External Causes of Developing Countries' Debt Crisis

The following text has been written for an undergraduate course in Sustainable Development in October 2005.

developing countries, HIPC, debt, debt crisis

Introduction

The international debt of developing countries has become a central theme of debate in international forums since the 1980s. Although the focus of interest is now shifting to the heavy indebtedness of some major economies like the USA the debt problem of developing countries still remains of some interest for the development perspective of the respective countries. Especially the heavily indebted poor countries (HIPCs), which the UN counts almost all to the least developed countries (LDC), face serious problems to serve their debt services, to increase their income and thus to improve livelihoods of their citizens at the same time.

I will hypothesise that developing countries (DC) are lost in the debt trap. In this paper I shall argue that within the current, northern, economic structure it is impossible for them to prosper. To prove this hypothesis I shall first give a brief overview of the development of the debt crisis and of the state of affairs. Then, in the next section I will deal with the external causes for the crisis, i.e. the factors which could not be influenced by DC governments, subdivided into cyclical and structural causes. Cyclical causes are due to developments on the international markets and in so far may strengthen existing structural imbalances. The external causes are regarded to be more crucial for the break-out of the crisis than the so called internal causes, e.g. corruption, nepotism, capital flight, because about 500 billion US-$ of debts were imputed to world-economic influences. This is 260 billion US-$ due to the oil price risings in 1973 and 1979/80, 100 billion US-$ because of deterioration of the terms-of-trade and 40 billion US-$ owing to an increase of interest rates \(^1\). Other authors calculate for the time period between 1973 and 1982 an increase of debts by 83 % or $401 billion due to external causes \(^2\).

The debt trap

What is commonly referred to as 'the debt trap' is indeed the vicious circle of borrowing to serve existing debts. To rup up scores is a quite usual activity in our world and at least since the middle-ages when the italian Bardis, Peruzzis, Medicis, the german Fuggers, and later then the Rothschilds and Barings started financing trade and wars in Europe it has become a big business. Private households borrow to buy a new car, a house or just for consumption, enterprises use this financial instrument to invest in new production techniques or to expand their businesses. Even for sovereign states is borrowing from private banks an usual business in order to fulfill their tasks of providing security and infrastructure for its citizens or just to finance special expenditures such as, for instance, wars or things like the german re-unification. So it is not a problem to be indebted but it becomes one when it turns out that the money cannot be payed back or the interests cannot be served in due time. The debtor is then forced to take up new loans in order to pay the old ones but now the conditions will have changed. Banks, in our days rating agencies which analyse and classify the economic

\(^1\) [Source: Other authors calculate for the time period between 1973 and 1982 an increase of debts by 83 % or $401 billion due to external causes.]

\(^2\) [Source: Other authors calculate for the time period between 1973 and 1982 an increase of debts by 83 % or $401 billion due to external causes.]
performance and financial situation of possible and real credit customers, will demote the creditworthiness of the debtor and thus interest rates will increase by a so called risk factor. The debtor has thus to pay more for the new loan than for the old one although his financial situation has not changed to the better. Furthermore, he has to spend most of the new loan to serve the old debt so that there is little money left for profitable investments or savings. In such a situation in many countries for private debtors a procedure for declaring bankruptcy exist. Enterprises which cannot repay their obligations dissolve existing capital and liquidate assets. Depending on the form of organisation managers can be held responsible with their private capital or not. At least in the USA a similar procedure can also be used by private households which lived beyond their means. In case of nation-state there does not exist a related instrument of getting rid of debts.

For developing countries this turning point has become reality at the end of the 1970s when real interest rates reached heights which were unsustainable for their relatively weak economies. The first country to default its debt service was Mexico in 1982 with a $70 billion obligation \(^3\). This moratorium is commonly referred to as the starting point of the outbreak of debt crisis which brought several other countries to follow the mexican precedent \(^4\). By doing so especially smaller private banks faced serious problems as they were reliant upon payments from their debtors. According to then US-american banking law have credits which were not served for six months or more to be written off \(^5\).

