Foreign Debt: Causes and Measures Taken

Ion Botescu
Ovidius University, Constanta, Faculty of Economic Sciences
ion_botescu@yahoo.com

Abstract

In an increasingly globalized world, any crisis, including the ones caused by the foreign debt default of a country, may have a negative impact which can be contagious both at regional and at global level.

Taking into account all the risks to which international creditors were subjectedover time, the stock of foreign debt worldwide has experienced a significant increase in the current millennium, actually demonstrating that international lending is profitable.

The causes of default, the measures taken by the concerned countries to get out of this situation and the specific examples were the elements which I have tried to capture in this paper. Last but not least, I have performed an analysis of the evolution of the foreign debt stock and the repayment capacity of small and medium-income countries, respectively the most vulnerable countries in terms of debt repayment.

Key words: debt, debt service, insolvency, odious debts, in debtness level
J.E.L. classification: H63, H69

1. The default of a country - general comments

In general, the foreign debt default of a state lies in its inability to pay the amounts owed to foreign creditors. This does not necessarily mean a depletion of its own foreign reserves and it does not mean that the state can no longer pay its monetary obligations towards the public sector employees or retired employees.

History records some examples of countries that have gone into foreign debt default due to their own will, and not because of a lack of financial resources to pay foreign creditors. Through their foreign debt default, these countries have used this opportunity to restructure their economies, thus creating a new development base for their nations.

We must also distinguish between a lack of liquidity and insolvency situation and a situation in which a country can be found in a particular moment of its existence. In the first case the country in question does not have, for a relatively short period of time, the financial resources necessary for its payment obligations towards foreign creditors in the context in which it has an acceptable capacity for the annual payment of foreign debt. The second situation involves the country not currently or in the future having the means for paying debts to international lenders or simply being unwilling to make such payments.

International experience in the field shows that a country in foreign debt default can act in one of three ways:

- request financial assistance from international financial institutions such as the International Monetary Fund, credits earned this way, if properly used (primarily for productive investments or infrastructure) can provide the time a country needs for an economic recovery;
- print a large amount of currency, which on one hand leads to a reduced domestic debt pressure, and on the other hand by reducing the national currency’s value against the major foreign currencies, cheaper domestic products on foreign markets are possible and

exports are stimulated. Thus the necessary foreign currency liquidity is obtained for the foreign debt service payment;

- effectively block the payments to external creditors; this is an extreme initiative and it has been used relatively rarely over time. (Florescu R. 31. mai.2011, Evenimetul zilei)

This last solution is not recommended, although in many cases it was inevitable. Being a solution with an extraordinary character its produced effects are also unusual in nature. More than 100 years ago France, England and Germany have used military force to make countries like Venezuela, Mexico, Egypt pay the owed amounts. It is obvious that such actions cannot be taken in the third millennium on debtor countries, examples from the past 15 years offered by Argentina or Greece are enlightening in this respect.

The main problem that occurs when a state no longer honour payments to foreign creditors are the losses that the latter suffer. Perhaps from a legal point of view creditors may find solutions in various courts to recover the sums subjected to dispute, but from a practical point of view their efforts are extremely difficult, even impossible in some cases. Seizure and sale of assets held abroad by the debtor country, including aircraft and ships temporarily held in other countries, are a solution for international creditors to recover the amounts due, solution which often turns out to be not to be sufficient. However the reputational damage to the image of the debtor country is significant, on the short term and especially on the medium and long term. Thus debtor countries will no longer have access to foreign loans for a long time, and when lending will resume, foreign loan funding will be made with higher costs than those existing on the market at the time. Moreover a foreign debt default contagion can appear in the other neighbouring countries placed in the same geographical area or which have similar economic and social characteristics.

It is suggested in the specialty literature that the situation in which a country enters a foreign debt default is similar to the one of companies, this being explained by the chance that should also be given to countries and not just firms to obtain the additional time needed for national economic recovery. This would require the existence of courts for the countries seeking the prescription or restructuring of foreign debt and their creditors. It is however difficult to manage such a procedure. In addition to external creditors, the debtor country has a number of obligations to its citizens, which generates a series of discussions on the priority of payments. Most country-specific activities cannot be stopped once the country becomes insolvent, thus a country cannot be effectively declared bankrupt.

