say domestic saving

covers domestic investment, interest on foreign debts and repayments of principal to foreign creditors.

The idea underlying this theoretical model, namely that injections of foreign capital can speed up economic growth, seems plausible on two counts: first, there are historical parallels, such as the economic history of the USA or Canada, and secondly an obvious analogy can be drawn with corporate financing, which is carried out by borrowing from the household sector. Although the two situations appear comparable, there is one not unimportant difference between them, because the national development model (growth-cum-debt) entails long-term debt redemption, whereas corporate financing does not. This concept seems to be the logical outcome of a process in which the economy in question should become a fully developed member of the world economy. Moreover, it would be inadvisable on political grounds to perpetuate an international distinction between creditors and debtors.

Nonetheless, a number of implications of the growth-cum-debt strategy must be borne in mind if it is to be successful. For example, payment commitments must be met at all times, especially debt servicing, the projects financed by foreign borrowing (if not the entire economy) must operate profitably and competitively and the debtor country must be able to earn sufficient foreign exchange to service its debts. In short, the liquidity, solvency and transfer criteria must be fulfilled. These three concepts occur with corresponding frequency in the discussion of the causes of the debt crisis in developing countries and also constitute the starting point for appropriate economic treatment of the problem.

The Latin American Debtor Countries

Hence, if Latin America's reaction so far to the first debt crisis is examined in the light of these three requirements, the following picture emerges. The countries in question are able to meet their payment commitments, so that rescheduling enabled them to pay due heed to the liquidity aspect. The solvency and transfer criteria, however, have received less attention so far, although the "export promotion" and "internal adjustment" measures are certainly steps in the right direction. The cause of this shortcoming probably lies in the monetary orientation and hence short timescale of the packages of measures taken so far.

This reaction and the situation it created are understandable if the onset of the first debt crisis in 1982 is seen as a rapid acceleration in the commercial banks' loss of confidence in the debtor countries'

² See for example M. H o l t h u s : Verschuldung und Verschuldungsfähigkeit von Entwicklungsländern, in: Hamburger Jahrbuch für Wirtschafts- und Gesellschaftspolitik, Vol. 26, 1981, pp. 239-255; R. E r b e : External Borrowing, Capital Formation and Growth in Developing Countries, in: INTERECONOMICS, Vol. 20, 1984, No. 1, pp. 16-23.

creditworthiness. Logically, the banks would not wish to throw good money after bad, so that the flow of capital to Latin America virtually dried up, having already been in decline since 1981. The more deep-rooted causes of the debt crisis will not be discussed here, nor the extent to which the banks' volte-face was justified; what is more interesting is the abrupt change in their lending behaviour, which forced the debtor countries to adjust their foreign trade at an equally rapid pace.

Latin America's trade balance had been in deficit for many years up to 1981, but the economic adjustment measures produced surpluses of just under US \$ 10 billion in 1982, around US \$ 30 billion in 1983 and US \$ 40 billion in 1984. In theory, the transfer of goods necessarily associated with this turnaround can be achieved by reducing imports or expanding exports. Both methods were pursued simultaneously in Latin America.

Overhasty Change

In 1982 and 1983 the emphasis was placed on curbing imports, partly through specific conservation measures and partly through a macroeconomic austerity programme as demanded by the IMF, in particular. In Latin America as a whole, the effect was to reduce imports by 20 % in 1982 and 29 % in 1983, though in some countries the impact was even more pronounced. This outcome has given rise to fierce debate, especially in connection with the IMF adjustment programmes. In purely economic terms, the central problem is to maintain the continuity of investment. Even if one leaves aside the doctrinal argument about the value of monetarist stabilisation policies in this context, the extent to which growth has been weakened and imports curbed gives cause for concern, as the permanent harnessing of internal resources in these economies depends more on complementary imports than in the industrial countries, so that macroeconomic prescriptions of sudden import reductions with virtually no reference to development policy jeopardise long-term development plans.

Adjustment through an expansion in exports such as occurred in 1984 is also problematic, however, and not only because of the increasing protectionism that can be expected in the USA or the industrial countries. Switching resources from the capital goods sector to the export sector (intersectoral resource mobilisation) may have a beneficial short-term effect on the current account, but over the long term the country may feel the lack of these investments in the necessary process of structural change, so that the switch will have an adverse balance of payments effect.

Newly industrialising countries whose exports include a relatively high proportion of finished goods – such as Brazil and Colombia – have a twofold advantage over LDCs when it comes to this kind of resource mobilisation; first, they can increase the output of goods for export by raising the capacity utilisation rate rather than withdrawing resources from the capital goods sector, and secondly the demand elasticities of their exports are such that they can expect currency depreciation to bring a significant increase in demand.

By contrast, those countries that export mainly raw materials, such as Chile, Ecuador and Venezuela, cannot stimulate foreign demand significantly by devaluing. Besides their "pure" exports, they have few products that are suitable for foreign markets owing to their poor international competitiveness, so that even a contraction in domestic consumption does not boost exports. Argentina, Mexico and Peru are halfway between the two extremes as far as the possibility of exporting finished goods is concerned.

Another way of expanding exports is to reallocate resources within the primary goods sector (intrasectoral resource mobilisation). A typical move would be to replace subsistence farming by cash crop production, although as a rule this presupposes a structure of agriculture different from that existing in most Latin American countries. In the prevailing circumstances, this would further aggravate inequalities in income distribution.