Meanwhile 200 financial institutions accounted for 80 per cent of obligations worldwide, in case of Brazil 800 Banks were involved. Only 20 of these institutes, seven from the USA, had exposures beyond a $10 billion level while a majority of the rest held debentures of below a $3 billion level. Altogether the share of financial market debts accounted for about $500 billion for all developing countries in 1982. Overall debt was about $900 billion with a share of one third for latin-american countries which borrowed most from commercial banks \(^6\). Between 1978 and 1982 33 countries accounting for 56 per cent of total debt borrowed externally two-thirds from commercial banks \(^7\). As US-banks played a key role in Latin-America it is clear that especially US-american officials had a big interest in getting the problem solved in order to protect their financial system and to some extent the world's financial system's stability.

The first attempt was made by then US-american secretary of the treasury James Baker who grasped the crisis as a transitory liquidity bottleneck and suggested to offer more fresh money to the debtor nations. This strategy failed because of the refusal of financial institutes to lend more money to debtors who are not even able to repay their old obligations. The next attempt came in 1989 from Nicholas Brady likewise US-american secretary of the treasury who went beyond the Baker-plan by obliging banks to lower interest rates and pose discounts on already existinig debts thus lowering overall obligations as a return service for granting multilateral guarantees. This initiative aimed at relieving major debtors as well as rewarding political allies of the USA, for instance, for their collegial behaviour during the Gulf war or the 'war against terror' \(^8\). In creditor syndicates such as the since 1956 existing Club of Paris, the consortium of bilateral creditors, the Club of London, the syndicate of private creditors, and the IMF and World Bank, the multilateral creditors debt rescheduling and even debt relief is discussed and negotiated but mainly for the small and poor debtors, the SILICs and HIPC:s, which account for only 10 per cent of third world's debt \(^9\).

So despite such action plans which helped the crisis has lost relevance for the international financial community developing countries with special regard to major debtors such as Brazil and other SIMIC:s still suffer from enormous indebtedness. By the means of debt rescheduling and the secondary market where obligations are sold or exchanged banks managed to get rid of most of their risky credits. On the secondary market ‘old’ and risky credits are traded as swaps. The main four kinds of swaps are debt-equity swaps, whereby debentures are exchanged for shares in national enterprises,
debt-buyback swaps, meaning that national governments buy their own obligations, debt-cash swaps, whereby mainly capital refugees buy debentures of their home country and then change it back in national currency, and debt-nature swaps which mostly international environmental organisations buy to acquire pieces of endangered land to build up national reservates\(^\text{10}\).

At present total external debt amounts at $2,5 billion for the 187 developing countries including China and Russia. This means an increase by a factor of 35 between the years 1970 and 2001\(^\text{11}\). In relative terms is sub-saharan africa the region with the most severe burden to carry. In 1996 it owed 81 per cent of total GNP or $227 billion followed by latin-america with 41 per cent of GNP equivalent to $636 billion\(^\text{12}\). What is more are developing indebted countries paying significant sums as a net transfer to the creditors. This net debt transfer amounts for the time period 1996-2001 at $120 billion to bilateral creditors and at $140 billion to private creditors. According to World Bank figures have developing countries payed back $2000 billion more than they actually lended in the period from 1980 to 2001\(^\text{13}\).

**Structural external Causes**

Structural external causes are causes which cannot be influenced by third world governments but have to be altered by a common action undertaken by, in the best case, all governments together. They are inherent to the present world economic and trading system, to its way of functioning. The international division of labour as masterminded by liberalists like Adam Smith and David Ricardo suggests that countries dispose of comparative cost advantages which means that, for example, in country A labour as a factor of production is compared to country B relatively cheap. It should be thus in the interest of country A to attract labour intensive production branches from country B whereas country B where the factor labour is relatively expensive must either compete with country A and thus drop its own labour costs or generate its own comparative cost advantage, say, in capital intensive production, in order to attract production branches from country A.

E. Heckscher and B. Ohlin have developed this theory further to the so called factor-proportion-theorem assuming that within a totally free market economy due to international trading activity prices for labour and capital will come to an equilibrium over a period of time. The present division of labour shows still developing countries as producers of raw materials and suppliers of labour whereas industrialised countries play the role of manufacturers and suppliers of capital intensive goods. This so called international division of labour has its roots in colonial times when Spanish and Portuguese conquered South America. At this time raw materials were shipped to the respective home countries where they were manufactured and purified.

