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Third World

Is Another Debt Crisis in the Offing?

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While taking a significant toll on public revenues [1] repayment of the public debt has, since 2004, ceased to be a major concern for most middle-revenue countries and for raw material-exporting countries in general. In fact the majority of governments of these countries are having no trouble finding loans at historically low interest rates. However, the debt crisis that hit the advanced industrial countries in 2007 could radically change the conditions of indebtedness in developing countries in the near future. Are we approaching the onset of another debt crisis in developing countries? The question requires thought, because if such is the case, we need to be prepared and take appropriate measures to limit the damage.

The Historical Facts

The last two centuries in the history of capitalism saw several international crises (three in the 19th century and two in the 20th [2]), which directly affected the fate of emerging countries. The origin of these crises and the moment at which they peaked are closely related to the pace of the world economy and to that of the advanced industrial countries in particular. Each debt crisis was preceded by an abnormal boom in the countries of the center, with an excess of capital being partly recycled into the economies of the periphery. The crisis was generally triggered by a recession or crash affecting some of the main industrialized economies.

Easy Money

In the past few years, many developing countries have seen their export revenues soar thanks to the rising prices of goods they sell on the world market: hydrocarbons (oil and gas), minerals, and agricultural products. This allows them to draw on these foreign exchange revenues to repay the debt and be credible candidates for new loans.

In addition, the commercial banks of the North, who had pulled back on loans at the end of the 1990s after the financial crises in developing countries, gradually re-opened the credit lines starting in 2004-2005 [3].

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Other private financial groups (pension funds, insurance companies, hedge funds) have given credit to developing countries by buying bonds that these countries issued on the leading stock exchanges. States have also increased their offers of credit to developing countries, for example China, which has been on a widespread lending spree, and Venezuela, which finances Argentina and the Caribbean countries. In general, the interest rates and the risk premiums are far below those that prevailed up to the early 2000s. We should also mention the substantial credit granted within developing countries by local or foreign banks operating in the South.

The Situation Is Changing

Things changed when the private debt crisis hit the advanced industrial countries in 2007 [4]. For a detailed analysis of the cause of the crisis and the international context, see Eric Toussaint, *Banque du Sud et nouvelle crise internationale*, Liège-Paris: CADTM-Syllepse, 2008, chapters 9 and 10.

This crisis was triggered by the bursting of the speculative real estate bubble in the US which brought about the collapse of several private debt markets (subprimes, ABCP [5], CDO [6], LBO [7], CDS [8], ARS [9], etc.). This crisis is far from over and the world is only now feeling the impact of its repercussions.

While there was a veritable flood of credit up to July 2007, various private sources suddenly dried up in the North.

Private banks that were tied up in shaky debt packages began to distrust each other and were reluctant to lend money. The authorities of the US, Western Europe, and Japan had to inject huge liquidities on several occasions (hundreds of billions of dollars and euros) to prevent the North's financial system seizing up. During this time, private banks that financed themselves by selling non-guaranteed certificates could no longer find buyers for these on Northern financial markets. They had to clean up their books and write off the huge losses incurred by their risky operations of the previous years.

To keep afloat they had to call in fresh money, provided by the sovereign-wealth funds of Asian and Gulf countries. Banks that could not find fresh money in time were acquired by others (Bear Stearns [10] was bought by JP Morgan) or by the state (Northern Rock Bank was nationalized by the British government). Some of them did not escape bankruptcy. Freddie Mac and Fannie Mae, two North-American mortgage giants, were in virtual bankruptcy in July 2008. These two institutions were privatized during the neo-liberal wave but were state-guaranteed. Their mortgage portfolio amounts to some \$5,300 billion (the equivalent of four times the external public debt of all developing countries). Washington nationalized them in September 2008. [11]. These two institutions were privatized at a time when they were making huge profits. Now that they have recently paid out dividends to their private shareholders, they have been nationalized so that the state can take over their losses. As the editorial of the very neo-liberal magazine *The Economist* itself declared in its 30 August 2008 issue: "That is capitalism at its worst: it means shareholders and executives reap the profits, but the taxpayer bears the losses."

