Chapter 13
Balance of Payments, Debt, Financial Crises, and Stabilization Policies

■ Key Concepts

This chapter maintains its focus on in~~ternational monetary and m~~acroeconomic issues with the discussion of odious debt and its prevention and the impact of the global financial crisis on to developing countries that was added in the eleventh edition included in this edition as well.

The major topics are:

- Understanding the balance of payments accounts. facts
- Identifying recent trends in developing country balance of payments accounts.
- Understanding the causes and effects of debt crises through the example of the 1980's debt crisis.
- Attempts to alleviate macroeconomic instability in the economy including debt relief.
- The impacts of the global financial crisis on developing countries.

Basic balance of payments accounting is introduced in section 13.2 of the chapter. Key definitions include the current account, the capital account and the cash account or net change in international reserves. A detailed numerical example is used to illustrate how the accounts work, as well as the impact of capital flight. Options for financing and reducing payments deficits are discussed including increasing net exports, changing the official exchange rate, borrowing, adopting IMF stabilization policies, and acquiring SDR's.

Recent trends in the balance of payments of LDCs are presented and explanations are offered, for instance, why current and capital account balances declined in the 1980's and 1990's. LDC current account balance declined as a result of a fall in commodity prices and the contraction of world trade (associated with the 1981–1982 world recession and protectionism). The capital account balance declined as a result of rising debt obligations, capital flight, and reductions in the amount of new lending.

Sections 13.4 and 13.5 are devoted to the debt crisis and methods of alleviation. The basic transfer is defined as the difference between net capital inflow and interest payments on accumulated debt. The basic transfer represents the amount of foreign exchange that a developing country gains or loses each year from international capital flows. A very significant issue in development economics is a negative basic transfer for many developing countries during the 1980s.

billion

The dimensions of the 1980's debt crisis are reviewed. Total external debt of developing countries more than doubled from 180 billion in 1975 to $406 billion in 1979, a mere 5 year period. In the same time frame the debt service payment tripled from 25 billion to 75 ~~million~~. The text summarizes the history of the debt crisis noting that the first oil shock triggered international lending through a combination of increased loan demand and recycling petrodollars that expanded the supply of loanable funds. The second oil shock triggered a reversal of this process, as interest rates rose. Stagnation reduced the demand for developing country exports, and already high debt levels made further borrowing to accommodate high oil prices all the more difficult.

Typical elements of an IMF stabilization package are outlined: liberalization of foreign exchange and import controls, devaluation, interest rate increases, deficit reduction, wage restrictions, reduced price controls, and a general opening up of the economy. The text finds that these elements have not worked well in response to the debt crisis, leading to adjustment without growth and negative consequences for living standards.

A case study on Mexico is included in the chapter ~~as Box 13.1.~~ This case study highlights Mexico's battle with the international financial community over its foreign debt and the relative stagnation of real per capita income from the early 1980s to the present day (a .5% annual increase between 1981 and pre-crisis 2008).

Recent initiatives for managing the debt crisis include debt forgiveness, debt restructuring, new SDR allocations, repayments linked to export earnings, debt-for-equity swaps, and debt-for-nature swaps. A new section on odious debt and its prevention has been added. The text reexamines the current situation of the debt crisis. Until 1997, LDC debt was considered to be one of the top international crises. However, a majority of loans were then restructured and if the debt crisis is defined as a threat to large commercial banks it might be considered over after the restructuring. But if one defines the debt crisis as a threat to development prospects, the text argues that then the crisis is not over. In fact, debt relief, though promised to certain countries, has been very slow to come.

The text also highlights the concerns of instability that appeared with the 1997–98 financial crisis across Asia, Latin America and Russia. In addition, the enormous U.S. trade imbalance and its eventual impact on the debt performance of developing nations is still a large unanswered question.

The final section of the chapter deals with the global financial crisis and how it affects the developing countries through trade and the interconnected financial markets of today. While it is uncertain why the crisis occurred, financial deregulation in the United States and large trade imbalances between East Asian countries and developed countries (U.S.) are largely cited as reasons. The section then goes on to discuss the effects the crisis had on developing nations in the areas of economic growth, exports, foreign investment inflows, developing country stock markets, aid, distribution of influence among developing countries, worker remittances, poverty, health and education, and general policy framework.

The text also looks at how the crisis affected different regions of the global economy – China, India, and other East Asian countries in particular. China experienced an economic slowdown between 2008 and 2009, before resuming its historically fast economic growth by the end of 2009 and into 2010. The final part in the chapter looks towards the future and examines the prospects for recovery and stability following the recession. The chapter outlines five reasons for caution—the United States large trade deficits, large fiscal deficits in most OECD countries, market perceptions that risk of sovereign debt default is high, the risk of deflation, and the benefits of exporting manufactures to high-income countries.

