Nunnenkamp, Peter

Article

The deadlock in dealing with developing country debt : a review

Weltwirtschaftliches Archiv

The Deadlock in Dealing with Developing Country Debt: A Review*

By

Peter Nunnenkamp

Capital no longer flows to countries where it is relatively scarce. After the debt crisis erupted in 1982, the sudden reversal of international capital transfers has led to the perverse situation of capital exporting Third World economies. From the creditors' point of view it is tempting to argue that it is up to the borrowers to restore their attractiveness for foreign capital through policy reform. By contrast, borrowers argue that it is up to the creditors to remove disincentives for internal adjustment by granting debt relief in the first place. The discussion on which side should take the lead in breaking through the vicious circle of underadjustment and underlending resulted in a deadlock.

The time-tried saying "it takes two to tango" retains its validity here. None of the parties involved can be expected to take its part unless some idea exists about the behaviour of the other side:

- Borrowers are uncertain whether internal adjustment efforts will be honoured by foreign creditors through relaxing the strict capital rationing.
- Creditors are uncertain whether debt concessions will automatically result in intensified adjustment efforts of the borrowers.

The decisions of both sides are closely intertwined so that uncertainty is systemic [Blejer, Ize, 1989]. The objective of the research pro-

* A review of: Sachs, Jeffrey D. (Ed.), Developing Country Debt and Economic Performance. Vol. 1: The International Financial System. A National Bureau of Economic Research Project Report. Chicago, London 1989. The University of Chicago Press. IX, 400 pp. – Sachs, Jeffrey D. (Ed.), Developing Country Debt and the World Economy. A National Bureau of Economic Research Project Report. Chicago, London 1989. The University of Chicago Press. XI, 335 pp.

ject on developing country debt by the National Bureau of Economic Research to analyse the debt crisis from two perspectives, that of the individual debtor country and the international financial system, is thus well-taken. The outcome of the project, presented at a conference in September 1987, includes eight papers, on debt crises that occurred before World War II, on political factors that contribute to poor economic policies in many debtor countries, on the role of the banks and multilateral institutions during the current crisis, on the effect of developed country economies on the debtors, and on possible solutions to the debt problem (published together with an extensive introduction by *Jeffrey Sachs* in the volume "Developing Country Debt and Economic Performance: The International Financial System"; subsequently quoted as Vol. 1). The findings from case studies on Argentina (*Rudiger Dornbusch* and *Juan Carlos de Pablo*), Bolivia (*Juan Antonio Morales* and *Jeffrey Sachs*), Brazil (*Eliana Cardoso* and *Albert Fishlow*), Indonesia (*Wing Thye Woo* and *Anwar Nasution*), South Korea (*Susan Collins* and *Won-Am Park*), Mexico (*Edward Buffie*, with the assistance of *Allen Sangines Krause*), the Philippines (*Robert Dohner* and *Ponciano Intal, Jr.*), and Turkey (*Merih Celâsun* and *Dani Rodrik*), as well as comments on the country studies by *Miguel Urrutia* and *Anne O. Krueger* are published in the companion volume "Developing Country Debt and the World Economy" (subsequently quoted as Vol. 2). This book additionally contains the editor's introduction and shorter and less technical summaries of the eight papers on selected topics.

The country studies (Vol. 2) help to understand why some debtor countries succumbed to a serious crisis while others did not. Fiscal and trade policies are shown to be of overriding importance. Moreover, it is discussed why most of the problem debtors have been unable to overcome the crisis. The reviewer does not share Urrutia's view that the feeling of "déjà vu" is nonexistent in reading the country studies. Nonetheless, they provide valuable insights especially on the politico-economic framework of internal decision making. Many of the policy failures in the debtor countries are not mistakes in the sense of technical misjudgements, but are the result of deeper political instabilities. In Argentina, the "destructive pendulum between populists and market-oriented reformists has meant that . . . the general atmosphere is one of skepticism about everything Argentine" (Vol. 2, p. 37). The Bolivian experience reveals ample evidence on the state being viewed as an instrument to satisfy the distributional agenda of particular interest groups; politics degenerated into "fierce battles of the 'ins' versus the 'outs'" (Vol. 2, p. 65). A fundamental disjunction between the pervasive role assigned to governments in the development process and their weak capacity is also to be observed in many African economies whose debt problems are not discussed within the NBER project.