In the same time, I believe that several international level rules should be set in order to eliminate bias and discrimination in the reduction and limitation of foreign debts contracted by different countries. We take into consideration the negotiating capacities of debtor countries, the lobby undertaken by powerful states towards the debt relief of countries where economic interests are held as well as the diminished time period in which the debtor's economy is blocked.

2.The causes which have determined the foreign debt default of some countries

The reasons that led to the inability or unwillingness of countries to honour their debts to foreign public or private creditors, are numerous, the most important being summarized in the following paragraphs.

The external debt itself, seen as both an absolute amount and as a percentage of GDP can in certain circumstances pose an unbearable burden on the economy of a country.

There were countries who were advised and even encouraged by foreign lenders to access foreign loans which were oversized in relation to their economic and social needs at the time. The changing world economic conjuncture as well as the mistakes made in their own development strategies have led to the impossibility of debtor countries (in many cases less economically developed countries) to pay their external debt service. Lending conditions set in contracts asymmetrically distributed risks between borrowers and lenders. Most of the risks were taken by borrowers, thus leading creditors to moral hazard, meaning that they didn't pay the due attention to analysing the conditions that must be met by the borrowing country to receive requested funding

Increasing amounts awarded by international lenders essentially meant an increase in the profits that they were going to receive.

A high external indebtedness level increases the risk of a country to default its foreign debt payments. The level, calculated as a percentage of the external debt to GDP, at which the risk of insolvency is imminent is relative. If we take as a reference the level of indebtedness of 60%, a figure circulated in EU regulations, we find that in the period 1970-2008 more than half of all foreign insolvency situations were in countries with an external indebtness level below 60% and less than half of the total occurred in countries with an external indebtness level below 60%. For the same period 16% of the total foreign insolvencies were registered in countries with an external indebtness level of over 100% and 20% for countries with an external indebtness level less than 40%. The figures relate to situations of insolvency recorded among emerging countries. (Reinhart C, Rogoff K. 2012, p.71)

For the so-called *odious debts* accessed by previous governments (usually dictatorships) when the political power changes, there are some justifications when they are not paid. Ethiopia's case is enlightening in this respect. Part of the proceeds of foreign loans were used in the 80's to purchase weapons used to neutralize political opponents, including through physical suppression. The paradox is that after the fall of the Ethiopian dictatorship the new governing politicians (who had to pay the external debt) were part of the political class which was actually subjected to the shooting weapons, weapons purchased with money from foreign creditors. I believe that the non-payment of such debt is justified, the creditors must be careful in terms of both financing dictatorial governments and in terms of how those governments use foreign loans.

Under the banner of odious debts not very well grounded external loans can also be included, loans that do not ensure sustainable development of the debtor countries. Many governments' accessed external loans for the funding of populist projects bearing in mind that the repayment of these sums will be made by the following government, putting the latter in a difficult financial situation.

It is estimated that in order to be included in the category of odious debt a credit must be given in the following circumstances:

- the government's initiative to access credit is not in accordance with the consent of their citizens;
- the sums of money from the granted foreign credit are not used effectively to meet the economic and social interests of the country;
- although they were aware of these two conditions international lenders have given the credit. (https://cersipamantromanesc.wordpress.com/2016/04/01/teoria-datoriilor-odioasesi-situatia-actuala-din-statele-lovite-de-criza-si-amenintate-de-un-faliment-total/)

Alongside the concept of odious debt the illegitimate debt concept has appeared, which generally nuances the same issues.

Even if foreign creditors have agreed in several cases to a reduction of foreign debts arising from loans poorly granted to regimes which proved to be dictatorial, both international financial institutions and private lenders avoid using the terms of odious debt and illegitimate debt for understandable reasons.

Apparently the *domestic debt* of a State should not have implications on foreign debt default. States have a number of tools, which can be used in order to reduce domestic debt, inducing a strong inflationary phenomenon in this sense. International experience demonstrates that emerging countries have gone into default to foreign creditors when they have recorded an average a debt approximately 200% higher than the GDP, coupled with an average external debt approximately 150% higher than the GDP. We can say that a large domestic debt, coupled with a significant foreign debt increases the probability of a country to enter into foreign debt default.

The effects of *banking crises* are numerous. The slowdown of the global GDP growth or the so-called negative growth, the worsening credit conditions in general and especially for poor countries, the loss of confidence in international financial markets etc., are just a few of these effects. At the same time the globalization of the world economy over the last 20-30 years has triggered a contagion phenomenon of crises. The economic contraction in some countries leads to reduced production and private consumption with direct consequences such as decreased imports from partner countries. The reduced exports on the background of banking crises represents a reduction in currency resources for some countries, increasing the risk of entering foreign debt default.

