

# Economic Development

12th Edition

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## Chapter 13

### Balance of Payments, Debt, Financial Crises, and Stabilization Policies



## **13.1 International Finance and Investment: Key Issues for Developing Countries**

- How major debt crises emerged during the 1980s
- Financial Crisis



# **13.2 The Balance of Payments Account**

- General considerations:
  - Balance of Payments (BOP)
  - Current Account
  - Surplus and Deficit
  - Capital Account

## Table 13.1 A Schematic Balance of Payments Account

Exports of goods and services	A
Imports of goods and services	B
Investment income	C
<del>Debt service payments</del>	D
Net remittances and transfers	E
Total <i>current account</i> balance ( $A - B + C - D + E$ )	F
Direct private investment	G
Foreign loans (private and public), minus amortization	H
Increase in foreign assets of the domestic banking system	I
Resident capital outflow	J
Total <i>capital account</i> balance ( $G + H - I - J$ )	K
Increase (or decrease) in <i>cash reserve account</i>	L
Errors and omissions ( $L - F - K$ )	M

Source: Adapted from John Williamson and Donald R. Lessard, *Capital Flight: The Problem and Policy Responses* (Washington, D.C.: Institute for International Economics, 1987), tab. 1.



## 13.2 The Balance of Payments Account (cont'd)

- General considerations (cont'd)
  - Cash Account or International Reserve Account
  - Three forms:
    - Hard currency
    - Gold
    - Deposits with IMF



# Table 13.2 Credits and Debits in the Balance of Payments Account

## “Positive” Effects (Credits)

1. Any sale of goods or services abroad (export)
2. Any earning on an investment in a foreign country
3. Any receipt of foreign money
4. Any gift or aid from a foreign country
5. Any foreign sale of stocks or bonds

## “Negative” Effects (Debits)

1. Any purchase of goods and services abroad (import)
2. Any investment in a foreign country
3. Any payment to a foreign country
4. Any gift or aid given abroad
5. Any purchase of stocks or bonds from abroad

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## **13.2 The Balance of Payments Account (cont'd)**


- A hypothetical illustration: deficits and debts
  - Current Account
  - Capital Account



# Table 13.3 A Hypothetical Balance of Payments Table for a Developing Nation

Item	Amounts (millions of dollars)	
<b>Current account</b>		
Commodity exports		+35
Primary products	+25	
Manufactured goods	+10	
Commodity imports		-45
Primary products	-10	
Manufactured goods	-35	
Services (e.g., shipping costs)		-5
Investment income		+1
Debt service payments		-15
Net remittances and transfers		+2
Balance on current account	-27	
<b>Capital account</b>		
Private direct foreign investment		+3
Private loans and portfolio investments		+4
Government and multilateral flows (net)		+3
Loans	+9	
Debt amortization	-6	
Resident capital outflow		-8
Balance on capital account	+2	
Balance on current and capital accounts	-25	
<b>Cash account</b>		
Net decrease in official monetary reserves		+25
Balance on cash account	+25	





**Table 13.4** Before and After the 1980s Debt Crisis: Current Account Balances and Capital Account Net financial Transfers of Developing Countries, 1978-1990 (billions of dollars)

Year	Current Account	Capital Account Net Financial Transfers
1978	-32.1	33.2
1979	+10.0	31.2
1980	+30.6	29.5
1981	-48.6	35.9
1982	-86.9	20.1
1983	-64.0	3.7
1984	-31.7	-10.2
1985	-24.9	-20.5
1986	-46.4	-23.6
1987	-4.4	-34.0
1988	-22.4	-35.2
1989	-18.4	-29.6
1990	-3.0	-22.5

Sources: International Monetary Fund, *World Economic Outlook*, 1988 and 1992 (Washington, D.C.: International Monetary Fund, 1988, 1992); United Nations Development Programme, *Human Development Report*, 1992 (New York: Oxford University Press, 1992), tab. 4.3.