Particularly the political economy of fiscal policy provides a key to understanding the origins of debt problems and the measures required for overcoming them. The widespread battle over income shares has stretched many Latin American governments far beyond their fiscal capacity and seriously undermined their capacity to tax income and wealth (e.g., land). In the era of easy foreign finance, the typically large gap between government expenditures and revenues was readily filled by bank loans. Unable or unwilling to raise taxes and restrain consumptive spending, many governments resorted to the inflation tax by printing money when foreign finance dried up. This resulted in a vicious circle of monetary expansion and large ad-hoc depreciations of the exchange rate which then fed into inflation. With accelerated inflation, the tax base was further eroded since the demand for real money balances fell and capital flight increased. Public investment was squeezed so that the growth prospects deteriorated significantly. At the same time, "many well-connected rent-seeking individuals made considerable fortunes in the course of the hyperinflation" (Vol. 2, p. 73) in Bolivia and elsewhere.

In sharp contrast to the dismal experience of most Latin American countries, external borrowing has not been used to avoid structural readjustment in South Korea. This country study contains important lessons on the merits of credibility, consistency and coherence in economic policy, especially in maintaining a competitive real exchange rate (see also the study on Indonesia) together with a sustainable fiscal policy. Although "the public-sector budget remains the Achilles' heel of the Turkish macroeconomy" (Vol. 2, p. 209), this country has shown that with a remarkable amount of adjustment it is well possible to overcome debt problems. So, one wonders why most Latin American governments can do anything except applying macroeconomically efficient fiscal, trade and exchange-rate policies. The hypothesis raised by Urrutia that the implementation and enforcement of income and land taxes is politically infeasible because the power base of many regimes in Latin America is exclusively the middle class clearly deserves further research. The chances for sustainable adjustment may be improved if programs were designed so that employment opportunities for the very poor or marginal groups in society were generated, thereby diversifying political support for the government.

Adjustment problems in debtor countries figure also prominently in the volume "Developing Country Debt and Economic Performance: The International Financial System" (Vol. 1). *Sebastian Edwards* shows that the immediate policy response to the debt crisis was based on the perceived short-run "effectiveness" of instruments such as capital controls and import quotas, rather than on efficiency. He is skeptical, however, about whether rapid trade liberalization, coupled with devaluation, privatization, and financial reform, is the most reasonable strategy to achieve adjustment with growth. Edwards argues that possible trade-offs inherent in the "orthodox" approach require a detailed discussion on the timing and sequencing of reforms; e.g., trade liberalization with lower import tariffs renders it more difficult to achieve fiscal consolidation unless other sources of revenue have been found. In general, "it is not recommended to undertake substantial trade reforms at the same time that a major anti-inflationary program is underway" (Vol. 1, p. 201). Trade liberalization should rather be a gradual and preannounced process, with the replacement of import quotas by tariffs as a first important step towards improving efficiency.

Similarly, Sachs concludes that simultaneous application of stabilization and widespread liberalization is unlikely to be sustainable and successful under highly inflationary conditions. His suggestion to postpone structural reforms until "*after* macroeconomic balance has been restored" (Vol. 1, p. 281) is not undisputable. Interestingly enough, the IMF has been harshly criticized for nearly exclusively addressing short-term stabilization issues during the first phase of debt renegotiations after 1982. A *credible* announcement that stabilization will be supplemented by structural reform not too far in the future appears crucially important. Otherwise positive supply responses from reallocating capital are hardly to be expected. While unemployment may be created by a too fast trade liberalization with downward real wage inflexibility, lingering reform efforts may undermine credibility and sustainability by allowing those groups negatively affected by structural reform to organize and lobby against it. Another important point made by Edwards on the credibility of trade reform is straightforward: Private agents are unlikely to respond positively unless inconsistencies between fiscal and exchange-rate policies are avoided; the experience of Chile with an overvalued currency in the early 1980s is very telling in this respect.

