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ORIGIN OF EXTERNAL DEBT PROBLEMS

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KEYWORDS :

Introduction:

The world financial system is under serious stress due to the rapid increase of external debt for several decades starting from the early 1970s. The period between 1973 and 1983, is marked by the increase in foreign finance from the developed world and international financial institutions to developing countries, resulting in a steep increase in the gross and net debt of the developing countries. During this period, the outstanding debt of the developing countries increased tremendously. By 1988, the external debt of the poor countries shot up to 50%. Debt indicators like debt to GDP ratio and debt to export ratio increased tremendously and thus reducing the repayment capacity of the poor countries.

Debt problems erupted in 1982, when Mexico suddenly announced its inability to service its debts. This had a cascading effect as many of the Latin American countries also shared its inability to service debts and required to reschedule their debt service. With several developing countries announcing their inability to keep with the scheduled repayments, in India, economists and ordinary people alike expressed serious doubts regarding the country's ability to service its debts. They argued that India, with its low GDP, per capita income, and widespread poverty levels, could easily fall victim to debt problems.

In situations where external debt is growing and the need for even more assistance for development activities, the fear of India falling into a debt trap was expressed by experts.

History of External Debt Problems:

The less developed countries' debt problem is now several decades old. Lending to less developed countries by multilateral institutions and the growing private banks lending to less developed countries started about 50 years ago, that is much before the Mexican fiasco in 1982. The history of external debt problem can be explained in 9 stages.

First stage (1969-73)

The first stage of the debt problems may have started in 1969, just before the first oil crisis. Around this time the European Banks, that had reaped the benefits of the large scale development of their economies, had filled their coffers with large reserves of cash. These banks were in search of new lending opportunities. Lending to less developed countries at that point of time looked very attractive and less risky, as the commercial bank debts of the LDC's were negligible then.

The banks that lent huge amounts of money to LDC's got a rude shock in 1973, when the OPEC increased oil prices. As most of the LDC's were oil importers, their import bills multiplied and their creditworthiness was severely damaged.

Second Stage (1974-1975):

1974 to 1975 witnessed a recession in European markets and their stock markets were at a low point. A collapse of a major bank in Germany sent shockwaves across the global financial market. In 1974, there was another bank crash and this happened in the United States of America: The 20th largest of the American banks, the Franklin National Bank, collapsed. In Britain, the rise of interest rates and simultaneous fall in the asset values caused a set back for the property companies and many of them collapsed. The bank of England had to intervene and save these companies.

These events gave a severe jolt to the confidence of international banking systems. Outside Europe and North America, Japanese banks were also under severe stress as they had to cough up higher rates of interest for funds.

Third stage (1975-1979):

This period was a mixed bag as there was a minor recession at the beginning and an upswing later. Developed countries adopted several measures to get their economies out of trouble. Further there was an increase in the price of their manufactured goods, which led to an increase in their export earnings. As a result their oil deficits diminished. This period ushered in a new found confidence in the European Markets.

Fourth Stage (1979-1981):

The fourth stage began with the second oil crisis in June 1979. This oil crisis had more severe effects in the developing countries, resulting in stress over debt repayment. Once bitten, the international lenders now took a very cautious approach. The volume of credit fell very sharply. Coupled with the oil shock and announcement of a new monetary policy, there was an abnormal increase in the interest rates. This also affected international lending. The new commitment of loans to LDC's was largely short term in nature. The high interest, short term loans sowed the seeds for the debt crisis.

Fifth Stage (1981-1982):

The fifth stage started in 1981. In this stage, syndicated lending from Europe increased though there was a risk, lending increased as there was intense competition for lending among bank. One varied feature during this stage was that short term loans were in greater demand than long term loans. By 1982, signs of danger began to show up. There was increased lending to the less developed countries' banks. The governments of these countries used the banks as fundraisers. The LDC banks used their borrowings to lend to their governments. The debt crisis in Latin America was much more visible. A war broke out between Argentina and Great Britain on the issue of the Falkland Islands. The crisis in Argentina, elicited banks to rethink the risks involved in lending to countries in this area. Many countries in the Latin American region experienced liquidity problems. The debt scenario at the time looked very bad, and it resulted in the downgrading of creditworthiness of countries in the region. The highlight of this period was the inability of Mexico to keep its debt service commitments. Mexico sought a debt service deferment. Brazil followed Mexico by seeking a moratorium. This was the starting point of the debt crisis.

Sixth stage (1982-1985):

At the end of the 5th stage, the debt crisis took shape and the bankers' reaction was to stop loans to LDC's. The banks now started lending only to those countries which the IMF considered less risky. Banks stopped their own assessment of the LDC's creditworthiness. However, lending in tandem with IMF proved difficult for banks as there were differences between the objective of the IMF and the Banks. While the objective of the IMF was to help countries tide over their development issues, the objective of the banks was to maximize their profits. Further, there was a difference in terms of the level of exposure, regulations by the governments and in taxes.

Seventh Stage (1985-1987):

This stage is best known for The Baker Plan. James Baker, the then United States Secretary of the Treasury, announced his plan in the IMF- World Bank meeting held in Seoul, in October 1985. The plan urged private banks to expand their lending to LDC's. The plan also urged the multilateral lending institutions to increase their financial assistance to LDC's. The LDC's on the other hand were asked to frame their policies in such a way that supply increases, and they were also asked to give more importance to private investments. The Baker Plan assessed that economic growth of less developed countries is the only solution to the debt crisis. It also advocated correcting imbalances, promoting reforms, and adopting the policy of austerity to tide over debt problems. It further asked the LDC's to cut down their imports, boost their exports and effecting structural changes.

Due to all these reforms, many countries were better off than they were in 1982. Though this was the case with some countries, many others who faced huge debt burdens were in dire straits even after rescheduling of their repayments, many of them had to use up a major part of their export earnings to pay interest to their lenders.

Eighth Stage (1987 -1989):

In this period, there was a visible change in the approach of the banks. Banks started providing more funds to the LDC's. However, the increased supply wasn't adequate for the debtors to come out of their difficulties. There was an attempt by Japan to increase the flow. Suggestions made by the Japanese finance minister did not find many takers in the IMF- World Bank meetings.

Stage Nine (1989):

The highlight of the 9^{th} stage was the announcement of the Brady Plan. The Brady Plan aimed at reducing the debt burden of the LDC's by $1/5^{th}$ within a period of 3 years. With the plan, Brady's target was to bring down the LDC's debt to a level that is manageable. To bring the debt to a manageable level, the interest- export ratio has to come down to about 20%.

Conclusion:

The Debt problem faced by many countries is the result of failed economic policies. It was no more than an indicator of economic uneasiness. It had grown into a malady which needed an immediate cure. Recent years witnessed many corrections in the economic policies of debt-ridden countries. From a near disaster situation in 1982, the world banking and financial systems have reached a stage of comfort. Banks are no longer worried about global debt problems. However, complacency in the Financial discipline can ring alarm bells in the future for LDC's. Therefore it is necessary, that banks tread cautiously while expanding their credit.

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