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How the Cash Flow Crisis Floored the LDCs

When the supranational agencies monitored the debts of developing countries, they overlooked the LDCs' sudden switch to short-term financing. Here's an analysis of the real plight of the LDCs — measured, not by debt-service ratios, but by cash flows

When the capital markets are functioning smoothly and a sovereign borrower is perceived as a good risk, banks compete to lend. Bankers compare the assessment of risk provided by their country-risk analysts and the trends in the economic and political situation with the returns they are earning.

But when these trends deteriorate sharply, often due to a shock, such as an increase in oil prices or political upset, the focus of attention shifts. Fundamental economic and political factors remain important and the usual issues, such as raw material resources, export growth potential, debt burden and political stability, are carefully reassessed. But the crucial shift is that attention is suddenly focused on cash flow and liquidity.

Countries are eventually forced to reschedule when their foreign exchange cash flow has deteriorated so far that available liquidity is not enough to meet commitments. This happens ultimately because fundamental country risk problems become too great. But it can also happen, and may catch banks by surprise, if the cash flow position is particularly vulnerable. If banks are unwilling to extend further credit when a country runs into difficulties, there follows a difficult process of adjustment, usually with IMF support and guidance, and a rescheduling of private and official debt.

The level of debt in many countries now is such that debt servicing is a major component of the balance of payments. Banks' willingness to continue lending depends increasingly on countries' abilities to manage such debt. While this rests ultimately on nations' overall economic and political health, high levels of debt bring increasingly large cash flows which require careful monitoring and control. Current high interest rates are a major burden; but as much of the debt built up in the 1970s is now falling due, amortization payments also are becoming substantial.

There are signs already that the growth of bank lending to LDCs is slowing down. Medium and long-term debt outstanding grew 24.6% a year from 1975 to 1979 and then slowed to 14.4% in 1979/81, a fall offset only partly by rising short-term debt. A few well-publicized reschedulings, high debt burdens in some countries and prudential considerations, with many banks holding sizeable LDC portfolios, could bring a further slowdown in lending.

But this does not mean that total debt will stop growing. The total debt of developing countries is certain to be close to $1 trillion by 1986. Nor does it mean that the annual debt servicing requirements of many developing countries will stop increasing. In 1986 banks may receive debt service payments of $156 billion compared with $104 billion in 1982, as well as rolling over short-term debt of at least $200 billion. It co[illegible] though, that the net flow of funds from banks to developing countries will fall, or even become negative, as countries repay more in interest and amortization than they raise in new loans.

A net flow back to banks would be a fundamental change of direction. In the last five years, banks provided a net flow of around $10 billion each year to developing countries. Without this, many countries would have suffered from lower economic growth in the face of oil price jumps and the slow-down in world trade growth. During the next few years the LDC current account deficit will remain high but an increasing proportion will be interest payments.

Maintaining a net inflow of development funds from the banks will require an improvement in world conditions, which have been particularly harsh in 1982: low commodity prices, stagnant world trade growth and high interest rates have made life difficult for LDCs. But also required is high-quality debt management to maintain a viable maturity schedule and control the enormous cash flows that are involved.

Short-term debt has boosted the total

The debt position at end-1981: Medium-term debt outstanding from private sources grew at 20% a year from 1976 to 1981, slowing to 15% in the last two years but taking the total to $309 billion.

At the same time debt from official sources grew more slowly, averaging 15.2% a year, bringing total medium and long-term debt of developing countries (based on World Bank data) to $489 billion at end-1981. A total of $140 billion in short-term debt, calculated from Bank of International Settlements data, takes the overall total of developing country debt to $629 billion at end-1981. The OECD secretariat, drawing on other sources as well as the World Bank's debtor reporting system, arrives at a figure for medium-term debt about $30 billion higher.

Some of the debt to banks is partly or wholly guaranteed by export credit agencies such as ECGD. Estimates for end-1981 by OECD indicate that if export credits are excluded, bank loans over one year stood at $172 billion or about 56% of the total outstanding. Calculations with the short-term debt included give a total bank exposure to developing country risks of $307 billion, compared with $82 billion at end-1975.