A slower speed of adjustment requires that creditors agree to limit the debt-service payments due to them in the initial years. Sachs forcefully argues pro debt relief in order to overcome the adjustment disincentives resulting from a debt overhang and to enhance the likelihood that debtor governments will adhere to IMF and World Bank conditionality. The compliance of debtor countries with conditionality has typically been rather weak because of the inherent limitations in enforcing conditionality in sovereign lending. Sachs expects that a better outcome can be achieved once IMF programs were based on partial and explicit debt relief.

Similarly, *Paul Krugman's* model of defensive lending suggests that debt relief is not only in the interest of debtors, but also optimal for creditors who thereby raise the expected value of the initial debt. The question remains, however, why the incentive for defensive lending has not induced additional bank lending on a sufficient scale in recent years. According to Krugman, "low bank lending was the outcome of a bargaining process in which, . . ., creditors had very high bargaining power compared with debtors. A shift in that bargaining process will produce a different result" (Vol. 1, p. 328). This conclusion somewhat contradicts the standard argument that sovereignty provides a strong lever of international borrowers to press for debt concessions. Moreover, the recent buildup of arrears to banks [Institute of International Finance, 1990], which is frequently considered as an innovative bargaining chip that may turn the tide, did *not* revive bank financing up to now.

Both Sachs and Krugman hardly consider that under conditions of systemic uncertainty it is not very promising for private creditors to remove the present debt overhang by ex-ante debt relief, which is in fact unconditional if only based on letters of intent. Because of the institutional peculiarities of sovereign lending, borrowers may redefine their bargaining position and ask for more relief, rather than implement adjustment measures, as soon as the creditors indicate that they are willing to forgive some debt. Sovereign risk and moral hazard by third countries can be reduced by an adequate timing of debt relief, i.e., when concessions are made only *after* internal adjustment by the beneficiaries has taken place. In a recent paper, it has been shown that replacing ex-ante relief by ex-post concessions for reform-minded borrowers provides strong adjustment incentives for borrowers suffering from a debt overhang [Nunnenkamp, Stüven, 1990]. An adequate ex-post relief scheme may also reduce the uncertainty of borrowers whether adjustment efforts will be honoured. This can be achieved by a credible commitment of the creditors that new capital transfers are made available once credit-constrained borrowers have implemented adjustment measures.

Another possible obstacle to a mutually agreed solution of the debt overhang problem deserves closer attention, i.e., the strong involvement of the IMF and the World Bank in international transfer negotiations. Arguments in favour of the older bond-era direct confrontation between problem debtors and their creditors are discussed by *Peter Lindert* and *Peter Morton*. They analyse how lending waves unfold and what can be done once a crisis is in full swing by referring to sovereign debt repayment since the early 19th century. It may reasonably be concluded that "the more recent approach of bringing the IMF and the World Bank into tripartite debt-crisis negotiations has brought extra costs relating to moral hazard, delays, and macroeconomic adjustment" (Vol. 1, p. 40). Arguably also the finding by these authors and *Barry Eichengreen* that commercial banks largely ignored the repayment history of debtors is because banks were confident to share at least possible losses with the public.

Increased multilateral lending to problem debtors in recent years has in fact transferred private credit risks to the public sector "by having the Bretton Woods institutions pull in as the panic-stricken private banks have been pulling out" [Islam, 1990, p. 17]. Interestingly enough, Eichengreen in his paper on "The U.S. Capital Market and Foreign Lending, 1920–1955" finds a dramatic decline in private lending and a similarly strong increase in public sector lending between the two postwar decades as well. Presently, commercial banks are strongly engaged in political lobbying on publicly subsidized exit options as well as official guarantees and cofinancing of new loans. The wait-and-see attitude of lenders may be overcome, however, if the rules of the game were clarified and the socialization of losses and risks unambiguously rejected. A similar reasoning may apply to debtor governments which bargain on publicly sponsored debt relief, thereby supporting those interest groups resisting immediate policy reform. The internal power balance may shift towards interest groups supporting policy reforms as soon as debtor governments have to realize that postponing adjustment is no promising alternative.