The depreciation of the *national currency* against major currencies determines a proportional increase of the foreign debt denominated in its own currency. The liberalization of capital markets by emerging countries, achieved in some cases due to the recommendations of international financial institutions, led to a high volatility in the concerned markets. At the first signs of crisis in emerging countries, speculators withdraw their capital, generating an extremely high pressure on the currency. Host countries are forced to use the monetary resources they hold in order to support the national currency. Massive capital inflows in emerging countries were accompanied in many cases by equally massive outflows on a short period of time, resulting in many cases in the entering of the concerned countries in foreign debt default.

Used by some countries as a solution for solving domestic debt problems, *inflation* at above certain levels can lead a country to enter foreign debt default. Experience shows that the risk of going into foreign debt default is major for countries with inflation rates of over 20% for several years. Average inflation rates recorded in the cases where countries have gone into foreign debt default, was in the year preceding of 33%, increasing in the coming years to levels by three digits. The figures refer to the cases of external debt default recorded between 1800-2008. [Reinhard C, Rogoff K. 2012, p.147; 217)**.**

3. Concrete actions taken by countries in foreign debt default

The information released especially in the last 20-30 years by the public media have induced the feeling that foreign debt default is a phenomenon specific to developing countries or countries in transition. It should be noted that in the beginning of its manifestation, the phenomenon of foreign debt default was met in many advanced countries in that age. England, France and especially Spain are significant examples in this respect. Generally excessive military expenditures and major maintenance expenses for royal courts were the causes of the entry into foreign debt default by the countries mentioned above. Including the last century advanced countries like Germany, Austria or Japan went into external debt default mainly due to military conflicts.

Indeed, in the period from 1970 until today we can state that the cases of external debt default are characteristic to the least economically advanced countries.

With few exceptions, countries that have gone into default attempted the restructuring of the foreign debt in order for short-term payment obligations to external creditors to be reduced. This has been accompanied by a bailout rule, meant to bring stabilization and economic recovery to the country. The credit necessary for that purpose, was negotiated and granted by international financial institutions and was accompanied by a series of measures that the concerned country had to apply. The universal recipe imposed the IMF several years ago to countries that have requested financial assistance consisted of measures that led to the budget revenues growth, along with decreased spending. It was not taken into account the extent to which financial investments would have boosted the mitigation of the crisis. By applying to a greater or lesser extent the provisions of the Washington Consensus they were able to obtain liquidity on the short term, reason for joy for private international lenders. Meanwhile, in most cases the potential for economic development of countries that have solicited financial assistance was reduced, with direct negative consequences on the living standards of the population.

The exception to the rule in their behaviour in foreign debt default may be heightened through the examples of Argentina and Iceland.

Most Latin American countries have benefited in the early 70s of generously sized loan terms, *Argentina* receiving significant funding from foreign creditors. This romantic period ended around 1980 with the rise in interest rates charged by American lenders. The harsh reality befell in Latin American countries but also on other countries who incurred large foreign loans impairing their economic development.

After the foreign debt restructuring, the Argentinian economy has experienced a period of growth based mostly on stimulating consumption. The sums of money obtained from privatizations carried out, including in areas of interest such as utilities and the substantial foreign loans contracted were the main sources for financing consumption. Argentina was until the end of the last century the obedient child of the IMF, which enabled the country to obtain massive external borrowing. In reality Argentina entered a spiral of increasing external debt, foreign loans were contracted sequentially to pay the old. Basically, in a relatively short period of time, Argentina's external debt doubled.

Massive withdrawals of money from Argentinian banks caused chaos in the country's economy, the incumbent president being forced to abandon his mandate in December 2001 following street demonstrations. The peso which was previously set at parity with the US dollar was allowed to float freely saw a strong devaluation, with negative consequences on the development of national wealth and business.

Although it acknowledged its debts, Argentina refused a new agreement with the IMF and thus entered foreign debt default. It gave priority to meet the medium and long term needs of the Argentinian citizens at the expense of foreign creditors. There was a 75% decrease in the value of Argentinian bonds held by foreign creditors. The years that followed were characterized by positive effects on the Argentine economy, the unemployment rate was substantially diminished, and the annual GDP grew at around 7%. However, from 2003 to the present day Argentina's access to international financial markets has been severely restricted.

