DEVELOPING COUNTRY DEBT

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THE ORIGINS OF THE DEBT "OVERHANG"

The great international borrowing campaign by the developing countries during the 1970s and early 1980s came about by the twin horsemen of the huge OPEC current account surpluses of 1974-81 and the pronounced weakness of the U.S. dollar during the second half of the 1970s. The former contributed mightily to the liquidity of the international capital market which, owing to exchange rate instability following the breakdown of the Bretton Woods system in the early 1970s, was funneled into short-term commercial bank deposits rather than long-term bonds. Without the OPEC surpluses, the amount of funds available for "recycling" to the developing countries would have been far smaller, and the terms much less attractive. Moreover, the oil price rise not only increased the "credit worthiness" of petroleum-producing countries but also created a new demand for funds to finance purchases by the petroleum-importing countries. Brazil, for example, borrowed some $7 billion during the very first year of the OPEC surplus (1974)—thereby virtually doubling her external debt in a single stroke—and continued for nearly a decade to justify her massive external borrowing on the basis of "oil shocks", as if they were unique to Brazil.

The weakness of the U.S. dollar contributed in a different manner.¹

¹One might quite plausibly argue that the behavior of the U.S. dollar during the 1970s, particularly from 1975 to 1979, itself contributed to the great success of OPEC during that period—and to its demise during the 1980-85 dollar recovery.
As the dollar became cheaper in virtually all currencies, dollar prices of internationally-traded goods soared, thereby diminishing the expected real magnitude of future debt service that was rapidly being contracted—mainly in U.S. dollars—by the borrowing countries. Indeed, while the nominal external debt contracted by the developing countries was exploding at an unsustainable average annual rate of 20 per cent during 1975-80, the real value of that debt (measured in constant U.S. dollar prices for imports and exports of the developing countries) was growing at only 7 per cent per annum.

Moreover, lenders also let themselves be deluded by the falling U.S. dollar, a fall that magnified the dollar value of the gross domestic products (GDP) and exports of the debtor countries, thereby masking the declining "credit worthiness" of even the most indulgent borrowers. By depressing the level of external debt in relation to the dollar value of GDP or exports of the borrowing countries, that magnification created a (false) sense of security for the lenders.

2 The increase in dollar prices of internationally traded goods—commodities in particular—was much greater than the U.S. internal inflation. During the second half of the 1970s the U.S. dollar commodity price index compiled by the International Monetary Fund, and published monthly in the IMF's International Financial Statistics (IFS), rose by 35 per cent relative to the U.S. consumer price index.

3 As the external debt was denominated mainly in U.S. dollars, and as countries service their external debt by producing more or consuming fewer internationally-traded goods, it is the dollar price of those goods that is relevant for converting the nominal debt into real terms.

4 This idea can be expressed more formally as follows. Let:
   \[ D = \text{nominal external debt in dollars}, \]
   \[ Y = \text{nominal gross domestic product (GDP) in domestic currency}, \]
   \[ E = \text{price of dollars in domestic currency (the exchange rate)}, \]
   \[ P = \text{the domestic price level}, \]
   \[ y = \frac{Y}{P} = \text{real GDP}, \]
There are several features of the post-1973 foreign indebtedness that magnified the intensity of the international debt storm that broke in 1982. In the first place, most of the borrowing took place in the international "capital market", rather than from institutional lenders such as the World Bank and the International Monetary Fund. This meant that (a) the interest charges were market rather than concessionary rates, and (b) the loans were of much shorter maturity than those offered by, say, the World Bank. Consequently, the ratio of debt service to debt on "capital market" loans has been roughly double that on institutional debt, causing annual debt service to rise even more dramatically than did the external debt itself. This posed no difficulty, of course, as long as the lenders played along with what was, in retrospect, a Ponzi game of unprecedented proportions: "roll over" hundreds of billions of dollars worth of maturing loans and extend new ones in amounts at least sufficient to cover the interest on existing debt.

Secondly, interest rates on a large part of the new debt were not fixed, but "floated" with the London InterBank Offer Rate (LIBOR) or the U.S. "prime" rate. When inflation the U.S. inflation rose to the 12 to 14 per cent range and the U.S. prime rate to 20 per cent in the 1979-81

\[ P_{US} = \text{the U.S. price level, and} \]
\[ e = E \cdot P_{US}/P = \text{the "so-called" real exchange rate.} \]

Taking \( d \) to be the ratio of external debt to GDP, both measured in dollars, we have:
\[ d = D \cdot E/Y = (D \cdot e)/(P_{US} \cdot y). \]

Thus even though \( D \) was growing rapidly (e.g., 20 per cent year) during the second half of the 1970s, that growth was largely offset by (i) the decline in the real exchange rate \( e \) associated with the falling U.S. dollar, (ii) the rise in \( P_{US} \) owing to the U.S. inflation, and (iii) the rapid growth in real output \( y \) in most of the borrowing countries, with the result that the increases in the ratio of dollar external debt to dollar GDP was deceptively small.
period, the shocking increase in debt service arising from the floating interest rates became onerous indeed.