The primat of free market economy did not exist as competition mainly focused on warfare. At the beginning of European industrialisation when interdependence and economic competition grew European powers seek to open up new sources. The British empire destroyed the quite far developed cotton production in India in order to supply their own industries with cotton and prevent a competition between these two countries. This can be seen as a major disturbance of the idea of a free market economy by means of military force. Soon other European countries followed Britain's example and conquered own territories in order to feed their growing industries. The then colonies were forced to produce agricultural raw materials in monoculture as well as minerals under european aegis. Still especially the South-American states are dominated by white, European elites controlling most means of production. Not only the economic system was dictated by European powers also administrative structures have been imposed leading to a dependence on European knowledge and provision of security. After the world wars when decolonisation processes started Third World
countries were lead by native elites educated in the North who maintained existing administrative and authoritarian structures as the cream layer thus contributing to a dualistic society. This is commonly referred to as an internal cause \[\text{[14]}\] but in fact these elites just kept colonial heritage.

When international financial system was rebuilt under US-american leadership colonisation entered a new sophisticated stage. With the Bretton-Woods institutions the industrialised states put the promise of free trade into real institutions. The GATT, in 1994 renamed to WTO and controlling about 90 per cent of world trade, should ensure the abolishing of obstacles to free trade, namely protectionism, while World Bank and IMF are responsible for reconstruction and monetary stability following the structure of the so called **Washington Consensus**.

This consensus is indeed a neoliberal one-size-fits-all strategy consisting of the major components liberalisation, deregulation and privatisation. A quick glance at the power distribution within the IMF shows that it is indeed an almost complete Northern institutions making the label „International“ misleading as the distribution of votes follows the economic power of each member state. Even if in the normal case decisions are being made unanimously the two African representatives would not have enough votes to overcome the German representative. A country which needs to reschedule its debts is forced to comply to the Washington Consensus otherwise no one, neither public nor private lenders, would lend it anything as lenders see it as a security guarantee when the respective country hands in its letter of intent to accept adjustment suggestions made by the IMF.

Therefore the IMF played a keyrole in the management of the debt crisis. Each country receives its individual package of adjustment measures consisting of the devaluation of the national currency, strict austerity in government expenditures and import activities, measures for combating inflation and re-privatisation of state owned companies. All in all these measures contributed for stabilising state finance on the short term but on the long term its measures were rather harmful for a sustainable and continuing development. As a result of throttled imports spare parts and agricultural chemicals became unavailable thus damaging industrial and agricultural production. So entrepreneurs and peasants had again to rely on the old fashioned way of production which handicapped structural change and modernisation, two of the expressed goals of IMF/World Bank's measures \[\text{[15]}\].

### Protectionism

One of the greatest obstacles for developing countries to generate income is the tariff and non-tariff protectionism by industrialised countries. The main driving force behind the establishing of GATT/WTO was the desire of traders and businessmen to overcome the protectionist period preceding the world wars. According to the factor-proportion-theorem would free, liberalised trade benefit all participating nations wherefore this idea has become the primat of world trade politics. However, it is arguable that opening up of markets and abolishing of trade barriers is always the right thing to do for developing countries in order to secure welfare gains. As one can see from history it has been the protectionism which gave european powers and the USA the freedom and the rest to develop their economic strength. In 1879 Otto von Bismarck observed: „I see countries guarding themselves prospering, I see countries which are open declining“ \[\text{[16]}\].

Recent developments in, for instance, China show that separation of markets and an individual process of opening instead of quick trade liberalisation as stipulated by WTO and the Bretton-Woods-Twins is indeed a much more suitable and also a more beneficial way of integrating into world trade. Compared to Russia whose transition into market economy has been supervised by international financial institutions China had an increase in income by 250 per cent in the last decade, reducing
poverty at the same time while Russia's income is about 60 per cent of China's with poverty increasing to between 20 to 40 per cent \(^{17}\). Also China's hesitating in liberalising financial markets prevented it from being seriously affected by the Asian-crisis without compromising its attractiveness for foreign direct investments (FDI) \(^{18}\).

