DEBT CRISIS OF THIRD WORLD: CAUSES AND CURES

***Dr Kamal Kishore, Post Graduate Department of Economics, DAV College, Amritsar, India**
kkeconomics@gmail.com, 9417091360

Abstract

It has been well established that external debt of developing countries increased manifold over the past three decades. There has also been corresponding rise in the debt service payments and other related variables showing pressure of debt on developing world. There have been many factors which exerted their influence on debt from time to time and consequently the problem continued to become more severe. The factor behind the increase in the debt burden have varied but are interrelated. A number of studies have summarized both external as well as internal factors responsible for debt problem to accentuate. mobilisation of domestic resources, longer term loans, productive use of resources etc are required to contain the problem.

Key Words: Debt, Development, Long Term

DEBT CRISIS OF THIRD WORLD: CAUSES AND CURES

Economic development has become a major social and political issue in the world affairs today. The acceleration of development is a pressing matter for poor countries. The poor countries, also called as third world countries and popularly known as developing economies, suffer from the problems of poverty, under employment and disguised unemployment, which mainly arise due to the deficiency of capital. Early post-war writers tended to define the problem of development as one of capital shortage.

Nurkse (1953; P.1) in this regard rightly says that underdeveloped countries, as compared with advanced countries, are under-equipped with capital in relation to their population and natural resources. There is no second opinion that the process of economic development and capital accumulation are interconnected. The vital role of capital in this respect depends on the fact that among the different factors of production, capital has the unique characteristic of unlimited expansibility. Capital is regarded not only as central to the process of development but also as strategic. The process of capital formation is interactive and cumulative, because capital formation increases income, which makes possible more capital formation (Kindleberger, 1958; P.35).

However, due to high propensity to consume and lack of power and will to save, the developing countries have not been able to generate much of the domestic capital for developmental purposes. The result has been that in the due course of time, developing countries have become dependent on external sources like international financial institutions, commercial banks and the developed countries for their capital requirements. But the experience has shown that during the last three decades, most of the developing countries have not been able to reap the benefits of foreign finance and have become indebted to international financial institutions, commercial banks and developed countries. The total debt stock of all developing countries collectively increased from just \$70.2 billion in 1970 to \$2597.1 billion in 2004 and \$5230 billion in 2012. (World Bank, 2004 and 2012). A large chunk of their resources goes to service their debt. This has led to emergence of many problems for the underdeveloped countries.

Keeping in view the above issues, the present paper attempts to analyse the factors behind the growing indebtedness of developing countries specifically with the following objectives:

- To study the magnitude of debt of developing countries
- To analyse the factors behind the growing indebtedness of developing countries
- To suggest measures to cure the problem

To meet the above objectives, the paper is divided into three sections. Section I concentrates on the magnitude of debt of developing countries. Section II analyses the factors responsible for the problem to grow. Section III summarises the study and suggests measures to contain the problem.

Data Base and Methodology

The external debt of developing countries is studied at 5 points of time viz. 1970, 1980, 1990, 2000 and 2012 i.e. the latest year for which data were available. Statistical tools like tables , ratios, percentages etc. are used to present , interpret and compare the data. Data have been collected from various publications of World Bank namely Global Development Finance, World Debt Tables , World Development Indicators etc.

SECTION – I

Trends in the Total External Debt and its Composition

Table 1 shows that tremendous increase has been registered in the total external debt of developing countries during 1970-2012. The total amount of debt which was around US$ 72.7 billion in 1970, increased around nineteen times to US$ 1371.4 billion in 1990 and finally reached $ 2392.5 billion and $ 5230 billion in 2000 and 2012 respectively. Thus the external debt experienced about 72 times increase during 1970-2012. Of the total debt, long term debt (including use of IMF credit) constituted the major component with on an average more than 80 percent share till 2000, the figure declined to 70.4 in 2012. Short term debt increased sharply from 12.9 percent in 1970 to 23.1 percent in 1980, but declined to 15.6 percent in 1990. But it increased to 29.6 percent in 2012 which is a cause of concern.

