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A third edition will be published in 2017, with a substantially updated chapter. This is the revised and corrected 2010 manuscript.

DEBT AND DEVELOPMENT

JOSEPH HANLON

LEARNING OBJECTIVES

- To learn that lending has a long history and that even lending to developing countries goes back 700 years.
- To understand the roots of the debt crises of the 1980s and 2000s, and the similarities between the most recent financial crisis in the North and earlier debt crises in the Global South.
- To see how lending to developing countries is linked to economic cycles and capital surpluses, to ‘loan pushing’ and default, and to the political interests of lenders.
- To recognize the role of the South as lender to the North and as a contributor to initially moderating a Northern financial crisis.
- To understand the concepts of illegitimate and odious debt and changes in lending which increase the liability of lenders.

Borrowing and lending is often sensible and necessary. Borrowing to cover unexpected expenses or loss of income, such as through sickness or a bad crop, has been common for millennia. Capitalism is based on borrowing for productive investment—a piece of machinery or an irrigation system or simply more stock that will produce increased income to more than repay the initial loan. Most large companies and many countries grow with borrowed money. Many people live in mortgaged houses—rather than save over many years to build a house, they borrow money and repay it over many years, and during that period the borrower can live in a better house.

Banking originated in Babylonia before 2000 BCE, when temples and palaces provided safe places for the storage of valuables—initially deposits of grain and later other goods, including cattle, agricultural implements, and precious metals. By the reign of Hammurabi in Babylon (c. 1792–50

BCE), lending had become common, and his famous code—the first public written code of laws—covers banking and debt.

Initially, people would borrow from relatives, temples, or merchants who might provide goods on credit. Credit-based banking had developed in the Mediterranean world by the fourth century BCE. The Roman Empire developed banking that took deposits and lent money at interest, but this ended with the decline of Rome. Modern banking began to develop in the Mediterranean in the twelfth to fourteenth centuries CE. As banking systems developed, individuals, kings, companies, and even countries borrowed.

But from the first, three issues have dominated. First, what happens when the borrower cannot repay? Can the lender take property from the borrower? Can the lender force the borrower to work for him or her? Can the loan become a liability of spouses or children? The Hammurabi code contains two important restrictions. Article 48 says that if a person owes on a loan and the crop fails because of lack of water or a storm, not only does the person not have to make debt payments in that year, but no interest is paid for that year as well. Article 119 says that a man in debt can give himself or his wife, son, or daughter in forced labour to the creditor but only for three years, after which the debt is considered paid and the person freed.

Second, what can the lender charge the borrower? **Interest** payments are most common, usually a percentage of the outstanding loan each year. The borrower pays back part of the money borrowed—the **principal**—plus interest. The basis of modern commercial banking is to take deposits and pay interest on those deposits and then lend out the money at a higher interest rate, with the difference between the two interest rates covering risk of losses for non-repayment and allowing some profit for the bank. This remains controversial, and **usury**—excessive interest rates—has been an issue down through the ages; most religions allow interest but ban usury. But the Greek philosopher Plato (427–347 BCE) opposed lending at interest. The Koran also opposes lending at interest but permits trading profits and profit from investment, which means that banks should invest in businesses, sharing risk and profit, rather than lending to them. The early Christian church also banned lending at interest, but this was later eased to a ban on usury.

The third issue has become more important only with the growth of capitalism: what happens if an individual, company, or country borrows money for an investment that proves not to be profitable and the loan cannot be repaid? Until the mid-nineteenth century in both the United States and Britain, debtors who failed to repay were thrown into prison. This regime was replaced by liberal bankruptcy laws that allowed most of the assets of the debtor to be distributed to creditors, thus

ending the debt, even if the assets were insufficient to cover full repayment. This proved to be one of the most important provisions of modern capitalism, because it encouraged business people to take risks without the fear of being thrown in debtors' prison. Over the twentieth century, bankruptcy laws became even more liberal, allowing individuals to keep their homes and giving more rights to workers in a company facing bankruptcy—even finding ways to keep a company operating rather than liquidating it to sell its assets. Thus, lenders have come to take an increasing share of the risks of modern capitalism.

LENDING TO DEVELOPING COUNTRIES

Private banks in developed countries have been lending to poorer developing-country governments and businesses for centuries, and the record has often been one of default and political intervention.

‘After King Edward I expelled the Jews in 1290 he needed the Italians to finance his wars. . . . To these Italian bankers England was a wild developing country on the edge of the world, a kind of medieval Zaire. Its exports of wool offered prospects of big profits; but with its despotic monarchs, its tribal wars and corrupt courtiers, it had a high country risk,’ wrote Anthony Sampson (1981, 29–31, 54–6) in his prescient book *The Money Lenders*. ‘But after King Edward III came to the throne in 1327 he was confident that he could compel his own English merchants to finance his wars; he defaulted on his Italian debts, and the [Florentine] banks of Bardi and Peruzzi collapsed.’

A century later, King Edward IV's War of the Roses took him deeper into debt. ‘After trying to reschedule their debts with the King, the Medici Bank had to write off 52,000 florins and close their London office. “Rather than refuse deposits,” concludes the historian of the bank’, the Medicis succumbed to the temptation of seeking an outlet for surplus cash in making dangerous loans to princes. ‘It was a warning relevant to more modern bankers,’ commented Sampson.

Four centuries later, London was lending to the new United States. ‘London saw it as a very unreliable developing country, with a black record of embezzlement, fraudulent prospectuses and default,’ noted Sampson. But the bankers made loans in any case. In 1842, 11 states, including Maryland, Pennsylvania, Mississippi, and Louisiana, defaulted. Setting a precedent that would be used often in later years, Barings Bank simply intervened in local politics. In Maryland, Barings helped to finance candidates in the next election who were willing to repay. ‘In the elections in 1846 the “resumptionists” narrowly won, and soon afterwards Maryland raised new taxes which enabled it to repay its debts. The campaign had cost Barings about \$15,000; it was worth it,’ wrote Sampson. Mississippi held out. By 1929, the unpaid debt was estimated at \$32 million, and as

recently as 1980, London banks were still trying to get Mississippi to repay on the loans it defaulted on 138 years earlier.

Sometimes there was military action in response. After Mexico defaulted in 1861, Britain, France, and Spain invaded. France installed Ferdinand Maximilian as emperor; he lasted only four years and failed to repay the debts (Eichengreen and Lindert 1989).