What is more, Northern states are far from having trade barriers abolished. It is indeed true that protectionism by protective and other duties in industrialised countries has become quite seldom. In the course of different negotiation rounds the average tariff rate has been decreased from about 40 per cent to under 4 per cent but non-tariff protectionism has rather seen an increase. At present the WTO counts about 800 different non-tariff trade barriers ranging from subsidies for unproductive production branches over technical norms, standards and consumer protection provisions to quantity restrictions and anti-dumping policies \(^{19}\). From currently 144 member states count 80 per cent as developing countries which shows that they seemingly hope to gain from a free world trade. Especially the agricultural market protection is a nuisance for developing countries as here are their comparative cost advantages located.

Despite WTO regulations pose the Triade states EU, Japan and USA maximum tariffs of 15 per cent and above on agricultural and industrial goods. It is estimated that the least developed countries could face an increase in their export proceeds by $2-3 billion per annum when these barriers were absent \(^{20}\). What is more, OECD countries are spending six times more on agricultural subsidies than they do for official development assistance (ODA). Would they abolish all agricultural subsidies this would mean according to World Bank estimates a $60 billion gain for developing countries which is about the volume of total international ODA. US-american cotton subsidies, for instance, exceed in amount the value of cotton produced and depressing international price. Sometimes agricultural protectionism even lead to direct destruction of bases of life in developing countries. Since 1984 the EC sold subsidised meat to west Africa to 30-50 per cent less the local price. As a result hundreds of thousands of nomad families making a living with cattle breeding lost their basis of existence. In addition a slaughterhouse build with development assistance means became useless \(^{21}\).

On the other side are protection duties for some developing countries a major source of income. For example account tariff proceeds in Burkina Faso for 46 per cent, in Sudan for 43 per cent and in Lebanon for 40 per cent of state income \(^{22}\). When these barriers are abolished due to WTO regulations countries lose not only a main source of income but also has their domestic production to face foreign competition which may lead to rising unemployment and decreasing tax revenues.

### Decrease in Raw Material Prices and Terms-of-Trade

Due to a marginal diversity of export goods about 84 developing countries are heavily dependent upon raw materials as they gain 60 per cent of export revenues from this source \(^{23}\). In the last years they faced a steady decline of raw material prices \(^{24}\), about 50 per cent within last 25 years \(^{25}\). In the case of coffee and sugar this was mainly due to saturation of markets and preceding overproductions. Another reason was the weakness in growth of industrialised countries at the entrie of the 1980s which had two side effects.

On the one hand developing countries faced a downturn in demands on the other hand the supply pressure lead to a deterioration of raw material prices. In the time period from 1984 to 1986 the average value of all raw materials lay at the lowest level since the 1930s whereas UNCTAD estimated that cumulative losses in exports were in the period from 1980 to 1983 responsible for almost half of new external loans \(^{26}\).
Within developing countries winnings are often, unlike in industrialised countries where strong labour unions and stock holders absorb yields, directly reinvested which leads to an improved production which in turn leads to a decline in market prices. Another reason for decrease in raw material prices is the substitution of natural resources leading to a lower demand. Examples are the substitution of natural rubber by synthetic rubber or cotton, jute and sisal by synthetic fibres.

The terms-of-trade (ToT) reflect the relation of imports and exports. Rising import costs and decreasing export yields mean a deterioration, decreasing import costs and rising export prices mean an improvement. It is debatable whether they are suitable to properly reflect the (power-) relationships on the world market as there exist four different kinds measuring different exchange relations. Commodity ToT calculate index numbers for the relation between import price and export price indeces. Income ToT reflect the import capacity of a country taking also import quantity into account. These two concept may differ in their index tendencies as a deterioration of export prices can be compensated by an increase of export prices. Commodity ToT and income ToT measure only the exchange of goods and services but do not give information about changes in productivity.

