

**ISSUES OF THE INTERNATIONAL DEBT CRISIS: A STUDY IN DEBT
DIPLOMACY, 1980 – 1990**

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Abstract

This paper is a critical examination of some economic and ethical issues of International debt crisis. Mexico's default of interest payment on foreign debts in August 1982 marked a turning point in the history of international debt diplomacy, a development that initiated a discourse on International debt crisis. Since then, many states especially in the Global South began to have difficulties in the servicing and payment of foreign debt. Also, Western financial institutions faced serious problems which some people feared disintegration of the system in the 1980s. However, these institutions survived the crisis by introducing some innovations into the system. These innovations included debt rescheduling, reduction of interest rate, extension of repayment period and injection of fresh capital into the system. This paper examines some economic and ethical issues of international debt in the ongoing debt crisis facing most states in the Global South and suggests a way forward for the creditor and debtor states who are major actors in the International debt diplomacy.

Introduction

Debt arises when an economic interaction leads one person or state to owe money to another. A debt is therefore something owed. It allows a state to invest and consume beyond the limit of its domestic production . Borrowing is a normal economic transaction particularly in the western liberal capitalist system. It becomes necessary to borrow from foreign sources when a deficit occurs in a State's current account in order to avert economic disruption or bankruptcy. Borrowing is resorted to as a way of bridging a gap in domestic savings and the requirement of the economy. The borrowing could add value to the economy if appropriately invested and demand of the economic situation particularly on income generating ventures.

However, accumulation of loans that are not invested in any income generating venture make a repayment a crisis when the debtor is overwhelmed and the amount required for repayment is too high a percentage of income thus damaging the overall economic prospects. Liquidity problems derive essentially from inability to service and amortize debts on the time schedule initially contracted. ii

This is the situation in which many states in the Global South, such as Nigeria found themselves. The structure of the International economic system and the role therein of multilateral institutions such as the International Monetary Fund (IMF) conspire to determine the economic policy options available to these heavily indebted States. The huge debt is also a result of the patterning of Africa's incorporation into the global capitalist system, the adoption of a road to

development that led to increasing dependence, the frustration of development and increasing capital drain . For debtor's states, a debt crisis is a serious burden with great destabilizing effect over the economic, political and social fortunes of the State. Hermann Sautter argued thus;

The poverty rate has increased due to growing employment and reduction of real wages in the formal sector. The informal sector which is often characterized by an astonishing dynamism and flexibility was not able to compensate for these damages. Besides the economic and social dimensions, one must also mention the political aspect of the problem. The governments in the indebted countries are required to meet certain conditions which even industrialize, countries would be unable to meet: they must cut public services, raise taxes, accept temporary cut back in real wages in order to fight inflation and at the same time, they must accept a net resources outflow into the exterior. These requirements endanger the political legitimacy of these countries and limit the scope of action. iv

Without debt relief, emerging democracies in Third World Countries cannot respond positively to the core values of liberalism such as the rule of law, accountability, transparency, human rights and good governance. This is also because to service increasing interest and amortization liabilities, indebted countries have to commit a large proposition of their export earnings to debt service payments. The heavy debt service payment have inevitably put pressure on budgets leading to rising fiscal deficits in heavily indebted countries and further make them very vulnerable to economic pressures from the States in the Global North. v

In order to have a good discourse on economic and ethical issues on international debt crisis, this paper structured in four parts. Part one takes a look at the economic aspects of the international debt crisis. Part two examines the ethical issues in debt problems while part three focus on some issues that can serve as a leeway to the crisis. Part four is the concluding remarks.