## **13.2 The Balance of Payments Account (cont'd)**

- A hypothetical illustration: deficits and debts (cont'd)
  - Inflow
  - Outflow
  - Amortization



# 13.3 The Issue of Payments Deficits

- Some initial policy issues
  - International reserves
  - Restrictive fiscal and monetary policies:
    - Structural adjustment
    - Stabilization policies
  - Special drawing rights (SDRs)



## **13.3 The Issue of Payments Deficits (cont'd)**

- Trends in the Balance of Payments

# Table 13.5 Developing Country Payments Balances on Current Account, 1980–2009 (billions of dollars)

Country Group Name	1980	1981	1982	1983	1984	1985	1986	1987	1988
Emerging market and developing economies	29.621	-25.712	-52.604	-51.328	-31.097	-32.317	-65.062	-32.642	-44.718
Central and eastern Europe	-14.435	-12.426	-4.715	-7.55	-5.859	-7.517	-8.979	-6.857	-3.048
Developing Asia	-6.893	-11.544	-13.428	-17.145	-9.859	-20.244	-16.665	-5.786	-15.365
Latin America and the Caribbean	-27.677	-43.789	-42.287	-7.501	-1.266	-1.955	-17.089	-9.427	-9.322
Middle East and North Africa	79.021	60.438	24.563	-9.828	-8.55	-1.695	-16.793	-7.705	-8.788
Sub-Saharan Africa	0.519	-17.542	-16.363	-8.736	-4.442	-0.058	-4.943	-1.883	-6.821
	1989	1990	1991	1992	1993	1994	1995	1996	1997
Emerging market and developing economies	-32.1	-18.325	-96.354	-82.433	-120.66	-80.472	-96.838	-68.491	-71.108
Central and eastern Europe	0.816	-4.623	-1.452	-1.577	-14.718	1.441	-10.067	-12.185	-16.167
Developing Asia	-18.814	-11.984	-4.028	-8.57	-28.215	-16.373	-37.330	-30.235	12.435
Latin America and the Caribbean	-4.977	-0.893	-17.374	-34.75	-45.88	-51.962	-38.003	-38.057	-66.134
Middle East and North Africa	-3.575	2.942	-66.776	-26.232	-22.305	-10.81	-3.055	15.760	15.895
Sub-Saharan Africa	-4.057	-2.387	-5.001	-6.53	-5.915	-6.068	-10.030	-4.833	-7.184
	1998	1999	2000	2001	2002	2003	2004	2005	2006
Emerging market and developing economies	-102.725	-11.290	95.837	53.507	82.743	148.898	205.685	407.037	627.183
Central and eastern Europe	-15.681	-23.585	-28.852	-10.852	-18.660	-32.551	-55.253	-60.491	-88.543
Developing Asia	53.826	39.746	42.869	40.755	63.413	83.608	91.573	142.743	271.048
Latin America and the Caribbean	-89.946	-55.521	-48.566	-53.546	-15.823	8.319	20.538	32.789	46.586
Middle East and North Africa	-26.109	16.482	80.643	48.903	33.493	61.796	92.125	207.505	281.474
Sub-Saharan Africa	-15.751	-10.414	1.649	-5.261	-12.732	-11.506	-8.640	-1.653	27.657
	2007	2008	2009	2010	2011	2012	2013		
Emerging market and developing economies	596.905	669.237	253.755	323.275	410.457	380.579	235.848		
Central and eastern Europe	-136.132	-158.981	-48.091	-82.560	-119.330	-79.357	84.844		
Developing Asia	394.913	429.367	276.764	238.819	97.572	108.721	138.461		
Latin America and the Caribbean	6.710	-39.041	-30.267	-62.792	-77.930	-104.474	140.639		
Middle East and North Africa	262.861	346.577	49.063	179.692	417.426	421.076	317.639		
Sub-Saharan Africa	9.346	-3.999	-27.582	-15.432	-17.349	-38.265	-51.996		

Note: Developing economies include what the IMF terms *emerging economies*.

Source of data: International Monetary Fund, *World Economic Outlook Database*, April 2010 and October 2013.