But why do banks lend to foreign governments when it is too easy for them to default? In part, they do so because many of these loans are profitable for both parties and are repaid. In his book *Manias, Panics and Crashes*, the eminent economist Charles Kindleberger (1978; 1996) details his view of economic cycles and international lending. He argues that each cycle starts with a period of real growth involving a rise in profits, often coming from the use of new technologies or new transportation/communication systems such as railways. This growth is linked to a rapid expansion of bank credit. Eventually, money growth outstrips possible productive investments while investors look for ever higher rates of profit. Increasingly, money goes into speculation, and this is often linked to fraud and swindles. This is the period of ‘bubbles’, or what Kindleberger calls ‘manias’. It usually involves international lending as banks run out of domestic borrowers and become more desperate to lend and make higher-risk foreign loans—just as the Medicis did with Edward IV in the fifteenth century. Eventually, the bubble bursts, prices fall, and investors try to sell or to collect on their loans. This is the period of ‘panic’ as investors all rush for the exit. The panic feeds on itself, leading to the ‘crash’. Kindleberger points to the tulip mania of 1634, the South Sea bubble of 1720, the cotton and railway booms of the 1830s, and so on.

The past 250 years have seen four of these cycles:

1. growth 1780–1820, mania 1820s, crisis 1830s and 1840s;
2. growth 1850s, mania 1860s, crisis 1870s and 1880s;
3. growth 1893–1913, mania 1920s, crisis 1930s;
4. growth 1948–67, mania 1967–79, crises in early 1980s and late 1990s each followed by a new mania, crisis from 2008.

The 1870s, the 1930s, and the period from 2008 saw crises triggering major global depressions.

After each cycle, there have been retrospective complaints of reckless lending and of **loan pushing**—banks and lending agencies so desperate to lend money that they encourage foreign governments to take loans they do not need and encourage borrowers to live beyond their means. Towards the end of the mania, borrowers are encouraged to take new loans simply to repay old

ones. With the panic, lending suddenly stops, borrowers cannot repay, and they default. Francis White, the US assistant secretary of state for Latin American affairs in the early 1930s, commented that ‘in the carnival days from 1922 to 1929, when money was easy, many American bankers forsook the dignified, aloof attitude traditional of bankers and became, in reality, high pressure salesmen of money, carrying on a cut-throat competition against their fellow bankers, and once they obtained the business, endeavoured to urge larger loans on the borrowing countries’ (Drake 1989, 43). During the 1920s, according to evidence before the Senate Committee on Finance, there were 29 representatives of US financial houses in Colombia alone trying to negotiate loans with the government.

In 1973, the US Federal Reserve governor Andrew Brimmer noted that ‘the main explanation’ for the sharp rise in lending to less developed countries was the ‘failure of demand for loans from borrowers in developed countries to keep pace with the expansion of credit availability’ (Darity and Horn 1988, 8). Brimmer cited a particular form of loan pushing, which involves a drastic softening of terms—similar to a drug pusher offering cheap heroin in order to create addiction. In the mid-1970s, international loans had a negative real interest rate—that is, in real terms (taking inflation into account), poor countries had to repay less than they borrowed. Loan pushers in the mania phase stressed that they were literally giving money away. But these loans were on variable interest rates, and in the early 1980s, those rates jumped dramatically, setting off the threat of default and fuelling the panic.

International development lending has two phases. In the growth period, lending can be profitable and promote productive investment and growth; indeed, careful borrowing by poorer countries has accelerated industrialization and development by allowing investment in infrastructure and equipment that could not have been afforded otherwise. But in the mania and loan pushing phase, when bankers are ‘high pressure salesmen of money’, poor countries take unproductive loans that they cannot repay.

GOVERNMENTS, POLITICS, THE COLD WAR, AND THE DEBT CRISIS

Initially, most lending was by banks, but increasingly in the late nineteenth and early twentieth centuries, loans were in the form of bonds, which could be sold to individuals and other investors (and which were often highly speculative or fraudulent). During the First World War, the United States government became a substantial lender to the countries fighting against Germany. In 1923, it extended the repayment period until 1983 and reduced the interest rate, but in 1934, in the depths of the Depression, Britain and five other European countries defaulted. No further payments were

ever made, except by Finland. The debts are still on the books, and the US Treasury reported that as of 30 June 1997, they stood at \$33.5 billion. Outstanding First World War debts to the US include: \$14.6 billion for the UK, \$11 billion for France, and \$3.2 billion for Italy. But in 2009, the British government confirmed that it had no intention of paying this debt.

The Second World War was even more expensive, and in 1945 Britain became the world's largest debtor. John Maynard Keynes was sent to Washington, and in December 1945 he negotiated the best deal he could get for Britain—a loan of \$3.75 billion at 2 per cent interest. The final repayment was made only in 2006.

The end of the Second World War brought about four major changes in global politics and economics (some of which had their roots in earlier decades):

- Decolonization began, and many countries became independent.
- The Depression of the 1930s and then the war had made clear that there was a need for new international institutions, leading to the creation of the United Nations and the two **Bretton Woods Institutions** (BWIs)—the World Bank and the International Monetary Fund (IMF). The World Bank first lent for European reconstruction and then to newly independent countries (see chapter 9).
- Major corporations began to arise, increasingly international and linked to international trade and often backed by 'export credits' (loans given to government and companies to import goods from the lending country).
- The advent of nuclear weapons changed the nature of war and of empire. Military power and brute force were no longer the means to conquest, replaced instead by three options. The first was so-called 'low-intensity warfare' in which unacceptable governments were undermined or overthrown by security services backed by limited military force. For example, the United States created or backed opposition movements in Nicaragua, Angola, and Mozambique. The second involved larger wars but limited to single countries such as Vietnam. The third, and most important for this chapter, was the growing use of non-military means—economic power in particular. Thus, loans became an important way of wielding power.

One of the first developments in postwar economic conditions was US lending to Britain in 1945 for which the United States required Britain to move quickly to free trade and to make the pound convertible to the dollar within 15 months. The outflow of money from Britain was so great that much of the loan was dissipated, and convertibility was abandoned within weeks. But this was an

early example of the kind of package of conditions that in the 1970s became known as structural adjustment.

John Perkins (2004), in a book titled *Confessions of an Economic Hit Man*, describes working for one of the largest international consulting firms and, indirectly, for the US National Security Agency from 1971 to 1981. He was one of a group of people, he wrote, whose job was to produce hugely exaggerated economic growth forecasts (in some cases, greater than any country had ever reached) for developing countries. These forecasts would justify vastly oversized electricity, railway, and other infrastructure projects that would be financed by international loans (both from commercial banks and the World Bank). Some money was siphoned off into the foreign bank accounts of the these countries' leaders to ensure they would not 'notice' that the projects were indeed white elephants. This strategy had two goals. First, contracts would go to US engineering companies (and often the money never left the US). But second, and much more sinister, was a conscious effort to burden the developing country with unpayable debts 'so they would present easy targets when we needed favors, including military bases, UN votes, or access to oil and other natural resources' (Perkins 2004, 15). It was a particularly political form of loan pushing.