Finally, the bulk of the post-1973 external indebtedness of the developing countries consisted of loans that were either contracted or guaranteed by the governments of the borrowing countries; to a great extent these loans were destined to finance ordinary domestic-currency fiscal deficits, rather than imports or investment projects. The implications were enormous: as with all sovereign debt, debt service is a political decision, and one which has become an international political issue.

**WHAT PRECIPITATED THE DEBT CRISIS?**

The international debt crisis came about when the conditions described above sharply reversed in the early 1980s. First, the U.S. dollar made a remarkable recovery, experiencing a real appreciation that, by 1985, made it as strong as it had been in 1975. This appreciation, together with the world recession of 1981-82, provoked a great decline in the dollar prices of internationally traded goods, with commodities once again leading the way. The result was a dramatic rise in real rates of interest on external debt (from around zero to 20 per cent or more), and equally dramatic increases in the ratios of external debt to GDP (or exports) as the dollar value of the latter literally collapsed and, with it, the bankers' confidence in their portfolio of developing-country paper. Moreover, a

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5 From 1980 to 1985, the IFS commodity price referred to earlier fell 25 per cent in nominal terms, and 44 per cent with respect to the U.S. consumer price index. Roughly speaking, the developing countries had borrowed cheap dollars, but had to service their debt with dear ones.

6 Argentina provides a dramatic if extreme example. Partly because her real output fell about 15 per cent from 1980 to 1982, partly because her peso was quite overvalued against foreign currencies in general in 1980 (perhaps by as much as 30 per cent), but mainly because of the recovery of the U.S. dollar, the Argentine GDP measured in dollars fell from $157 billion in 1980 to $58 billion in 1982.
combination of the rising dollar, falling demand, and growing crude petroleum production by non-OPEC members erased roughly $200 billion of OPEC revenue and decimated the OPEC surplus that had fueled the borrowing spree in the first place; worse yet, as several of the major OECD countries shifted from rough fiscal balance to massive fiscal deficits, the international capital market became flooded with treasury paper of quality rather higher than that offered by the developing countries. The world economy had suddenly shifted from the "best" to the "worst" case for the borrowing countries. Deprived of the massive annual infusions of "fresh money" with which to service her external debt, Mexico went into de facto default in August 1982, and the international debt crisis burst upon us. The rot was great indeed: by the end of that year, most of the developing countries were in technical default.

This is not to say that lending to the developing countries ceased or that they were required to repay their existing loans; to the contrary, since 1982 the external debt of the developing countries has continued to grow, but at a rate of only about 7 per cent per annum. The rub came because the decline in the rate of growth of external debt did not provide those countries with sufficient new loans to cover the interest due on the old ones. The direction of the "net resource transfer" had been reversed, and most of the developing countries have had great difficulty in adjusting to that change.

CAPITAL FLIGHT: ALL THAT BAD?

One of the ironies of the current international debt issue is the fact that many of the major debtor countries are also major creditors; that is,

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7 The increase is fiscal deficits in the OECD countries was roughly $300 billion.
much of their external indebtedness is balanced by external assets acquired earlier during the borrowing campaign via a process commonly referred to as "capital flight". Indeed, some of the major borrowers are actually net creditors. It is commonly argued that capital flight has severely aggravated the debt crisis by worsening the domestic economic situation in the countries where it has occurred. These arguments appear to assume that capital flight reduces, dollar for dollar, the domestic capital stock of in country, and/or that repatriation of the flight capital would facilitate service of the external debt. To address these issues, we shall examine the circumstances under which capital flight occurs.