## **13.4 Accumulation of Debt and Emergence of the Debt Crisis in the 1980s**

- Background and analysis
  - External debt
  - Debt service
  - Basic transfer

## 13.4 Accumulation of Debt and Emergence of the Debt Crisis in the 1980s (cont'd)

Net capital inflow,  $F_N$ , is

$$F_N = dD \quad (13.1)$$

Basic transfer, BT, is

$$BT = dD - rD = (d - r)D \quad (13.2)$$

Where  $d$  is percent increase in total debt

$D$  is total debt

$r$  is the average interest rate

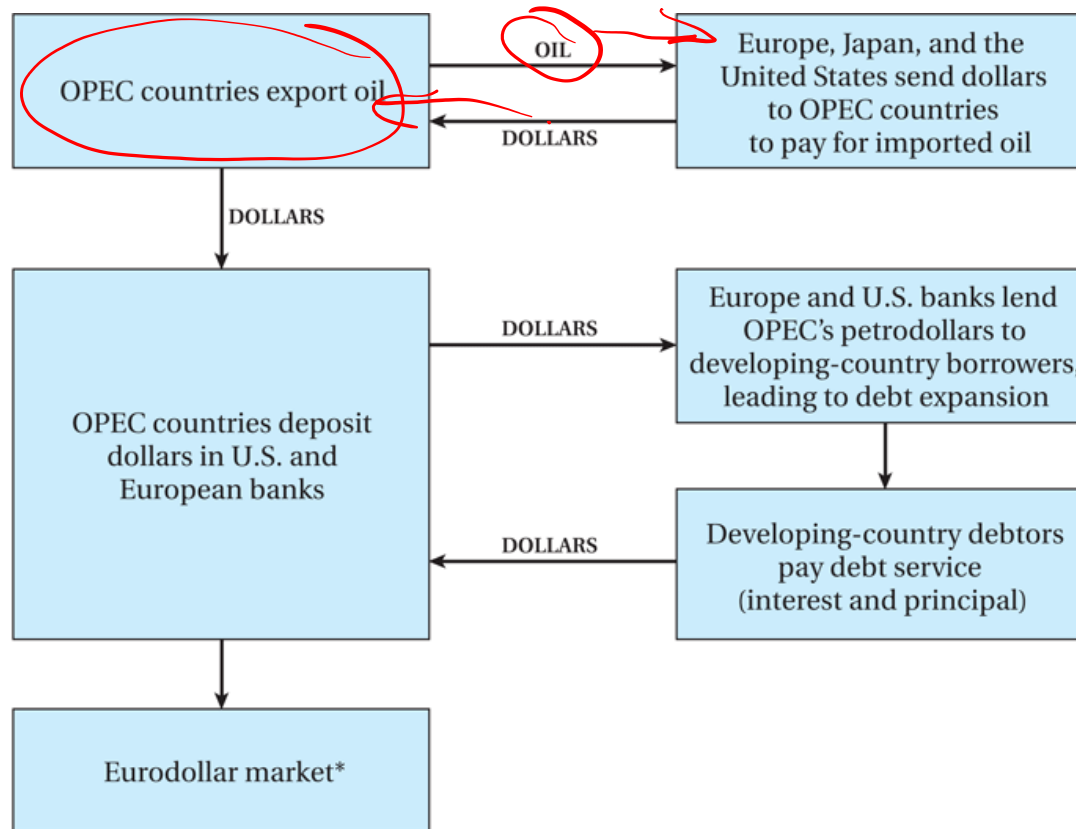




## **13.4 Accumulation of Debt and Emergence of the Debt Crisis in the 1980s (cont'd)**

- Origins of the 1980s Debt Crisis
  - OPEC oil price increase
  - Increased borrowing
  - Excess of imports
  - Lagging exports

# Figure 13.1 The Mechanics of Petrodollar Recycling



\*Eurodollars are dollar deposits in any bank outside of the United States, not necessarily in Europe only. Rather than send their surplus dollars to the United States, non-U.S. banks began in the 1970s to accept direct dollar deposits, pay interest on them, and lend them directly to developing-country borrowers.

