15

Henryk Wnorowski

DEBT CRISIS

1. The nature and genesis of the crisis

The world has been going into debt since money became used. Therefore, a state policy, which depends on borrowing capital from abroad is neither a new nor unusual phenomenon. Neither is it a negative phenomenon, often on the contrary, it is a source of deriving material benefit by both the persons providing the capital and the borrowers. The former charge interest and other fees in varying ways and to varying degrees – these are direct benefits, they also have the opportunity to promote their own exports, to take over new markets – these are indirect benefits associated with economic expansion. The latter – raise new external sources of funds that allow them to invest in the economic development of their country. They are countries that are not in a position independently, only through internal sources, to achieve higher levels of economic growth.

Debt becomes a problem when for various reasons debtors are unable to implement their obligations to creditors on time. The seriousness of the situation is the greater, the wider range of actors are increasingly eager to borrow. These difficulties are further aggravated when countries move away from the so-called bounds of safety, i.e. situations when the annual debt service exceeds 25% of the value of annual exports, and the volume of yearly interest payments exceeds 10% of exports. The debt crisis occurs when the majority of debtors fall into a loop of indebtedness, i.e. it comes to temporary or complete financial insolvency[1].

[1] A basic condition for debt service is to achieve a sufficiently high, positive balance of trade, namely the creation of appropriate export capabilities. This is possible if the obtained loans are invested in investments aimed at increasing revenues from exports. However, if foreign

The phenomenon of taking out foreign loans by developing countries began to take pace in the second half of the twentieth century. Gradually, it covered the growing number of countries. After 1970, on the international financial market there appeared some significant free funds seeking investment. Their existence was the result of extremely rapid economic growth of industrialized countries. Thanks to that, the private banks in those countries had spare funds which were partly directed to countries lagging behind. On the other hand, there was an increase of interest in obtaining external financing from foreign funds by those states themselves. Moreover, borrowing seemed to leaders of countries to be an extremely positive move (often they were leaders of countries that had recently regained their independence), considering the fact that the nominal interest rate on the international financial market was then moderate. The prices of goods which were exported by developing countries were much higher than today, which gave them the prospect of development, and hence, the prospect of having means to repay their liabilities.

Of greatest importance for the growth of indebtness was the appearance on the international market of the so-called petrodollars. It was a consequence of a sudden increase in oil prices, at first by the end of 1973 and then at the turn of 1979-1980. The total price of oil rose in that period more than tenfold. Oil-exporting countries (OPEC) received a huge surplus. Their positive balance of payments with foreign countries increased from 6.2 billion dollars in 1973 to 66.7 billion dollars in 1974. So the oil-exporting countries found themselves suddenly in possession of a huge surplus of cash from their sale of crude oil. Due to the low level of development, they could not use all those resources in the country and they invested the so-called petrodollars mainly in the form of private locations in Western commercial banks. Bank accounts, especially in Britain and the United States, had a huge amount of inflow (*Świat w...* 1991, pp. 15-16).

Increasing deposits with commercial banks, naturally inclined to liberalize credit policy. This also met with growing tendency of other countries lagging behind to borrow abroad. The nominal interest rate on the international financial market was at that time moderate, and prices of goods exported by these countries went up. As a result, what was needed were decreasing exports, to pay a specified amount of interest and repayments. In some years the increase in export prices exceeded even the level of interest rates, which meant that the so-called real interest rate was negative. Under

funds made available were not properly invested, it may eventually prove that a given country is having problems in servicing the incurred debts, therefore, it incurs new loans to service the old ones. This creates a self-starting mechanism of an "indebtedness loop" exacerbated by ever-increasing level of interest rate which exceeds the level of income from exports. Insolvency of the debtor is therefore due, on the one hand to the amount of the commitments made, on the other hand to the state of the economy whose current options do not allow to service obligations for debt inherited from the past.

such conditions, additionally taking into account the rate of inflation, the debtor countries viewed their lending capabilities with optimism, hence their propensity for borrowing was high.

During the same period, their interest in obtaining funds from abroad to carry out ambitious plans of social and economic development had grown. For their accomplishment there were not enough internal sources of financing, so the countries strove for external financing in the form of foreign loans. They were to be used for the construction of new industrial plants which in the future could repay loans by exporting their production. Such a mechanism appeared to be very simple, but could act only in the case of good investment projects and high discipline, but in the case of those countries they had not always been perfect.

