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International Debt and Economic Instability

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The debt experience of the 1920s and 1930s was one of pervasive default. Half the outstanding Latin American debt was completely in default by 1949, and nearly half was serviced on an adjusted basis, having been written down as to principal and interest. Only a tiny 1.9 percent continued to be serviced on the terms originally contracted. By comparison, today's debt performance is dramatically successful.[1] A great historical experiment is now underway in which involuntary debt service is being extracted at extraordinary costs to the debtors and to the trading interests of the creditor countries. The essential instruments are two: a return of government involvement in private debt collection that had gone out of fashion after nineteenth century gunboat diplomacy and the International Monetary Fund (IMF) as the administrator of the mugging.

Even with this help, debt collection is not totally successful. The Baker plan turned out to be primarily a cover for commercial banks to reduce their share in debt rescheduling, leaving the bag to multilateral agencies with no net benefit to the debtors. Today lesser developed country (LDC) debts trade at deep discounts, suggesting that not all is well. The recommendations for action go in three directions. The Bradley-Lever approach is to recognize the problem, treat debts as a political issue, and strike a bargain that enhances growth and trade. Improved LDC growth performance would be a positive

[1] On the history of sovereign debts see Lipson (1985), Edelstein (1982), Rippy (1959), Landes (1979), Feis (1965), Mintz (1951), Lewis (1948). Maddison (1985), McGrane (1935), Royal Institute (1937) and Winkler (1933). A particularly important and controversial treatment is given by Eichengreen and Portes (1985).

benefit and a partial offset to concessions granted under the bargain, but there would also definitely be an increase in the quality of debts outstanding.[2] The banks' position, advocated most skillfully by Cline (1986), is to pretend all is well. The position is to hold out for the mystical day of a return to voluntary lending or, more pragmatically, for a bailout by taxpayers. A third approach is to focus on a more or less unconditional reduction in interest rates applicable to reschedulings, perhaps to the level of Libor. Other possibilities include gearing debt service to export prices or export revenues. These are the possibilities that debtor countries tend to think of as they enter rescheduling negotiations and before disillusionment is visited upon them.

It is clear that the LDC debts can be kept going for another year, or even several years if enough rescue ingenuity and pressure is applied. But the costs of avoiding a solution are mounting for the debtor countries, the creditors' trade and employment, and the creditors' foreign policy interests. The debt problem in its trade implications is certainly one element in the growing U.S. protectionist sentiment. This is now being more widely recognized and hence a welcome debate on realistic options is finally emerging. This paper reviews where the debt problem stands, how it relates to the macroeconomics and growth problems in Latin America, and what reasonable solutions might look like.

The debt problem

We start in this section with a brief review of facts about the debt. What is their size, what part is owed to banks and what part to other creditors, and when were the debts incurred? The next question is where the debt crisis came from. Finally, we look at the broad facts of the adjustment process over the post-1982 period. The year 1982 serves as a benchmark since in August of that year the first country, Mexico, declared that debts could not be serviced on the contracted schedule. Credit rationing set in immediately, and in short order a long list of countries had to reschedule their debts?

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2 See Lever and Huhne (1986) and Bradley (1986).

3 See Simonsen (1985) and Cline (1985).

Debt facts

Table 1 shows the value of external debts in current and constant dollars as well as debt-GDP ratios. The table brings out the large increase in debt in two stages. Between 1978 and 1982 debts increased due a combination of poor domestic macroeconomic policies and an increasingly adverse world economy. In 1982-85, domestic policies were geared toward adjustment, but the world economy was insufficently accommodating to help reduce debt burdens.

Since 1982 total debt has continued to increase, even more in constant dollars than in current dollars. Table 2 follows up with the composition of debts and new borrowing by creditor. It highlights the changing role of private creditors before and after the debt crisis.

TABLE 1
External Debt and Debt-GDP Ratios: Capital Importing LDCs

	1978	1982	1985
Debt in current dollars (billions)	399	752	888
Debt in constant dollars*	590	752	978
Debt/GDP Ratio (per cent)	25.6	33.2	38.1

*Deflated by the world unit import value index, 1980=100.
Source: IMF World Economic Outlook, April 1986

TABLE 2
LDC Debts to and New Borrowing from Private Creditors (Percent of Total)

	1978	1982	1985
Debt			
All LDCs	34.7	34.9	41.7
Major Latin debtors	67.0	75.6	72.8
New Borrowing			
All LDCs	71.2	51.5	37.6
Major Latin debtors	92.1	66.5	−13.3

Source: IMF and Morgan Guaranty