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## **13.4 Accumulation of Debt and Emergence of the Debt Crisis in the 1980s (cont'd)**

- Origins of the Debt Crisis (cont'd)
  - Debt-servicing obligations
  - Debt-service payments
  - Debt-servicing difficulty
  - Oil shocks



## **13.4 Accumulation of Debt and Emergence of the Debt Crisis in the 1980s (cont'd)**

- Origins of the Debt Crisis (cont'd)
  - Developing countries' two options:
    - Curtail imports and restrictive fiscal and monetary measures
    - More external borrowing



## **13.5 Attempts at Alleviation: Macroeconomic Instability, Classic IMF Stabilization Policies, and Their Critics**

- The IMF stabilization program
  - Macroeconomic instability
  - Stabilization policies
  - Four basic components of IMF stabilization program:
    - Liberalization of foreign exchange and imports control
    - Devaluation of the official exchange rate
    - Stringent domestic anti-inflation program
    - Opening up of the economy to international commerce



## **13.5 Attempts at Alleviation: Macroeconomic Instability, Classic IMF Stabilization Policies, and Their Critics (cont'd)**

- The IMF stabilization program (cont'd)
  - Such policies can be politically unpopular because they hurt the lower- and middle-income groups.
  - Less radical observers view the IMF as neither a developmental nor an antidevelopmental institution.
  - See Box 13.1



## **13.5 Attempts at Alleviation: Macroeconomic Instability, Classic IMF Stabilization Policies, and Their Critics (cont'd)**

- The IMF stabilization program (cont'd)
  - Tactics for debt relief:
    - Debtors' cartel
    - Restructuring
    - Brady Plan
    - Debt for equity swaps
    - Debt for nature swaps
    - Debt repudiation
  - For the case of Mexico, see Box 13.3





# **“Odious Debt” and Its Prevention**

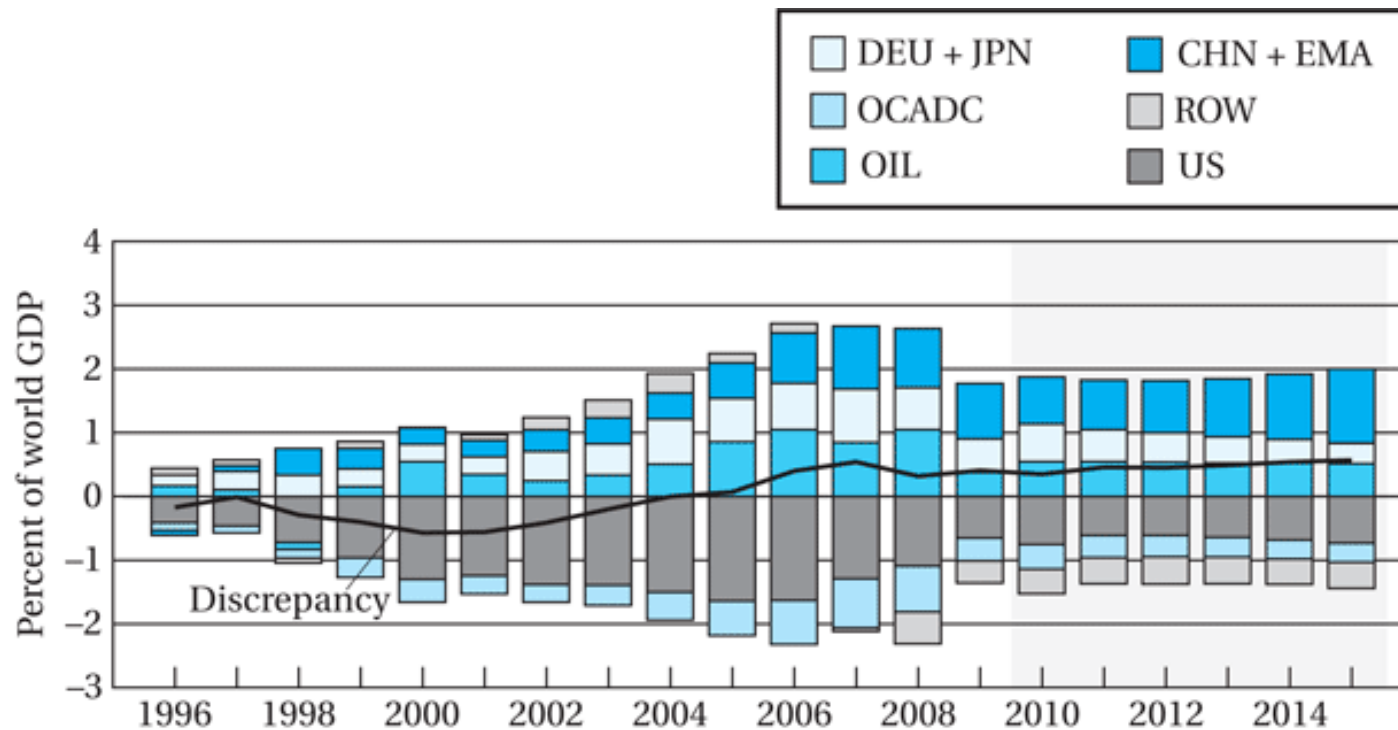
- What is odious debt?
  - Sovereign debt used by an undemocratic government in a manner contrary to the interests of its people should be deemed invalid
    - See Box 13.4



