Politics and Economics of External Debt Crisis

The Latin American Experience

Edited by

Miguel S. Wionczek

in collaboration with Luciano Tomassini

Politics and Economics of External Debt Crisis

The Latin American Experience

edited by Miguel S. Wionczek
in collaboration with
Luciano Tomassini

ROUTLEDGE
Routledge
Taylor & Francis Group
LONDON AND NEW YORK

First published 1985 by Westview Press, Inc.

Published 2019 by Routledge
52 Vanderbilt Avenue, New York, NY 10017
2 Park Square, Milton Park, Abingdon, Oxon OX14 4RN

Routledge is an imprint of the Taylor & Francis Group, an informa business

Copyright © 1985 Taylor & Francis

All rights reserved. No part of this book may be reprinted or reproduced or utilised in any form or by any electronic, mechanical, or other means, now known or hereafter invented, including photocopying and recording, or in any information storage or retrieval system, without permission in writing from the publishers.

Notice:
Product or corporate names may be trademarks or registered trademarks, and are used only for identification and explanation without intent to infringe.

Library of Congress Cataloging in Publication Data
Politics and economics of external debt crisis.
(Westview special studies on Latin America and the Caribbean)
Includes index.
1. Debts, External--Latin America--Addresses, essays, lectures. 2. Latin America--Economic policy--Addresses, essays, lectures. I. Wionczek, Miguel S. II. Series.
HJ8514.5.P65 1985 336.3'435'098 84-15377

ISBN 13: 978-0-367-28363-6 (hbk)

Contents

List of Tables and Figures v
Preface, *Miguel S. Wionczek* ix

Introduction, *Miguel S. Wionczek and Luciano Tomassini* 1

Part 1
Global and Regional Issues

1 External Debt of Developing Countries in Late 1983, *Dragoslav Avramovič* 6

2 The World Crisis and the Outlook for Latin America, *Víctor L. Urquidi* 36

3 The International Scene and the Latin American External Debt, *Luciano Tomassini* . . . 53

4 External Debt Problems of Latin America, *Enrique V. Iglesias* 73

5 Coping with the Creeping Crisis of Debt, *Albert Fishlow* 97

6 Latin American Debt: Act Two, *Pedro-Pablo Kuczynski* 145

7 Capital Market Financing to Developing Countries, *Ariel Buira* 170

8 The World Monetary System, the International Business Cycle, and the External Debt Crisis, *José Luis Feito* 193

Part 2
Case Studies

9 Argentina's Foreign Debt: Its Origin and Consequences, *Marcelo Diamond and Daniel Naszewski* 231

10 Rescheduling Brazil's Foreign Debt: Recent Developments and Prospects, *Paulo Nogueira Batista, Jr.* 277

11 The Mexican External Debt: The Last Decade, *Ernesto Zedillo Ponce de León* 294

12 The Renegotiation of Venezuela's Foreign Debt During 1982 and 1983, *Eduardo Mayobre* . . 325

13 The External Debt, Financial Liberalization, and Crisis in Chile, *Ricardo Ffrench-Davis* . . 348

14 Peru and Its Private Bankers: Scenes from an Unhappy Marriage, *Robert Devlin and Enrique de la Piedra* 383

15 The Role of External Debt Problems in Central America, *Jorge González del Valle* . . . 427

16 Where Do We Go from Here?, *Miguel S. Wionczek* 437

List of Acronyms 460
About the Contributors 462
Index 465
About the Book and Editor 482

Tables and Figures

Tables

1.1 Largest debtor countries 8
1.2 External debt per capita 27
1.3 External debt as proportion of gross national product 28
1.4 Country group debt-service ratios: Total debt service and interest as percentage of exports 29
1.5 Country debt-service ratios: Interest and amortization as percentage of exports 30
1.6 Ratios of total debt service to merchandise exports for selected developing countries in the 1920s and the 1930s 31

4.1 Latin America: Total external debt 74
4.2 Latin America: Net financing available after payment of profits and interest 75
4.3 Latin America: Ratio of total interest payments to exports of goods and services . . 76

5.1 Developing-country debt 102
5.2 Consumptive behavior of debtor nations 106
5.3 Sources of deterioration in the current account of nonoil developing countries, 1979-1982 108
5.4 Elasticities for developing-country export volume and terms of trade with respect to OECD income growth and changes in income growth 116
5.5 Alternate balance-of-payments projections for large oil-importer debtors 119
5.6 Estimating equations for export volume elasticity in Table 5.4 139
5.7 Estimating equations for terms of trade in Table 5.4 140