Developing country reserves at end-1981 stood at $106 billion, according to IMF data — equal, on average, to 2.5 months of import coverage. Total deposits with banks by governments and residents of these countries stood at $204 billion at end-1981, but many of these belong to residents and are not

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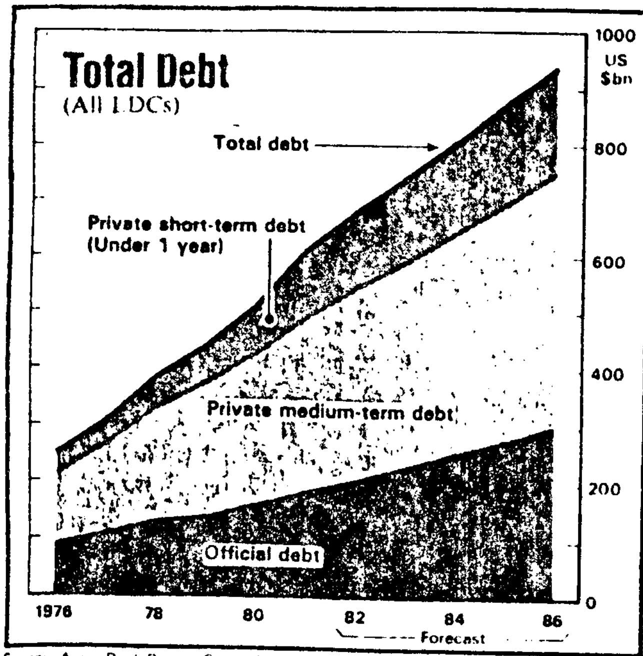
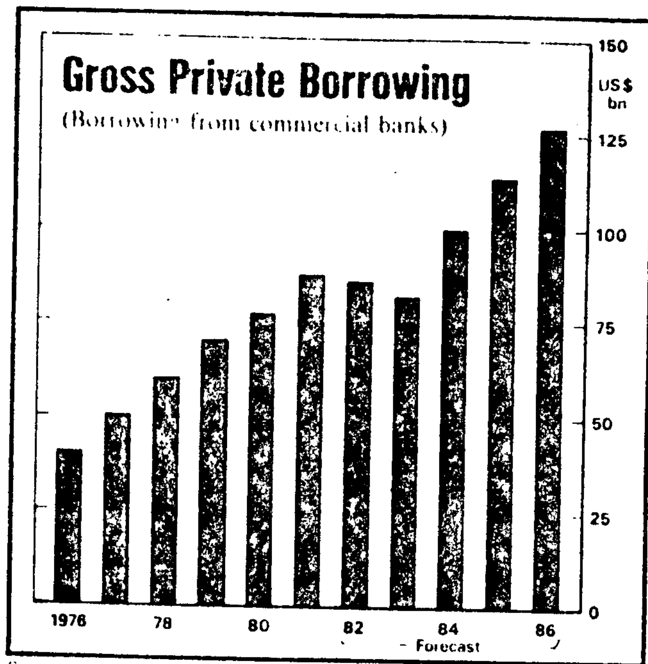
Debt keeps rising . . .



Source: Amex Bank Private Capital Market Model

. . . so does bank lending . . .



Source: Amex Bank Private Capital Market Model

necessarily available to the central bank.

Debt projections to 1986: The charts show the way borrowing requirements and debt levels could develop over the next five years. They show what will happen if the increased caution evident in bank lending in recent months, prevails. Gross borrowing from the banks remains steady in 1982 and 1983 then resumes its rise in 1984, reaching a total of $127 billion in 1986 which, with a projected total of $300 billion in official debt, brings the overall total to $954 billion. But the growth in private debt is much slower than before: only 8% a year, compared with 18% in the four years to 1981.