# **Resolution of 1980s-1990s Debt Crises and Continued Vulnerabilities**

- Highly indebted poor countries (HIPCs)
- Some progress but vulnerabilities remain

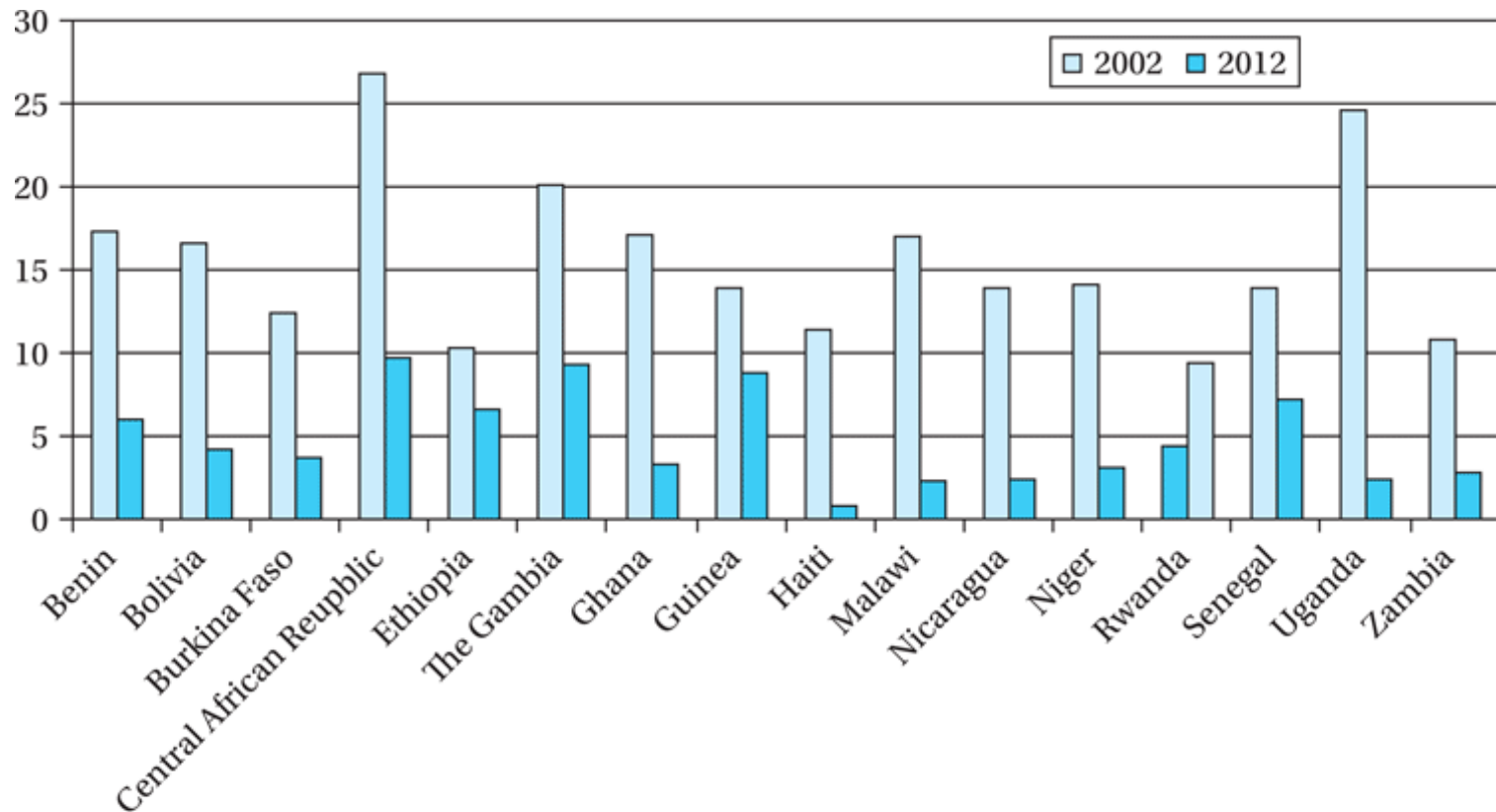
# Figure 13.2 Global Imbalances



*Note:* IMF groupings are China and “emerging” Asia (CHN+EMA); a group of European economies with Turkey termed “Other Current Account Deficit Countries” (OCADC); Germany and Japan (DEU+JPN); and oil exporters (OIL). For the rest of the world (ROW), a net current account deficit has opened up, a trend that is projected to continue.