Although capital flight is a nebulous concept and is inherently difficult to measure, it is clear that a sustained capital outflow must be financed by a corresponding inflow of foreign exchange.\(^8\) The typical motivations for capital flight (i.e., tax avoidance or evasion, fear of a devaluation) are unlikely to be consistent with that capital flight being privately financed (e.g., foreign borrowing by the private sector); rather, significant capital flight is unlikely to occur unless it is financed by external borrowing on the part of the public sector. The Latin American experience, where there appears to have been considerable capital flight during the second half of the 1970s and early 1980s, broadly supports this assertion: in each and every country experiencing significant capital flight, there was a simultaneous accumulation of even larger amounts of

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\(^8\)The term "capital flight" as commonly used generally refers to any foreign investment by residents of a developing country, quite apart from the fact that there may be quite legitimate reasons for those investments (e.g., portfolio diversification on the part of firms in the import-competing and export-oriented sectors). Nonetheless, the measures of capital flight that are commonly used attempt to capture all foreign investments being made by residents of the countries in question. Certainly those measures, if applied to the developed countries, would turn up evidence of massive capital flight.
public-sector external debt. While foreign borrowing obviously is not sufficient to generate capital flight (several Latin American countries with large accumulations of foreign debt did not experience capital flight), public-sector foreign borrowing will certainly facilitate the realization of any predisposition toward capital flight. Thus it seems to be no coincidence that foreign indebtedness and capital flight have occurred hand in hand; indeed, it is not extreme to argue that capital flight was a direct consequence of the public policy decisions in the developing countries.

Let us turn first to the fiscal implications of capital flight. While the amount of tax avoidance and evasion effected by capital flight varies from country to country, in most cases it is minor relative to total tax collections. Even in the most extreme cases, estimates of accumulated capital flight do not exceed 75 per cent of GDP; assuming that those investments earn a rate of return of 8 per cent, the income flow from those foreign assets amounts to only 6 per cent of GDP. As tax collections in the typical developing country amount to less than 20 per cent of GDP, it seems unlikely that the revenue loss can exceed 5 per cent of actual tax collections (or 1 per cent of GDP) even in the extreme case. One may adjust this estimate upwards if he believes that the effective tax rate on the income in question would be higher than average, but clearly the fiscal loss from this source has not been the main cause of the enormous fiscal deficits that have been observed recently in a number of heavily-indebted developing countries.

A more relevant question concerns the fiscal implications of public-sector external borrowing cum capital flight. Again assume that flight capital amounts to 75 per cent of GDP, that the public-sector external debt is also 75 per cent of GDP, and that the average interest
rate on that external debt is 9 per cent. As the interest alone poses a fiscal cost of nearly 7 per cent of GDP, tax evasion arising from capital flight is merely the tip of this fiscal iceberg.

A second reason for concern about capital flight, particularly in the developing countries, is the adverse effect it may have on the domestic capital accumulation. While it is sometimes asserted that capital flight directly reduces a country's capital stock, there are three reasons why this is unlikely to be true. In the first place, capital flight will not reduce private-sector investment unless the same factors that motivate capital flight also reduce the attractiveness of domestic investment.\(^9\)

Secondly, the amount of capital owned by residents of the country in question is not diminished by capital flight, some of it is merely relocated. Thirdly, as the level of saving is not invariant with respect to investment alternatives, the capital flight option may actually increase the amount of capital owned by the residents of that country. As consumption is an ever-present alternative to foreign investment, depriving domestic residents of foreign investment opportunities will cause at least part of the aborted flight capital to be consumed rather than saved.

Whatever may the final verdict on the faults (or merits) of capital flight, the fact of the matter is that it persists but in a slightly different form: reinvestment of the earnings from the flight capital. Indeed, much of the "sacrifice" attributed to exigencies of external debt service is made instead to finance foreign investment, as an example will make clear. Consider a hypothetical country whose annual interest charges

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\(^9\) One of the those reasons is, of course, tax evasion. If the income from capital is taxed in the developing country, then access to (untaxed) foreign income streams will ultimately require the before-tax rate of return at home to rise so that the after-tax rates of return are the same, and that increase will reduce domestic investment. The appropriate solution, of course, is tax reform.
on foreign debt of $5.0 billion are being meet by $3.0 billion in new loans and a $2.0 trade surplus. The balance of payments data will show a surplus in the capital and trade accounts of $3.0 billion and $2.0 billion, respectively, and a deficit in the service account of $5.0 billion.

Now suppose that this country has (privately-owned) foreign assets that earn $3.0 billion a year. If those earnings are not repatriated, the balance of payments accounts will be exactly as described above. But were those earnings to be repatriated even momentarily before being reinvested abroad, the accounts would change radically. The capital account surplus would decline to zero, the service account surplus would decline from $5.0 to $2.0 billion, and the trade surplus obviously would be unchanged. Note, however that nothing has changed, except that it is now clear that 60 per cent of the trade surplus is financing new foreign investment (capital flight?), and only 40 per cent is going for debt service. Indeed, this is precisely the current situation of more than one heavily indebted developing country.

HAS THE DEBT ISSUE BEEN RESOLVED?