Table 1

Composition of External Debt of Developing Countries (Billion US $)

Items	1970	1980	1990	2000	2012
Long Term Debt (Including IMF credit)	63.4 (87.1)	420.8 (76.9)	1157.6 (84.4)	2045.7 (85.5)	3685 (70.4)
Short Term Debt	9.3 (12.9)	126.0 (23.1)	213.8 (15.6)	346.8 (14.5)	1345 (29.6)

Total	72.7 (100.0)	546.8 (100.0)	1371.4 (100.0)	2392.5 (100.0)	5230 (100)

Note: Figures in parentheses represent percentages of the total.

Source: World Bank, *Global Development Finance: Country and Summary Tables*, Various Issues.

Long Term Interest Payments

Table 2 shows that interest payments by developing countries against external debt increased considerably from $ 2.5 billion in 1970 to $ 101.7 billion in 2000 although some decline was observed later on as the figure reached $135 billion in 2012.The table also shows that most of the interest payments were made to private creditors (PPG as well as PNG) as the interest payments to these sources were just $ 0.8 billion each in 1970 which increased to $ 37.5 billion and $ 30.6 billion in 2012respectively. In relative terms, interest payments against PPG debt constituted the maximum share of 68.2 percent in 1970 which further increased to highest at 90.4 percent in 1990. Later on, a decline was observed and the figure reached 58.5 percent in 2012. Of PPG

Table 2

Composition of Long Term Interest Payments (Billion US $)

Items	**1970**	**1980**	**1990**	**2000**	**2003**	**2012**
A. Public & Publicly Guaranteed	1.7 (68.2)	23.3 (76.9)	47.7 (90.4)	70.9 (69.6)	61.4 (69.4)	79 (58.5)
A.1 Multilateral						
1. Concessional	0.02 (0.6)	0.2 (0.5)	0.4 (0.8)	1.2 (1.2)	1.4 (1.6)	3.3 (2.4)
2. Non-concessional	0.3 (12.3)	2.3 (7.6)	10.2 (19.3)	14.7 (14.5)	10.8 (12.2)	6.7 (4.9)
Total	0.32 (12.9)	2.5 (8.1)	10.6 (20.1)	15.9 (15.7)	12.2 (13.8)	10.0 (7.4)
A.2 Bilateral						
1. Concessional	0.4 (16.5)	1.5 (5.1)	3.5 (6.5)	5.3 (5.2)	5.8 (6.5)	6.5

						(4.8)
2. Non-Concessional	0.2 (7.4)	1.3 (4.4)	4.6 (8.8)	6.1 (6.0)	5.9 (6.6)	1.3 (1.0)
Total	0.6 (23.9)	2.8 (9.5)	8.1 (15.3)	11.4 (11.2)	11.7 (13.1)	7.8 (5.8)
A.3 Private Creditors	0.8 (31.4)	18.0 (59.3)	29.0 (55.0)	43.6 (42.7)	37.5 (42.4)	61.7 (45.7)
B. Private Non-Guaranteed	0.8 (31.8)	7.0 (23.1)	5.1 (9.6)	30.8 (30.4)	27.1 (30.6)	55.6 (41.2)
Total Interest Payments (A+B)	2.5 (100.0)	30.3 (100.0)	52.8 (100.0)	101.7 (100.0)	88.5 (100.0)	135 (100)

Source: World Bank, *Global Development Finance: Country and Summary Tables*, Various Issues.

source, maximum interest payments were made to private creditors (Guaranteed) whose share increased from 31.4 percent of the total interest payments in 1970 to 59.3 percent in 1980 but declined gradually to 45.7 percent in 2012. Share of multilateral sources in interest payments increased from 12.9 percent in 1970 to 20.1 percent in 1990 but declined later to 7.4 percent in 2012. Share of bilateral sources showed fluctuating trend and declined from 23.9 percent in 1990 to 5.8 percent in 2012. Share of interest payments against PNG debt, first declined from 31.8 percent in 1970 to as low as 9.6 percent in 1990 but increased later and reached 41.2 percent in 2012. It is also important to note that interest payments were obviously more in case of non-concessional debt compared to that for concessional multilateral debt. debt service payments made on long term debt).