To internal causes of the crisis we can include the low level of absorption of a large flow of financial and material resources from abroad which took place in a relatively very short time (too short as for the organizational capacity of countries-borrowers) as well as weaknesses in their use. The latter resulted in, inter alia, a lack of profitability of investments financed by foreign loans, spending part of them for the purchase of arms for the army (in the countries of Latin America and Africa), and finally to the aggravation of the socio-economic inequalities within societies receiving assistance (in many cases, the money ended up with local, religious, ethnic or military elites). The mismatch between the location of well and badly off social groups is visible today. The Gini coefficient, which measures income inequality in the societies studied, on a scale from 0 to 1 takes for countries such as Bolivia, Brazil and Mexico, respectively 0.60, 0.58 and 0.50. It takes the value 0 when all incomes are equal, 1 when all property is concentrated in the hands of one person.

Despite the rapid growth of the debt of developing countries (Table 1) which had grown from 130 billion dollars in 1973 to 336 billion in 1978 those countries still showed an economic growth and serviced their debts untill came a bad year for the world economy in 1979. At that time, OPEC raised their oil price from 13 to 32 dollars per barrel. Industrialized countries responded to the increase with the introduction of restrictions on oil consumption and a rise in inflation, although it adversely affected the fight against unemployment. Finally, the Federal Reserve System in the United States applied a tough anti-inflationary monetary policy, which contributed to driving world economy in 1981 into a deep recession. Before that, this policy had had a negative indirect impact on the real income of less developed countries. Negative effects were transposed through two main channels – through a high interest rate and the dollar exchange rate.

Great Britain, France, Japan, Germany and Italy acted in a similar way. By contrast, developing countries responded to the rise in oil prices by increasing their debt from336 billion dollarsin 1978 to 662 billion in 1982. It is estimated that $260 bn out of the $326 bn debt increase was eaten up by the purchase of crude oil (Głuchowski, 1997, p. 138).

Table 1
Foreign debt of the four largest debtors in the period 1972-1982
(in millions of U.S. dollars)

Years	Argentina	Brazil	Mexico	Venezuela
1972	6 028	10 165	7 028	1 712
1973	6 429	12 939	8 999	1 891
1974	6 789	19 416	11 946	1 784
1975	6 874	23 737	15 609	1 494
1976	8 258	29 031	20 520	3 313
1977	11 445	41 397	31 189	10 727
1978	13 276	53 614	35 732	16 568
1979	20 950	60 419	42 828	23 896
1980	27 157	70 838	57 378	29 310
1981	35 657	80 643	78 215	32 093
1982	43 634	92 812	86 019	32 153

Source:(Głuchowski, 1997, p. 141).

Thus, on the one hand, operating costs of the existing debt and the need for new capital increased, on the other hand, the world prices of goods exported by the debtors had an adverse impact on their income and thereby on their ability to repay loans. The prices of raw materials, exported mainly by developing countries, fell during the period 1984-1986 by almost a quarter, to a level lower than in 1975, while the prices of industrial products imported by these countries were still rising. The result was the terms of trade index adversely shaping in the 80s for those countries. The persistence of a negative level of this indicator in the long run had a strong destabilizing effect on the balance of payments and growth of developing countries' debt. The most affected were the most indebted countries and countries with the lowest income per capita (*Międzynarodowe...*, 1988, p. 17).

A fairly common phenomenon was the fact of taking out new loans with much higher interest in order to pay cheaper ones, obtained earlier. It was a situation in which debt grew directly, while the borrower taking out more expensive loans did not use them to achieve economic goals. Consequently, on account of contracted new loans, which generally did not cover the whole of the old debts, and due to much worse conditions of servicing them, the indebtedness increased twice. Thus, the situation of the debtors became increasingly difficult and the crisis was in the air.

2. The outbreak of the crisis

In 1981, none of the major debtors did not operate in full its debts for the reasons previously described, but as a symbolic date of the outbreak of the debt crisis is regarded the speech of Mexican Finance Minister, Jesús Silva Herzog of 12 August 1982, who officially declared that his
government was not longer able to handle its debts. Mexico's situation was unusual because since the mid-70s it was one of the major oil exporters and profited from increases in price of this raw material in 1973-74 and in 1979. International bankers, including the U.S., taking into consideration the financial resources of this country, recognized it as a safe borrower. Meanwhile, the economic policy adopted by the government of Mexico was not very correct as it decided to spend borrowed money primarily on the growth of public spending and financing of social programs. And although the 70s were in essence successful, that policy entailed a huge financial deficit (Głuchowski, 1997, p. 30) and inclined the government of that country to do that non-standard behaviour.