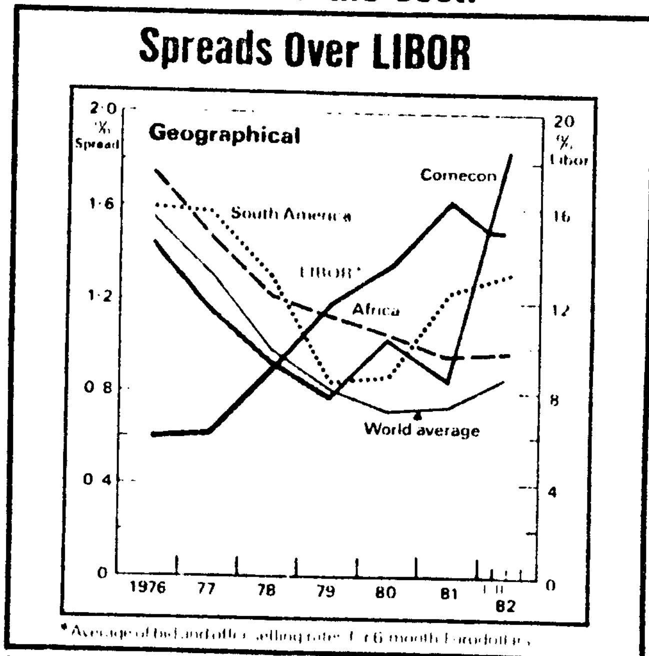
Moreover when the net flow from banks to developing countries is calculated — that is, taking net borrowing plus interest receipts on official deposits held with the banks, minus interest costs — a striking result emerges. After five years of positive flow to the developing countries averaging $10.5 billion a year, the flow turns negative. In the five years 1982/86 banks would receive a net inflow from developing countries averaging $12 billion a year.

Brighter times ahead — perhaps

These projections were obtained using a computer model (the Amex private capital market model) to simulate the implications for the capital markets of a set of assumptions on trade, official financing and interest rates. The assumptions in this simulation could be optimistic: the trade deficit of developing countries is expected to fall in 1983 as world trade recovers and commodity prices move up, while tight control of imports by a number of countries continues; oil prices are assumed to stay constant in real terms, which implies a rise in the import bills for some countries.

The effect of an oil price rise in this simulation is muted by the inclusion of several key oil exporters, notably Indonesia, Mexico, Nigeria and Venezuela. This is breaking with the common practice of considering non-oil producing developing countries and oil exporting countries separately, but that distinction is looking less useful. The sudden, unexpected emergence of an oil glut in 1981 left seve[illegible] for oil exp[illegible]

. . . and the cost.



*Average of bid and offer selling rates for 6 month Eurodollars
Sources: Euromoney, LIBOR NatWest

Public sector

balance of payments disequilibria at least as great as the problems of oil importers. Moreover, the high absorbing oil exporters are major borrowers on the international capital markets.

Overall, the trade deficit narrows in 1983 and then worsens again by 1986. But in real terms, with an assumption of 8% inflation of export prices, this represents a substantial improvement. Since, in addition, the volume of LDC exports is expected to rise by 6% a year, the effective deficit shrinks even further.

The non-financial service balance for developing countries is expected to improve as domestic shipping and insurance expand and tourism grows. Thus the increasing differential between the current account deficit and the trade gap seen in the last few years, caused mainly by the increasing interest costs of debt, will disappear.

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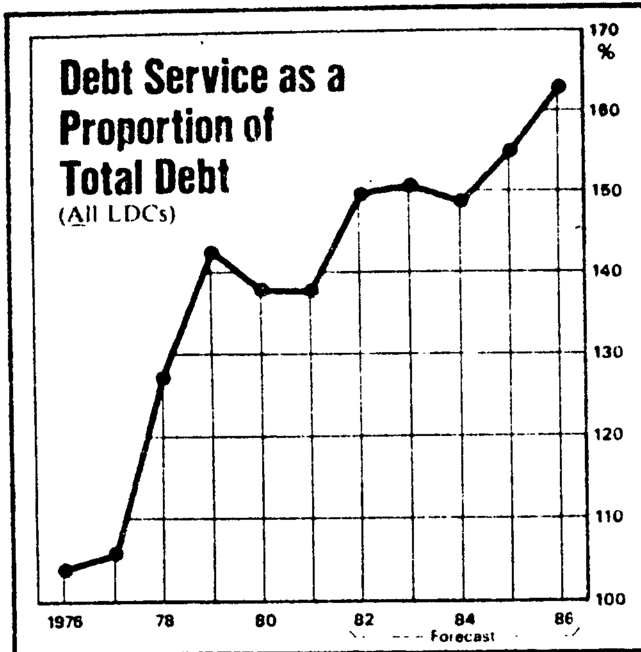
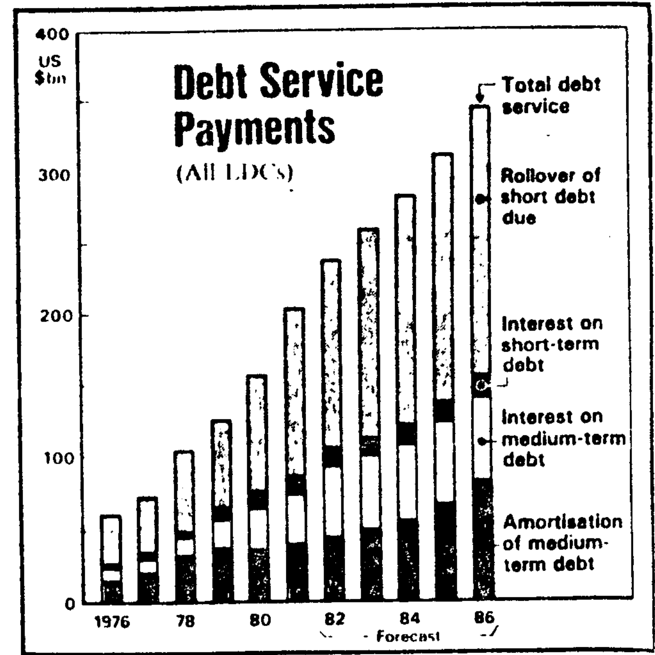
Borrowing to repay . . .