The Cold War led to quite extensive lending in order to prop up and tie Western client dictators. One study (Hanlon 2006) estimated that one-quarter of developing-country debt consisted of Cold War loans to Western-backed dictators. Box 14.1 gives the example of the Congo/Zaire.

THE 1980s DEBT CRISIS

In 1970, developing-country debt was \$69 billion, which may seem like a lot of money, but it proved to be quite small in comparison to what was to come in the following years. The 1970s was one of Kindleberger's mania periods, with a surplus of capital. There was a sharp increase in loan pushing; in the mid-1970s, global interest rates were 3 per cent lower than global inflation, which meant that real interest rates were negative—countries were being told, in effect, that they could repay *less* than they borrowed. Over the decade, developing-country debt increased seven-fold to \$494 billion in 1980. Figure 14.1 shows both total debt stock and what is called 'net transfer on debt'—that is, new loans minus interest payments and principal repayments on old debts—which is thus the actual cash flow into or out of the borrowing country. The top graph shows the sharp increase in debt, while the bottom graph shows that there was a real transfer of money to developing countries in the 1970s.

But by 1984, **real interest rates** had reached a peak of 12 per cent. In 1982, Mexico could not pay the interest on its \$60-billion debt and defaulted, setting off a massive debt crisis. Throughout the remainder of the 1980s, debt was constantly renegotiated, and new loans and bonds were issued to repay old loans. Most commonly, the new bonds or loans allowed a longer time to pay and sometimes lower interest rates. Money was borrowed to pay even the unpaid interest on old loans, which meant interest was charged on the interest. By 1990, developing-country debt had reached \$1,208 billion, yet as the second graph shows, the poor countries received no benefit from these new loans—indeed, in the decade 1984-93, developing countries transferred \$81 billion to the rich countries, yet their long term debt *increased* by \$675 billion.

Initially, it was hoped that the crisis was temporary and that if debt was rescheduled or refinanced, it could be paid off eventually. The main idea in the mid-1980s was simply to lend more money to debtor countries to allow them to at least pay the interest on their debts. But it was becoming clear that the crisis was systemic. (See, for example, George 1988, Payer 1991, and Pineda-Ofreneo 1991.)

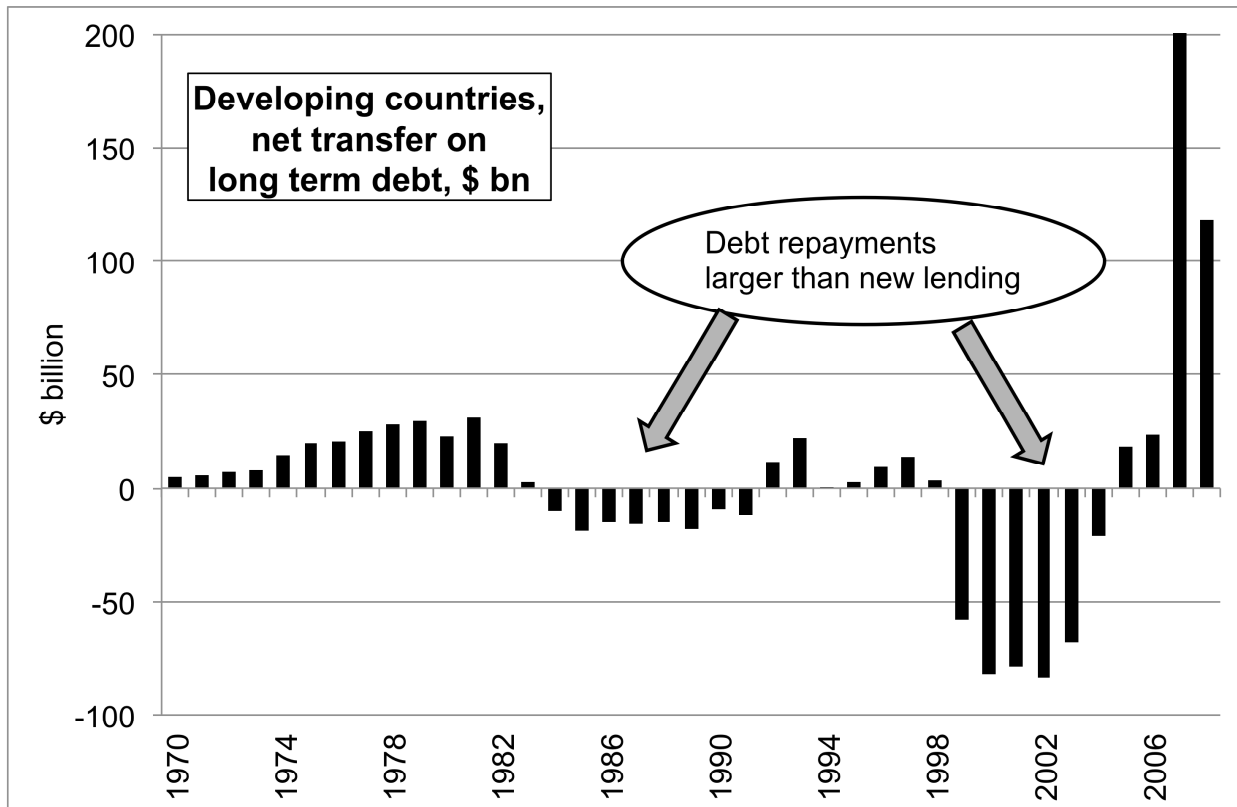
Since loans could not be repaid, some private lenders wanted to be able to sell the debts. Selling goes back to at least the fifteenth century: typically a bank or investor gives cash to the original lender, usually for less than the actual face value of the loan, and takes on the responsibility of collecting the debt. Factoring or invoice selling became a common method of industrial finance in the twentieth century. For example, a company sells goods and sends an invoice requiring a promise of payment in 90 days but then immediately sells the invoice to a finance company; the company is thus paid immediately, which reduces its need for working capital. Bonds are explicitly a form of tradable debt, because the original bondholder, who actually lent the money, can sell the bond to other investors. A market grew up in which developing-country debt was traded, and some countries bought their own debt back at a discount. Debt was used for privatizations, and there were debt-for-nature and debt-for-development swaps in which small amounts of debt were cancelled if the money was used for environment or development purposes. But as Figure 14.1 shows, that debt was still rising inexorably.