While Mexico in the early 80s was one of the most indebted countries in Latin America, its moratorium did not merely mean the problems of that country, but it also caused global problems (Table 2). The United States considered Mexico's stability as a matter directly related to its own safety so it granted both direct aid to Mexico and through the International Monetary Fund. The Fund agreed on a partial restructuring of the Mexican debt. But when other Latin American and other countries considered the case of Mexico as a convenient precedent and announced successively a suspension of repayment of their debts, it turned out that the generosity of the U.S.A. and the IMF no longer included them to the same degree.

An important event for raising an issue of debt crisis in Peru was also the decision to allocate only 10% of its export earnings on servicing foreign debt. This meant that, for example in 1985, 330 million was spent for this purpose, while that year's debt obligations amounted to $ 1.7 bn. Peru's decision had such a result that the American banking supervisory authority, assessing the value of foreign loans concluded that the majority of loans granted to this country was of limited value. Therefore, the U.S. debt banks were obliged to create a reserve fund of at least 15% of Peruvian debt. Similar protection was recommended for certain other loans to six countries, including Poland (Głuchowski, 1997, p. 68).

Table 2
Foreign debts of some 160 heavily indebted countries in the world in the 80s
(in billions of U.S. dollars)

Country	1980	1985	1986	1987	1988
Algeria	19.365	16.483	20.436	24.386	24.85
Argentina	27.157	50.947	52.374	58.423	58.936
Brazil	72.92	104.59	112.04	123.87	114.59
Chile	12.081	20.384	21.144	21.502	19.645
China	4.504	16.722	23.746	35.428	42.015
Egypt	19.131	40.066	44.16	49.89	49.98
Philippines	17.417	26.643	28.531	30.052	29.448
Greece		18.681	21.331	23.914	23.514
India	20.582	40.886	48.351	55.325	57.513
Indonesia	20.944	36.75	43.117	52.668	52.6
Yugoslavia		22.277	21.482	22.472	21.684
Columbia	6.94	14.241	15.363	17.007	17.001
South Korea	29.48	47.158	46.728	40.459	37.156
Malaysia	6.611	20.45	21.939	22.68	20.541
Morocco	9.71	16.289	17.83	20.094	19.923
Mexico	57.378	69.88	100.88	109.29	101.57
Nigeria	8.921	19.324	23.164	30.039	30.718
Pakistan	9.93	13.362	14.886	16.692	17.01
Peru	9.386	14.174	15.986	18.118	18.579
Poland	8.894	33.326	36.67	42.615	42.137
Portugal	9.729	16.627	16.653	18.346	17.168
Sudan	5.163	9.128	9.808	11.516	11.853
Thailand	8.297	17.528	18.554	20.707	20.53
Turkey	19.131	25.983	32.789	40.932	39.592
Venezuela	29.345	35.24	34.55	35.205	34.657
Hungary	9.764	12.836	16.088	18.694	17.561

Source: (Stanek, 1993, p. 85).

Other countries followed the example of Peru, including Nigeria, the Philippines, Venezuela, despite that international banking and financial circles were suprisingly stoical about the news and took no counteraction. The debt crisis became fact and the creditors undertook negotiations on the restructuring of debts. The International Monetary Fund advised stabilization programs, liberalization of economies and reducing public expenditure. In return, it promised debt restructuring, but only after completing specified terms of the stabilization programme. Debtor countries gained self-confidence, they often tried to take the initiative in the settlement of the problem, and they were getting used to operating under the debt crisis.

3. Debt crisis in Poland

The reasons for the barriers of debt in Poland were generally similar to those for other major debtors. They can be divided into factors of internal and external nature. The former can include:

- wrong economic policies of the 70s which were aimed at taking out foreign loans to expand industrial capacity;
- misuse of borrowed capital, up to 80% was devoted to consumption and supply imports;
- lack of adequate export growth to secure a successful foreign debt servicing.

External factors, in turn, are:

- development of the international credit market in the 70s;
- sharp rise in debt servicing costs in the late 70s and 80s;
- very strong restriction on the flow of foreign loans in 1980 and the abandonment of them in the following year.

In the dynamics of the external indebtedness of Poland we can distinguish two basic phases. The first covers the period of 1971-1980. This is a phase of the accumulation of debt, due to heavy use by our country of foreign loans. The second phase started in 1981 and lasted until 1992. This was the phase of recurring of debt and its growth, due to non compliance with the Polish obligations concerning debt service and accrued interest which had not been settled on time. (Zabielski, 1997, pp. 340-341).

The beginning of payment problems fell in 1981 and was slightly ahead of the global crisis. In the spring of that year, as a result of the collapse of the economic situation, Poland was forced to suspend payment of principal instalments and interest on foreign loans. The debt grew rapidly, and the cash inflows derived from investments financed by loans and export inflows of indebted economy did not keep pace with the costs of debt service, contributing to the increasingly rapid rise. Payments were made to a small extent and with a lot of financial effort[2].