The double factorial ToT consider factorial exchange relations in domestic and foreign productivity progress to explain whether a domestic factorial unit can buy more or less foreign factorial units during a period of time. Single factorial ToT just reflect the domestic factorial exchange relations within the export sector. The double and single factorial ToT concepts are not used frequently as they are not so easy to investigate and may hence be regarded as more interesting from a theoretical perspective. Of practical interest are the commodity ToT which showed for some countries a decline in the time period from 1985 to 1991. However, some of developing countries facing decreasing commodity ToT's also showed increasing income ToT's which is due to the different effects of productivity improvements. Improvements concerning the production of raw material result in a higher quality causing inevitably a decrease of raw material prices while improvements in the production of manufactured goods increase the quality of products. Industrialised states try to balance possible welfare losses by subsidising their agricultural sector while developing countries need either to increase their export quantities risking a further decline in prices or to diversify their export structure.

Changes on the International Capital Market

A major reason for the present dependency of developing countries on private banks and thus the dependency on market price fluctuations was the extension of private banking activities in the wake of the oil price rallies. Due to the need for a recycling of petrodollars private banks were searching for investment opportunities and hoped to find them in the south. Almost desperate bankers harried ministers of finance to take up fresh money to cheap conditions. One latin american minister of finance recalls that „bankers tried to corner [him] at conferences to offer [him] loans“. Private banking activities were facilitated by the role or, as one author puts it, the 'non-role' of multilateral IMF. The IMF was not able to cope with the rising need of developing countries to finance their significantly increased import bills. The OPEC cartel and the commercial banks charged with petrodollar recycling were in the position to satisfy these demands. The absence of a reliable country-risk monitoring system, the state of not knowing of bankers of how much they lend to whom and the plenty of available money made it easy to lend ever more fresh money. In addition did developing countries count in the 1970s as profitable investment opportunities and the competition between private banks as well as the need to grow forced them to find ever new investment opportunities.
Another option would have been an increase of funds for international financial institutions but this in turn would have meant a decrease of the voting power of some industrialised countries accompanied by an increase of OPEC state's voting power and was thus seen by a majority of IMF members as not a favourable option. Furthermore, a weakening of industrialised countries commercial bank's control over financial flows would have been another result and according to the washington consensus is privatisation and hence an increasing role of private enterprises in world economics the striving goal. What is more did the improved availability of external finance for developing countries lead to an economic expansion which in turn meant growing exports for industrialised countries. So the IMF, dominated by Northern countries, decided to rather support private banking activities.

With the detoriation of the former Soviet-Union the structure of development assistance changed also. Industrialised countries diversified their aid to meet new demands from the former Soviet-bloc states. Likewise trade and financial relations moved in direction from the South to the East integrating rather newly industrialised countries in world trade than traditional developing countries which means for the latter a vanishing of possible finance sources.

**Cyclical external Causes**

Cyclical external causes are due to fluctuations on world markets. However, they are determined by the structure and the way of economic interaction. The events which had a considerable impact on indebtedness of mainly developing countries were the two oil price shocks and the rise of interest rate level.

**Oil Price Risings**

In 1973 the Yom Kippur war between Israel and a coalition of Egypt and Syria lead to a first rising in oil prices. The OPEC states showed a growing self-confidence and started to exploit the oil dependency of western states as an instrument for exercising political pressure. By the end of 1973 the oil price multiplied by the factor four from about three dollars per barrel to twelve dollars. A second oil price shock occurred in 1979 caused by the outbreak of the first Gulf war between Iran and Iraq resulting in losses in oil production and feelings of insecurity. This time the price rises to about $39 per barrel.

All in all the oil bill of importing countries has multiplied by the factor eleven. While northern countries could cope quite well with high oil prices because some of the petrodollars were invested, some returned in form of orders to northern companies developing countries suffered triple. In the first place they had to face an increase in their import expenditures due to a rise in costs for manufactured goods and oil and secondly because of additional loans which became necessary in order to pay the aforementioned imports.