The way political processes and institutions influence developing country stabilization and adjustment efforts is examined by *Stephan Haggard* and *Robert Kaufman*. The size of debtor countries, their political significance for creditor security calculations, and access to nonconditional resources are considered as determinants of international bargaining positions and outcomes. More interestingly, government bargaining with domestic actors over how to allocate adjustment burdens on the home front is analysed. It is convincingly shown that none of the major sectors, i.e., business, labour, and agriculture, represent undifferentiated sets of interests. Three institutional variables are considered that may determine which interests matter politically: the type of regime, political-electoral cycles, and the strength of the administrative apparatus. The lack of a systematic association between either democracy or dictatorship and the ability to adjust leads the authors to apply finer distinctions. In contrast to "plebiscitary" democracies, "consultative" democracies provide "opportunities for persuasion, obtaining feedback and negotiating compensating agreements" (Vol. 1, p. 235), thereby improving the chances for sustainable adjustment. Strong authoritarian states are likely to do significantly better than weak ones. Especially for many poor developing countries, the main problem is the "lack of political institutions capable of channeling and containing demands and weak administrative capacity" (Vol. 1, pp. 238 f.). Therefore, it seems that too much focus has been placed in the past on discrete policy reforms, and not enough on promoting institution building and administrative human-capital development. If policy reform programs are likely to raise expectations and fail, it may indeed be superior to have no program at all. But the question remains open whether the economic crisis of the 1980s will lead to a rearrangement of basic coalitional patterns in problem debtor countries that improves the chances for successful adjustment.

Creditor countries may help reform-minded interest groups within the debtor countries to gain political influence by performing policies that add to the benefits of internal adjustment. *Rudiger Dornbusch* shows international interest rates, commodity prices and industrial countries' growth to be crucially important in improving the external conditions for a solution of debt problems. Recent forecasts on these variables provide a mixed blessing at best [e.g., IMF, 1989]. Though the decline in developed countries' GNP growth is expected to remain modest, the 1988 improvement in non-fuel primary commodity prices was not sustained, and real interest rates are unlikely to decline in the near future. Unless comprehensive trade liberalization is initiated by the creditor countries, the world macroeconomic environment is unlikely to provide a setting in which debtor countries can grow out of their debts by export booms and improving terms of trade.

Consequently, the various proposals for resolving the international debt crisis, reviewed by *Stanley Fischer,* will remain on the agenda. This refers to the question of debt relief in the first place. The two NBER volumes provide important insights as far as the diagnosis and therapy of the problems involved are concerned, but some suggestions remain controversial. Most notably, both debtor countries and private creditors have little interest in revealing the dimensions of whatever compromises they might ultimately be willing to make unless systemic uncertainty and the still prevailing confusion about the rules of the game are resolved.

References

Blejer, Mario I., Alain Ize, *Adjustment Uncertainty, Confidence, and Growth: Latin America after the Debt Crisis.* IMF Working Paper, WP 89/105. Washington 1989.

Institute of International Finance, *Improving the Official Debt Strategy: Arrears Are Not the Way.* Washington 1990.

International Monetary Fund (IMF), *World Economic Outlook.* Washington, October 1989.

Islam, Shafiqul, *The Mexican Debt Accord: Lessons for the Brady Plan.* Washington 1990, mimeo.

Nunnenkamp, Peter, Volker Stüven, *How to Reduce Uncertainty for International Capital Flows: The Investor's View.* Kiel Institute of World Economics. Kiel 1990, mimeo.