South Korea and its successful development strategy of export promotion among others is highlighted in this case study. It also examines the current account and debt problem experienced in the 80's and the recovery from the East Asian financial crisis.

1997-8

■ Discussion Topics

- Discuss the pros and cons of running a trade deficit. Some initial balance of payments concepts can be reviewed and then opened up for discussion. Discuss the alternative options and opportunity costs.
- Have students locate data on remittances and capital flight for select countries and discuss the impacts on growth, income distribution, etc.
- Proposals for debt forgiveness or debt cancellation and now odious debt are much in fashion, especially with rock stars heavily involved (Live 8, Bono, etc.). Students will find it interesting researching their arguments and using development economics to evaluate them.
- Discuss the current global financial crisis 2010 and its impact by studying countries like China, India, and South Korea.
- Reasons for caution in recovery from the global crisis could be discussed as students come up with potential solutions in the future.
- Compare and contrast the successful strategy of debt management of South Korea with the failure of Brazil.

■ Sample Questions

Short Answer

1. Provide a concise statement on the relationship between the debt crisis and: (a) foreign direct investment, (b) trade liberalization, (c) absolute poverty, and (d) investment levels.

   Answer: May be asked as a long essay or subdivided into short essays. Answers will depend on what you cover in lecture.

2. Consider the following hypothetical data for a developing country:

Year	Total Debt ($ bn)	Debt/Export (%)	GDP Growth	Inv. Growth
1	6	134	0.6%	–1.0%
2	6.5	147	2.9%	1.1%
3	7	159	5.1%	1.6%
4	7.5	174	6.4%	2.4%
5	8	198	1.1%	–0.6%

   Does this country have a debt crisis? What additional pieces of quantitative or qualitative evidence (if any) would help you to decide?

   Answer: Various answers are plausible and this will depend on lecture coverage. Close attention to investment growth should be found in students' answers.

3. An IMF official was quoted as acknowledging that the Fund's stabilization packages have often led to adjustment without growth. However, he said, "the Fund is a firefighter not a carpenter, and you cannot expect the firefighter to rebuild the house as well as put out the fire." Provide a balanced evaluation of this statement.

   Answer: Suggestion: Nothing should be left smoldering either.

4. Explain what is meant by capital flight. How would you distinguish capital flight from the normal desire of investors to diversify their portfolios by investing abroad?

Answer: Students should show that they understand capital flight as discussed in the chapter.

5. What economic variables would you need to consider in order to distinguish between a developing country with a short-term balance of payments problem and one in a debt crisis? Explain what data you would need to look at and why.

   Answer: Look for an understanding that investment in exportable goods must increase above trend during borrowing to provide foreign exchange earnings sufficient to repay the debt without a drop in the standard of living.

debt

6. Explain how the devaluation of a developing country's currency is supposed to reduce its external debt. Give two reasons why a devaluation may be less effective than expected.

   Answer: Discussed in the chapter.

100 $ → ¥7 700¥

50 $ → ¥14

7. Outline the principal sources of the debt crisis.

   Answer: Discussed in the chapter.

8. Outline the elements of an IMF stabilization package. Explain the mechanism by which it is expected to help a balance of payments deficit. How successful have these packages been? Explain your answer.

   Answer: Discussed in the chapter.

9. What kinds of domestic policies, short of significant debt reduction, can be followed to alleviate a debt crisis? How effective have these policies been?

   Answer: Expectations here will depend on lecture coverage.

10. Consider debt-equity swaps as an approach to debt reduction. *Briefly* describe how this works. State two arguments in favor of significant reliance on this strategy and two arguments against.

    Answer: In favor: may help restore a healthy balance between debt and equity, which in turn provides greater flexibility in repayment of debt, and may help facilitate a privatization program. Against: leads to issue of high-powered currency (so may be inflationary) and in some indebted countries there is limited availability of companies in which foreign investors have an interest in purchasing. If the question is asked after Chapter 15 has been covered, pros and cons of MNCs in development may figure into the answers.

11. Why may the debt crisis be only "sleeping" rather than "dead?"

    Answer: Debt restructuring has postponed but not eliminated the need for eventual repayment, and a small share of debt has actually been written off. It remains to be seen whether indebted economies have reformed sufficiently and will operate in an economic climate that enables the debts to be repaid. See section 13.4 (especially page 693).

12. Provide a definition of the current account, the capital account, and the cash account. What is the relationship between the three accounts?

    Answer: Discussed in the chapter.