BOX 14.1 CONGO, KLEPTOCRACY, AND THE COLD WAR

General Joseph Mobutu took power in the Congo in 1965, changing the country's name to Zaire. Mobutu may have been on the West's side in the Cold War, but he was also one of the world's most corrupt dictators, and his government was widely described as a 'kleptocracy'. In 1978, the IMF appointed its own man, Irwin Blumenthal, to a key post in the central bank of Zaire. He resigned in less than a year, writing a memo in which he said that 'the corruptive system in Zaire with all its wicked manifestations is so serious that there is no (repeat no) prospect for Zaire's creditors to get their money back.' When Blumenthal wrote his report, Zaire's debt was \$4.6 billion. When Mobutu was overthrown and died in 1998, the debt was \$12.9 billion, and Mobutu had luxury estates in France and elsewhere and probably billions of dollars stashed abroad. For once, the private sector saw that they had no chance of getting their money back and stopped lending after 1981. But shortly after the Blumenthal memo, the IMF granted Zaire the largest loan it had ever given an African country. The World Bank was hardly involved in Zaire when Blumenthal wrote his memo, but during the next 15 years it lent \$2 billion to Zaire—and was still giving new money to Mobutu as late as 1993. Western governments were the biggest lenders and continued to pour in new money until 1990—even though Zaire had virtually stopped repaying its debts in 1982. As part of his loyalty to the United States, Mobutu provided a home for the US-backed Unita forces in Angola; in 1987, when he permitted US covert action against neighbouring Angola, the US pushed through yet another IMF loan to Zaire, this time over the objections of some IMF officials.

After the overthrow of Mobutu, Zaire was renamed the Democratic Republic of the Congo (DRC), and donors were anxious to help the new government. But the IMF pointed out that the DRC was in arrears because it was not repaying the debt of the old Mobutu regime. This had the effect of blocking other aid, since donors will not help a country that has no IMF program. Four countries—France, Belgium, South Africa, and Sweden—gave the DRC a bridging loan of \$522 million in 2002 to repay the money the IMF should never have lent to Mobutu in the first place. The IMF immediately gave DRC a new loan of \$543 million, of which \$522 million went directly back to the four countries to repay the bridging loan.

Figure 14.1 Developing-country debt and payments



Source: World Bank, *Global Development Finance*, July 2010.

Definitions:

“Stock” is the total amount owed.

“Short-term” debt includes all debt having an original maturity of one year or less and interest in arrears on long-term debt. Other debt is “long term”.

“Net transfer” is the amount of new lending minus interests payments and principal repayments. It is thus the total amount developing countries received from (above the 0 line) or paid to (below the 0 line) all creditors.

“Developing countries” are those with 2008 GNI (gross national income) per capita of less than \$11,906, calculated by the World Bank atlas method.

Industrialized-country finance ministers became increasingly worried in the 1980s that the debt crisis would lead to the collapse of major banks because they had to write down developing-country debt on their books and not treat them as assets. So ministers looked for ways to help the banks, and they settled on bond issues to refinance the debt, because such bonds could be sold by banks to investors. Thus, because they had a value, they could be treated as assets if they were not sold.

In 1989, US Treasury Secretary Nicholas Brady launched a scheme for middle-income creditors that came to be named after him. Countries would issue new 20-year bonds, effectively guaranteed by the US, and these bonds would be exchanged for outstanding bank debt—usually at a discount so that the total debt was reduced by 30 per cent or more. Nearly \$200 billion in such bonds were eventually issued.

Many of the bond issues, new loans, and refinancings had conditions attached, especially conditions linked to free market and neo-liberal economic policies. Another issue was that many of the loans in the 1970s had been made to private companies rather than to governments, and as part of efforts to save industrialized-country banks, developing-country governments came under huge pressure to take over these private loans—in effect, the North demanded that the South nationalize private debt.

By the mid-1990s, the World Bank and the IMF had accepted that the poorest countries could not sensibly repay their debt, and they were approving poor-country budgets in which only a small portion of debt was being repaid. In 1996, they finally launched the **Heavily Indebted Poor Countries** (HIPC) initiative, which broke new ground by accepting for the first time that some loans made by the two institutions would have to be cancelled. This was to be done in parallel with proportionate debt cancellation by government (bilateral) and private creditors.

Debt cancellation involved three groups of creditors—the **Paris Club**, which comprises most government (bilateral) lenders; the ‘London Club’ of banks and commercial creditors; and the IMF, World Bank, and other development banks. The IMF and World Bank handled the negotiations and demanded that developing countries follow strict neo-liberal structural adjustment. The process was very complex, and in the first two years there was no debt cancellation.

Meanwhile, Jubilee 2000, an international campaign launched in 1997, called for the ‘cancellation of the unpayable debt of the world’s poorest countries by the year 2000 under a fair and transparent process’. The campaign was highly successful in three ways. First, it took what had been considered an arcane and technical issue, which supposedly could only be understood by economists, and

turned it into an easy-to-understand campaigning issue. Second, it joined together local debt campaigns in numerous countries, North and South. Third, it gained unexpected support—24 million people from 166 countries signed a petition—and successfully brought pressure on Northern governments. At the 1999 meeting of the finance ministers of the Group of Eight (G-8) richest countries in Köln, Germany, it was agreed that HIPC debt cancellation would be increased from \$55 billion to \$100 billion. At that time, 41 countries were considered eligible for HIPC, and they had \$207 billion in debt. But of that, \$100 billion was not being serviced anyway—mainly with the agreement of the IMF and the World Bank, since most of those countries had Bank and IMF programs. This meant that the Bank and the IMF were admitting that the money would in effect never be paid. The \$100 billion would just go to writing off debt that the institutions knew would never be repaid—not a particularly generous move. In 2006, after 10 years of HIPC and six years after Köln, the World Bank admitted that debt cancellation under HIPC had only reached \$62 billion for 30 countries. The failure of HIPC led to increased pressure from the G-8, and in 2006, the IMF, the World Bank, and the African Development Fund (ADF) introduced the Multilateral Debt Relief Initiative (MDRI) under which they agreed to cancel more debt of countries that had already completed the HIPC process—by the end of 2009 \$106 billion had been cancelled under the two programs, thus finally reaching the level promised a decade earlier. Although most debt cancelled was not being repaid in any case, for a few very poor countries such as Mozambique, the process did substantially reduce actual debt service payments.

