THE PROBLEM OF EXTERNAL DEBT
IN POST-SOCIALISM COUNTRIES
(THE CASE OF EASTERN EUROPE)

GRZEGORZ GÓRNIEWICZ

ABSTRACT. In the present paper, apparently the most heated problem of modern international finances, i.e. external debt of post-socialism countries has been taken under the spotlight. The primary purpose of the paper was to point at the reasons for the occurrence of external debt and the measures taken for the sake of fighting it so far. The case of Eastern Europe will be considered in greatest depth.

Keywords: external debt, international finance, debt crisis

Introduction
At the beginning of the twentieth century, the global scale of external debt of developing countries took the greatest proportions so far. The debt crisis appeared to be without precedents in the area of world economy.

The straight reason for emerging of external debt was the augmentation of in commodity exchange between well developed countries and the countries which are regarded as developing. That phenomenon happened mostly thanks to loans passed from the richer countries to the less developed countries; yet, it is noteworthy that it was also well developed countries that ran into debt.

Not only Latin-American, African, Asian countries but also European post-socialism countries were included among debtors. The external debt of Eastern Europe countries is a big affliction to their economies and thus the author of the present paper got interested in that very issue. Within the context depicted here, particularly the possibilities of solving the issue are the most essential.

All references are expressed in Polish or English language respectively.

1. The scale of external debt
In the group of Eastern Europe countries, the greatest external debt is attributed to the biggest country- Russia. At the end of 2007, the debt exceeded 356 mld USD. From 2000 on, the debt increased twice as much and from 1990- almost

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2 According to the division used by United Nations Statistics Division, Eastern Europe comprises the following countries: Belarus, Bulgaria, Czech Republic, Hungary, Poland, Republic of Moldova, Romania, Russian Federation, Slovakia and Ukraine. http://unstats.un.org/unsd/databases.htm
6 times as much (look at table 1.). The dynamic growth of external debt is connected with the Russian economy opening itself after the collapse of the Soviet Union in 1991. It is to be underlined that the external debt of the former Soviet Union was relatively low; in 1986, it amounted only to 26 mld USD. The low external debt resulted mostly from political reasons (that is, separating the Soviet Union from the credits from capitalistic countries).

The close second concerning the aspect of the amount of external debt of Eastern Europe countries is Poland (almost 170 mld USD). In the whole analyzed period, the external debt of Poland systematically rose. The great dynamism of the increase of external debt was observed in the seventies, which resulted from the opening of Polish economy with the policies undertaken by E. Gierek. The next decade showed the systematic, yet slower increase of the external debt resulting from Poland not wholly discharging the duties attributed to it. The advent of the transformation of the form of government triggered off the reduction of Polish external debt; yet, on the turn of XXI century, the debt dynamically increased again. The increase was mainly due to Polish enterprises and foreign banks running into debt. It could all be attributed to the fact that the conditions of taking credits were more favorable abroad than in Poland.\[3\]

The third place is occupied by Hungary (over 125 mld USD). The history of the country accumulating external debt bears some resemblance to Polish process of accumulating debt.

Table 1.

<table>
<thead>
<tr>
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<td>49,3</td>
<td>63,5</td>
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<td>-</td>
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<td>Romania</td>
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<td>10,2</td>
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<td>10,2</td>
<td>74,5</td>
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<td>-</td>
<td>59,3</td>
<td>160,3</td>
<td>356,5</td>
</tr>
<tr>
<td>Slovakia</td>
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<td>-</td>
<td>2,0</td>
<td>11,1</td>
<td>36,3</td>
</tr>
<tr>
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<td>-</td>
<td>-</td>
<td>-</td>
<td>12,1</td>
<td>69,1</td>
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\[3\] G. Górniowicz, Konsekwencje międzynarodowych przepływów kapitału dla gospodarki światowej ze szczególnym uwzględnieniem Polski, Wydawnictwo Uniwersytetu Kazimierza Wielkiego, Bydgoszcz 2007, s. 81–82.
The forthcoming places with respect to the amount of external debt are occupied by: Czech Republic (almost 75 mld USD), Romania (over 74 mld USD) and Ukraine (about 69 mld USD). The case of Romania is exceptionally interesting, which country unprecedentedly reduced its debt in the eighties, thus expending huge cost not only economically but also socially— all relating to the policy conducted by N. Ceausescu. However, on the turn of the twenty first century, the external debt of Romania dynamically increased. That phenomenon is caused mainly by the opening of Romanian economy, stemming directly from the needs for governmental system transformations and the integration with the European Union.