The huge debts incurred by its own banks were the main problem that *Iceland* faced in 2008. The debt of Icelandic banks that year was approximately 5 times higher than the country's GDP. Taking major risks, unlike the US and to some extent the EU, Iceland did not use the taxpayers' money to rescue banks and they were are left to fail. Loans and deposits taken by the population were taken over by the new state banks. Those responsible for the banking system disaster were brought to court.

The Icelandic citizens' will expressed in the 2010 referendum resulted in the prohibition of the payment of money borrowed by Icelandic banks from foreign creditors. The referendum also decided that Iceland will not be able to access credit without the consent of its population.
Iceland's failure to pay its international lenders has lead the country to enter an apocalyptic time. Furthermore, the subsequent development of key economic indicators placed Iceland above several countries that have received substantial financial assistance from international financial institutions.

4. Trends in the evolution of foreign debt and the repayment capacity of states

Resorting to international credits is a current practice, found in the last hundred years, with an obvious tendency to intensify in the periods of major disruptions in the global economy.

There is an interesting study by the World Bank based on statistical reports of 120 small and medium-income countries regarding the evolution of external debt stock and flow. We can see a more significant increase in the foreign debt stock subject to the studied countries in the period that followed the global financial crisis, fact which demonstrates the increasing financing needs of states to overcome the crisis. In 2013 and 2014 the external debt stock growth was tempered. We need to emphasize the significant increase in the 2000-2014 period of the stock of foreign debt from $ 1,343,300,000,000 to $ 5,391,500,000,000.

Regarding the structure of the foreign debt stock we can conclude that there has been a significant decline in the share of long-term debt in the total foreign debt stock from 83.8% in 2000 to 69.9% in 2014. This trend shows a significant increase in the short-term needs for funding of the studied states.

Table 1. The evolution of the external debt stock and repayment capacity, all low - and middle - income countries (US$ billion)

	2000	**2009**	**2014**
All low - and middle-income contruies			
• External debt stocks	1743	3174	5391
• Long-term external debt	1461	2346	3770
• External debt stocks to exports (%)	122,5	79,2	79,1
• Debt service to exports (%)	20,0	10,1	8,9
• Reserves to external debt stocks (%)	30,4	131,2	113,5
East Asia and Pacific			
• External debt stocks	497	938	1816

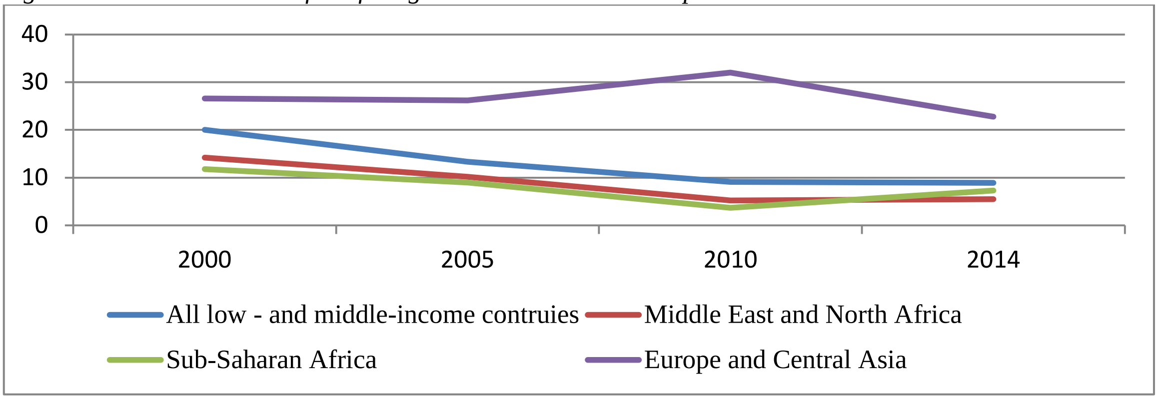
• Long-term external debt	418	565	871
• External debt stocks to exports (%)	78,2	46,6	48,4
• Debt service to exports (%)	11,4	4,9	3,8
• Reserves to external debt stocks (%)	55,4	296,1	239,6
Europe and Central Asia			
• External debt stocks	203	777	1024
• Long-term external debt	148	600	790
• External debt stocks to exports (%)	156,2	179,8	152,6
• Debt service to exports (%)	26,6	33,2	22,8
• Reserves to external debt stocks (%)	17,2	28,0	23,6
Latin America and the Caribbean			
• External debt stocks	524	677	1346
• Long-term external debt	453	576	1148
• External debt stocks to exports (%)	155,5	110,9	137,2
• Debt service to exports (%)	39,2	17,1	15,6
• Reserves to external debt stocks (%)	18,6	64,2	53,5
Middle East and North Africa			
• External debt stocks	143	160	187
• Long-term external debt	116	119	141
• External debt stocks to exports (%)	120,5	51,0	55,4
• Debt service to exports (%)	14,2	5,8	5,5
• Reserves to external debt stocks (%)	30,6	174,6	145,6
South Asia			
• External debt stocks	162	364	613
• Long-term external debt	153	292	495
• External debt stocks to exports (%)	183,0	110,5	104,2
• Debt service to exports (%)	17,2	6,9	17,5
• Reserves to external debt stocks (%)	26,7	81,9	58,5
Sub-Saharan Africa			
• External debt stocks	212	255	402
• Long-term external debt	172	193	323
• External debt stocks to exports (%)	185,5	82,8	87,0
• Debt service to exports (%)	11,8	5,0	7,3
• Reserves to external debt stocks (%)	16,1	60,5	42,8