The World Bank estimates that between 1989 and 2008 (inclusive), \$306 billion of developing-country debt was cancelled under HIPC and other negotiations. That may seem like a lot of money until one looks more closely at Figure 14.1. The first graph shows that despite a brief drop in 2001 due to debt cancellation, total debt continues to increase. But the huge increase in debt is not bringing any benefit to developing countries. As the second graph shows, in just five years during the mid-1990s was there a transfer of money from North to South. We already noted that in the decade 1984-93, developing countries transferred \$81 billion to the rich countries, yet their total debt *increased* by \$675 billion. In the next decade (1994-2003) the poor continued to subsidize the rich, transferring \$340 bn to the rich countries – yet long term debt increased by another \$717 billion. For 20 years, the developing world gave \$58 million to the rich world every day – yet the debt burden increased by \$191 million every day. The OECD Development Assistance Committee estimates that total aid (excluding debt relief, technical assistance and humanitarian aid) in those 20 years was \$893 billion, so half of aid went right back to the North. Despite huge payments made to the rich countries, developing country debt increased by \$1.7 trillion in those two decades. Aid and debt cancellation were like using a bucket to try and empty an ever-deeper ocean.

The key point is that in the 1970s, developing countries did gain money through international borrowing, but in the years since the crisis of the 1980s, they gained nothing. Struggling to repay and sending more and more money to rich countries, they fell deeper and deeper into debt.

During the previous crisis, the great depression of the 1930s, many international borrowers simply defaulted. Europe stopped paying its First World War debt to the US in 1934; most Latin American borrowers also stopped paying. The major difference between the 1930s and the 1980s was the existence of the Bretton Woods Institutions, which enforced continued repayments (as is clear from Figure 14.1). Many poor countries became increasingly dependent on international aid from the industrialized countries, and these ‘donors’ in turn made their aid conditional on recipient countries having World Bank and IMF programs. One condition of these programs was continued debt repayment. Little concession was made for economic problems such as bad crops, and the debt bondage has lasted indefinitely. Indeed, with respect to the BWIs, developing countries have fewer rights than the citizens of Hammurabi’s Babylon did nearly 4,000 years ago.

Another highly controversial condition was that poor countries adopt neo-liberal economic policies and what were known as ‘structural adjustment programs’, which we will explore in the next section (also discussed in chapter 9).

THE SOUTH PAYS TO SOLVE THE NORTHERN CRISIS

The 1930s Depression largely affected the United States and Europe, while developing countries, notably in Latin America, continued to grow. The response of the industrialized countries, and mainly the United States, to the most recent Kindleberger cycle—growth 1948–67, mania 1967–79, and then crisis—has been to ensure that the situation of the 1930s is not repeated. The three decades from 1979 showed a different mix, as the industrialized countries used new manias to end crises. They also tried to export the crisis to the South, and money was to be extracted from the developing countries in order to prevent depression in the industrialized countries. Thus the 1980s saw the developing country debt crisis, which was followed by new speculative and lending mania. This became so grotesque that there was even a Hollywood film, “Wall Street”, in 1987, in which the leading character says “greed, for lack of a better word, is good. Greed is right, greed works.” Greed continued until the Asian financial crisis of 1997-99. Then it resumed and the early 2000s saw an unprecedented mania of borrowing and speculation, leading to the crash of 2008. Whereas the debt crisis of the early 1980s and the Asian financial crisis of the late 1990s largely affected the global south, the crisis of 2008-11 mainly affected the industrialized North – for nearly three decades the North had used the Global South to stave off the crisis, but this finally came to an end.

The US pursued four strategies to shift the most recent crisis onto the Global South: imposing a neo-liberal economic model, raising interest rates in the early 1980s, borrowing to fuel consumption, and forcing countries to keep dollars as reserves. The following discussion elaborates these strategies.

The development model that originated in the 1930s Depression, continued through the Second World War, and then supported the 1960s and 1970s growth phase had been state-led—not just in the then-socialist countries but also in European and Asian capitalist countries and in developing countries following either model. But the crisis beginning in the late 1970s was marked by stagnation in the US economy and led to the introduction of an entirely new economic model—neo-liberalism. First introduced by Augusto Pinochet after he took power in a US-backed coup in Chile in 1974, it was later adopted by the British government of Margaret Thatcher beginning in 1979 and the US administration of Ronald Reagan from 1981. Linked to right-wing libertarian political philosophies, this policy called for smaller government, **privatization** and the withdrawal of the government from the economy, sharply reduced regulation and reduced power for trade unions, and lower taxes on the rich to encourage them to invest (usually accompanied by lower spending on health and education, on the grounds that the poor should take more responsibility for looking after themselves). A key part of the package was free movement of goods and capital (but not people), so customs barriers and capital controls were removed. In the 1980s, the World Bank and the IMF began to impose neo-liberal economic policies on developing countries (see chapters 3 and 9). The poorest countries had to accept, because aid was dependent on having programs the BWIs imposed, which included three key policies:

1. They enforced debt repayment.
2. They forced poor countries to open their borders to manufactured goods from the industrialized countries. This put an end to import substitution industrialization, which had been the model followed by the now-industrialized countries and was the model being followed by the developing world. (Chang 2002)
3. They forced the developing countries to instead follow a model of export-led growth, which led to many countries rapidly expanding the production of agricultural and mineral exports. That meant increased competition and a drop in the prices paid by the rich countries to the poor countries. Cocoa sold for \$2,604 a tonne in 1980, less than half that (\$1,267) in 1990, and even less in 2000 (\$906). Coffee similarly fell from \$3,243 per tonne in 1980 to \$1,182 in 1990 and \$913 in 2000. For many countries, the loss in income was far greater than the aid they received or their debt service payments. The result was little growth and an increase in poverty in most developing countries in the 1980s and 1990s—except for China, which

did not follow the new model, had the highest growth rates, and became a major industrial country (see epilogue).

So the impact of neo-liberalism was to lower the prices of raw materials for the industrialized countries, thus reducing the impact of the crisis on them and forcing the developing countries to bear the brunt of it. The second step came in the early 1980s when US President Ronald Reagan sharply raised interest rates, which did initially create a flow of money from South to North (as shown in Figure 14.1) but which also triggered the debt crisis.