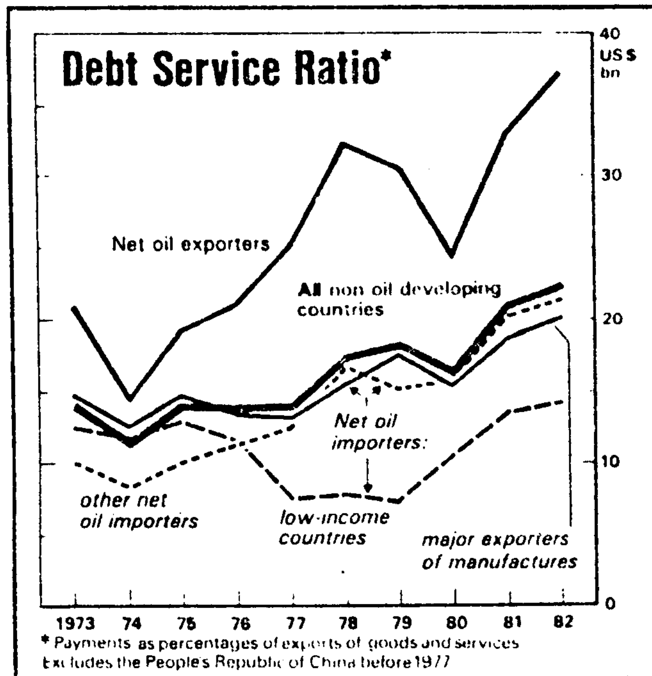
Source: Amex Bank Private Capital Market Model

more debt payments . . .



Source: Amex Bank Private Capital Market Model

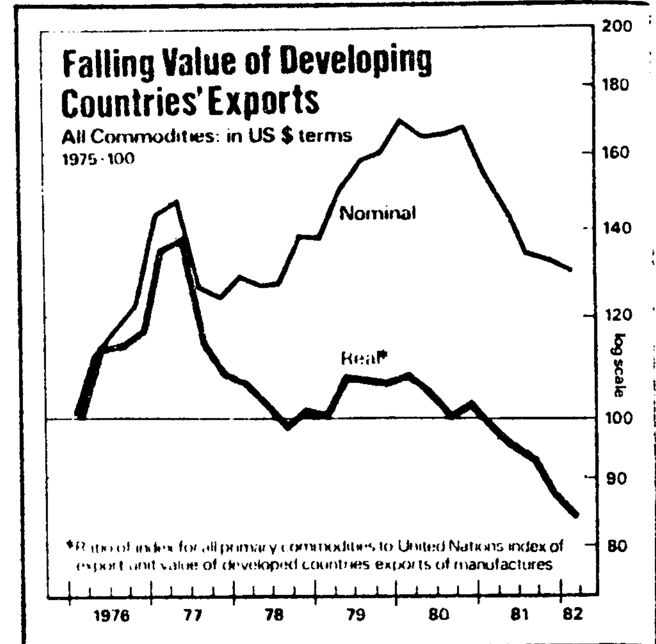
eating up export earnings . . .



