REVIEW ARTICLE:

THE POLITICAL ECONOMY OF THIRD WORLD DEBT

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> "Today, Mexican industry is developing dynamically in many different directions. Our knowledge of the local business terrain can be invaluable. So if you're interested in Mexican business opportunities - of any kind - talk to Bank of America".[1]

INTRODUCTION - THE PROBLEM

A bewildering array of words and figures has recently been produced on the so-called Third World debt crisis. However, the long term political economic forces which are at the root of the crisis have received little analysis. Thus, after a brief review of the "numbers" which have led to the current concern, it is these political-economic issues which will be addressed.

The most extensive data on Third World debt is contained in tables published by both the World Bank and the Bank of International Settlements (BIS). Several other sources provide useful summaries of such data.[2] The most commonly cited figure is that total indebtedness of Less Developed Countries (LDC's) reached $630 billion by the end of 1981, with some $140 billion of it being short-term debt (or having a maturity of less than one year).[3] Some $300 billion worth of the total indebtedness is owed to private banks (as opposed to governments and multilateral institutions) with the US banks' share being something over one third.

After taking into account available assets such as LDC Deposits with BIS banks which offset these debts, other sources estimate that banks in the West had an exposure in the non-OPEC LDC's amounting to some $159 billion at the end of 1982.[4] $108 billion of this was owed to US banks with some $70 billion of it being owed by borrowers in Latin American and Carribean countries. Of the $70 billion, some $40 billion is owed to the 9 largest banks in the US and some $54 billion was owed by the so-called "MBA" countries (Mexico, Brazil and Argentina). This concentration of borrowings potentially makes the debt both more threatening and more manageable.[5]

During the period 1975-79, international earnings were a large percentage of the total earnings of the ten largest banks in the US. For instance, Citibank Brazil generated 20% of the entire company's earnings in 1982.[6] This relatively high return on foreign loans encouraged such banks to leverage themselves into a position where their total amount of foreign loans exceeded their shareholders' invested equity by an average of 169%.[7]

The banks' worst exposure in this respect is in Mexico, where Manufacturers Hanover Trust has loans equalling nearly 80% of its shareholders capital.[8]

A variety of equally dramatic figures is available in respect of the LDC's. For instance, the debt service payments of the middle income developing countries for 1982 averaged 17% of the sale proceeds of their exports.[9] Equally, the Brandt Commission points out that between 1980 and 1982, LDC export revenues fell by $40 billion, their debt service payments rose by $37 billion, and long-term and medium-term lending to LDC's fell by $5-10 billion.[10]

Nevertheless, if only to maintain depositor confidence, bankers constantly assert that the situation outlined is not particularly troublesome.[11] Such denials do not seem to square with the continuing decline in international bank lending to the Third World.[12] In the meantime, with the accounting profession's cooperation about what constitutes a default,[13] and with the help of huge renegotiation fees, bank profits have continued to soar.[14] Both the US government and the bankers maintain that the situation will right itself naturally by economic growth in the industrialised countries enlarging the volume of LDC exports. Therefore, in addition to examining the political-economic forces behind the figures, this article will assess the potential for a crisis and what might be done to avoid it. During this discussion, it should be borne in mind that major sovereign country defaults on bank loans are a recurring feature of the history of the last 150 years.

THE POLITICAL ECONOMY OF LDC DEBT

The background

The only recent full length studies of the political-economic forces that form the background to the current LDC debt crisis have been books by Gisselquist[15] and Versluysen respectively.[16] Gisselquist takes a liberal perspective while Versluysen follows a more conventional line. Neither of them present adequate conclusions on likely developments or remedies to the problems. However, a review of their presentations provides a useful starting point for this analysis.

In conformity with several other works on modern political economy,[17] Gisselquist sees four periods between 1870 and the present.[18] The first period, from 1870 to 1930, is portrayed in terms of a multilateral, multicentred world of nation states and of a slowly disintegrating British Empire. The second, from 1931 to the outbreak of World War II, was a period of multiple blocs, notably the British empire, the French empire, and the Japanese empire. The United States was still struggling to establish itself as a trading force in the face of resistance from these other blocs. The third period, from World War II to 1970, Gisselquist considers was dominated by the American and Soviet blocs. Finally, after 1970, a multilateral, multicentred world is seen to have emerged again with the recovery of Europe and Japan.