Economic Aspects Of International Debt Crisis

Most states in the Global South enmeshed into International debt crisis since the early 1980s. The debt stock increased substantially between 1980 and 1987. It was only in 1988 that the increase subsided. Most Third World countries, especially in Africa were heavily indebted to official creditors (about 75% of their debts are with public creditors such as the Paris club and London club). The average growth rate of total debt stock was about 20% to 25% between 1979 and 1981. The consequence was a deterioration of the usual debt ratio. The relationship between foreign debt and Gross National Product rose from about 35% in 1979 to 65% in 1987.

vi

Since the 1990s, nearly 40% of total export earnings had to be used for debt service payment. Taking interest payment alone in the share is 20% which was twice as high as in the late 1970s. This ugly development can be linked to both external and domestic factors. One of the external factors was the evolution of interest rate of these foreign debts. During the 1970s, real interest rates (differences between nominal interest rates and inflation rates) was relatively low, meaning that debtor countries were rewarded for taking financial resources of the creditor

countries. This scenario changed dramatically after 1980. The level of real interest rate tripled between 1980 and 1984 mainly because by the monetary and fiscal policies of the major industrialized states. Many indebted countries such as Nigeria, Ethiopia, Kenya among others were unable to pay these high interest rates and this led to the international debt crisis. At the same time, the terms of trade worsened in the developing states beginning from 1981. vii

Therefore, when interest rates increased substantially, the chances to earn a foreign trade surplus for servicing the outstanding debt worsened. From both sides, the heavier debt burden weakened the capability of the debtor countries to bear the burden of debt crisis. The indebted countries were pushed into serious debt crisis. The difficulty these states had in repaying this debt caused commercial banks to reevaluate the credit standing of their debtors. This reevaluation led the banks to drastically restrict their disbursement. Forced by this reduction in resource inflows, debtor countries had to take drastic measures in correcting their external imbalances, whether or not they had agreed to an adjustment programme with the IMF. Such measures as devaluation, a restrictive monetary and fiscal policy as well as special export incentives were all used in an attempt to rescue the deficit in the balance of payment. Surprisingly, these met with great success, which can be attributed more to the reduction of imports, rather than to the increase in exports. The growth in export was hindered by the protectionism practiced by the highly industrialize countries. viii

The consequence of activating the balance of trade was a dramatic reversal of the net capital flow. Until 1982, the heavily indebted countries were net-capital importers, since 1983, they are net exporters. There was net transfer from official and private creditors to all heavily indebted countries, the net transfer being defined as the differences between total disbursement and total debt service payments. In this situation, private creditors ceased to be capital exporters. They imported capital which means that the indebted countries changed their position and became net-capital exporters. With regards to official creditors the change was less dramatic. The heavily indebted countries received an inflow of capital from these sources but on a much lower level than before. The capital outflow was more the result of an import reduction than of an export growth. By reducing imports, debtor countries tried to keep their maintenance imports at the same level as before. The improvement of the balance of current account can primarily be attributed to a restriction of imported capital goods. This had an effect on the investment process. ix

The ratio of total investments to the Gross Domestic Product dropped drastically, especially in African States. In 1988, the investment ratio was the lowest since 1960. This, in turn, had consequences for the growth rate of national income, as this rate depended more or less on the process of capital formation. In most of the indebted countries, the growth in population the income per capita fell substantially. This was a sketch of the bleak economic conditions in the heavily indebted countries. Many erroneous decisions made internally growth impeding effects and were further aggravated by an increase of real interest payment. This economic situation had an effect on social and political conditions in these countries. 10.

One of the social effects was growth in poverty. The poverty rate increased due to growing unemployment and through a reduction of real wages in the public sector. The private sector, which is often characterized by an astonishing dynamism and flexibility, was not able to compensate for these damages. Of course, the growing impoverishment in indebted countries has many causes. One cannot solely blame the foreign debt crisis, yet, the debt crisis has, no doubt contributed to the worsening of social conditions. 11.

