

The 1980s international debt crisis

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Introduction The international debt crisis has its origins in the inability of a number of Less Developed Countries (LDCs) experiencing serious difficulties in coping with their debts and their inability in meeting the debt service requirements. The crisis can be dated to August 12, 1982, when the Minister of Finance of Mexico announced that Mexico would be unable to meet its August 16 obligation to service an \$80 billion debt which was mainly dollar denominated.

This inability was due to a combination of doubling import prices for oil, obligations from past external borrowings and rising protectionism in the industrial countries left with little foreign exchange to pay for imports. This sparked of a worsening situation where by October 1983, 27 countries owing \$239 billion had rescheduled their debts to banks or were in the process of doing so and other countries were following suit. A majority of these 27 countries were from Latin America.

The four largest - Mexico, Brazil, Venezuela, and Argentina owed various commercial banks \$176 billion, or approximately 74 percent of the total LDC debt outstanding (Wellons, 1987). Of this amount, roughly \$37 billion was owed to the eight largest U. S. banks and constituted approximately 147 percent of their capital and reserves at the time. As a consequence, several of the world's largest banks faced the prospect of major loan defaults and failure. Causes of the International Debt Crisis The Wall Street Journal noted in 1981:

It doesn't show on any maps, but there's a new mountain on the planet - a towering \$500 billion of debt run up by the developing countries, nearly all of

it within a decade . . . to some analysts the situation looks starkly ominous, threatening a chain reaction of country defaults, bank failures and general depression matching that of the 1930s. Grounds for the international debt crisis of the 1980s are varied. A major reason was thought to be the role of banking consortia in extending large loans to LDC governments with minimal analysis of the debt service prospects of the borrowing country.

The banks lent loans to the LDC governments irrespective of the prospects of debtor export earnings, or the effectiveness of domestic management of fiscal, monetary or foreign trade policies. A major reason for this inattention to debt carrying capacity of the LDC countries was because a large share of the debt build up was in the form of sovereign debt owned by the LDCs. Unlike ordinary debt contracted between two private parties which is collectible by law, sovereign debt is above the law and not subject to external enforcement.

The widespread assumption was that sovereign debt always gets repaid. Unfortunately however, most banks did not anticipate that the burden of servicing sovereign debt might become so harsh that living standards of the debtor countries would suffer and thus affect the willingness of these countries to continue repaying the debts. A striking example of this occurred in 1985 when the Peru government announced that it would unilaterally limit payments on its foreign debt. It declared that it would limit payment on it \$14.

3 billion foreign debt to about 10% of its export earnings or half of the nation's debt service ratio. The miscalculation or mismanagement of

sovereign debt issues by the banks was not the only cause of the debt crisis. The crisis was further brought on by global economic shocks and economic policies in many of the borrowing countries. Three global economic shocks were of prime importance (Gillis et al, 1987): 1. The sharp run-up in world oil prices in 1979 through 1981, from \$ 13. 50 per barrel to \$ 36 per barrel, and the even sharper drop in oil prices in 1985 and 1986 to as low as \$10 per barrel.

In addition to generating inflationary pressures around the industrial world, these price movements caused serious balance of payments problems for developing nations by raising the cost of oil and of imported goods.

Developing countries needed to finance these deficits, and many began to borrow large sums from banks on the international capital markets. The oil price rise that caused the deficits also increased the quantity of funds available in the Eurodollar market through the dollar-denominated bank deposits of oil-exporting countries, thereby fueling the lending boom.

The banks merely re-channeled the funds to the oil-importing developing countries as loan credits. In addition, the rise of oil prices also helped to bring on the world recession of 1974-75, which would eventually produce a decline in world commodity prices for minerals and agricultural goods, thereby further exacerbating the developing countries debt burden. 2. The global recession that resulted in part from the 1979 to 1981 oil price rise depressed export earnings of many debtor countries to the point that most had no choice but to delay debt service.

Because most LDC credits were priced to LIBOR rates, debt-service costs grew progressively greater as these rates reached record levels. This along with the slowing in world growth and drop in commodity prices left exports stagnant and debt-service commitments hard to meet. Another factor that compounded the debt-service problem was that most of the new bank loans to the LDCs went on to cover accrued interest on existing debt and/or to maintain levels of consumption, rather than for productive investments.

3. A third factor was the combination of the sharp rise in nominal interest rates after 1979 and the decline in world inflation after 1982 which led to a steep increase in world interest rates particularly in the years 1979-1983. Loans as a result became more expensive and most countries lacked the export earnings to carry such expensive debts. Wertman (1984) further argues that poor economic management in many debtor countries also contributed strongly to their debt problems.

The crisis countries delayed too long in undertaking measures that would have otherwise allowed them to cope with the unexpected debt crisis. Argentina, Brazil and Mexico are prime examples of such countries. In all these three, economic growth after 1979 was much slower than before and inflation rates surged almost out of control. All three countries also had to undertake emergency debt rescheduling in the early eighties and were denied access to new international borrowing at normal market norms.