Next places in the presented classification are occupied by Slovakia (over 36 mld USD) and Bulgaria (almost 35 mld USD). The Republic of Moldova— being one of the poorest among European countries— enjoys the lowest external debt (slightly over 3 mld USD). Also, Belarus is burdened with the low external debt (7 mld USD).

### Table 2.

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>External debt (% of GDP)</th>
<th>External debt per capita</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belarus</td>
<td>7.1</td>
<td>1.793</td>
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<tr>
<td>Bulgaria</td>
<td>40.2</td>
<td>8.458</td>
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<td>Czech Republic</td>
<td>29.7</td>
<td>1.411</td>
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<tr>
<td>Hungary</td>
<td>65.7</td>
<td>12.200</td>
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<tr>
<td>Poland</td>
<td>27.2</td>
<td>4.927</td>
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<tr>
<td>Republic of Moldova</td>
<td>33.8</td>
<td>543</td>
</tr>
<tr>
<td>Romania</td>
<td>30.2</td>
<td>1.354</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>17.0</td>
<td>2.500</td>
</tr>
<tr>
<td>Slovakia</td>
<td>33.2</td>
<td>6.788</td>
</tr>
<tr>
<td>Ukraine</td>
<td>21.2</td>
<td>709</td>
</tr>
</tbody>
</table>

Source: www.cia.gov.

The indicator demonstrating how strongly a given country is afflicted with the external debt comes in the form of the relation to gross national product (GNP) (look at table 2). Considering the situation from the perspective of that criterion, Hungary and Bulgaria are the worst-off. Another indicator confirming the affliction with debt is external debt per capita (look also at table 2). Assuming that criterion, also Hungary is decisively the worst-off. On average, each citizen is burdened with the external debt amounting to 12 000 USD. The second place, similarly to the former classification, is occupied by Bulgaria (almost 8,5 thousand USD of external debt per citizen).
2. The reasons for the occurrence of the issue of external debt in Eastern Europe Countries

The situation of each of debtor countries is distinguished by its specific character. Because of that, it is unfeasible to list all the factors giving rise to the occurrence of the phenomenon of external debt\(^4\). The original reason for taking external loans is definitely the considerable lacking in one’s own capital as well as the eagerness for development, consumption and expansion. Running into debt can be mainly attributed to the level of the development of a country; so, the reasons for running into debt are different for well-developed countries and for developing countries respectively. Having considered the main aim of the paper, only the latter reasons will be taken under the spotlight.

In spite of multifarious differences, some common causes, which are typical of developing countries, may be distinguished. Embarking on the most general classification, and external (independent of the debtor country) sources of external debt should be separated and the internal (dependent on the debtor country).

External causes (independent of debtor countries) of the occurrence of external debt include:
- unfavorable terms of trade and the requirements of liberalizing trade predicted in international agreements,
- protectionist policy on the market of developed countries,
- wavering interest rates,
- changes pertaining to terms of crediting and the decreasing foreign capital influx.

The internal sources (dependant on the policies followed by debtor countries) of the occurrence of external debt include:
- investment policies and liberal import norms,
- budget and finance policy and currency policy,
- national capital flight\(^5\).

Despite the fact that the above-mentioned reasons are typical of the majority of countries, in the case of analyzed countries, one can point to a certain characteristic. The characteristic is traceable to the former belonging of Eastern Europe countries to socialistic block. That belonging was connected with the reasons of paradigmatically internal character. The economies of Eastern Europe countries were then wholly dependent on political nomenclature. Market was de facto not operative, and completion was totally eliminated. The observation of long-term processes of economic growth under the conditions of a system of

\(^4\) The main cause of the occurrence of external debt was the increase of values of contracted credits having its roots in oil crisis.

permanent deficiencies, which are the reflection of continuous lack of balance, allows for noticing the permanent increase of economic disproportions, which must have resulted in the acute social-economic crisis. Apart from them, the governmental system and planning national economy, and disadvantageous agricultural policy bore some influence on the occurrence of crisis.

Having taken loans, the governments of respective countries intended to assure the means for rapid and wide-ranging modernization of their economies. It was assumed that the loans will be repaid with commodities produced due to imported investment goods. The concept of “self-repayment” of loans was promoted. In then nomenclature, such loans were regarded as equivalent to “free-of-charge” loans. The successful results from the starting period prompted the continuation of the program of rapid growth and the accelerated investment efforts. However, in the forthcoming years, the depreciation of the starting period reformations took place because the resources of producing potential were exhausted. The concept of accelerated economic growth involving introducing great social organizations and opening the economy to the foreign countries terminated as a fiasco. External debt was transformed from the factor accelerating the economic growth into the barrier to economic development.