Long Term Debt Service

Long term debt service is the sum of principal and interest payments actually made during the year against the long term debt. 'Debt service payments' is an important indicator of the external debt burden since higher debt service payments put pressure on the balance of payment position of an economy. An analysis of debt service payments on long term debt to various sources as described in Table 3 shows that debt service payment in absolute terms increased at a rapid pace and increased from just $8.7 billon in 1970 to huge level of $606 billion in 2012. Persistent rise in debt service payments to all the sources, was observed during 1970-2012. It was observed that most of the debt service payments from among the PPG sources, went to private creditors. In 2012, out of $ 179 billion paid to PPG sources, $109 billion were paid to private creditors as debt service. It was also observed that private creditors both (PPG and PNG) were paid $ 536 billion out of total debt service of $ 606 billion by developing countries in 2012. Debt service to multilateral and bilateral creditors also increased from just $0.7 billion and $1.8 billion in 1970 to $ 38 billion and $ 31 billion respectively in 2012. Large part of debt service payments was made to PPG sources in relative terms since its share rose to as high as 89.3 percent in 1990 compared to 62.5 percent in 1970, which, however, declined to 29.5 percent in 2012. Of PPG sources, large part of the payments were made to private creditors

Table 3

Composition of Long Term Debt Service (Billion US $)

Items	**1970**	**1980**	**1990**	**2000**	**2003**	**2012**
A. Public & Publicly Guaranteed	5.4 (62.5)	50.3 (72.8)	119.6 (89.3)	207.9 (59.6)	205.0 (54.0)	179 (29.5)
A.1 Multilateral						
1. Concessional	0.1 (0.5)	0.3 (0.4)	1.6 (1.2)	3.5 (1.0)	4.2 (1.1)	10 (1.6)
2. Non-concessional	0.6 (7.7)	3.8 (5.6)	21.7 (16.2)	35.5 (10.2)	44.4 (11.8)	28 (4.6)
Total	0.7 (8.2)	4.1 (6.0)	23.3 (17.4)	39.0 (11.2)	48.6 (12.9)	38 (6.3)
A.2 Bilateral						
1. Concessional	1.1 (12.5)	3.8 (5.4)	8.5 (6.4)	16.7 (4.8)	19.0 (5.0)	24 (3.9)
2. Non-Concessional	0.7 (8.3)	3.7 (5.3)	11.0 (8.2)	20.3 (5.8)	20.3 (5.3)	7 (1.1)
Total	1.8 (20.8)	7.5 (10.7)	19.5 (14.6)	37.0 (10.6)	39.3 (10.3)	31 (5.1)

A.3 Private Creditors	2.9 (33.5)	38.7 (56.1)	76.8 (57.3)	131.9 (37.8)	117.1 (30.8)	109 (18.0)
B. Private Non-Guaranteed	3.3 (37.5)	18.7 (27.2)	14.5 (10.7)	140.9 (40.4)	174.9 (46.0)	427 (70.5)
Total Debt Service (A+B)	8.7 (100.0)	69.0 (100.0)	134.1 (100.0)	348.8 (100.0)	379.8 (100.0)	606 (100)

Source: World Bank, *Global Development Finance: Country and Summary Tables*, Various Issues.

(Guaranteed) whose share increased from 33.5 percent of the total payments in 1970 to more than half of the total i.e. 56.1 percent in 1980 and 57.3 percent in 1990. However, decline was registered in the later years and figure finally reached 18 percent in 2012. PNG sources accounted for a substantial share of the total debt service payments for a substantial share of the total debt service payments which although declined from 37.5 percent in 1970 to 27.2 percent and 10.7 percent in 1980 and 1990 respectively but took a sharp upward turn to 40.4 percent in 2000 and finally to 70.5 percent in 2012.

SECTION – II

It has been well established that external debt of developing countries increased manifold over the past three decades. There has also been corresponding rise in the debt service payments and other related variables showing pressure of debt on developing world. There have been many factors which exerted their influence on debt from time to time and consequently the problem continued to become more severe. The factor behind the increase in the debt burden have varied but are interrelated. A number of studies have summarized both external as well as internal factors responsible for debt problem to accentuate.