6.1 Estimated debt burden of some major developing countries 150

7.1 External debt of nonoil developing countries 174
7.2 Multilateral debt renegotiations, 1974-1983 175

8.1 The international business cycle and nonoil developing countries 195
8.2 Aspects of the external debt cycle in selected groups of developing countries . . 204

9.1 Argentina: GDP and consumption 232
9.2 Argentina: Gross domestic product 233
9.3 Argentina: Growth of foreign debt 236
9.4 Argentina: Balance of payments for the 1976-1981 period 247
9.5 Argentina: Estimate of loans applied for and received during 1983 263

10.1 Brazil: Balance of payments (main items), 1968-1982 279
10.2 Brazil: Gross international reserves of the monetary authorities (Banco Central and Banco do Brasil), 1976-1982 281
10.3 Brazil: Net international reserves of the monetary authorities, 1976-1982 282
10.4 Brazil: Net international reserves of the monetary authorities (Banco Central and Banco do Brasil), September 30, 1982 283
10.5 Brazil: Net international reserves of the monetary authorities (Banco Central and Banco do Brasil), June 30, 1983 287

11.1 Mexico: Some basic indicators of the Echeverría term 296
11.2 Mexico: Evolution of the foreign public debt during the Echeverría term 298
11.3 Mexico: Basic economic indicators during the López Portillo term 303
11.4 Mexico: The evolution of the total external debt during the López Portillo term 306
11.5 Mexico: The flows of the external debt during the López Portillo term 307
11.6 Mexico: Current account during the López Portillo term 309
11.7 Mexico: Public finance during the López Portillo term 311

13.1 Chile: Annual deficit on current account and capital movements 355

13.2 Chile: Total external debt and debt with private financial institutions 357
13.3 Chile: External debt, by borrowers 358
13.4 Chile: Article 14--Gross annual flows of credit, by debtors 360
13.5 Chile: Real exchange rate and wages 364
13.6 Chile: Domestic and external real interest rates reflecting their level with the conversion of external transactions into pesos 366

14.1 Peru: Distribution of external public debt by source of finance 384
14.2 Peru: Total external debt 390
14.3 Peru: Index of the cost of bank borrowing, 1971-1976 391
14.4 Peru: Selected expenditure as a percentage of GDP 395
14.5 Peru: Growth rates of selected economic indicators 397
14.6 Peru: Net capital inflows and transfer of financial resources 399
14.7 Peru: Savings/investment coefficients 400
14.8 Peru: Net flows of medium- and long-term loan capital by type of creditor 401
14.9 Peru: 1978 restructuring of commercial bank debt 404
14.10 Latin America: Provisional data on terms of debt rescheduling: 1982-1983 411
14.11 Peru: Distribution of commercial bank loans according to purpose, 1971-1976 . . . 417

15.1 Central America: External debt outstanding . . 429
15.2 Central America: Long-term external debt to official creditors 430
15.3 Central America: Apparent overall cost of external debt 431
15.4 Central America: Apparent external debt burden on interest account 432
15.5 Central America: Intraregional debt positions, end 1983 436

Figures

4.1 Evolution of London Interbank Offer Rate (LIBOR), nominal and real 80

13.1 Conventional conceptual framework of the Liberalization of Capital Markets 351

14.1 Comparison of margins and maturities on bank credits for Peru, Brazil, Mexico, and Bolivia, 1973-1979 392

14.2 The evolution of bargaining power in the borrowing cycle 414

16.1 The LDCs seem headed for a resource gap 449

Preface

The immediate origin of this volume can be traced to a small informal meeting of a group of Latin American economists and political scientists held in Mexico City in late August 1983 under the auspices of the Tepoztlan Club. After having discussed the most recent information on crisis and debt in Latin America and the external debt management experiences in Argentina, Brazil, Chile, Mexico, Venezuela, and Central America, the participants came to the following conclusions:

1. Although the current international economic crisis presents many of the characteristics of a particularly severe and prolonged recessive phase of the economic cycle, it also contains structural factors that distinguish it from the crisis of the 1930s.
2. The current crisis has spread to all parts of the world, including socialist economies, via multiple and complex channels, due to the evolution of an interdependent world with a highly integrated economy.
3. The causes of the acute external and internal economic imbalances in Latin America go back to the 1960s. The actual depressive and almost desperate economic situation in the 1980s, however, reflects a new crisis within a crisis due in part to external factors and in part to the inadequacies or extravagance of most Latin American domestic economic policies. When one looks at the policies followed in the past ten years by individual countries, particularly in fiscal, monetary, and trade matters, one has to recognize the lack of coherence, forethought, and realism that predominated in successive stages of policy implementation in the region.
4. Recently and with prodding and the blessing of international financial organizations, many Latin American countries, facing external and domestic crises of a magnitude never registered before, took the road of adjustment of the external sector by means of recessive policy, which compromises long-term productive

capacity and growth potential and puts to the test the political and social tolerance of the highly indebted countries. Little, if anything, has been done in the framework of the extremely negative international developments to set in motion selective changes in development, investment, consumption, and importing patterns that would permit the achievement in the medium term of some sort of balance in the external sector without compromising the economy's growth potential.

5. The probability of Latin American countries overcoming the present economic crisis will depend on their capacity to undergo a process of internal structural adjustment and on the reactivation of the world economy. The current world scene is characterized by uncertainty as regards the possible evolution of the world economy and perplexity as to how the crisis must be faced in the industrial countries themselves.

6. Despite the overall gloomy circumstances of the world and the Latin American economic scene, a number of emergency measures could be taken to alleviate the crisis and, in particular, the financial difficulties of the region born from its unusually high external indebtedness. All these measures might bring some positive results providing the political will were present in industrial countries, international official financial and development agencies, and the international financial system. Presently, little evidence of such political will is available.

7. Such emergency measures were identified as the reprogramming of debt payments and, as far as possible, the refinancing of the accumulated interests on the debt; the strengthening and improvement of the role of international financial organizations; the undertaking of additional action designed to increase the credit available from all possible sources--public and private--in order to lighten the burden of indebted Latin American countries; and an increase in the overall international liquidity.

8. Such emergency measures should be complemented by others of medium- and long-term nature, including the design of a more stable medium-term financing; the increase in the participation of international financial organizations in external development-oriented financing; the issuing of bonds and similar documents, negotiable in secondary capital markets, by a number of industrial countries; and the creation, within the International Monetary Fund (IMF), of special terms with the aim of financing that part of the balance-of-payments deficits of the debtor countries attributable to the increase in interest rates over and above traditional levels.

9. Additional measures that are strongly advisable are the reversion of protectionist tendencies in the industrial countries, the selective increment of direct foreign investments in Latin America, and the

strengthening of regional and subregional economic integration schemes in Latin America, which go through the disintegration stage because of both extraregional and intraregional difficulties.

The substantive discussions of the Mexico City meeting, whose major analytical points and proposals for remedial actions appear above, also made it clear to all its participants that whereas the subject of Latin American crisis and indebtedness is presently very fashionable in the industrial countries, most of the growing literature on these matters originates in them and reflects _their_ concern. Very often the question is phrased in the form of the possible costs to industrial countries, and especially to the international banking community, of the present Latin American misfortunes. Moreover, many otherwise competent experts from the northern latitudes look exclusively at the economic and financial aspects of the crisis, raising only marginally the key issue of how long Latin American societies can live with the austerity resulting from the painful external IMF-tailored adjustment programs. Very little if anything is written by these industrial countries' experts about both the political and social consequences of all these merciless exercises for the Latin American region itself. Moreover, the Latin American writings on the subject are hardly accessible to those on both sides of the North Atlantic because of the language barrier, among others.

Thus, the purpose of this book is to diminish to some degree this dangerous asymmetry of views available in the North that distorts greatly the real picture in which the major factors are not only the international banking community's interests and international financial agencies' viewpoints but Latin American interests and viewpoints as well. After all, the recycling of privately held funds of the order of some US$250 billion lent to Latin America in the 1970s was not a charity or rescue exercise but a big business operation that resulted in very sizable profits for lenders--whether of discriminate or indiscriminate type--year after year. What kinds of benefits and profits ensued from all this, not to direct official and private Latin American borrowers but to Latin American societies, still remains to be established. Since the literature on these aspects of Latin American crisis and indebtedness is, to say the least, very scant in the lender countries and even within independent academic circles, the asymmetry of views is much greater than it would appear.