*Source:* International Monetary Fund, *World Economic Outlook*, October 2010, p. 29. Used by permission of International Monetary Fund.

**Figure 13.3** Debt Service Ratios for Selected HIPC Countries, 2002 and 2012



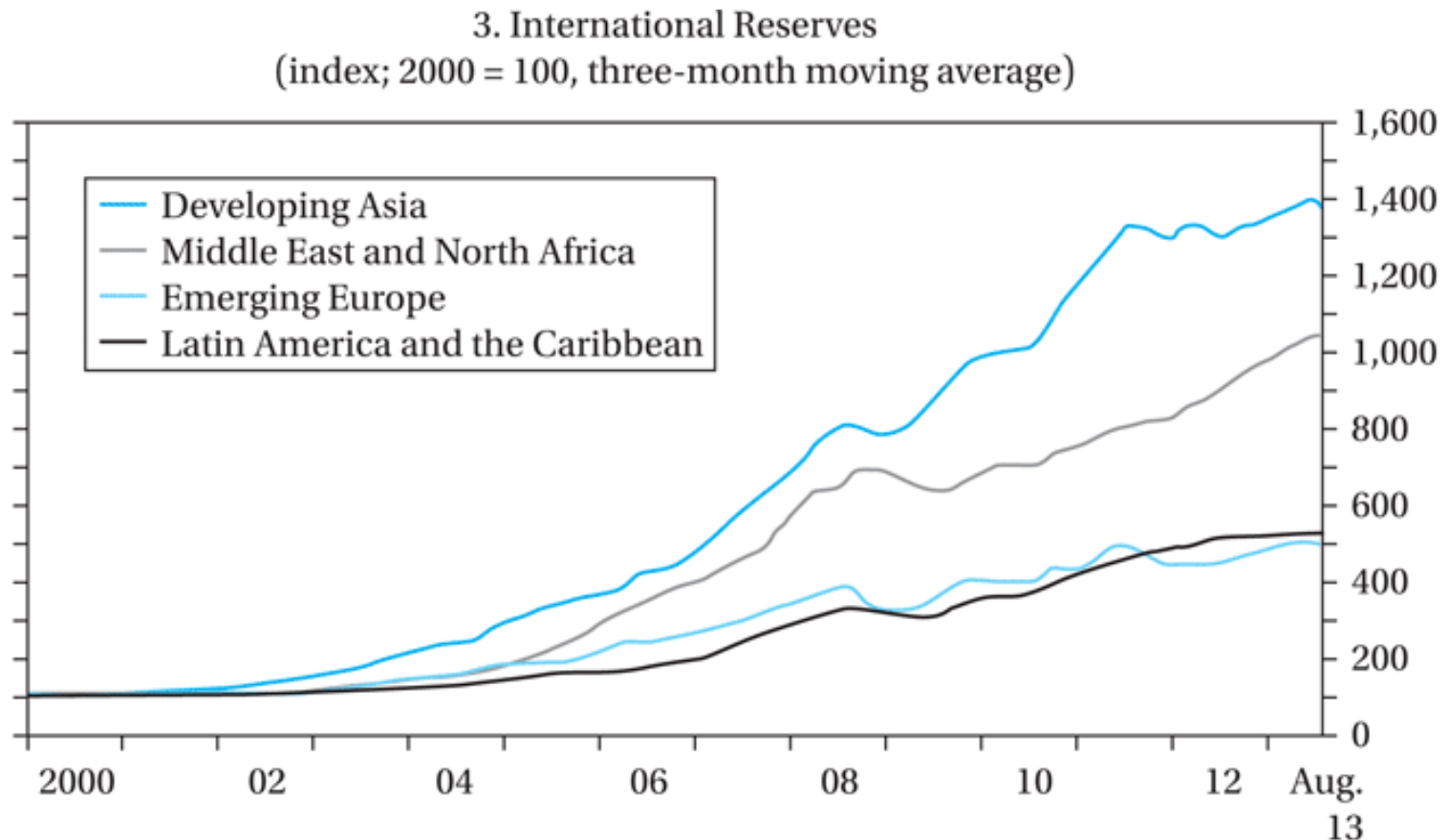
Source: Data drawn from [http://siteresources.worldbank.org/INTDEBTDEPT/ProgressReports/23514662/HIPC\\_update\\_12-19-13.pdf](http://siteresources.worldbank.org/INTDEBTDEPT/ProgressReports/23514662/HIPC_update_12-19-13.pdf); Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Statistical Update, Dec. 19, 2013, Table 3, page 15, accessed 10 March 2014. .



