Journal of International Affairs, Vol. 3, No. 2, January-June, 1997 51

International Debt Crisis and the Developing Countries

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I. Introduction

International lending and borrowing are the natural features of capitalist economic activities which has played an important role in the development of most major industrialized countries, and continues to play a significant role in the process of development of the developing countries. In addition to aid from developed countries, foreign borrowing is needed as a supplement to domestic savings to bridge the chronic savings-investment gap of the developing countries. However, if the lenders and/or the borrowers do not know how to properly manage them they may become a burden instead of a catalyst to development— and exactly this was the case in the late 1970s and early 1980s. Since then the international debt crisis has become an important issue in the entire world. A number of solutions were proposed and a number of policies were implemented by both the lenders and the borrowing countries to reduce this crisis. However, with few exceptions, the crisis has aggravated over time. Since early 1970s, external debt accumulation was very rapid for many developing countries, particularly those in Latin America, and especially for Mexico, Brazil, and Argentina. South Korea and India also became a major external debtor as well with rapid growth of external debt accumulation. Since 1985, external debt rose again quite rapidly for many countries, especially in Africa and for Mexico where total accumulated external debt stood at $166 billion in 1995, an increase by 41 per cent since 1993. Only in South Korea and Chile the debt burden has reduced very insignificantly.[1] Tables 1A & 1B report the external debt burdens of some selected countries from the categories of low-income and middle-income countries. From these tables we see that accumulated debt has increased for all categories of developing countries during the period 1990-95.

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The author is grateful to S.M. Ikhtiar Alam, Associate Professor, Economics & Business, Independent University, Bangladesh for his valuable comments on an earlier draft and for his valuable guidance and encouragement in writing this paper.

The onset of the international debt crisis is usually dated as beginning when Mexico announced its decision to suspend payment on its scheduled external debt payment in August 1982. By mid-1982, the private international banks had begun to reduce their petro-dollar recycling to sovereign borrowers dramatically as a consequence of the slowdown in the growth rate of international economy.

II. The background and nature of international debt crisis

The causes of the international debt crisis may be attributed mainly to a number of changes which took place in the international arena at the end of the 1970s. The first reason is believed to be linked with the first oil crisis in 1973, when OPEC substantially increased the oil price. This decision of OPEC to raise the price of oil directly affected the current account balances of many less developed nations lacking adequate domestic oil reserves. "The price per barrel of Saudi Arabian light crude oil, which provides a bench mark for other prices, rose from $2.59 on 1 January 1973 to $5.18 on 1 November 1973 and then to $11.65 on 1 January 1974. From 1973 to 1980, the export price of oil rose by about 500 per cent, after another spike in price in 1979-80."[2] As a result of this massive increase in oil prices by OPEC caused a counterpart balance of payment deficits for the oil exporting countries across the world. The factors which caused the supply of loanable funds to increase created its own demand in these deficit countries. Private banks were desperate to lend out the surplus capital of the OPEC countries to meet the unlimited demand by the deficit countries. The demand for foreign private bank borrowing by the less developed countries was particularly very high due to the fact that overall commodity prices in the international market were quite high, exports were buoyant and inflation had reduced the real rate of interest on loans to almost zero. International credit looked cheap and sovereign borrowers looked good risks from the lenders point of view. By mid-1970s, US banks developed a network of international banking facilities throughout the free world. Approximately one hundred and fifty banks in the United States had an international banking department. Branch offices of these banks were widely distributed throughout the world, and about forty five percent of overseas branches were located in Latin America and in the Caribbean. Many of these branches were established solely to avoid the many regulations applicable to deposits and taxation. At the end of 1975, there were three hundred and sixteen

banks with one thousand, nine hundred and four branches abroad that held assets in excess of four hundred billion US dollars— approximates fifteen percent of all commercial banks assets.[3] "But these circumstances suddenly changed. Depression in the developed countries, mainly self-inflicted to reduce the rate of inflation, caused world commodity prices to tumble, exports to languish, and real interest rates to rise. On top of these nominal interest rates floated upwards and the [US] dollar appreciated."[4] As a consequence, current account deficits of many borrowing countries increased significantly and their ability to service external debt reduced to an alarming level, which in turn further increased the need for external debts of these countries. This situation is still unchanged. If most of these countries were to default "on their interest of principal payments, the stability of the international financial system would be under threat. A default would be likely to produce failures in individual banks, the theoretical bankruptcy of the country concerned, and a general loss in confidence in the international banking system. Growth in the developing world could virtually come to a standstill, and the volume of international trade investment would be likely to fall."[5]

III. The role of various players in international debt crisis

The present situation of the debt crisis is not significantly different from what was mentioned in the above quotation. It is thus pertinent to analyze the roles played by the banks, the borrowing countries, and various international institutions, particularly the IMF and the World Bank.

The massive growth of bank lending to developing countries during the 1970s has been criticized on two main grounds:

1. The international banks failed to (or did not want to?) fully understand the complexity of commercial and country risk assessments when making the loans for three important reasons. First, these international banks have failed to properly predict the political upheavals of the borrowing countries. Second, most of these lending banks provided loans to different developing countries without proper and systematic risk assessment because of low domestic demand for capital. Third, these loans were and still are, in most cases, based on variable interest rates, which are generally very high. But the effects of