Unfortunately, in professional literature, there is a lack of complete information pertaining to the exploitation of external credits by Eastern Europe countries. Yet, it is beyond the shadow of a doubt that the exploitations were highly inappropriate. In the case of Poland, according to the estimate data, only 20% of credits received in the seventies were devoted to financing investments and enhancing producing potential. Their main part (about 65%) was used to import raw materials and materials for production. The remaining part was used to finance buying consumption articles - particularly agricultural articles – because national nutrition production could not overtake the consumption growth. Due to extremely ineffective economy of real socialism in a country of the huge agricultural potential (about 30% of citizens were occupied with agriculture) basic agricultural products were missing.

The very exploitation of investment credits by Poland also proved to be a big misfiring. The best example is probably buying the license from the company Massey - Ferguson - Perkins (400 mln USD) which was supposed to lead to the development of tractors’ industry and the production of combustion engines. The company was then on the verge of bankruptcy and would have certainly gone bankrupt but for the buying of license.

The eighties were the period where external debt of Eastern Europe countries underwent further increase. The increase resulted not so much from

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7 Ibidem, s. 83
taking new credits but mostly from paying liabilities on time. Because of penalty interests, the external debt continued to rise.

The beginning of the new decade became a breakthrough not only economically (commencing of reformations within the so-called government transformation) but also politically. The disintegration of the Soviet Union caused the emergence of new countries (Belarus, The Republic of Moldova, Russia and Ukraine). Czechoslovakia divided itself into two separate countries (Czech Republic and Slovakia). Bulgaria, Poland, Romania and Hungary remained in an unaltered shape.

On the turn of the new century, external debt of the mentioned countries underwent the dynamic increase caused by many factors. The main of them include:

- new credits connected with government system transformation, entering or preparing to enter European Union
- the improvement of rating and thus, easier access to credits not only by the government, self-governments but also by companies and banks
- the decrease of dollars’ rate of exchange, in which external debt is expressed.

To summarize, the general conclusion can be stated. It was mainly the lack of its own capital needed to reform relatively lagging economies that caused the increase of Eastern Europe countries’ external debt. Probably, in the forthcoming years, because of the progressing processes of European integration and globalization, the discussed phenomenon may take even greater proportions.

3. Some methods used to reduce external debt

When confronted with the serious difficulties of discharging the debt liabilities, a given country can react in three possible ways

1) not discharging the defaults operative within,
   a) repudiation- making the obligations conferred upon the debtor invalid at some time and the utter resignation from paying debts, this could trigger off oppressions by creditors
   b) moratorium- appealing for the renegotiation of the terms of the original credit contract
2) carrying on paying debts at any possible cost
3) restructuring the debt.

Due to the title of that section of the text, the most important factor is the restructuring of debt. Sticking to the nomenclature adhered to by International Monetary Fund, the terms refers to the changes in conditions of repaying debts. Restructuring takes the forms of rescheduling or refinancing. Rescheduling assumes the form of a formal procrastination of payment in virtue of debt-operating
and coming to a consensus to pay the debt of determined sums later. Refinancing of debt connotes the protraction of crediting period pertaining to payments being in effect or superseding the present or future payments in virtue of debt operating by means of a new medium-term credit. Restructuring can also be a hybrid of both forms relating to overdue and future payments in virtue of debt-operating.

Due to a great number of government and commercial creditors, it is unimaginable to execute the negotiations asunder concerning the solution of external debt puzzle with all the creditors. That is the reason why governmental affairs of creditor countries are expressed by Paris Club and the affairs of commercial banks, where unguaranteed credits were taken, are sketched by London Club.

As from 1978, a large number of debt-restructuring operations were executed. Restructuring methods became the fundamental means of resolving external debt problems of underdeveloped countries. The afore-mentioned methods have their pros and cons. One of the pros is the fact that they allow the debtor to “take breath” at least within the period of procrastinating with payments. On the other hand, one of the cons is postponing the issue of debt payment and thus, not allowing for the proper conditions for debt operating in the future to emerge. All in all, restructuring agreements basically serve little purpose but to postpone the problem of payments. Furthermore, if a debtor country fails to give its economy the proper stimulus and vigor to gain proper surplus in current account balance, then-the span of time when the date of operating procrastinated payments comes-the stalemate situation appears, in which already restructured debt craves for restructuring again. All that implicate some cost assuming the form of additional margins of profit and bank commission. Yet, in spite of all that, the distinctive quality of restructuring debt is that there is proneness for continuous improvement of debtors’ conditions. Despite the very proneness, restructuring debt turned out to be inadequate to resolve the issue of global debt.