* Payments as percentages of exports of goods and services. Excludes the People's Republic of China before 1977

Sources: World Bank, Debtor Reporting System; and Fund staff estimates and projections

export income falls . . .



*Ratio of index for all primary commodities to United Nations index of export unit value of developed countries exports of manufactures

These projections raise important issues. Although debt continues to rise, the debt burden stabilizes and then falls. The debt service ratio, including interest on short-term debt, peaks at 24% in 1982 and then drops steadily to 20% in 1986. Total repayments due to the banks rise from $244 billion in 1982 to $345 billion in 1986 but, as a proportion of exports of goods and services, decline from 43% to 36%. Total debt, including official debt, as a ratio to exports of goods and services, falls from 1.24 to only 0.98. In short, although the total debt of LDCs reaches almost $1 trillion in 1986 the burden, on any measure, falls significantly.

If banks are not providing a net flow to LDCs, what impact will this have on their econo[illegible] growth? If developing countries could borrow mor[illegible] [illegible]nies would, on average, be able to grow faster. But these projections do not mea[illegible] that a slow-down in growth is inevitable. Much of the borrowing in recent years has been needed to offset higher oil prices. I[illegible] the debt burden is stabilized in coming years, future shocks wi[illegible] be more readily accommodated by the banks.

Cash flow analysis: A cash-flow approach to the analysis o[illegible] debt servicing capability is increasingly important. Analysis o[illegible] the flow captures a greater amount of payment than the traditional debt service ratio. Repayments of medium-term bank debt by developing countries are expected to total $44 billion in 1982, compared with $21 billion in 1977. But the growth of short-term debt in the last few years, spectacular in 1979 and 1980, means that in 1982 LDCs need to repay or roll over $1[illegible] billion, about three times the medium-term figure. When inte[illegible]

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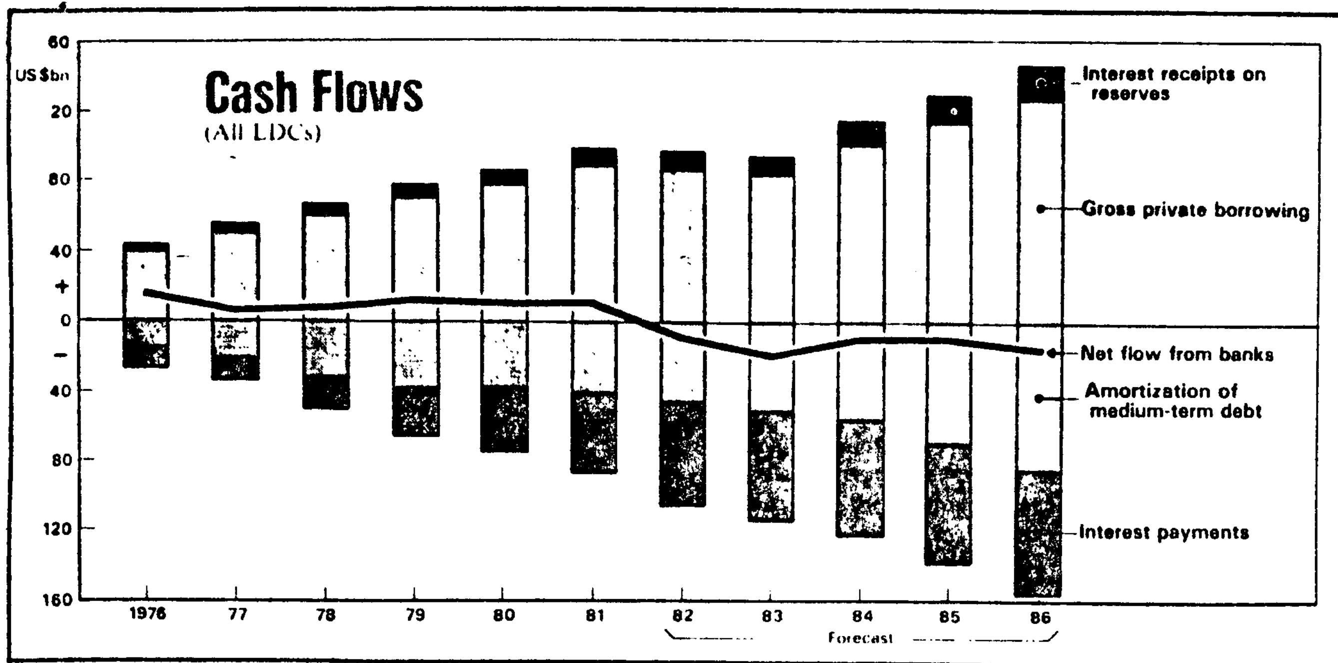
. . . and cash dries up.