An examination of these past periods reveals characteristics of the current period. The period after 1870 was the first modern period during which government to government lending became important. In particular, it was a period when lenders began to exercise political control over troublesome borrowers by using influence in the bond markets to prevent new bond issues to borrowing countries until existing loans had been rescheduled. In addition, both in France and the United States, foreign bonds could not be issued until the government had given its approval. In his work on imperialism, Lenin observed how this period saw the combination of finance capital and foreign governments to produce new forms of national dependence.[19]

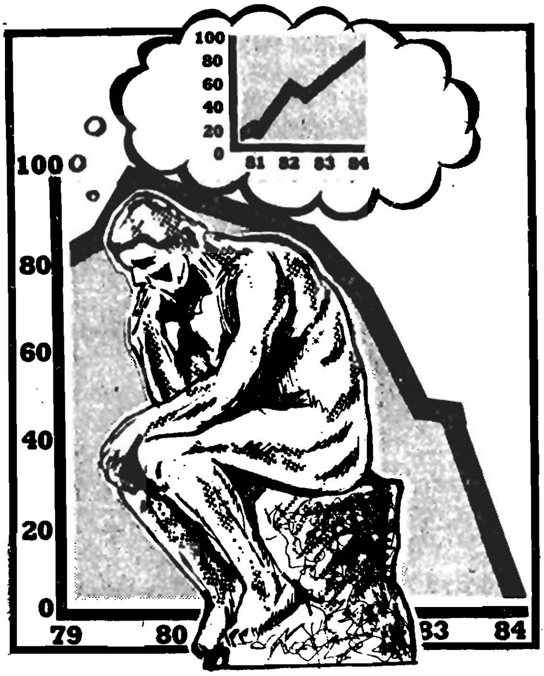
Nevertheless, such cooperation was not sufficient to prevent many bond defaults during the recession and deflation of the 1870's. In the case of many Latin American countries, contributing factors were the actions of reckless bankers and corrupt governments.[20] The major defaults of the period, however, were those of the US railroads of the 1890's, those brought about by the Russian revolution, and those of the German government in respect of war reparations. An important factor in these loan losses was disagreements among the major creditor powers. Towards the end of the period, a significant feature was the emergence of multilateral loans, together with a degree of cooperation among central banks of various countries. Cooperation also emerged among central bankers and private bankers.

Cooperation gave way to conflict during the second period. Further, the numerous defaults which occurred at the time (including Britain and Germany) were to cause the substantial curtailment of international private lending to governments for some 35-40 years. The period of the two-bloc world which lasted until the end of the 1960's began with the efforts of the United States at the various conferences on the post-war financial system. These efforts were successful in that the U.S emerged as the dominant financial and political power in the West. Shortly afterwards, the Marshall Plan not only assured Europe's regeneration but also the prosperity of U.S. industrial capital. Thereafter, such U.S. aid as was available flowed to the Third World, rather than to Europe. The significant features of such aid and the other financial flows in this period were that it was mostly in the form of government to government loans and grants within the boundaries of the two blocs. During the 1960's, official development assistance (ODA) from the U.S. to governments began to decline. The U.S. was seeking to offload some of its burden in order to deal with increased competition. This competition among capitalist powers would continue to increase while rivalry between the capitalist and socialist blocs would decrease. Private export credits (finance tied to purchase of the donor's exports) increased as a share of total financial flows. Finally, the competition between industrialised countries for current account surpluses contributed to deficits in LDC's and larger financial flows to them.

The final acts which set the stage for the 80's debt crisis came in the late 60's and early 70's as the U.S. began to experience balance-of-payments difficulties due to increased competition from Europe and Japan, together with the mounting costs of running an empire (including the Vietnam war). It was clear to the American ruling class that steps would have to be taken if the U.S. were to maintain its hegemony. Accordingly, the U.S. began to favour more multilateral financing in order to spread the burden of international aid. There was a decrease in U.S. direct aid and a corresponding increase in the funding capacity and power of the IMF. At the same time, the U.S. began devaluations to regain its competitiveness, favoured higher oil prices to enhance its dividend and taxation revenues, and began to support private bankers lending to LDC's (with oil funds) to replace the declining U.S. aid.