The third response to the crisis was simply to borrow money. According to the White House, United States' public debt in 1940 was \$51 billion, and the cost of the Second World War pushed it up to \$260 billion. By 1970, it had only risen to \$381 billion. But as stagnation set in, the US started to borrow at an unprecedented rate, pushing the debt to \$909 billion in 1980, \$3.2 trillion (\$3,200 billion) in 1990, \$5.6 trillion in 2000, and \$13.8 trillion by 2010. Much of this borrowing is from abroad – according to the IMF, US external debt (public and private) jumped from \$6 trillion in 2002 to \$14 trillion in 2010.

At the same time, the US was increasingly consuming a great deal more than it produced. The trade deficit (goods and services) was small until the 1990s, when it started to jump, from \$65 billion in 1993 to \$160 billion in 1998, \$380 billion in 2000, and \$757 billion in 2006. Increasingly, the US was importing goods instead of producing them, and it had to borrow money to pay the bills.

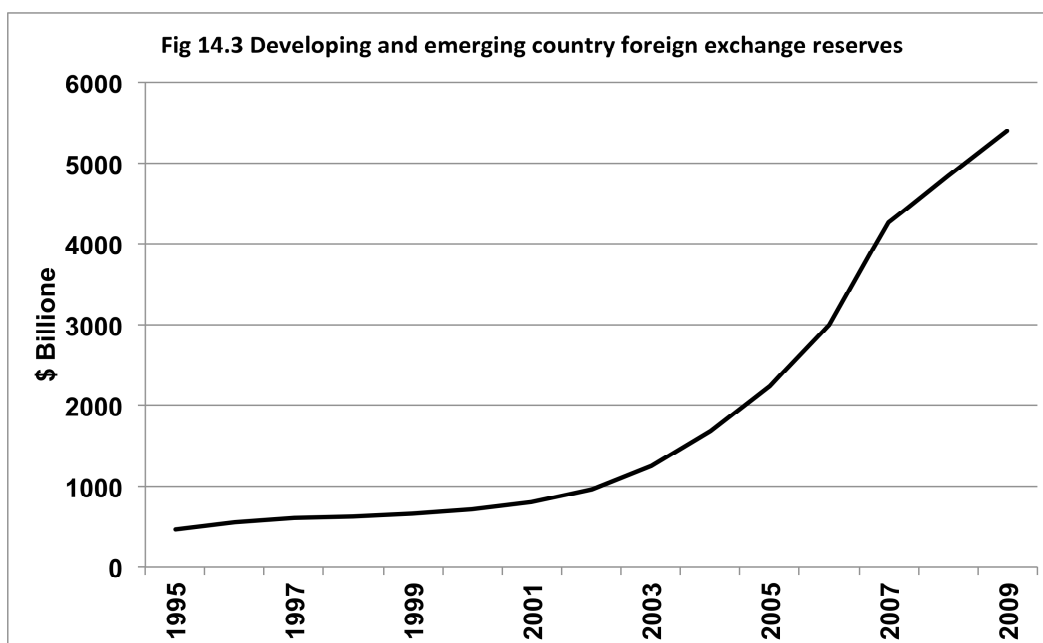
The United States had already made a fourth change, the impact of which only became clear later. From 1934, the price of gold had been fixed at \$35 per ounce; gold was used as financial reserves by most countries. But the US was having trouble paying for the Vietnam War, and in 1971, president Richard Nixon announced that there would be a free market in gold; the price rose to \$140 within two years. As well as helping to pay for the war, this move had a much more subtle effect—instead of gold, US dollars became the world's reserves. Each dollar that a country holds as a reserve is a promise by the US government to eventually provide one dollar in goods. Indeed, reserves are mostly held in US government bonds or as deposits in US banks. The biggest holder of US government bonds is China, with \$900 million. Thus, in effect, countries holding reserves are lending money to the United States.

Two very different factors have led to a sharp increase in foreign holdings of US bonds and dollars in the early years of the twenty-first century. An East Asian financial crisis from 1997 to 1999 was triggered in part by excessive and speculative international and domestic borrowing, causing the collapse of banks and currencies. With a sudden outflow of speculative capital, Thailand, Malaysia,

Indonesia, the Philippines, and South Korea all found themselves unable to pay short-term debt. The IMF and the US offered to ‘help’ but imposed neo-liberal conditions requiring that the economies become even more open. This was exactly the wrong response and made the crisis worse. One result was that East Asian countries built up their reserves sharply so that when the next cyclic monetary problem occurred, they would not need to turn to the IMF. That proved to be a wise choice, and they were less affected by the 2008 crash.

But in one way, this suited the United States, because middle-income East Asian countries were holding large amounts of dollars—in effect giving a big loan to the US. Meanwhile, the IMF insisted that poor countries substantially increase their reserves. They were too poor to use these reserves to gain independence from the IMF, and many thought that the reserves were excessive and that the money would be better spent on development. But it meant sharply increasing their holding of US dollars or bonds. Figure 14.3 shows foreign reserves held by developing countries and makes clear the dramatic rise from 2003 when the US and its allies needed money to pay for the Iraq war. Reserves of all developing and emerging economies in 1996, before the Asian crisis, were only \$600 billion; by 2003 this had risen to \$1.3 trillion, and by 2009 to \$5.4 trillion. Approximately 60% of these reserves are in US dollars or US government bonds. More than \$3 trillion, one-quarter of US public debt, is held by foreign governments as reserves.

Figure 14.3 Developing-country foreign exchange reserves



Source: International Monetary Fund. *Currency Composition of Official Foreign Exchange Reserves (COFER)*. 28 September 2007.

The net result is that in 2008, the last year for which reserve data is available, developing country debt was \$3.7 trillion but developing and emerging countries were holding \$4.8 trillion in reserves. Thus, the poor countries were lending \$1.1 trillion to the rich countries. These loans had been preventing a 1930s style depression in the industrialized countries while depressing the economies of the developing countries.

TWO FINAL QUESTIONS

First, why borrow?

The changing nature of international debt in the second half of the twentieth century and the way that post-1980 debt has mounted astronomically without any apparent benefit to developing countries raises two key questions: Is borrowing worth it? And what is the liability of the lenders?

Poor people well understand the debt trap, constantly borrowing to survive and sinking ever deeper into debt, with debt service payments becoming greater than any benefit gained from the initial borrowing. And yet the other side of borrowing is also obvious. Borrowing to buy a car and having the use of the car while paying off the loan over three years, or taking a mortgage on a house and being able to live in it for the 20-year repayment period, means that because of interest, we pay far more than the actual cost of the car or house but we consider it reasonable because we have the use of the car or house during that period. And large parts of modern industrial development are based on borrowing money to construct a building or buy a piece of machinery that will make a company more productive and thus sufficiently profitable to pay off the loan. This is exactly the argument used by the World Bank and developing countries alike for foreign borrowing as a way of stimulating more rapid growth.

