Unit Seven: Money Problems - “Debt Crisis” and Financial Crises

Dr. Russell Williams
Required Reading:
- Cohn, Ch. 11.

Class Discussion Readings:

Outline:
1. Introduction
2. Causes of the “Debt Crisis”
3. Managing the Crisis
4. Interpreting the Debt Regime
5. Financial Crises . . . .
6. Conclusions
7. Further Reading
1) Introduction – What’s the Big Deal About the “Debt Crisis”?

a) What is the “debt crisi(e)s”?

Many states have had large public sector debts . . . what is unique in this case?

i) Debts in foreign currency – money owed to foreign agencies/banks
   = Foreign exchange required to make payments ($$$$’s USD)

ii) “Debt Crisis” partially a balance of payments problem - Lower income states’ debt crises started by current account deficits . . .
   = Financed by unsustainable borrowing from private foreign banks

What makes a state’s debt crisis severe?

- Size of the debt vs. ability to generate foreign exchange for payments
  = “Debt Service Ratio”: Ratio of debt payments to exports

- If debtors can’t raise foreign exchange to make payments . . .
  = Balance of payments crisis
  = Risk of default on foreign debts
b) What were the “risks” of the debt crisis?

By 1980s, crisis was widespread - threatened:

a) Basic operation of international financial system
b) Solvency of major private banks
   - E.g. Canada’s “big banks” and their depositors
c) Development
d) The poor . . .
c) What were the “politics” of the Debt Crisis?

- North, Orthodox/Neo-liberals and IFI’s:
  - *Cause*: Poor domestic policies & unwillingness to adjust
  - *Challenge*: Risk to the stability of international financial system and banks

- South, Interventionist Liberals, Historical Structuralists, Dependency Theorists:
  - *Cause*: Failure of international financial system and/or capitalism
  - *Challenge*: Crisis in “development” for world’s poor states

- Similar cleavages in all subsequent financial crises . . . .
  - Reveals North/South relations . . .
    - Suggests South’s “dependency” in global finance . . . ?
    - Illustrates ongoing debate about development challenges - **systemic** versus **domestic** sources of economic problems in South
    - Explains demands for IFI reform
2) Causes of the “Debt Crisis”?

Many factors may have played role . . . .

a) Oil and Food “shocks” (1970-1973)
   = Sudden increase in price of food and oil imports
     ■ “OPEC”
     ■ Created “current account deficits” for many southern states
       ■ Essential imports?
       ■ Governments borrow in global capital markets to offset current account deficits
     ■ 1979 – Price of oil doubled!!!
b) End of Breton Woods System (1972)
   i) Emergence of private global financial markets
      - Alternate source of money for South
      - Challenges ODA for all but poorest states
   ii) Unregulated offshore financial centres
      - "Off-ledger" bank lending
      - Bank "reserves" & "equity" insufficient to meet domestic regulations
        - Risky . . . . “Prudential oversight” essential to banking (E.g. Armijo)

c) “Petrodollars” - OPEC oil revenues deposited in commercial banks
   - OPEC members = massive current account surpluses
   - Offshore banks engage in necessary, but reckless lending . . .
d) Inappropriate Policy Choices:

- **Argument**: Private lending allows southern states to avoid IMF/World Bank “Conditionality”
  - Adjustment not required . . .

- **Argument**: Not all states responded to system problem in same way
  - Not all borrowed excessively to solve problem . . .
    - E.g. S.E. Asia

- **Argument**: Some states had wrong development strategies
  - “Import Substitution” counties harder hit
  - “Export Led Growth” countries shielded by higher manufacturing exports
    - Offset increasing oil and food prices, or increased ability to service debt
e) Global Recession (1979-1982):
- Collapse in commodity prices – not Oil!!!
- Southern states dependent of commodity exports?
  =Deepens balance of payments problems

f) US Policies
- High interest rates – to offset US inflation
- Reagan deficits = “Crowding out” debtors in capital markets
  - Both increase borrowing costs for LDC’s
The crisis unfolds . . .

- LDC debt grew 11X between 1970 and 1984 . . . .
  - However, total LDC external debt was only 2.5X the size of Canada’s Public Debt . . .

- Late 1970s: States try to reschedule debts to avoid escalating payments . . . .

- 1982: Many African and Latin American “LDC’s” passed “point of no return”
  - Debt Service Ratio: = Interest costs exceed total exports
  - Mexico announces it can’t service debt = $78 billion
    - Triggered emergency . . . . Many states could default
    - Implications?

- Debtor nations and banks blamed problem on “systemic crisis” and asked for help
Competing interpretations of causes emphasize different factors and different solutions!

- Critics of globalization (Historical Structuralists, Dependency Theorists and “Interventionist” Liberals)
  - Stress role of unregulated financial markets and banks
    - “Loan pushing”
  - Unregulated competition in banking
  - North and IFI’s encouraged private lending in 1970s
  - Dependency theorists emphasize commodity dependency
  - Illegitimacy of regimes that incurred debt

However, not all states ran into same problem . . .
Competing interpretations of causes emphasize different factors and different solutions!