Besides the economic and social dimensions, one must look at the political aspect of the debt crisis. The governments of the indebted countries are required to meet certain conditions which even industrialized countries would be unable to meet: They must cut public services, raise taxes, accept a temporary cut back of real wages in order to fight inflation and at the same time they must accept a net-resource outflow into the International system. These requirements endangered the political legitimacy of these countries and limit their scope of action. It is possible therefore, to compare the situation in these indebted countries to Germany's situation during the 1920s. The inflexibility of Germany's former enemies on the issue of war reparations contribute to her economic ruin, thereby creating a basis on which a dictatorship could come into existence. In a similar fashion, democracies in heavily indebted countries, felt threatened because they were unable to come to terms with their debt services.

12

Ethical Issues On The Debt Crisis

It is not surprising that this debt crisis raised some moral questions. These issues became even more emotional, the more ambiguous the analysis of economic conditions becomes. There were some theological critics who have sympathy for the medieval prohibition of interest and demanded a restriction of the exchange economy on an International level. The most common demands made by these critics who argued purely from moral standpoints were in favour of a general debt cancellation. Typical of these arguments was the individual-ethical paradigm. Ethical appeals which were directed towards banks and governments demanded that the burden of debt be lessened. International credit relationships were attacked as being too complex and restrictions of trade relationship as well as a return to a subsistence economy were suggested.¹³

However, a serious ethical evaluation of the debt crisis can only be made on the basis of a social ethical paradigm. This required the acceptance of an exchange economy at the national and international levels and the recognition of the fact that every economy needs to be put in order. Proceeding from such a standpoint, it is first of all the rules of order which are responsible for the moral quality of those acting within the order. Therefore, moral appeals should not only be directed to individual firms but also to those who are responsible for shaping an economic order. They must establish rules and institutions which correspond to the values of the society. However, this does not make individual ethical consideration obsolete, for each set of rules stands in a complementary relationship to the behavior of the individual, to whom these rules apply. The related question here is which ethical values should economic action serve? In answering this question, one meets with some problems in view of international economic relations because major actors of the International economy have different values. All State actors that participate in international economy, the preservation of human life and the right to develop one's life are central ethical values. Therefore, the purpose of economy is to make available the necessary goods needed to preserve human life. Under such conditions of scarcity, this can only mean that these goods must be efficiently produced and distributed. Also, it is a social value to preserve the life of all members of society, and to put them in a position in which they can achieve their own goals. 14

Another issue is, which rules are suitable to guide economic actions towards a realization of these values. To address this issue, the argue that the establishment of a market is more likely to provide for an efficient production of goods, and at the same time, it can better

facilitate the self development of those in society who participate in production. In this way, one can speak of the market as a legitimate ethical institution. With additional institution oriented towards a redistribution of income, one can accomplish those social goals which were not accomplished by the market itself. 15

The creation of markets and their integration into the world capially system was a political achievement. In this context, some specific duties of the political system remain to be fulfilled. Some of these explanations relates to securing the congruity of responsibility, competence and liability in economic decisions, to secure free access to markets, and to establish suitable rules for internalizing external effects. It is argued that a competent political system which can fulfill the duties on national and international credit markets will lead to a satisfying ethical result. This consist an efficient national and international resource allocation, facilitating the development of countries which participate in this allocation and improving social conditions for helping the poor. 16

The antithesis of this position claimed that because there has been lack of competent political system within the countries and on an international level, international credit businesses have allowed a questionable ethical result to come into being namely; the resource allocation became distorted, the scope of action of many debtor countries, and of many people living in these countries were restricted and the basic conditions needed to survive deteriorated. 17

However, it is pertinent to highlight the duties of a political system and demonstrate to what extent they have remained unfulfilled and what the resulting consequences were. In this case, deficiencies in the economic order are one of the major causes of asymmetrical and unsatisfactory results in international financial system. Proper decisions relating to the use of scarce resources can only be expected when the person in the position of decision making is responsible for the results of his decisions and is held accountable, that is he is either rewarded or punished. In view of this first condition of an economic order: the congruity of responsibility, competence and liability, deficiencies were evident, which led to an inefficient allocation of capital. This was heavily responsible for bringing about the debt crisis.