Source: International debt statistics - https://openknowledge.worldbank.org/bitstream/handle/10986/23328/9781464806810.pdf?sequence=1&isAllowed=y

The strong increase of the external debt stock accumulated by small and medium-income countries may induce the idea of the increasing likelihood of foreign debt default situations. We have in mind the fact that countries in the mentioned category have relatively limited possibilities of foreign loans repayment.

Concern about increasing the number of countries that could end in a position of foreign debt default is mitigated by the favourable evolution of the foreign debt stock's share in total exports and the share of foreign debt service in total exports. These indicators have showed a downward trend, the share of the foreign debt service in total exports dropping spectacularly from 20% in 2000 to 8.9% in 2014. In the same period the foreign reserves of states have significantly increased, which was caused on one hand by clauses inserted in the financial support agreements concluded between applicant countries and the IMF, and on the other hand by the preventive measures that some states have taken as a result of lessons learned from previous crises, e.g. Asian countries. The development of indicators shows that the situation of the studied countries which did not have loan repayment capacity has improved.

Figure no 1. The evolution of the foreign debt service in total exports - %



Source: International debt statistics - https://openknowledge.worldbank.org/bitstream/handle/10986/23328/9781464806810.pdf?sequence=1&isAllowed=y

From the geographical area evolution point of view we see that lower and middle incomes countries from the Middle East, North Africa and sub-Saharan Africa countries registered the lowest increases in the stock of foreign debt, in relation to countries from other geographical areas. Simultaneously there has been a remarkable improvement in the ability to pay foreign loans. On the opposite side of the spectrum lie the small and medium-income countries of Europe and Central Asia.

5. Conclusions

Loans, including sovereign ones, are necessary to meet the present and future needs of entities, including those of nations. By taking a loan we can consider from a particular point of view that we bring the future in the present. The condition that emerges is that the loaned sums of money be properly used. On how countries have spent the proceeds of foreign loans there are numerous examples where decision makers have used these sources of funding for electoral purposes or to satisfy the populist demands. There were cases in which eventually the sums obtained from foreign credits ended up in the accounts of political leaders. Accessing credit was also due to the hypothesis that repayment will be made by future governments. The gain was twofold, on the one hand, the governments that have accessed foreign loans spent money to meet important momentarily needs of voters thus gaining their goodwill and on the other hand the future governments who were due to pay the loans were seen to lack the money needed for development, thus creating discontent.

The entry into foreign debt default represented a state in which rich countries entered, but mostly in which countries with a low level of development entered. The causes that determine the entry into foreign debt default are many and tend to recur cyclically. It would be beneficial for the different nations if their political leadership would proceed to learn from their own experience and that of other countries.

International institutions, primarily the IMF should alter their attitudes regarding the conditions under which financial assistance grants are awarded to countries in difficulty toward supporting the economic and social development on a medium and long term.

We must not forget that in recent years the financial situation of most countries has improved, thereby reducing the possibility of entering in foreign debt default. We have reached this positive situation by increasing exports and the national foreign exchange reserve, but also through debt restructuring, including debt prescription in the case of the poorest countries in the world.

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