Debt Repayment and Economic Adjustment

by Owen F. Humpage

Some people believe that zebras are white with black stripes; others maintain that they are black with white stripes. The truth, of course, is that zebras are both white and black.

Many observers consider the developing-country debt situation from a similarly one-sided perspective. Some see it primarily as a financial problem, focusing on the difficulties associated with obtaining and servicing foreign loans. Others see it largely as a problem of real economic adjustment. Focusing on consumption, investment, and trade patterns in heavily indebted countries.

Like the zebra’s stripes, however, these elements of the debt problem are both part of the same animal. The ability of heavily indebted countries to service their international debts depends on their ability to generate and sustain a commensurate trade surplus. The extent to which these countries make the requisite policy adjustments will determine whether full and timely servicing of the debt is feasible or whether additional restructuring is inevitable.

The international debt situation involves questions about financial arrangements and about resource adjustments. To fully appreciate the complexity of the problem, one must consider both sets of questions and must understand how they interact.

Assume, for example, that a debtor country must service a debt to the United States. Because its financial obligations are in dollars, the debtor country must acquire dollars. It might do so initially through the sale of official international reserves, but nations generally hold only small amounts of reserves and, once depleted, must seek other remedies. Over the long run, the debtor can acquire the necessary dollars only by running an export surplus.

Consequently, a country that must service loans through a sustained net capital outflow must adjust its domestic economic policies to generate a commensurate trade surplus. The...
adjustment process requires changes in prices and incomes that can impose severe social and economic costs. If the debtor cannot make these adjustments immediately, a rescheduling of debt service must follow to buy time for the adjustments; otherwise, the debtor will default.

### Rapid Change and Rapid Adjustment

In the early 1980s, the overall financial position of the heavily indebted countries rapidly changed from that of net recipient of capital, the traditional position of developing countries, to that of net remitter of capital, a role typically played by advanced nations (figure 1). Underlying this shift in capital flows was a sharp acceleration of inflation. Interest rates rose sharply, and translated quickly into higher debt-service costs, because international lending agreements permitted frequent adjustments to market interest rates. With the economic prospects of the debtor countries becoming more uncertain, capital flight aggravated the adjustment problems of some countries, especially from 1980 through 1983. In addition, inflows of private capital, especially long-term credits, dried up after 1982, as did miscellaneous sources of funds tied to the financing of exports and of direct foreign investments. By 1985, the heavily indebted countries became net remitters of capital. The one-to-one correspondence between financial and trade flows required debtor nations to generate and to sustain a trade surplus. As the debtor countries’ net inflow of capital rapidly shrank from 1980 to 1981, however, their collective trade deficit grew larger. The volume of exports, which had grown at an average annual rate of 2 percent between 1970 and 1979, slowed in 1980 and declined in 1981 and 1982. The volume of imports did not contract initially, but began to slow in 1981 and fell sharply in 1982.

The further deterioration in the developing countries’ trade deficit reflected the slowdown in worldwide economic activity that quickly followed the rise in interest rates. Economic growth in the large industrialized countries, which constitute the major market for developing-country exports, was very sluggish in 1980 and 1981, and fell 0.4 percent in 1982. As economic growth in developing countries slowed, exports and income growth also slowed. In addition, commodity prices fell sharply in 1981 and 1982, affecting nearly all heavily indebted countries, which typically are exporters of natural resources and agricultural goods. Because trade patterns could not quickly adjust to the changing patterns of financial flows, the heavily indebted countries used official foreign-exchange reserves to help finance part of the net capital outflows, and thereby to “buy time” for adjustment. Many also began to reschedule their debts. According to the World Bank, an average of three developing countries per year rescheduled their debts in the 1970s. Thirteen countries did so in 1981 and 21 countries rescheduled in 1982. Through rescheduling, countries could stretch out repayments and usually could secure additional financing from commercial banks and official channels. In effect, rescheduling and refinancing could reduce near-term net capital outflows and could help debtor countries avoid default. As they used reserves and rescheduled loans, the heavily indebted countries began to take steps to generate trade surpluses. This required them to increase private savings (reduce private consumption) relative to private investment and to lower their government budget deficits. Developing countries often undertook these adjustments as part of a rescheduling agreement. Despite cutting expenditures and raising taxes, budget deficits increased, as governments in debtor countries took over, or guaranteed most of their countries’ debts. Private consumption fell sharply in 1983 and has remained below 1982 levels in most heavily indebted countries. With large budget deficits and with further cuts in private consumption politically infeasible, more and more of the adjustment burden has shifted to investment spending. Unfortunately, one way to increase private savings relative to private investment is to cut investment. The decline in investment spending in developing countries tends to worsen their long-term prospects for economic growth and development. A deterioration in the terms of trade, the ratio of a country’s export prices to its import prices, also contributed to the shift from trade deficit to trade surplus among the heavily indebted countries from 1981 to 1983. The deterioration in the terms of trade reflected both a decline in worldwide demand as well as the development of policies designed to enhance exports and to counteract rising trade barriers. Although a decline in the terms of trade could enable a country to carve out a larger share of world markets, it is a two-edged sword. As exports become cheaper, debtor countries must produce and sell more goods to pay off a given level of debt service. Because primary commodities are likely to be less sensitive than manufactured goods to relative price changes, developing countries’ trade flows might respond only to relatively large changes in the terms of trade. The real resource costs of debt service rise, and the debtor country is worse off relative to the case where it can service a given amount of debt at a higher terms of trade.

### Two Steps Forward, One Step Back

Thanks largely to rescheduling, and with economic adjustments under way, the heavily indebted countries generated an export surplus sufficient to match their net transfer of financial capital without a reserve loss after 1982. Interest payments leveled off, and capital flight seemed to slow. In 1984, the situation improved further. The trade surplus continued to grow, and the heavily indebted countries added to their reserves. In 1984 and 1985, with the rescheduling of debt, these countries could generate a sufficiently large surplus to achieve and to maintain the net capital outflow needed for their debt-service obligations. Worldwide economic activity continued to accelerate through 1984, enabling the trade accounts of debtor nations to improve further as a result from expanding exports than from contracting imports. Capital flight also seemed to taper off, and the terms of trade improved.

The gains made through 1985, unfortunately, began to erode in 1986. Although interest payments and other capital outflows continued to slow, the heavily indebted countries could not generate a trade surplus of equal magnitude in 1986; they consequently lost reserves. Last year brought some improvement, but not when compared to the situation in 1984 and 1985. Debtor-country export volumes declined sharply in 1985 and 1986, largely reflecting a slower pace of real economic activity among industrialized countries. The terms of trade for debtor countries declined sharply once again in 1985, increasing the real cost of servicing their international debt.

### Continuing Uncertainties

After nearly six years of austerity, rescheduling, and refinancing, the heavily indebted countries have made great strides in shifting their trade accounts from deficit to surplus. Nevertheless, they have made little progress toward reducing their debt burdens. The ratio of total external debts to exports rose from 304.4 percent in 1981 to 328.9 percent in 1987. The ratios of debt service to exports and of interest payments to exports have improved somewhat since 1981, but remain high (figure 2).