The seeds of the debt crisis was sown in 1973-74 when Organisation of Petroleum Exporting Countries (OPEC) quadrupled the price of petroleum. For many less developed countries (LDCs) lacking adequate domestic oil reserves, the decision to substantially raise the petroleum prices in the world market for a barrel of oil was a severe jolt. For most less developed countries, it resulted in a dual problem of trade deficit (since import obligations grew beyond export earnings) and high current account deficits in the balance of payments. Since deficit on current account needs financing through surplus on capital account, the high oil import bill forced oil importing poor countries to increase external borrowings.

The deficit on current account was also accentuated by steep increase in the prices of manufactured goods, especially capital goods. A second round of oil price hike by OPEC in 1979-80 further deteriorated the current account balances and as a result, combined current account deficit of non-oil exporting developing countries doubled from $42 billion to $88 billion during 1970-80.

Following the oil shocks, developing countries resorted to private sources of finance, though, until late 1960s, capital flows to developing countries were mainly in the form of long term loans from official creditors which were frequently associated with project financing and were made an concessional terms (IMF, 1981; P.4). Financing of temporary balance of payments difficulties was largely accomplished by IMF and the borrowings from official creditors are generally conditional and require adjustment programmes supported by these multilateral institutional to be implemented in the borrowing countries. Instead of approaching this source of finance, developing countries, in general, resorted to commercial banks for their financing needs since this source was easily approachable and less conditional. Growing reliance on private sources of credit caused worsening of average terms of developing countries' debt. Rise in real rates of interest increased the cost of debt on fixed as well as floating rates of interest debt.

In 1980-82 global recession made matters worse by reducing the volumes of developing countries' exports to industrial countries. Following the severe strains of balance of payments position and finding it difficult to meet cost of external debt, Mexico in August 1982, suspended the repayment of its loans to private banks and sovereign lenders. The crisis aggravated further as more and more countries found it hard to service their debts out of their foreign exchange earnings (Thirlwal, 1999; P.409).

The external circumstances which were behind the growing debt problem were supplemented by the monetary, fiscal and regulatory policies of the developed countries. Developed countries adopted expansionary policies after 1973-74 leading to rapid rise in prices. Real interest rates came down and external borrowings became less expensive which induced developing countries to borrow more.

An important part was also played by the trade policies of developed countries, which due to the recession and high unemployment rates in their economies in early 1980s, used highly protectionist policies thereby reducing exports from developing countries and hence the export earnings meant to service the debt. In general, combination of high interest rates and recession in 1981-82 damaged the capacity of developing countries to sustain growth and avoid debt servicing difficulties (World Bank, 1985; P.55).

Among other factors, capital flight from developing countries in the late 1970s and early 1980s, was a major factor in the rapid accentuation of the debt service problems in a number of countries including Argentina, Mexico, the Philippines and Venezuela. In a number of countries, borrowing abroad had to finance not only current account deficits but also private capital flight induced by unstable domestic and political conditions.

In addition to the external factors, the domestic inadequate policies played a major part in accentuating the debt difficulties of developing economies. The adoption of inappropriate exchange rate policies constituted one of the most important domestic causes of debt crisis. Large fiscal deficits, too much unproductive expenditure and use of external borrowings for consumption purposes in the past played an equally important role and remained the major domestic reason for growing debt difficulties of many nations. Many oil exporting countries in the wake of large earnings from oil exports resorted to massive spending programmes.

The expansionary policies of debtor countries, in general, led to increase in their fiscal deficits. There is significant positive relationship between growing government deficit and accumulation of foreign debt (World Bank, 1985; P.62). Experience of Argentina, Mexico, Morocco etc. illustrates the connection between fiscal deficits and inflow of foreign finance. The severe debt problem of Latin American countries, among other factors, was due to the defective domestic policies which included heavy public and private expenditure during 1978-82.