All but three contributors to this volume are Latin Americans. Moreover, not only are practically all these Latin American writers technically competent observers of the regional economic and financial scene, but many

have participated either directly or indirectly in the most recent attempts to renegotiate the crushing burden of external debt at national level. I have also been exposed for some time to all these issues as suggested by two books, LDC External Debt and the World Economy and International Indebtedness and World Economic Stagnation, published in English under my editorship in Mexico City and Oxford in 1978 and 1979, respectively. They appeared at the time when the Latin American crisis and debt were still considered by both the lenders and the borrowers as a minor and passing issue. What might seem almost amusing, but is in fact tragic, is that the contents of these volumes--which stressed that the structure of the LDC external debt was not sound (in the late 1970s), nor was the volume of borrowing in international private financial markets and the conditions attached to it sustainable for the borrowers in longer terms--were dismissed by some distinguished reviewers in prestigious economic and financial journals of the industrial countries as the expressions of the "undue pessimism of a group of like-minded people."

The first part of this book presents eight chapters on the Latin American crisis and indebtedness within the framework of the worldwide economic crisis from which the long-heralded recovery is still not yet in sight. Most of these contributions concentrate not only on economic and financial issues but on political and social aspects as well. All contain a number of prescriptions as to what could or might be done to free both the world economy and Latin America from the present complex predicament comparable only, albeit partially, with the Great Depression of the 1930s. It is particularly satisfying to me that Part 1 starts with a contribution by Dragoslav Avramovič. During his long intellectual and professional career that took him subsequently through the World Bank, the Secretariat of the Brandt Commission, and the UN Conference on Trade and Development (UNCTAD), he dedicated most of his time and attention to the international indebtedness problems, as witnessed by his two seminal studies Debt Servicing Capacity and Postwar Growth in International Indebtedness (1958) and Economic Growth and External Debt (1964).

Part 2 contains seven case studies of the process of external debt accumulation and the rarely successful attempts at renegotiation in 1982 and 1983. The chapters in this part deal respectively with Argentina, Brazil, Mexico, Venezuela, Chile, Peru, and Central America (discussed as a subregion). As readers will find out for themselves, the authors do not necessarily form a "like-minded group" from either the theoretical or the ideological viewpoint. Some of them are more neoclassical and some more structuralist. But, since

all are knowledgeable, intellectually independent, and clear minded in their respective analytical approaches and, in addition, know their "stories" from first-hand experience, some sort of composite picture emerges from their findings that is not necessarily complimentary of each of the major actors in the "indebtedness game."

The fact that most authors of the seven case studies dedicate considerable attention to domestic political aspects of the indebtedness and its renegotiations adds additional dimension to this second part of the book. One learns from it that, contrary to the established wisdom, neither the international financial agencies, the international banking community, government officials of the borrowing countries, nor even the private borrowers are dispassionate angels. All have their ideologies, political and economic objectives, and bureaucratic interests, among others, which more often than not are in conflict with those of the other actors, independent of whether the actual transactions are of a multilateral or bilateral nature. Under these conditions, crisis gestation, indebtedness accumulation, and external adjustment processes cannot be reduced to models, equations, targets, and statistical series manipulations. The international financial relations have always been, are now, and shall be exercises in power and politics. This is perhaps the most important message of this book.

This volume could not have been produced without the most efficient cooperation of a group of contributors dispersed in the triangular area limited by such distant points as Santiago, Chile; San Francisco, California; and Geneva, Switzerland. The manuscript was prepared within a record time of four months thanks to the generous logistic facilities of El Colegio de México in Mexico City with the no less generous help of the Program for Joint Studies on Latin American International Relations (RIAL) at Santiago. Both institutions deserve sincere thanks for their most sympathetic and helpful attitude toward the project.

Miguel S. Wionczek
Mexico City

Taylor & Francis
Taylor & Francis Group
http://taylorandfrancis.com

Introduction

Miguel S. Wionczek
Luciano Tomassini

A majority of experts agree that the world economy is passing through its worst crisis since the depression of the 1930s. Less consensus exists, however, about the nature and causes of the crisis and therefore about whether at a global level a sustained economic recovery is now underway. The fact that the recession in the industrialized countries has been superimposed upon profound structural transformations makes the situation all the more complex and provokes a general climate of intellectual confusion.