The re-emergence of the multilateral, multicentred world in the 1970's was in the first instance due to the comparable industrial capacity of Europe and Japan. The two major features of the period in terms of the Third World debt situation were the coming of age of the Euro-currency market and the first oil price rise. The Euro-currency market simply means a market in major currencies in countries where those currencies are not legal tender (e.g. trading in the U.S. dollar in Europe).[21] Versluysen has analysed the rise of this offshore market in terms of the internationalisation of finance capital to meet the needs of international productive capital (which takes the form of transnational corporations). A by-product of this process was the use of the Euro-market by the LDC's when declining aid and the oil price rise began to lead to increasingly large LDC deficits. With detente thawing the two-bloc world, the East European nations were also able to avail themselves of this new source of development finance. The situation of the LDC's and their subsequent need for new sources of finance was at the same time exacerbated by an increase in world-wide protection and a decline in their real terms of trade.[22] (This has been demonstrated most vividly by President Nyerere's famous comment on how many extra tons of a primary product now have to be exported in order to purchase one tractor.)

At a more immediate level, it is apparent that the private banks were very eager to "re-cycle" the influx of oil funds which occurred after the oil price rise ("petro-dollars"). Equally, the LDC's welcomed such funds which were free of the "apron-strings" to which they had become accustomed in the case of official development assistance. There was no requirement that the credit be used productively on projects which would generate a cash flow to repay the loans. The result was that the private banks once again became the channels of the largest share of international financial flows to the Third World, as they had been during the multilateral,



multicentred period of 1870-1930. Several technical advances in the Euro-market, such as the use of floating-rate loans, interbank borrowing, and off-shore offices (havens), greatly assisted the banks' growth in size and profitability.

Gisselquist[23] has usefully summarised these developments in terms of patterns of international financial flows as a whole. He notes that whereas the strongest industrial countries normally have current account surpluses while LDC's have deficits, the oil price rise distorted this pattern for a time. In due course, such industrial countries adjusted to regain their surpluses (partly at the expense of a stable international financial system), the OPEC countries accumulated huge reserves in the international banking system, and the LDC's and the weaker industrial countries incurred larger deficits. International financial balance was naturally achieved via the private banking system making the OPEC reserves available to finance the deficit countries. While the rich nations have been able to obtain private finance and the poorest nations[24] have been able to obtain only government finance, the "better-off" LDC's have had access to substantial quantities of both private and government funds. It is these LDC's which are the subject of the current crisis.

The IMF

A study of the political-economic background of the crisis also requires an examination of one other major actor in the current multilateral world - the International Monetary Fund (IMF).[25] As already noted, this organisation was created at the Bretton Woods conference in 1944, as a compromise between the positions of the U.K. and the United States. The chief delegates of those two countries were John Maynard Keynes and Harry Dexter White respectively. Given the decline of the British empire, Keynes envisioned a world central bank which would effectively take over much of the U.K.'s large international debt. On the other hand, the United States sought an international financial system which would support the reserve status of the U.S. dollar. It only accepted the IMF on the basis that it could control it directly.[26] Even after the U.S. gerrymander was modified in the 1960's, the system whereby a member's vote is dependent on its GNP still means that ten industrial countries control 56% of the total vote.[27] Contrary to the ideals of Keynes, the IMF has pursued a world system which first failed to limit the balance of payments surpluses of the U.S. and then protected the capacity of the U.S. to run continuing balance of payments deficits.

Other aspects of the Fund emerged during the period 1950-60 while the U.S. was the dominant global force. First, the financial capacity of the Fund was not permitted to grow as planned[28] although some expansion did occur. Secondly, although a system of "no-strings" loans had been planned, the U.S. was able to interpret the rules to allow for a system of loan conditionality.[29] This has been the means by which the IMF has imposed its policies of deflationary monetary control, cuts in public expenditure, devaluations, and maintenance of foreign investment.[30] Thirdly, it is clear that throughout the post-war period the IMF has been used politically by the U.S. as an agent of its foreign policy.[31] This has now seriously undermined its legitimacy within the Third World and its consequent ability to meet the demands of the current crisis.[32]

Accordingly, the small financial capacity of the Fund was a factor in the pattern of borrowing which has emerged, while conditionality has allowed the emergence of a new imperialism whereby the U.S. enforces policies (via the IMF) designed to maintain economies which are open to international capital, with its ongoing cycles and crises.[33] The IMF's role as a agent of U.S. hegemony has also prevented it being a vehicle of international cooperation and has undermined its capacity to do so even to the limited extent its position might have permitted.

A CRITICAL LOOK AT PROPOSED SOLUTIONS

The currently proposed solutions to the debt crisis can be divided into three broad categories. First, there is the growth solution according to which the problem will be solved by growth in the industrial countries. It is said that such growth will lead to an increase in the LDC exports so as to allow LDC's to meet their debt-servicing commitments. The second solution maintains that at least some debts will have to be written off mainly by setting up an international agency to take over the debts. At the same time, policies of mild global economic expansion would be followed. The third solution simply relies on

increased regulation of banks. Each of these will now be assessed in turn.