To answer this question it is instructive to observe the striking asymmetry between the record of the developing countries in servicing their bond debt and their bank loans. While there have been neither arrears nor default on bond indebtedness, the international commercial banks have had to repeatedly reschedule their loans to the developing countries; indeed, only one Latin American country—Colombia—has failed to reschedule those obligations on at least one occasion since 1982. Nonetheless, there have been open suspensions of debt service, and arrears are enormous—but there
have been no declarations of default. Clearly the risk of being declared in default by a commercial bank is nil, the reason being the inherent vulnerability of those institutions.

Because bond issues of any given country are usually widely held by individuals as well as capital market institutions, it is highly probable that failure to service those bonds will induce at least one bond holder to declare default. To be sure, an individual or non-bank institutional investor declaring default of sovereign debt certainly stands to lose his investment in its entirety, but no more. Moreover, a default declaration will have immediate and dire consequences that debtor countries deplore; indeed, the laws of some creditor countries require the debtor to be declared in default on its entire outstanding debt even though it is in arrears on but a portion of it. Because of these costs, debtor countries have consistently taken great care to avoid a de jure default on their external bond issues.

A commercial bank declaring default, however, stands to lose not only its investment but faces further adverse consequences: (a) it must either increase its capital to absorb the write off or contract its deposits accordingly, and (b) regulations and/or convention may well require that bank to "punish" the defaulting country by refraining from doing business with it for a significant period of time. This loss of future business is an important consideration from the point of view of the commercial banks; indeed, those banks may well have profited handsomely from their loans to the developing countries over the past fifteen years even if they must

10 Although Brazil has had long "pauses" in her debt service, and Argentina has made no debt service payments since April 1988, neither country has been declared in default. Moreover, commercial bank debt paper has traded in the secondary market for less than five cents on the dollar without the slightest threat of the debtor country (Bolivia, in this case) being declared in default.
ultimately write off substantial portions of them.

Consequently, commercial banks are prepared to negotiate as they have a higher interest in avoiding the consequences of default; indeed, since 1982 many of those banks have increased their exposure in certain countries quite substantially to prevent existing loans from becoming "nonperforming", even though it is highly doubtful that the "new" money will ever earn any interest. In short, the commercial banks prefer to "throw good money after bad" rather than face the consequences of nonperformance.¹¹

The practice of "throwing good money after bad" is tantamount to a write down of existing debt service, which in turn is a de facto write down of the external debt of the developing countries. In that sense, the international debt crisis has been largely resolved; what remains is the delicate task of transforming these de facto write downs into formal agreements between debtors and creditors.¹² As that process involves a "game" between the two parties, a game in which the creditors attempt to minimize the write downs while the debtors try to maximize them, we can anticipate a long process characterized by threats, periodic "crises" (of

¹¹This de facto capitalization of interest is reflected in the abnormally low price-earnings ratios of the more heavily exposed U.S. commercial banks. By extending new loans, the commercial banks induce the debtor countries to remit the full amount of interest due. Asset markets, recognizing that the new loans are unlikely to be serviced in the future, conclude that the true interest earnings are but a fraction of the income being posted on the books by the banks, and value the shares accordingly.

¹²Debt conversions and debt-equity swaps will obviously play a role in the resolution of the debt problem, but the evidence to date from Mexico and Brazil suggests that the scope for such activities will be very limited unless accompanied by a substantial de facto write off of existing commercial bank debt. While there has been significant repurchase of Bolivian and Chilean external commercial bank debt, those repurchases have taken place with considerable discounts of Chile debt and enormous discounts in the Bolivian case. Moreover, as most of the Chilean external debt is privately owed, her case is somewhat atypical.
minor proportions!), and a great deal of theatrics all around. Both sides have an incentive to portray these crises as a threat to the international financial system—but only for their collective gain. Left undisturbed, however, the nature of the outcome is cannot be in doubt: the creditors will, in the final analysis, formally acknowledge the *de facto* write-downs—as they have recently done in the case of Mexico.¹³

The only development that is likely to prevent the foregoing scenario is a well-intentioned but gratuitous intrusion into the negotiation process by developed-country governments (or certain multilateral institutions) that signal the creditors the possibility of recuperating their losses—which they have every incentive to do. It is of upmost importance, then, that neither governments nor the multilateral institutions mistake the periodic but quite artificial debt "crises" staged by debtors and creditors alike for the real thing. While negotiations clearly can resolve the debt issue, those negotiations can succeed only if they are conducted in an atmosphere devoid of moral hazard.

¹³Commercial banks cannot postpone the "hit" by delaying the formal write down; indeed, their share prices indicate that they have already taken that hit. Additional losses will be suffered only if asset markets have underestimated the unwillingness of the debtor countries to pay.