At First, Most Developing Countries Were Not Affected

At first, the stock exchanges of many developing countries saw an influx of speculative money that was eager to flee the epicenter of the crisis, in other words the US. The capital released by the bursting of the real-estate bubble which swept the Atlantic from West to East and struck Ireland, Great Britain, and Spain (the list will get longer in the coming months) took refuge in other markets: the raw materials and food product markets in the North (thus further increasing prices) and certain stock markets in the South. [12].

On another front, the decision of the US Federal Reserve to periodically lower its target interest rate also lightened — at least provisionally — the South's debt burden. Also the price of raw materials remained high, allowing exporting countries in the South to garner some large revenues.

Will the Developing Countries Continue to Build Up Large Revenues from Their Exports?

Slower economic growth, already being felt in North America, Europe, and Japan, will lead to less exports of manufactured products, mainly by China and other Asian countries. China's domestic demand will not be enough to compensate for the drop in external demand.

The slowdown of economic activity in the industrialized countries, China, and other Asian countries with a high consumption of raw materials (Malaysia, Thailand, South Korea, etc.) should eventually bring down the price of hydrocarbons and other raw materials. Of course the price of oil could remain high if OPEC were to agree to reduce the oil offer or if a major producer was prevented from producing oil at the normal rate (an attack on Iran by Israel and/or the US; a possible social and political crisis in Nigeria or elsewhere; a natural disaster in this place or that) and if speculators riding on the high wave continue buying into oil.

The future of exported food prices will depend on a number of factors. In order of importance: whether or not agrofuel production continues to increase; whether or not bullish speculation on the commodities exchanges continues; crop results (cereals should be on the rise in Europe), which are influenced in particular by climate change.

To this should be added the eventuality of less remittances by migrants to their native countries.

Mexican, Ecuadorian, and Bolivian workers in the US construction industry are directly affected by the real estate crisis and are fast losing their jobs. The Bank for International Settlements has underlined this trend: "In addition to lower capital inflows, a slowdown in the advanced industrial economies would also lead to a decrease in workers' remittances. This could have particularly large effects in countries in Central America, Mexico, India and the Philippines, thus increasing their external financing needs relative to the more comfortable circumstances of the past few years." [13].

To sum up, there is no guarantee that the substantial foreign currency revenues of those exporting countries that benefited most from them will continue. On the contrary, they are likely to diminish in the next few years.

Tighter Loan Conditions and a Possible Loss of Revenues

But the uncertainty is not only about revenues: spending may also see wide variations. According to the authors of the BIS 2008 Annual Report, the present trend for banks to reduce their credit offer is likely to last and even get stronger. In many cases, variable rate loans granted by banks of the North to developing countries are indexed to Libor (London Interbank Offered Rate), which is very volatile and tends to rise.

The losses that banks have to absorb have been at a high since 2007. The number of debt payment defaults is on the rise in the North. The credit default swaps market, these unregulated credit derivative contracts that were supposed to protect debt holders against the risk of payment default, is in a state of uncertainty because the sums involved are so enormous.

The outcome is obvious: banks and other institutional investors are thinking twice before granting new loans, and when they do grant them, they impose tougher conditions [14]. And this is just the beginning. In June 2008, the BIS wrote: "In this setting, sovereign spreads (in other words the risk premiums that public authorities pay to lenders) remain well below the levels observed in past periods of financial turbulence, but are significantly higher than they were in the first half of 2007, highlighting the risks that financing constraints could become binding." [15] A little further on, the BIS added: "As for the corporate sector, corporate bond spreads have recently widened more than sovereign spreads in a number of EMEs, indicating that some borrowers are starting to face tighter financing conditions after many years of easy borrowing." [16]

Also according to the BIS Annual Report, the countries most at risk are South Africa, Turkey, the Baltic states, and those of Central and Eastern Europe, like Hungary and Romania (in the last two the real estate bubble is about to burst, while to make things worse loans have been indexed to strong currencies, the Swiss franc in particular).