- **Neo-liberals:**
  - Emphasize responsibility of debtor states
  - Reckless private borrowing to avoid domestic adjustment (i.e. Avoid IMF conditionality)
  - Money used badly . . .

- **However:**
  - Debt crises was global phenomenon – even in North
    - Different outcomes based on **Debt Service Ratios**
    - Most causes “exogenous” – beyond their control
  - Even “wise” countries ran into problems
3) Managing the Debt Crisis:

- Phase I - Private sector *collective action* problems

- Phase II - IMF Debt Crisis Mgmt. Regime
  - Assumed problem was short term
  - E.g. liquidity/foreign exchange crises . . . .
Debt Crisis Mgmt. Regime Strategy:

a) Provide IMF/World Bank “Structural Adjustment Loans (SAL’s)” – short to medium term loans

b) Re-establish conditionality:
   - Adjustment – reduce consumption of imports
   - Post 1985 – Adopt Neo-liberalism - Current account surpluses, savings and FDI needed
     - Economic reforms:
       - Deregulation
       - Privatization
       - Export led growth
       - Gov’t cutbacks!
Debt Crisis Mgmt. Regime Strategy:

d) Establish creditor “clubs” to negotiate “debt restructuring”

- “Debt Rescheduling”: reduce size of current payments
- “Debt Relief/Forgiveness/Reduction”: Reduce size of total debt

- Principles: Imminent Default, Conditionality and Burden Sharing
  - E.g. States had to agree to IMF SAL to qualify

- “Paris Club” - Creditor Gov’ts and debtors
- “London Club”: Private commercial banks
Debt Crisis Mgmt. Regime Strategy:

“Phase II” failed for many states . . .
Phase III - Direct “Northern” (US & G7/8) Mgm’t:

- Purpose: *Minimize risk to financial system*

  a) Banking Reform

  b) “Case by Case” crises management:
     - i) **Baker Plan** (1982-88) - Emergency lending but no relief
     - ii) **Brady Plan** (1989-97) – Limited debt reduction

  c) **“Heavily Indebted Poor Countries Initiative (HIPC)”**: (1996-Present): Debt rescheduling *and relief* on IMF and WB loans to countries eligible for **“Soft Loans”** – have to be very poor and have a high debt service ratio

    - **G7/8 initiative**
    - Widespread NGO support (Jubilee 2000 and Bono)
Phase III - Direct “Northern” (US & G7/8) Mgm’t:

d) “**Multilateral Debt Relief Initiative (MDRI)**”: Those states that got relief under HIPC, could get complete debt relief if they were poor enough.

- However, only a small number of countries qualify for these programs and progress slow . . . .
4) Interpreting the Debt Regime:

- **Successes:**
  - Prevented financial system collapse
  - Many developing countries and NIC’s returned to capital markets

- **Failures:**
  - Disaster for development – the “lost decade”
  - Human costs of debt management?
Political Impacts:

- New Role of the IMF
- Entrenchment of Neo-liberalism in South
  - States requiring IMF assistance have no choice
5) Financial Crises . . . .

Since the “LDC” Debt Crisis there have been a series of global financial crises . . . .

- 1997 Asian (or “East Asian) Financial Crisis:
  - E. Asian states successful, but poor financial regulation, high capital imports and a real estate bubble led to balance of payments crises in 1997 . . . 
    - IMF refused assistance without large conditionality
      - E.g. Government cutbacks, high interest rates – may have made crisis worse
    - G8 refused calls for regulation of financial markets
5) Financial Crises . . . .

- **2008 Financial Crisis:**
  - Real estate bubble, capital imports and poor financial regulation trigger crisis in “northern” banking
  - Liquidity crisis, but not a balance of payments crises (?)
  - **IMF**, **G8** and **G20** respond with coordinated stimulus (!)
  - **IMF** responds with expanded BOP financing programs and reduced conditionality
  - **G8 → G20** respond with calls for new regulation

- Debate: “**Lender of Last Resort**” vs. “**Moral Hazard**”
I – The Crisis

External Financing to Emerging Market Economies 1995-2009, in Millions (USD)

Data obtained from Institute of International Finance
2008e (estimated), 2009f (forecasted by IIF)
6) Conclusions:

**Areas of Agreement:**
- Debt and financial crises illustrates Southern dependency(?)
- Debt crisis illustrates successful management
  - Each theory has a different explanation . . .

**Areas of disagreement:**
- Causes of financial crises?
- Are the responses to financial crises “appropriate”?
- Role of IFI’s – need for reform?
  - Focuses attention on IFI’s political biases
Further Reading:

**Critical Perspectives on Debt Crisis:**

**Reforming IFI’s:**
For Next Time:

- **Unit Eight: The Global Trade Regime**
  - *Essay due in class, Nov 12!!!!!!*

- **Required Reading:**
  - Cohn, Ch. 7 & Cohn, Ch. 8 pp 222-239.

- **Class Discussion Readings:**