But economists distinguish between foreign and domestic borrowing. Does a country borrow from its own banks and citizens—say, by issuing bonds—or does it borrow from foreign banks and the World Bank? Economists such as Cheryl Payer (1991) have argued that few countries have successfully developed on the basis of foreign loans, or at least not for very long periods.

Borrowing for economic development requires that the economy and productivity grow rapidly enough to generate the extra income to repay the loan. Foreign borrowing makes very different repayment demands from those of domestic borrowing, and the imposed policies of the Bretton Woods Institutions become very important.

Traditionally, countries developed by protecting their infant industries from foreign competition so that these companies could sell their goods locally, become profitable, and repay their loans. The

imposed neo-liberal model requires that economies be open, which gives no space for local industry to grow and become profitable. Further, foreign borrowing is in currencies of the industrialized world—US dollars or euros. Therefore, the BWIs pushed countries to produce exports that they could sell for hard currency. But as we have seen, this strategy was undermined by what is known as the ‘fallacy of composition’—if everyone is producing more of the same exports, the price falls. So countries had to produce still more exports to pay for their loans. At the same time, structural adjustment policies often demanded devaluation of the local currency. All of this made foreign loans much more expensive than domestic ones, and as it turned out, economies simply did not grow rapidly enough to pay the much higher cost of foreign borrowing. Economies also did not grow because the imposed BWI policies did not promote growth. So foreign borrowing not only was more expensive but came with policies that retarded growth.

BOX 14.2 LENDING TO APARTHEID SOUTH AFRICA

When Nelson Mandela walked out of prison in 1990, the international banks handed him a bill for \$21 billion. In effect, the bankers told Mandela, ‘In 1985, we told the white government that we understood that they had financial problems and that it was expensive to keep you in jail and maintain white minority rule, and thus debt payments could be deferred. But now that you are out of jail, and South Africa has majority rule, it is time for you to pay the cost of keeping you in jail.’ Mandela was told by the international community to pay up, so he did. In 1997, South Africa paid an incredible \$6.5 billion in debt service—more than four times what the banks demanded of the apartheid state.

Yet because of apartheid, South Africa had been forced to leave the Commonwealth in 1961. In 1973, the United Nations began to describe apartheid as a ‘crime against humanity’, and in 1977, the UN imposed a mandatory arms embargo on the country. In 1982, an article by two lawyers from the First National Bank of Chicago in the *University of Illinois Law Review* warned their employer and other banks of the consequences of a change of sovereignty in South Africa for loan agreements. They noted that in loan documents, the description of the intended use of the money was often too general to ensure that the loan benefited the people and thus to ensure repayment. The banks did not listen, however, and South Africa’s debt jumped to \$16.9 billion.

Was the new South African government liable for repayment of the apartheid debt?

Second, what is the responsibility of the lender?

Boxes 14.2 and 14.3 help to explain the final question. Is it acceptable to lend to a government that the United Nations says is committing a crime against humanity? Do lenders and contractors have a responsibility to point out that a nuclear power station should not be built on an earthquake fault?

In international law, it is widely accepted that when a government changes, the successor government assumes the laws, contracts, and debts of the previous government. The United States exemplified one of the few exceptions to this convention after it seized Cuba from Spain in 1898. Spain demanded that the US pay Cuba's debts, but the US refused on the grounds that the debt had been 'imposed upon the people of Cuba without their consent and by force of arms'. Furthermore, the US argued that in such circumstances, 'the creditors, from the beginning, took the chances of the investment. The very pledge of the national credit, while it demonstrates on the one hand the national character of the debt, on the other hand proclaims the notorious risk that attended the debt in its origin, and has attended it ever since' (Adams 1991, 164). In the intervening century, the US has never revised its view that Cuban debt was not the liability of the new government. It held a similar view in 2003 after the invasion of Iraq to overthrow the government of Saddam Hussein, when US Treasury secretary John Snow said, 'Certainly the people of Iraq shouldn't be saddled with those debts incurred through the regime of the dictator who is now gone' (Hanlon 2006, 211).

The name and doctrine of **odious debt** was formalized by Alexander Sack, who wrote:

If a despotic power incurs a debt not for the needs or in the interest of the state, but to strengthen its despotic regime, to repress the population that fights against it, etc., this debt is odious to the population of all the state. This debt is not an obligation for the nation; it is a regime's debt, a personal debt of the power that has incurred it, consequently it falls with [the] fall of this power (Adams 1991, 165).

BOX 14.3 PHILIPPINES AND NUCLEAR POWER

The Philippine dictator Ferdinand Marcos was finally overthrown in 1986 and fled into exile with his wife Imelda. He had an estimated \$5 to \$13 billion stashed away in foreign banks, suggesting that up to one-third of the Philippines' foreign borrowing had passed into his very deep pockets. Most of Marcos's borrowing took place during the loan-pushing boom of the 1970s, and by 1983 there was a net outflow of money, which continued during more than a decade of democratic government.

The largest single debt of the Philippines was for the Bataan nuclear power station. Completed in 1984 at a cost of \$2.3 billion, it was never used because it was built on an earthquake fault at the foot of a volcano. It was built by the US multinational Westinghouse despite a much lower bid by General Electric that was favoured by a technical committee. Marcos overruled his own advisors, and Westinghouse later admitted that it paid a commission to a Marcos associate, which the *New York Times* estimated at \$80 million. Much of the construction was done by companies in which Marcos had an interest. Bribes were paid in Switzerland. The International Atomic Energy Authority noted that attempting to build a nuclear power station in an area of such high seismic activity was ‘unique in the atomic industry’. We can all be grateful that the plant was never put into operation and never became an Asian Chernobyl.

The nuclear power station was financed by the US export credit agency Ex-Im Bank, the Union Bank of Switzerland (which is accused of holding some of the Marcos billions), Bank of Tokyo, and Mitsui and Company, all of which were repaid. In 2007, the Philippines finally paid off the debt for the 30 year old power station which should never have been built and was never used.

Surely the same rule should have been applied to the apartheid regime in South Africa and the Mobutu regime in Zaire (Boxes 14.1 and 14.2), but lenders, including the World Bank and the IMF, refused to accept that their original lending had been improper.