There are numerous indications that the expansion of money lending to the developing countries in the second half of the 1970s was the result of political pressure from the governments of the creditor nations. Of course, the export interests of the industrial nations also played a role. Due to this pressure, commercial banks expected that eventually the blame for losses could be shifted to the general public. This could be expected especially in those cases where the government openly credit guarantees. Therefore, the commercial banks became involved in a moral hazard. The competence in giving credit did not go hand in hand with responsibility and accountability. The consequences were a great expansion of bank credits without a careful examination of various projects which credit was requested. Herein lays one of the major causes of the debt crisis. 18

A shift of risk allowed by such distortions in the decision making process may not only cause a careless credit expansion but also an abrupt restriction of new credits, which may produce a typical feast and famine syndrome. This happened when government rescue action in favour of liquid or insolvent commercial banks are regarded as less probable than before. Then the careless granting of credit turned into an over-careful credit policy. There were many

indications that Mexico's default of payments in 1982 played a greater in promoting such behaviors. 19

Government in the States of global North began to sound warnings regarding careless lending policies. The commercial banks saw therein signs of change in attitude of governments in respect to their former declaration of guarantees. This led to a drastic drop of new loans, and therewith increased the liquidity problem in the indebted countries. It was likely that this liquidity crisis whereby one must keep in mind that a clear differentiation does not exist between these two issues. 20

Against this backdrop, the Commercial banks lacked the congruity with regard to responsibility, competence and liability, which developed into a moral hazard, led to an inefficient allocation of financial resources. This became one of the major causes of the debt crisis. A second factor which further worsened the situation was the creation of market barriers. These barriers played a greater role at three different levels. One, in the early 1980s, the regulations of the Commercial banks in the United States limited the domestic business of these banks which led, with a given high liquidity to an over expansion of international lending. Two, many small and medium scale enterprises in the global South were excluded from the formal credit markets. The foreign credits were only made available to businesses who were active and regular participants of the formal market, whereby statal and parastatal enterprises were given preferences. This market barrier in the heavily indebted States in the global South impeded the growth of production as well as the realization of social goals. xi Three, the most severe market barrier was created at the International Level. Within few years, the industrial States of the global North began to ignore the General Agreement on Trade and Tariff regulations to protect their national markets. Various excuses and loopholes were found in order to circumvent GATT regulations and justify protectionism. The countries mostly affected by these situations were the newly industrialized States which bore part of the debt burden. In the face of this situation, it is safe to argue that it was the policies of the industrialized countries that forced the heavily indebted countries into serious economic hardship, thus leading to the impoverishment of these countries. These existing barriers at the International Level became a basic deficiency of the International economic order²¹.

GATT could not resolve the logjam caused by fiscal policies of the industrialized countries. Furthermore, these barriers led to an aggravation of the debt crisis and also engendered inefficient allocation of credits which culminated and compounded foreign trade problems in the heavily indebted countries. Another deficiency which led to worsening of the debt crisis was the absence of rules to internalize the impact of external fiscal policies that is the pecuniary effects at the International Level caused by the industrialized countries. These countries, with strong market power and political will to enforce certain fiscal policies which impacted adversely on the economics of the heavily indebted countries. There were neither institutions to internalize these effects within the bureaucratic settings of the heavily indebted countries, nor an International regulatory body which could limit the market power of the industrialized countries. These problems led to the heightening of the debt crisis. The combination of restrictive money lending policies and expansion of certain fiscal policies contributed in no small measure to the increase in international interest rate as well as triggering off of a change in International capital flow. These factors aggravated the debt crisis, and created an International 'Crowding Out' effect. In this ugly situation, the heavily

indebted countries bore the brunt of these policies as no international institution nor regulations, were put in place to ameliorate the situation²².