[2] Despite its massive foreign debt burden Poland has never announced a unilateral moratorium, and has not suspended completely the servicing of their debt. There were partial repayments.

Table 3
Polish foreign debt to its main creditor groups (in millions of U.S. dollars)

	1989	1990	1991	1992	1993	1994
Paris Club	27 387	32 778	31 526	29 559	28 667	26 818
Guaranteed apart form PC	563	530	444	358	276	224
London Club	9 230	11 164	11 733	12 163	12 696	7 988
USSR/ CMEA	2 143	2 408	2 572	2 591	2 711	2 395
Other	1 152	1 387	1 930	2 235	2 780	
Short term	318	207	206	138	116	
Total	40 793	48 475	48 411	47 044	47 246	42 174

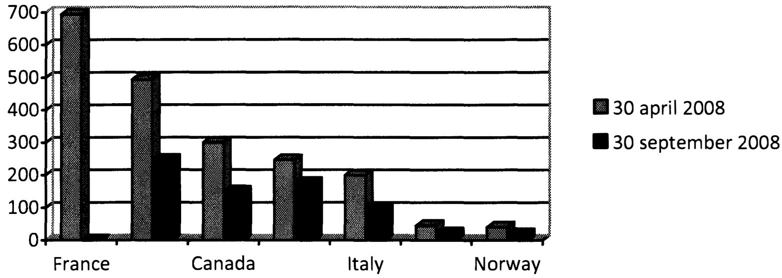
Source: (Głuchowski, 1997).

Since the beginning of the 80s Poland opened negotiations on its debt. Talks were held parallel with the official creditors grouped in the Paris Club with representatives of commercial creditor's banks, i.e. the so-called London Club. Negotiations started in a very complicated and tense political and social situation and at the deteriorating state of the Polish economy. Signing of the first restructuring contracts took place already in 1981.

Crucial negotiations were undertaken by the Polish government after the beginning of the transformation of our economy. They ended in April 1991 with signing of the "Memorandum of Understanding on debt reduction and reorganization of the Polish Republic," with the Paris Club and in March 1994, a framework agreement with the London Club. These agreements differred essentially on the principles and details of the payments, both of them reduced the approximately 50% of the debt repayment and spread them for another 25 years. However, Poland took every effort into early repayment of its debts.

Generally, the creditors were not interested in earlier repayments than recorded in the agreements. Usually, it is easier to communicate with the Paris Club, which Poland managed to achieve three times in 2001 with Brazil, in 2005 with Germany, Great Britain, the USA, Switzerland, Holland, Sweden, Canada, Denmark, Spain, Finland and in 2008 with the countries shown in Figure 1.

Figure 1
Repayment of old loans



Source: (Glapiak, 2008).

***

The debt crisis has lasted for nearly three decades and is still a great menace to both countries in debt, as well as for the whole world economy. Methods that had been used to rescue the situation proved to be insufficient, although it should be noted that some debtors significantly reduced the scale of their debts. For most of them the burden of debt from the 70s is today insignificant, from others it requires more sacrifices. Unfortunately, both sides have taken out plenty of new debts, which today seem to constitute a much greater menace to these economies than the so-called old debts, and can cause more serious consequences.

The current situation with regard to foreign loans, according to the author, allows to make an observation that the use of foreign funding by different countries was a permanent element of the functioning of economies and lives of societies for a long time. However, it seems that awareness about temporariness of this form of financing and the need for the repayment of debts as soon as possible was greater in the past than it is today. The justification for borrowing was more ambitious too, mostly the development objectives were considered. Of course, budgetary discipline was not always observed properly. Today, at the outset, money is borrowed to cover day-to-day expenses.

References

Glapiak, E. (2008). Polska spłaca długi, *Rzeczpospolita* 2.06.2008.
Głuchowski, J. (1997). *Międzynarodowe stosunki finansowe*, Warszawa: PWE.
Międzynarodowe zadłużenie a skuteczność polityki dostosowawczej (1988). Raport Centrum Badań nad Zadłużeniem i Rozwojem, Kraków: Uniwersytet Jagielloński.

Stanek, K. (1993). *Spłata zadłużenia zagranicznego gospodarki. Problemy minimalnoczasowe*, Warszawa: SGH.

Świat w obliczu kryzysu zadłużeniowego (1991). Raport dla Klubu Rzymskiego, Warszawa: Publikacja Polskiego Towarzystwa Współpracy z Klubem Rzymskim.

Zabielski, K. (1997). *Finanse międzynarodowe*, Warszawa: Wydawnictwo Naukowe PWN.