Over the longer term, therefore, import curbs and export promotion measures aimed at short-term objectives undermine the solvency of Latin American developing countries and hence their ability to make real transfers. In the growth-cum-debt model this manifests itself as an exogenous shock forcing them to make a rapid transition from phase one to phase two; until a few years ago the debtor countries' net new borrowing exceeded their debt service obligations in the same period, but now a significant net transfer of financial resources to industrial countries is taking place, estimated at a cumulative volume of US \$ 47 billion between 1983 and 1986 for the 24 largest debtor countries, with Latin America accounting for the bulk of this amount. True, this does not entail a transfer from Latin America to the rest of the world on the scale indicated by the current account of the balance of payments, but the switch from a trade deficit to a surplus affects the current account in the same direction, so that Latin America would very nearly have been catapulted from phase one to phase three of the growth-cum-debt process within the space of two or three years.

Theoretical Framework for a Common Concept

This rapid turnaround in Latin America's foreign trade and payments is consistent with the chronology but not the timing of the orderly sequence of events underlying the growth-cum-debt model. However, if this model has been selected as the development concept, it has a number of consequences for the appropriate handling of the debt problem of Latin American countries, or indeed developing countries in general:

- In general, the countries in question have not yet reached a level of development that will allow them to plug the savings gap with domestic resources, so that they need not only fresh funds to maintain their liquidity but also further long-term commitments of foreign capital.
- The debts they have accumulated are out of proportion to the additional investment, not least because of the use of investment funds for consumption and because of capital flight, so that they hamper development. A cautious reduction in debt (old debt) is therefore desirable.
- In order not only to restore but also to safeguard the debtor countries' creditworthiness, the appropriate use of resources must be guaranteed, for example by means of development policy conditionality.³
- Over the longer term, repayment of the developing countries' debts calls for a willingness on the part of the industrial countries to accept deficits on their trade and current accounts.
- Efforts by the industrial countries to reduce the level of real interest rates indirectly favour exports from developing countries and also facilitate internal growth in the indebted economies.
- Excessive exchange rate fluctuations, measured in terms of purchasing power parities, disrupt international trade in goods and services and hence shake one of the pillars of the growth-cum-debt model in that they act like non-tariff barriers to trade or provide an excuse to introduce tariff barriers.

Apart from these more "technical" aspects, the final problem of significance as far as the possibility of a second debt crisis is concerned lies in the political difficulty of obtaining consensus on a common concept. The interests of commercial banks, international organisations, developing countries and industrial countries are certainly in conflict with one another, but there are no fundamental differences as far as the operation of the world economic and monetary system is concerned. However, stalemate has been reached, for understandable reasons, as no group wishes to be

the first to make concessions. That at least raises the question whether an attempt should not be made to negotiate a joint approach based on the parties' willingness to compromise on individual items. The points mentioned above could then form a kind of theoretical framework within which concrete measures could easily be worked out to suit present policies and various suggested "solutions" that have been brought into the debate.⁴

Additional Problems

The demonstrable need for action is further heightened by the fact that under the surface two problems are growing that could give a debt crisis among the developing countries an entirely new dimension. First, adjustment policies are seriously straining the social climate in Latin American countries, so that it has not become any less likely that some kind of debtors' cartel will emerge as a result of political radicalisation or action to prevent this. Secondly, the fact that the USA has become a debtor country and that its current account deficit, which already amounted to US\$ 102 billion in 1984, is continuing to increase may have devastating effects on Latin America's trade balance and hence its ability to service its debts. This problem can be expected to become significant as soon as the USA manages to reverse the direction of its foreign trade flows, as it eventually must, and it will be all the more serious the later the turnaround occurs.⁵

In conclusion, the debt situation of the developing countries can be summarised in the apparently paradoxical statement that their debts are too high and growing too slowly. The current stabilisation of the situation now makes it both possible and necessary to gear policy not only towards maintaining the developing countries' liquidity, as in the past, but also towards development objectives; in this case that means paying heed to the solvency and transfer criteria and pursuing an overall concept oriented towards these aims. If that does not happen, there is a real danger that a second debt crisis will occur, with all the inadequacies of a further round of ad hoc debt management that that will entail.

³ In this regard see P. Körner et al.: Im Teufelskreis der Verschuldung. Der Internationale Währungsfond und die Dritte Welt, Hamburg 1984, especially pp. 214 ff.; F. L. Sell: Das Verschuldungsproblem der Dritten Welt als Aufgabenstellung der Wirtschaftspolitik, in: Vierteljahresbericht der FES, No. 97, September 1984, pp. 233-240.

⁴ For an overview, see A. Konrad: Wege aus der Schuldenkrise, in: Wirtschaftsdienst, Vol. 64, 1984, pp. 140-144; G. D. Baer: Die längerfristige Bewältigung der Verschuldungsprobleme: planmäßige Lösungswege als Alternative zu pragmatischem Handeln? in: Beihefte zu Kredit und Kapital, No. 8, Berlin 1985, pp. 29-49.

⁵ With regard to these problems, see C. F. Bergsten: The Second Debt Crisis Is Coming, in: Challenge, Vol. 28, No. 2, 1985, pp. 14-21.