Deficits caused by excessive public sector investment, growing government consumption often in the form of subsidies to public sector enterprises to cover operative deficits and inability to raise taxes as spending increased, were not only unsustainable but also produced frequently the inefficient investment.

The failure of many Sub-Saharan African countries to adopt their policies to the changed external environment tended to exacerbate the debt servicing problem. Besides expansionary fiscal policies and borrowings against exports to maintain consumption levels, many of these countries pursued other policies that weakened their external position. Growing fiscal deficits and surging private credit demand led to massive monetary expansion and higher inflation in many countries.

Domestic Policy errors certainly played a role in the build up of external vulnerability and the eventual outbreak of East Asian Crisis in 1997-98. In early 1990s, major industrial countries adopted low rates of interest in response to recession. The relatively high growth rate, low risk East Asian market economies with a record of relatively stable exchange rates made them attractive investment locations. By 1994, an increasing volume of this investment consisted of short term funds seeking profit from the rates of interest differentials.

The underlying causes of Asian crisis which created severe payments problem for countries like Thailand, South Korea and Indonesia have been clearly identified. Although massive funds became available at relatively low rate of interest, however, domestic allocation of these borrowed funds was inefficient. Weakening of exports in mid 1990s for a number of reasons and massive capital outflows were reflected in widening current account deficits. To make the matter worse, a substantial portion of capital inflows was in the form of short term lending by commercial banks in the region, leaving the countries vulnerable to external shock.

Poor domestic policies too played their role in the Russian Crisis in 1998. After six years of economic reforms in Russia, privatisation and stabilisation programmes experienced some limited success. Yet in August 1998, Russia was forced to default on its sovereign debt, when it declared suspension of payments to foreign creditors. Low tax collections causing public sector deficits to remain high and high government debt contributed significantly to the problem. East Asian Crisis in November 1997 too had its effect on Russian economy. After the onset of the Asian crisis, rouble came under speculative attack. The Russian default in August 1998 caused investors to flee emerging markets and raised the cost of Argentina's foreign borrowing. There was appreciation of Peso (Argentina's currency) exchange rate resulting from a devaluation in Brazil which was Argentina's main economic partner. Economic activity and tax revenue collections continued to decline alongwith a reduction in foreign exchange reserves due to reduction in exports as a result of currency appreciation. As a result, Argentina suspended its external debt payments to foreign creditors in December, 2001.

While the Asian crisis was essentially the external debt problem between financial institutions in both lending and borrowings countries, the crises in other emerging market economies such as Russia (1998), Brazil (1999) and Argentina (2001) were associated with external debt problems between sovereign borrowers and overseas private investors. Domestic factors played an equally important role even in Brazilian crisis in 2002. Despite significant progress in economic reforms throughout the 1990s, and an examplary development of the policy framework in the second part of the decade, Brazil suffered a major public debt and currency crisis in 2002.

Section III

Thus the history of the past three decades reveals that both external as well as internal factors were responsible for the debt problem to become more serious over time. Oil price hikes, protectionist policies of the industrial countries, rise in interest rates, availability of external finance at relatively cheaper rates, capital flight from the debtor countries due to decrease in investors' confidence were among the major external factors where as domestic poor policies, weak macroeconomic adjustments, unproductive and inefficient use of funds, increase in consumption levels, rising fiscal deficits, appreciated exchange rates, inability of the debtor governments to generate domestic tax as well as non tax revenue have been among the internal factors responsible for growth of debt.

Inspite of the efforts made by the developing countries themselves or at international level, debt situation of developing countries in general remained not only intact, but has rather worsened. The study suggests certain policy measures to combat the problem.

First and foremost, the developing countries must formulate their policies in such a way that the borrowed funds are used in productive avenues ,more emphasis should be laid on mobilisation of domestic resources, loans should be raised for a longer period of time since it has been seen that countries having more dependence on short term debt are more prone to debt difficulties. The practices of chronic budget deficits, overvalued exchange rates, excessive unproductive expenditure of the government, etc. should be discouraged since they are the clear warning signals that the borrowed funds are being used to postpone rather than facilitate adjustments.

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