The Growth Solution

This solution is derived from econometric models of the global economy which assess the impact on LDC debt of changes in variables such as industrial country growth, the oil price, interest rates, the dollar exchange rate, commodity prices, and inflation. These solutions are basically optimistic, stressing that if a growth of about 3-4% is attained in the industrial world during the next 5 years, then LDC debt is manageable. Needless to say, this view represents the reigning Eastern U.S. "establishment" view. The three available variations of the theory are those of the U.S. Administration,[34] the Morgan Guaranty Trust Company,[35] and the Institute of International Economics in Washington.

The paper by Cline of the Institute of International Economics begins with two crucial but questionable assumptions - that bankers will go on lending to LDC's and that political upheaval in any LDC will not occur. He then runs forty computer simulations of the global economy. He concludes:

> "Based on individual country projections through 1986 for the 19 largest debtor countries, accounting for two-thirds of developing country and Eastern European debt, if a critical threshold of 3 percent annual OECD growth is achieved in 1984-86 the debt problem becomes considerably more manageable. The size of debt and deficits relative to exports declines substantially. At present, then, the debt problems should be judged as one of illiquidity, not insolvency. But appropriate macroeconomic policies of cautious expansion should be followed in the OECD to help ensure that the critical growth threshold of 3 percent is achieved."[36]

The U.S. Administration study comes to the same type of conclusion, except that it finds an even higher rate of growth of 4.2% to be required before the debt becomes manageable. Naturally, there is considerable concern even within "the Eastern U.S. establishment" about whether such growth rates can be achieved. For a start, it should be noted that industrial country growth rates have been steadily declining for two decades, averaging 5.2% for 1960-70, 3.2% for 1970-80, 1.4% for 1980, and 1.8% for 1981. Secondly, even the current Morgan Guaranty study finds:

> "As regards OECD growth, there are still considerable doubts about the prospects for sustained recovery. Although U.S. recovery appears on track... there is still uncertainty about the direction of U.S. interest rates because of the prospective large U.S. budget deficits. Moreover, economic policy and outlook in Europe and Japan are not as promising as in the U.S. Europe is plagued by high and rising unemployment, large budgetdeficits in some countries, and considerable wage rigidities. Also, a European economic recovery is

highly contingent on Germany, where modest growth is foreseen. In Japan economic growth is well below potential, and signs of recovery are still quite faint."[37]

These doubts are echoed in recent suggestions to the effect that even if the current recovery initially produces the required growth rates, such a recovery will be short-lived.[38] The growth forecasts also overlook the intensifyingstruggle between different sectors of capital and between capital and labour over the amount by which industries in the developed world should be protected from competition from Third World exports. Meanwhile, there will be continuing struggle among the leading industrial nations over the same issue as the U.S.A. continues to pressure Japan and Europe to keep their markets open to Third World exports.[39]

Morgan Guaranty proposes a variation of the growth solution by incorporating parts of the second strategy such as more expansion through additional official development assistance and less reliance on deflationary adjustment in the LDC's. As such, it is more realistic than most capitalist proposals because it recognises the part played by deflation in earlier defaults, and the potential for deflation to lead to political upheaval. It also represents a case of the bankers getting "cold feet" in the manner in which it proposes the substitution of multilateral lending and direct investment for bank lending to LDC's. For instance, Morgan proposes a scheme for the World Bank to guarantee private investment in the Third World and to advise on policies to attract foreign investment and prevent government intervention. However, when it opposes writing-off any debt on the grounds that it would be a disincentive to further lending to LDC's, it is difficult to believe that more lending would be contemplated in the foreseeable future.

'However, the Chilean man-in-the-street appears to have few complaints.'

In sum, the chief problems with the growth solution are that it is questionable whether the required growth will be achieved and whether the required conditions of ongoing bank credit and LDC political stability will hold. In addition, the major objection from the Third World point of view is that LDC's are required to bear the entire burden of adjustment while the bankers continue to make large profits and the industrial world does nothing about redistributing any political or economic power or resources. The Third World remains a neo-colony of the West.

The Debt Reduction Solution

Proponents of this view accept that something more than rescheduling and waiting for growth is necessary to overcome the problem. There are two trends of thought in this group. On the one hand, several people with close connections with the banking industry propose reducing the LDC debt burden by having it assumed by an international agency which issues bonds to finance itself.[40] The other trend is represented by the Brandt Commission which places more emphasis on expansion of multilateral funding with possibly some reduction of debt either by write-offs or by utilising the bond solution. Further variations again are to reduce the debt either by indexing it to inflation[41] or by requiring LDC's to make payments only in accordance with foreign exchange earnings.[42] Both of these last two variations can be dismissed as politically unrealistic.