"In view of the turmoil engulfing banks in advanced industrial economies, the second major vulnerability in some EMEs concerns the sustainability of bank-intermediated capital flows. Historically, bank flows have periodically been subject to sharp reversals, such as during the early 1980s in Latin America and during 1997-1998 in emerging Asia." [17]

Conclusions

As a result of the crisis affecting advanced industrial countries, loan conditions will certainly tighten for developing countries. The large currency reserves that they have been able to build up over recent years will serve as a buffer against the consequences of tighter conditions, but will not be sufficient to protect them entirely. Certain weak links in the South's indebtedness chain are in danger of being directly affected in the near future, all the more so since some of them have already been severely affected by the world food crisis of 2008. It is vital therefore to closely follow a situation that is presently uncontrolled, and prepare to find solutions. Otherwise the people will once again have to pay the highest price. [18]

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[1] Between 20% and 35% of the state budget is devoted to repaying the public debt in numerous countries. In the case of Brazil, the portion of the state budget devoted to repaying the internal and external public debt is four times higher than the sum allotted to education and health spending! See Rodrigo Vieira de Ávila, "Brésil : La dette publique est toujours bien là!" 10 March 2008 and Gabriel Strautman, "Deuda Pública: ¿Quién Debe A Quien?" 6 August 2008

[2] See Eric Toussaint, *Your Money or Your Life*, Chicago: Haymarket books, 2005, chapter 7. See also Eric Toussaint, *The World Bank: A Critical Primer*, London: Pluto, 2008, chapter 4.

[3] "Cross-border claims of BIS reporting banks on EMEs (emerging economies) were estimated at \$2.6 trillion in 2007, an increase of \$1.6 trillion over the past five years" (BIS, 78th Annual Report, Basel, June 2008, p. 41).

[4] For a detailed analysis of the cause of the crisis and the international context, see Eric Toussaint, *Banque du Sud et nouvelle crise internationale*, Liège-Paris: CADTM-Syllepse, 2008, chapters 9 and 10.

[5] North-American ABCPs (asset backed commercial papers) are negotiable certificates issued by banks or other companies on the financial market for a short period (2 to 270 days). These certificates are not collateral-backed (for example by a real estate property). They depend on the confidence of the ABCP buyer in the bank or company that sells it.

[6] Collateralized Debt Obligations.

[7] Leveraged Debt Buy-Out. The acquisition of companies financed by debts.

[8] Credit Default Swaps. The purchaser of a CDS wishes, in purchasing it, to protect himself against the risk of non-payment of a debt. The CDS market has developed significantly since 2002. The volume of CDS-related sums increased eleven-fold between 2002 and 2006.

The problem is that these insurance policies are sold without regulatory control. The existence of these CDS has encouraged companies to take more and more risks. Believing themselves protected from defaults on payment, lenders grant loans without verifying the borrower's ability to repay.

[9] Auction Rate Securities. These securities sold in the US represent credits to city councils, universities (for student grants), hospitals, etc. Each week, clients can buy or sell them via an auction system. In June-July 2008, the market collapsed and the banks that had sold these debts had to buy them back from their clients and pay state-imposed fines. The sums involved are estimated at \$330 billion and the fines paid by UBS (\$150 million), Citigroup (\$100 million), JP Morgan, Morgan Stanley, etc. add up to hundreds of millions of dollars.

[10] Bear Stearns, the 5th largest investment bank in the US, was heavily involved in the CDS market

[11] This is a prime example of privatized profit in times of economic prosperity and public-borne losses in times of depression

[12] But for the latter this was short-lived: some of them are experiencing a sharp downturn (Shanghai, Hong-Kong, Bombay-Mumbai, Sao Paulo, etc)

[13] BIS, 78th Annual Report, Basel, June 2008, p.55

[14] BIS, op. cit.

[15] BIS, p. 51.

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[16] The BIS also writes: "Bank credit to the private sector has expanded tremendously over the past five years — in Latin America by a cumulative 7 percentage points of GDP and in CEE by 30 percentage points. Such rapid credit growth could have overstretched the capacity of institutions to assess and monitor credit effectively, p. 54.

[17] BIS, p. 53.

[18] As regards alternative proposals, see: Eric Toussaint, *Banque du Sud et nouvelle crise internationale*, op cit., chapters 1 to 4. See also: Eric Toussaint, "Quelles alternatives pour le développement humain?" 22 August 2008; and Damien Millet and Eric Toussaint, *60 questions/60 réponses sur la dette, le FMI et la Banque mondiale*, CADTM-Syllepse, 2008, chapters 10 to 12.