## 13.6 The Global Financial Crisis and the Developing Countries

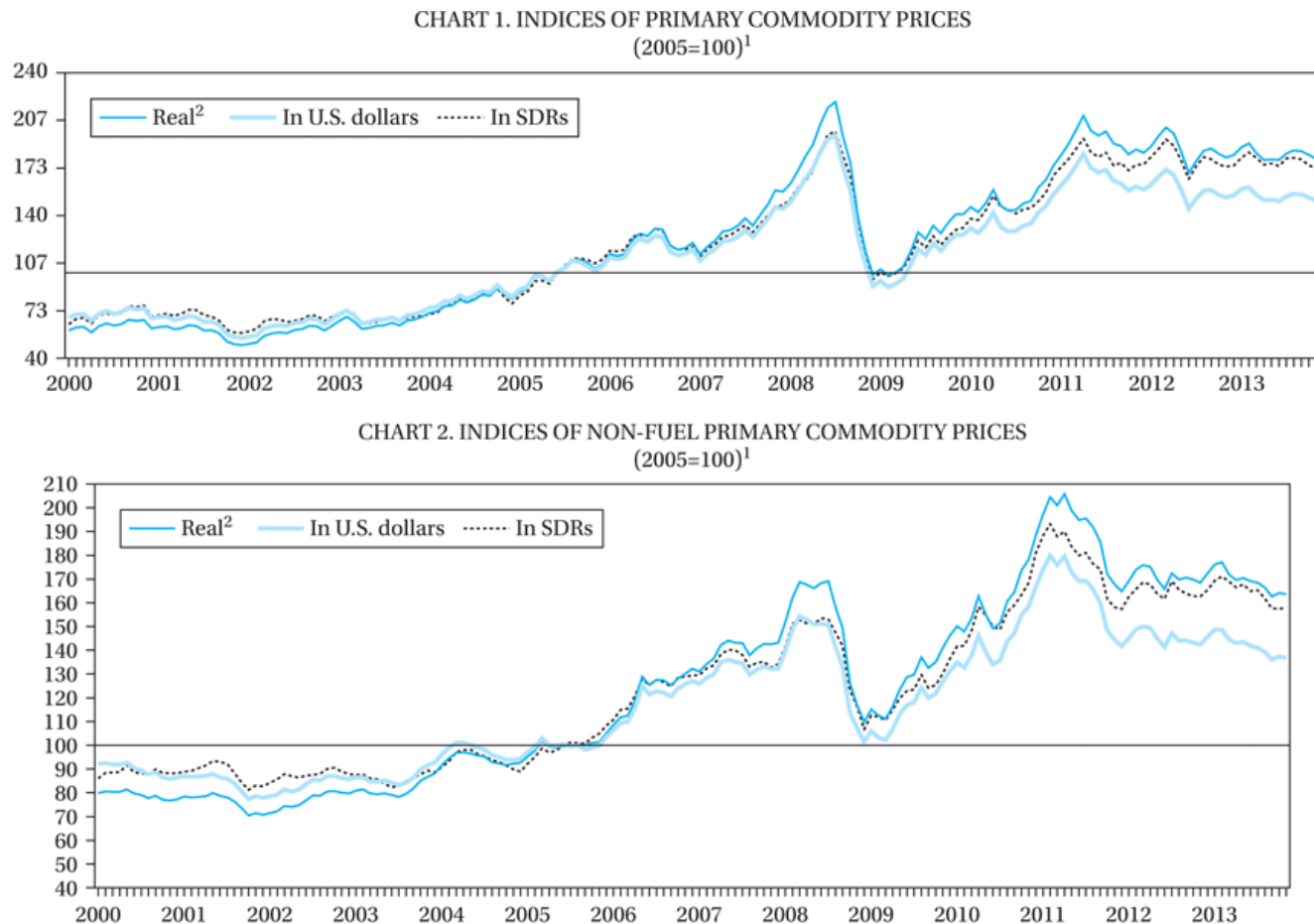
- Causes of the crisis and challenges to lasting recovery
- Economic impacts on developing countries
  - Economic growth
  - Exports
  - Foreign investment inflows
  - Developing-country stock markets
  - Aid

**Figure 13.4** International Reserves (Index 2000 = 100, three-month moving average)



Source: IMF, *World Economic Outlook Transitions and Tensions*, October 2013, Fig. 1.10, panel 3, p. 10, <http://www.imf.org/external/pubs/ft/weo/2013/02/>. Used with permission,

# Figure 13.5 Indices of Commodity Prices (Total and Non-Fuel), 2000–2013



Source: IMF, <http://www.imf.org/external/np/res/commod/Charts.pdf>, update of October 10, 2013. Used by permission of the IMF.

<sup>1</sup>Indices comprise 60 price series for 44 non-fuel primary commodities. Weights are based on the 2002-2004 average of world export earnings.

<sup>2</sup>Deflated by US CPI





## **13.6 The Global Financial Crisis and the Developing Countries (cont'd)**

- Economic impacts on developing countries
  - Distribution of influence among developing countries
  - Worker remittances
  - Poverty
  - Health and education
  - General policy framework



## **13.6 The Global Financial Crisis and the Developing Countries (cont'd)**

- Differing impacts across developing regions
  - China and the exchange rates controversy
  - East Asia and Southeast Asia except China
  - India
  - Latin America
  - Africa



## **13.6 The Global Financial Crisis and the Developing Countries (cont'd)**

- Prospects for recovery and stability
- Opportunities as well as dangers?



# Concepts for Review

- Amortization
- Balance of payments
- Basic transfer
- Brady plan
- Capital account
- Capital flight
- Cash account
- Conditionality

- Current account
- Debt-for-equity swap
- Debt-for-nature swap
- Debtors' cartel
- Debt repudiation
- Debt service
- Deficit



# Concepts for Review (cont'd)

- Euro
- External debt
- Hard currency
- Highly indebted poor countries (HIPCs)
- International reserve account
- International reserves
- Macroeconomic instability
- Odious debt
- Restructuring
- Special drawing rights (SDRs)
- Stabilization policies
- Structural adjustment loans
- Surplus