The various bond solutions all propose some expansion of global credit. In this respect, the Brandt Commission has the most exhaustive analysis of the various ways the IMF could expand its financial resources. The Brandt Commission proposals have the additional feature of advocating the replacement of the IMF's short-term deflationary stabilisation policies with longer term LDC development strategies as well as seeing the necessity for some transfer of resources to the Third World (although totally within the confines of the capitalist trading system). On this basis, with greater LDC participation in the IMF, the organisation could emerge as a neutral world central bank free of the problems that have plagued it thus far. Although Brandt's analysis does not go to this length, this would be a move towards one of the stable models of a world system, free of the hegemony of any one ascendant power.[43]

The chief problem of both the bond and the expanded credit aspects of this theory is that it is politically unlikely to occur in any acceptable fashion. Although the banks claim that it would be a disincentive to future lending, it has already been noted above that they are hardly likely to lend again anyway. In any case, if a variation of the bond solution were adopted, it is unlikely that the banks would be forced to privatise much of the loss, notwithstanding that the logic of the notion of bankruptcy indicates that the shareholders should bear the loss. It is more likely that the taxpayers would bear the burden of the write off of debts with finance capital surviving larger than ever.

The Regulation of Banks Solution

The various solutions in this category concern controlling the banking sector by such things as requiring more disclosure of information, by imposing country lending limits, by regularising the procedures for rescheduling debt, and by changing the structure of the IMF to enhance its legitimacy.[44] The obvious criticism of these types of measures is that they are designed to prevent the next crisis and not to overcome the current one. The preoccupation of the U.S. Congress with such matters bespeaks the parochial, isolationist tendencies of that assembly.

18. Gisselquist, *op.cit.*, pps. 7-12.

19. Cited in Gisselquist, *op.cit.*, p. 40.

20. Gisselquist, *ibid.*, p. 35, 55.

21. Versluysen, *op.cit.*, p. 16.

22. *Ibid.*, p. 139.

23. *op.cit.*, pp. 12-26.

24. Brandt Commission, *op.cit.*, p. 22.

25. Gisselquist, *op.cit.*, chapter 8.

26. Gisselquist, *op.cit.*, p. 220.

27. Versluysen, *op.cit.*, p. 172.

28. Dell, S., "On Being Grandmotherly: The Evolution of I.M.F. Conditionality", International Finance Section, Princeton No. 144, October, 1981, p. 16.

29. Dell, *op.cit.*, pp. 1-10.

30. Versluysen, *op.cit.*, p. 173.

31. See a report of a recent Congressional study in *Wall Street Journal*, 18 May, 1983. See also Gisselquist, *op.cit.*, p. 224.

32. See *Wall Street Journal*, 4 January, 1983, for example.

33. See the analysis by Payer, C., "Effects of World Bank Project Lending on Borrowing Countries", a paper prepared for the Centre for Economic & Social Studies of the Third World, April, 1982, unpublished.

34. See *New York Times*, 19 April, 1983.

35. See Morgan Guaranty Trust Company, "Global Debt: Assessment and Long Term Strategy", *World Financial Markets*, June, 1983.

36. Cline, W.R., "Mexico's Crisis, The World's Peril", *Foreign Policy*, No. 49, Winter 1982-83, p. 107.

37. *Op. cit.*

38. *New York Times*, 14 July, 1983 and *Wall Street Journal*, 3 October, 1983.

39. Epstein, G., "Domestic Stagflation & Monetary Policy: The Federal Reserve and the Hidden Election", in Ferguson, T. and Rogers, J. (eds.), *The Hidden Election*, Pantheon, N.Y., 1980, pp. 141-195.

40. See Rohatyn, F.G., "The State of the Banks", *The New York Review*, November 4, 1982, Weinert, R.S., "Banks and Bankruptcy", *Foreign Policy*, No. 50, Spring 1983, and Steinberg, B., "How the debt bomb might be defused", *Fortune*, May 2, 1983.

41. *Wall Street Journal*, 24 March, 1983.

42. *Wall Street Journal*, 3 March, 1983.

43. Block, *op.cit.*, p. 224.

44. Gisselquist, *op.cit.*, p. 243-251.

45. See Gisselquist, *op.cit.*, p. 242.