Although the Jubilee 2000 campaign focused simply on ‘unpayable debt’, campaigners increasingly took up the issue of lenders’ co-responsibility and of what came to be defined as the broader areas of ‘illegitimate debt’—loans that were improperly made and should be the liability of the lender, not the borrower. This would include the Philippines Bataan nuclear power station on the grounds that the lenders and builders had a fiduciary duty—not just to the Philippines but to the safety of all of East Asia—not to support a nuclear power station on an earthquake fault.

Rapidly growing consumer protection in the second half of the twentieth century applies also to lending. That principle would require that lenders take due care to see that a loan is reasonable, that the borrower is competent to borrow, and that the borrower can reasonably be expected to repay. The British Consumer Credit Act 2006, for example, defines ‘unfair relationships between creditors and debtors’: if a borrower refuses to pay and alleges that the relationship was unfair, then ‘it is for the creditor to prove the contrary.’

Similarly, modern civil and commercial law has broadened contractual obligations in complex business transactions beyond the strict delivery of goods to include dissemination of professional

advice, discovery of special risks, and so forth, especially if one party is less knowledgeable than the other and therefore must trust the other's superior skills. Neglecting these accessory obligations may be considered a breach of contract.

In domestic law, greater responsibilities have been imposed on lenders. This means that loans like those to apartheid South Africa and Mobutu or for Bataan would simply not be acceptable under domestic law in most industrialized countries. Yet concepts of unfairness and the broader obligations in domestic law are only now being brought into international lending. For example, the United Nations Institute for Training and Research argues that in developing countries, the lender is often connected with the project design, while the borrower must rely on external expertise, typically from the lender, because they lack the technical know-how to plan infrastructure policies and to implement projects. Therefore, the lender must bear some responsibility for improperly designed, badly implemented, or environmentally damaging projects.

Two governments have moved on this issue. In 2006 Norway became the first creditor country to acknowledge the concept of **illegitimate debt**, and that such debt must be cancelled.' That year, Norway unilaterally cancelled export credit debt for ships that had been used to promote Norwegian shipyards rather than for developmental purposes. And in 2010 it launched the first ever "creditor audit" of all of its lending to developing countries. On the debtor side, the government of Ecuador established an independent Public Debt Audit Commission in 2007, which found that only 20 per cent of debt was related to development projects and 80 per cent was the result of refinancing old debt with new debt. It found that debt had been refinanced in this way in violation of both national and international law, that debt contracts violated Ecuador's sovereignty, and that excessive interest rates amounted to usury. President Rafael Correa declared the debt 'illegitimate' and refused further payments. In 2010 there were at least three commissions (two in United Nations agencies) studying the concept of illegitimate debt.

Lender-borrower co-responsibility, as well as odious and illegitimate lending, are now becoming recognized as concepts in international law and domestic lending concepts such as unfairness and broader obligations of lenders are being taken into account. However, it may take several more years before the principle becomes established.

The 2008 financial crisis

Illegitimate debt is not just an issue for developing countries. Indeed, the 2008 financial crisis was caused by trading in illegitimate debt. The trigger was "sub-prime mortgages" in the United States.

Mortgage companies gave home loans to people who were manifestly unable to pay, and like the

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loan pushers of the 1920s and 1970, they offered low interest initially and encouraged people to borrow more than they needed and spend the money on consumer goods. The mortgage companies then sold on the loans to gullible bankers, who packaged them as allegedly safe investments, usually purchased with other loans. By 2006 there were \$600 billion in sub-prime mortgages, but they supported \$6 trillion of securities and investment vehicles. The crisis came when banks realized that poor people could not repay the outstanding billions of dollars in loans and that the original lenders were taking no responsibility for what was clearly illegitimate lending. The whole house of cards collapsed; not only could the sub-prime mortgages not be repaid, but the loans for the investment vehicles could not be repaid either.

But this was not just a domestic US issue. In Spain and Britain, house prices were rising faster than incomes in the early 2000s, and the loan pushers encouraged people to borrow more than the value of the house and use the money for holiday or consumer spending, because they could always sell the house later at a higher price. It was a classic Kindleberger mania. With the panic, house prices fell, people could not service the loans, and banks could not sell the houses to recover the loans. Governments poured in more than \$2 trillion to bail out banks and keep them from collapsing.

And the loan pushing of the 1970s continued on an international level. From 2001 US investment banks lent money to Greece, but in ways that kept the loans off the books, because they would have violated European Union rules. In effect, Greek officials mortgaged the country's airports and highways, pledged future lottery revenues, and bought and sold special bonds. It was loan-pushing and sub-prime lending on a global level. *The New York Times* (13 Feb 2010) commented: 'Wall Street tactics akin to the ones that fostered subprime mortgages in America have worsened the financial crisis shaking Greece and undermining the euro by enabling European governments to hide their mounting debts'.

Not surprisingly, questions have been raised in Europe and the United States about the right of the initial lender to shirk all responsibility for manifestly bad loans.

SUMMARY AND CONCLUSION

Lending and borrowing, and regulations to control loans and loan collections, go back some 4,000 years. International borrowing goes back at least 700 years, but it remains controversial. Charles Kindleberger proposed that the economy runs in cycles of growth, mania, and crisis and that during the mania phase, there is a surplus of capital that leads to increasingly risky and speculative lending, particularly loan pushing to developing countries. During the crisis period, borrowers often cannot repay and therefore default.

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Lending in the 1970s, both commercial loan pushing and lending to Cold War allies, led to a loan crisis in the early 1980s when interest rates were suddenly driven up. During the 1970s, lending did provide new money for developing countries, but since then there has been a net transfer of wealth from poor countries to rich ones. Developing-country debt has increased dramatically—from \$494 billion in 1980 to \$3,719 billion in 2008—but with no discernible benefit to borrowing countries. Meanwhile, however, the United States and other industrialized countries have been net borrowers, with developing countries holding \$5,400 billion in Northern bonds and other debts. Thus, the period since 1982 has seen a huge transfer of wealth from poor countries to rich ones, and developing countries have become major lenders to the rich industrialized countries.

QUESTIONS FOR DISCUSSION

1. Should lenders take more responsibility for improper lending?
2. How would one define ‘illegitimate lending’?
3. Are developing countries building up excessive reserves in US dollars and thus lending too much to the United States? What are the alternatives?
4. Do developing countries need to borrow internationally?

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INTERNET RESOURCES

IMF on HIPC: <http://www.imf.org/external/np/exr/facts/hipc.htm>

European Network on Debt and Development (EURODAD): <http://www.eurodad.org>

For up-to-date discussion on illegitimate and odious debt, Probe International:
<http://www.probeinternational.org/catalog/odious.php>

Jubilee Debt Campaign: <http://www.jubileedebtcampaign.org.uk>