Source Amex Bank, Private Capital Market Model

est payments are added — approximately $48 billion on medium-term debt plus $12 billion on short debt and $44 billion in amortization of medium-term debt — the total payments reach $244 billion.

The traditional debt service ratio includes only the service on medium and long-term debt — $92 billion in 1982. The IMF now includes interest on short-term debt in its calculation, bringing the total to $104 billion. This is fewer than half the total payments due, although much of the short-term debt is trade related, normally easily refinanced. But countries often borrow more short term when medium-term finance is difficult to raise: this must be watched carefully. Latest data from the Bank for International Settlements for the second half of 1981 suggest that some countries are reaching this position.

Total cash flow repayments to the banks have risen faster than suggested by conventional measures. Measured against exports of goods and services, for example, the ordinary debt service ratio has increased from 16% to 19% between 1977 and 1981 while the total debt service ratio moved from 32% to 50%.

It's the fundamentals that are all-important

Fundamental country risk analysis is still very important when a country runs into difficulties, because if banks remain confident about the medium-term situation they will continue to lend and the cash flow position will remain manageable. In Korea during 1980 something similar to this occurred. After the assassination of President Park, the political unrest and uncertainty coupled with the effects on inflation and the balance of payments of the second oil price rise led banks to carefully reassess their lending. Most of them judged that the fundamentals were still sound and they were prepared to continue lending. Hence the government, although careful to borrow modestly on the syndicated credit markets, was able to finance the substantial current account deficit without great difficulty.

Other countries have been less fortunate. Banks have been unwilling to continue to lend in a deteriorating situation. Sometimes when a country begins to run into difficulties, lenders may restrict credit to short-term maturities, preferring not to make a long-term commitment in the f[illegible] f uncertaint[illegible] will not show up in the traditional debt service ratio but, because of the bunching effect on repayments, it can trigger off a debt crisis.

Table 1
See How It Grows
Developing countries' debt position 1976-81

Debt	1976	1981
	($ billion)	
Medium + long-term outstanding	212	489
of which private sources	124	309
of which bank loans other than export credits	61	172[1]
Short term (under one year) to banks	39	140[2]
Total debt outstanding	.251	629
Committed but undisbursed debt	74	110[4]
Reserves		
Deposits with banks	88	211[2]
Total reserves minus gold	59	106[3]
Debt Service		
Amortization on medium and long-term debt		
Private Sources	16	40[4]
Official Sources	4	9[4]
Interest payments on medium and long-term debt		
Private Sources	7	36[4]
Official Sources	3	7[4]
Interest payments on short-term debt	4	11
Debt service ratio (including interest on short-term debt)	17.7	20.8

Sources:
[1] OECD
[2] Bank for International Settlements
[3] IMF
[4] Estimate based on World Bank data

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The position of individual countries is shown in Table 2, in the order of debt outstanding to the banks. Several measures of debt and debt burden are presented as well as cash flow indicators. The potential importance of cash flow measures can be illustrated with a few examples where they give a different picture to the other measures. Comparing Chile with Colombia, for example, it is clear that Chile, with a debt service ratio of 45% and a net debt to current account receipts of 90%, has a higher debt burden than Colombia which has ratios of 12% and 22% respectively. Yet the cash flow indicator (column 7), showing total payments due as a percentage of current account receipts, gives almost the same value — 64% for Chile and 59% for Colombia.

The telling indicators

Another example is Argentina which has a debt service ratio almost half that of Mexico but the cash flow indicators are the same. In 1981, both countries needed to make interest payments on medium-term debt or to roll over short debt almost to the same sum in relation to their current account receipts.