**Risings in Interest Rates**

Extensive armament activities of the reagan administration combined with a tax-reduction induced investment recovery in the USA and a change in the operating procedures of the Federal Reserve's monetary policy coupled with tighter restraint lead in the early 1980s to a sharp increase in real interest rates and the value of the dollar. This had severe effects on developing countries interest payments and import bills. For instance, a 1 per cent change in the London Interbank Offer Rate...
According to estimates of different institutes are about 40 per cent in the rising of foreign debt of the south due to increased interest rates. A rise in the real value of the dollar made import prices for US-american goods more expensive while world recession additionally depressed commodity prices. In conjunction these two events caused a deterioration of the terms-of-trade. At the same time moved the USA from a net-creditor to a net-debtor country due to large current account deficits and thus becoming attractive for foreign investments which in turn induced capital outflows from developing countries.

Conclusion

Developing countries acted according to the capitalist paradigm that making debts to finance development and every day expenditures is a reasonable thing. They were assured in this assumption by industrialised countries who exactly did and still do the same. US-american total debt is just the most impressing example. Picking up loans is in itself not a problematic procedure and might be even beneficial for both sides, the lender and the borrower. But as there does not exist something like a procedure for declaring bankruptcy for sovereign units especially sovereign debtors should have an eye on their indebtedness and pay special attention to the conditions of loans as well as on their (future) economic performance to ensure that they will be in a position to repay the credits. In case of developing countries this went suboptimal if not wrong. In the first and second development decade they seemed to believe in the possibility of a gradual catching up to industrialised countries. What they probably did not took into account was the fact that no entrepreneur would have the interest to bring up its own competitor meaning that the North has no interest in competing with the South on a free market if he has no comparative advantage.

The international division of labour includes that the North provides knowledge, technology and finance (including development assistance by the so called “aid industry”) while the South takes care of providing raw materials and labour. In the third and fourth development decade then it turns out that some unexpected events could bring the whole sophisticated financial system close to collaps. The oil price shocks and interest rate risings made the precarious situation which was caused by structural imbalances between north and south obvious. Likewise came the priorities of the debt managers to sight which lay clearly on repaying of credits rather than on tackling the roots of the problem and reaching the humanitarian goal of poverty reduction. Without major and serious changes in the world economic order and its underlying moral basis, the abolishment of usurious interest rates and perhaps an international insolvency proceeding developing countries will stay for a long time caught in the debt trap although it is arguable that in international relations dominated by Realpolitik and profit seeking moral good behaviour in a non-darwinist sense can be expected.

May be the relation between North and South and the North’s attitude towards the debt crisis is pretty good described by Tom Clausen, a former World Bank president, who stated:

„Where people are desperate, you have revolutions. It’s not in our own evident self-interest to see that they are forced into that. You must keep the patient alive because otherwise you can’t affect the cure“  

39) (LIBOR) caused $850 million additional interest payments in Brazil $790 million in Mexiko.

40) A rise in the real value of the dollar made import prices for US-american goods more expensive while world recession additionally depressed commodity prices.

41) In conjunction these two events caused a deterioration of the terms-of-trade. At the same time moved the USA from a net-creditor to a net-debtor country due to large current account deficits and thus becoming attractive for foreign investments which in turn induced capital outflows from developing countries.

42) The international division of labour includes that the North provides knowledge, technology and finance (including development assistance by the so called “aid industry”) while the South takes care of providing raw materials and labour. In the third and fourth development decade then it turns out that some unexpected events could bring the whole sophisticated financial system close to collaps. The oil price shocks and interest rate risings made the precarious situation which was caused by structural imbalances between north and south obvious. Likewise came the priorities of the debt managers to sight which lay clearly on repaying of credits rather than on tackling the roots of the problem and reaching the humanitarian goal of poverty reduction. Without major and serious changes in the world economic order and its underlying moral basis, the abolishment of usurious interest rates and perhaps an international insolvency proceeding developing countries will stay for a long time caught in the debt trap although it is arguable that in international relations dominated by Realpolitik and profit seeking moral good behaviour in a non-darwinist sense can be expected.
Sources


Related Articles

- External Causes of Developing Countries' Debt Crisis


16) ibid.: 52.


19) ibid.: 327.


22) ibid: 359.


ibid.: 136 et seq.


ibid.: 151.


ibid.: 40 et seq.