13. Discuss the options for financing a balance of payments deficit.

    Answer: Discussed in the chapter.

14. Discuss some of the reasons why economists are concerned about the current recovery from the global financial crisis.

Answer: Large trade deficit. Large fiscal deficits in most OECD countries, market perception that risk of sovereign debt default is high, and risk of deflation all contribute to a cautious outlook for the future.

15. How did the Mexican debt crisis of the early 1980s come about? How has the Mexican economy coped during the past 20 years, in the aftermath of the debt crisis? What has been the legacy of the debt crisis for the Mexican economy?

    Answer: Discussed in Box 13.3.

16. What is meant by petrodollar recycling? Explain the mechanism by which this phenomenon occurred. What were the consequences of this phenomenon for developing countries?

    Answer: Explained in the section 13.4 "Origins of the 1980s Debt Crisis."

17. What is meant by the term Odious Debt"?

    Answer: Discussed in Box 13.4 "Odious Debt and Prevention."

18. Explain how international trade and trade policy helped South Korea transform itself from an underdeveloped country to a high-income country in the space of a single generation. You might begin by discussing South Korea's trade strategy. Why is international trade of such vital importance to South Korea?

    Answer: Discussed in the case study.

■ Multiple Choice

1. The flow of private foreign investment and grants and loans is included in a country's
   (a) current account.
   (b) capital account.
   (c) cash account.
   (d) none of the above.

   Answer: B

2. Debt service payments appear in
   (a) the current account.
   (b) the capital account.
   (c) the cash account.
   (d) errors and omissions.

   Answer: A

3. A typical IMF stabilization package involves
   (a) erecting barriers against foreign investment.
   (b) overvaluing the exchange rate.
   (c) liberalization of exchange controls.
   (d) a reduction in interest rates.
   (e) all of the above.

   Answer: C

4. The need for exchange controls may arise from
   (a) overvalued exchange rates.
   (b) export promotion policies.
   (c) a current account surplus.
   (d) all of the above.

   Answer: A

5. Which of the following was not a factor contributing to the debt crisis in Latin America?
   (a) The oil shocks.
   (b) Trade liberalization in many developing countries.
   (c) An increase in global interest rates.
   (d) A lack of investment opportunities in the developed countries.
   (e) All of the above.

   Answer: B

6. Special Drawing Rights are financial assets created by
   (a) the World Bank.
   (b) the United National Development Program.
   (c) multinational corporations.
   (d) the International Monetary Fund.

   Answer: D

7. Debt equity swaps may lead to
   (a) increased foreign ownership.
   (b) greater domestic inflation.
   (c) lower debt servicing requirements.
   (d) all of the above.
   (e) none of the above.

   Answer: D

8. A significant problem of a dual exchange rate system is that it
   (a) is difficult to administer.
   (b) leads companies to pursue rent-seeking behavior.
   (c) promotes black markets.
   (d) all of the above.
   (e) none of the above.

   Answer: D

9. A country with high inflation, rising budget and trade deficits, and a rapidly expanding money supply
   (a) is in transition.
   (b) has macroeconomic instability.
   (c) is practicing import substitution.
   (d) is practicing export promotion.

   Answer: B

10. Exchange of developing country debt (at a discount) for private ownership of state-owned assets is called
    (a) debt-equity swaps.
    (b) debt restructuring.
    (c) the Brady Plan.
    (d) debt-nature swaps.

    Answer: A

11. The debt service ratio is the ratio of
    (a) external debt to the size of the service sector.
    (b) external debt to total GNP.
    (c) internal debt to the size of the service sector.
    (d) internal debt to total GNP.
    (e) none of the above.

    Answer: E

12. The debt service ratio is defined as
    (a) the ratio of total debt to export earnings.
    (b) the ratio of total debt to GDP.
    (c) the ratio of payments on foreign debt to export earnings.
    (d) the ratio of payments on foreign debt to GDP.

    Answer: C

13. If the current account is a deficit of 25 then
    (a) the capital account is a surplus of 25.
    (b) the cash account is a surplus of 25.
    (c) the capital account is a surplus of 25 if the cash account is zero.
    (d) the cash account is a deficit of 25.

    Answer: C

14. The basic transfer is defined as
    (a) net capital inflow.
    (b) interest payments on foreign debt.
    (c) net capital inflow divided by interest payments on foreign debt.
    (d) net capital inflow minus interest payments on foreign debt.

    Answer: D

15. The concept of odious debt implies
    (a) an excessive debt.
    (b) a debt that is not the responsibility of the nation's people.
    (c) a large debt burden.
    (d) the total external debt of a nation's people.

    Answer: B