Global debt arose from unrestrained expansion of international finance system. Creditors eventually came to the conclusion that that it is not only world economy but also global political situation that should be alarmed. Keeping it in mind, at the conference of the so-called Group of Five (including France, Japan, Germany, United Kingdom and United States of America), they validated the plan pertaining to 15 debtors whose total debt equaled 437 million dollars altogether. The plan was proposed by the American Secretary of State, James Baker, on 8

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October 1985 during the yearly meeting of International Monetary Fund and World Bank in Seoul.

Putting Baker’s plan into practice fell flat. Though World Bank raised the amounts of credits, from which the group of countries the plan was devoted to benefited, quite much, commercial banks unfortunately failed to meet the expectations. The failure can be mainly attributed to negative evaluation of credit capacity of debtor countries\textsuperscript{12}.

10 March 1989, then Secretary of State, Nicholas Brady came up with the important proposal pertaining to the problem of solving external debt of developing countries being in the possession of moderate state revenue\textsuperscript{13}. Due to the structure of a debt owed by these countries, Brady’s concept is valid only when referring to private banks. Brady’s idea presupposed making financial means (originating from both the institutions mentioned thereafter and from some industrialized countries—mainly Japan) accessible to the debtor countries which try to implement the programs of economic reforms with full correspondence to International Monetary Fund and World Bank. The pecuniary means would be potentially used to finance the operations of debt reduction and debt-operating.

The essential innovation of Brady’s idea was coming to terms with the necessity of the remission of some debts by resorting to the so-called marked - based menu approach. The very approach includes:

1) debt for equity swaps - D/ES,
2) debt for bond swaps,
3) debt buy-back,
4) debt for exports swaps,
5) debt for nature swaps,
6) debt for local currency swaps\textsuperscript{14}.

To sum up, it should be stated that the methods whose aim was the reduction of the external debt failed. In spite some sort of success, the methods only served to survive crisis periods or to postpone potential crisis in the future. However, in previous decades, many a bank would have proclaimed their insolvency, had the afore-mentioned programs not come in handy. Probably, in the forthcoming years, creditors may agree on further compromise just to reassure just theoretical solvency of developing countries.

**Summary**

The basic reason for the occurrence of external debt on the part of Eastern Europe countries proved to be industrialized countries opening themselves and their economic expansion. Poorly developed countries did not manage to join the


\textsuperscript{13} “IMF Survey” 1989 March 20, s. 90

\textsuperscript{14} W. Berger, Financial Innovations in International Debt Management, Gabler, Wiesbaden 1990, s. 48.
functioning of capital market according to the same rules as adhered to by best
developed countries. External credits - whose task was to accelerate the
development of poorly developed countries and lead up to the elimination of
considerable discrepancies of economic levels - became to the great extent the
future restraint to the expected development (bearing the negative influence on the
economic situation of a country). Eastern Europe countries remained at the
positions of beneficiaries who cannot afford to launch the capital expansion and
even to repay the loans on time. The reasons for the failure are to be found both
within debtor countries and outside of them.

External debt of Eastern Europe was characterized by the similar increase
rate as the external debt of developing countries. On the other hand, Eastern
Europe has some specifics resulting from its former belonging to the group of real
socialism countries. Contracted credits were not taken advantage of effectively
because they did not undergo market verification. Furthermore, social realism
countries were characterized by having the economy of permanent deficiencies
with all their negative consequences. Taking external credits became a temporary
to soothe the barrier for development; yet, long-term, it caused the occurrence of
even greater deficiencies.

The external debt of post-socialism countries is not only the problem of
debtors but also creditors'. One can point at the occurrence of the so-called “debt
dialogue” between both Parties resulting from the resultant interdependence. The
very interdependence stems from the fact that when debt is small, it poses problems
only to a debtor country; yet, when debt takes bigger proportions, a creditor is
interested to solve the problem. Many a time, a creditor takes more care for debt to
be repaid than a debtor does. The banks of well-developed countries are so
implicated in giving credits to developing countries that, in their own interest, they
support the paying capacity of developing countries so that developing countries
should not go bankrupt.

In the forthcoming years, debt repayments will systematically increase.
Apart from repaying long-standing liabilities, Eastern Europe countries will
definitely contract new credits for the development of transforming economies,
integration needs and alleviation of financial crisis consequences.

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