Turkey, the only country in the table to have recently rescheduled much of its debt, has an ordinary debt service ratio of 17% while the cash flow ratio is only slightly higher at 23%.

Net flows from banks vary substantially between countries. The flow is calculated as the net increase in debt to banks, plus interest receipts on reserves, minus interest payments on bank debt. The flow is shown in column 9 as a percentage of initial bank debt. Mexico, for example, borrowed $14.4 billion net of amortization in 1981 and, after net interest payments of an estimated $6 billion, received a net inflow of $8.4 billion, a flow of 19.8% as a proportion of debt at end-1980.

But most countries received smaller net flow and several made net payments to the banks. Malaysia received the largest inflow, 67% in relation to original debt, but from a very low base. Egypt received the next largest inflow, 38%, and Chile was in third place. Brazil, for several years one of the key borrowers in the Euromarkets, received only a 3.2% inflow in 1981; without interest receipts the inflow would have been virtually eliminated.

The largest net outflow was recorded for Turkey and reflects both the caution of banks after the rescheduling, and the improvement during the year in the balance of payments. Algeria and Ivory Coast also recorded net outflows to the banks. □

Table 2
Who Owes What Among the Developing Countries
LDC debt and cash flow 1981 — major borrowers

	1 Total bank debt	2 Net bank debt / Current account receipts	3 Short term bank debt	4 Debt service on medium term	5 Debt service ratio	6 Total payments due	7 Total payments due / Current account receipts	8 Estimated net flow from banks 1981	9 As % bank debt 1981
	$ billion	%	$ billion	$ billion	%	$ billion	%	$ billion	%
Mexico	56.9	147	24.0	12.2	60.0	29.2	97	8.4	19.8
Brazil	52.7	176	14.3	16.0	58.0	30.9	114	1.5	3.2
Venezuela	26.2	25	14.4	6.8	37.0	19.9	77	1.2	4.9
Argentina	24.8	140	9.9	3.6	27.0	12.0	93	3.2	16.1
Korea	19.9	58	10.6	4.0	16.0	12.9	46	1.1	6.8
Yugoslavia	10.7	38	2.3	0.9	20.0	3.4	16	0.2	1.7
Chile	10.5	90	3.6	2.5	45.0	4.6	64	2.8	37.9
Philippines	10.2	76	5.4	2.0	24.0	6.6	77	0.2	2.2
Algeria	8.4	27	0.7	4.6	36.0	5.5	32	−1.8	−20.0
Indonesia	7.2	—	2.5	2.7	12.0	5.2	22	0.7	11.6
Taiwan	6.6	—	3.7	1.6	6.0	5.2	20	1.2	22.0
Israel	6.0	—	4.0	1.2	8.3	4.8	32	1.2	23.9
Nigeria	6.0	19	1.8	1.1	4.0	2.6	11	0.9	20.0
Colombia	5.4	22	2.3	0.8	12.0	2.9	59	0.7	14.4
Thailand	5.1	36	2.8	1.4	17.0	4.3	46	0.8	20.0
Ecuador	4.5	122	1.9	0.6	22.0	2.4	80	0.2	6.3
Turkey	4.2	27	0.8	1.4	17.0	1.7	23	−0.7	−17.5
Malaysia	4.4	07	1.2	0.5	5.0	1.6	10	1.8	67.2
Egypt	4.4	—	2.9	2.0	20.0	4.0	38	1.3	38.4
Peru	4.4	63	2.3	2.1	42.0	3.3	79	−0.1	−1.5
Morocco	3.7	71	1.0	1.6	35.0	2.8	66	−0.1	−2.9
Ivory Coast	3.2	78	0.7	1.0	39.0	1.6	49	−0.2	−6.7

Net bank debt: assets minus liabilities of banks reporting to BIS; —: negative net bank debt; **short-term bank debt:** debt with original maturity under one year; **total payments:** calculated as debt service on medium-term debt plus estimated interest on short-term debt, plus rollovers of short term debt; **net flow from banks:** calculated as increase in debt reported to BIS minus estimated net interest payments.
Sources: **Bank for International Settlements** (columns 1,2,3), OECD (4,5), **Amex Bank** estimates (6,7,8).

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