Another factor that led to debt crisis was lack of political will and expertise in the heavily indebted countries to put in place efficient relevant institutions and fiscal policies to engender a sound and resilient economic order; especially in Africa, Asia and Latin America. The above situation impacted adversely on the credit transaction with international creditors. In a rent-seeking State, private borrowing with international creditors is guaranteed by the State thereby socializing the risk of borrowing. This prompted the willingness of borrowers to become indebted and to accept variable and terrible interest rates. These factors led to the aggravation of the decline in the economic fortunes of these States and worsened the debt crisis²³.

In the height of these situations, the heavily indebted States made frantic effort to service these debts at the detriment of their political, economic and social development. Under these unbearable debts burden, they started various campaigns for outright cancellation of these debts, an effort that had not yielded the expected results. Rather these countries continue to wallow in these situations. However, bearing in mind the impact of these debt burdens on the political, economic and socio-cultural development of these indebted countries, one question begging for answer is what is the leeway to this logjam?, or the possible solutions to these problems or crisis? The remaining part of this paper will attempt to address this question.

Dispassionately, various steps taken so far to address the debt crisis have not dealt with the major cause of the debt problem which is the asymmetrical economic relationship between the rich States of the global North and the poor State of the global South. Rather, all proffered solutions hinged on the reduction of chest servicing, lowering the interest rates, extension of repayment timelines and even outright cancellation of these debts. From the realist point of view, it is senseless to cancel debt or even reduce debt service payment without changing the institutional structures which caused the debt problem. This is only a short term measure which will lead to a recurrence of the crisis²⁴. The paper argues that the first step to address the debt crisis is to restructure the International economic order so that International money lending can synergize with some ethical or moral values. In restructuring of the international economic order the paper recommend that:

First, government in the creditor nations must refrain from policies that distort the risk that Commercial banks have to bear in the course of lending. This was necessary in order to create enabling environment for allocation of financial resources efficiently and morally. Government of the lending nations must put in place insurance system for bank deposits as well as lender of last resort guarantees of central banks so that commercial banks are not the only one in the credit risks.

Second, existing market barriers, which exclude small and medium scale enterprises from credit market must be eliminated. This can be achieved through a consequent competition policy and by avoiding any interventionism. At the International Level, free market entry entails removing import barriers erected by the industrialized nations, giving room to GATT to ensure trade flows and reform International trade order.

Third, rules of engagement are required that can facilitate the internationalization of the external impacts. One way of achieving this goal is through a cohesive international

cooperation among the industrialized nations in the fiscal and monetary policies. Also, the IMF oversight role can address the existing lopsided relationship between the Creditor nations and indebted nations. This will ensure a stringer feedback mechanism in the Creditor's nations, especially in their decision making processes.

Forth, economic policies must be tailored to laid down rules and the ability of the State to shape the economic order must be ensured in order not to be undermined by private interest groups. Necessary amendment in monetary and fiscal policies must be made to ensure and improve stability in the financial system.

Finally, the long term solution to the debt crisis must be packaged with all relevant elements. Debt relief, extension of repayment periods, reduction in the interest rate must be backed up with a radical reform and restructuring of the international economic order. Since these elements are intertwined and complimentary, debt relief, reduction of interest rates and even extension of repayment period may not make and economic sense of the old structures and rules of the international economic order is left untouched. On the other hand, having the changes without granting the short term measures will not make any political or economic sense since the ethical and economic elements are complementary in this direction.

Conclusion

This paper has addressed the ethical (debt relief, debt cancellation, reduction of interest rate and extension of repayment timelines) and economic (restructuring and reforming the institutions and rules of international economic order) as the basic requirements of addressing the current debt crisis. The paper has argued the economic and ethical aspects of the debt crisis are complementary but not contradictory. The paper therefore concludes that the obligatory tasks of all the actors in the International economic system are to establish rules and institutions which can direct economic activities to meet and fulfill ethical values. The debt crisis is one aspect of the international economic system to which these measures applies.

Endnotes

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