This confusion is even greater in the case of Latin America. In effect, the international crisis has struck the region with singular force because of the high decree of integration that Latin America has achieved with the world economy and because the development strategies pursued by many countries in recent years were highly dependent on foreign borrowing. Among the principal manifestations of the crisis in the region, the one that stands out is the explosive growth of the Latin American external debt service and the high social cost of the adjustment that Latin American countries have been making in order to pay their external obligations under conditions of domestic and external crisis. Although under present circumstances it would be unrealistic to expect the countries "to adjust without pain," it is no less certain that the costs of adjustment should be better distributed among all the parties concerned--debtor nations, lending banks, industrialized countries, and international financial organizations--if sacrifices that could exceed the limits of political tolerance in Latin American societies are to be avoided.

It is because of all this that both debt and adjustment not only constitute two very closely linked themes but also have economic and political content. One of the factors that has complicated the understanding and the management of the crisis has been the reserve with which the majority of Latin American countries have treated these links between the politics and the economics of the

external indebtedness. The debt problem used to be considered as the almost exclusive responsibility of the monetary authorities and private banks of the debtor countries, on the one hand, and the foreign creditor banks and the IMF, on the other.

Observing the long-lasting lack of acknowledgment of the close links between the economic and the political nature of the debt problem, reflected in the extremely limited scope of the groups that have to date managed the crisis, one comes to the conclusion that little progress on the external debt will be achieved in the region as long as the entire issue is not put in the broad political context. Since the worsening of the crisis in late 1982 the first important step in this direction was made at the Quito economic conference held in January 1984, the conference called in response to an initiative of the president of Ecuador, Osvaldo Hurtado. At the Quito conference for the first time formal consideration was given to the debt problem at the political level. The regional consensus reached there was that the external debt service policies, as well as the modes and intensity of adjustment, must keep in mind proposals formulated by the Latin American countries themselves, because the whole exercise would fail in the longer run if the need to assure economic growth and acceptable living conditions for the Latin American societies of the region were forgotten during the adjustment process. Specifically, the Quito conference proposed that debt service not exceed a reasonable proportion of the debtor countries' export earnings.

This small progress toward more equitable treatment of the Latin American debt servicing and the adjustment process was in part the consequence of a wide and diverse discussion of the whole indebtedness problem that took place in Latin America in 1982 and 1983, lifting the curtain of secrecy that had surrounded that issue traditionally. The UN Economic Commission for Latin America (ECLA) and the Latin American Economic System (SELA) contributed to this debate but so too did a number of academic independent research organizations qualified to promote a frank debate on the subject. In effect, these academic institutions paved the way to a more open dialogue among governmental and nongovernmental sectors affected by the indebtedness crisis.

In this regard, two institutions joined forces to organize the conference of which this book is an indirect result. The Program for Joint Studies on Latin American International Relations (RIAL) with headquarters in Santiago, Chile, an association of Latin American social research centers, promoted during 1983 a series of meetings in various parts of the region about the external debt problems of Latin America. The other organization was the Tepoztlan Centre, a small Mexican think tank dedicated to reflection and debate about fundamental

questions concerning contemporary developing societies in Latin America and elsewhere. Joint efforts of these two institutions translated themselves into a conference that took place in the Tepoztlan Centre, Morelos, Mexico, in July 1983. This book represents in a way a follow-up of that gathering. The authors of several of the chapters included in this volume participated in the above-mentioned encounter, the major conclusions of which are reported in the Preface.

Taylor & Francis
Taylor & Francis Group
http://taylorandfrancis.com

Part 1

Global and Regional Issues

1
External Debt of Developing Countries in Late 1983

Dragoslav Avramovič

In the fall of 1983, forty to fifty developing countries engaged in debt-rescheduling negotiations. These countries included twelve of the twenty largest debtors, accounting for more than half of the total debt of developing countries. No immediate prospects for relief were in sight. Interest rates in real terms were almost as high as at the peak of the international credit crunch of mid-1982, which was the immediate cause of the debt crisis, and no improvement had taken place in the average maturity of the debt. Export commodity prices of developing countries had improved from the low point of November 1982, but new pressures on sensitive commodity markets had appeared since the summer of 1983. Capital market lending to developing countries had not recovered from the near collapse of August 1982. The debt-rescheduling and emergency-financing operations arranged at great effort during late 1982 and early 1983 would be running out in most cases during 1984, and new arrangements had to be made, frequently under more difficult circumstances than the first round. Deflationary pressures on the major developing debtor countries had already taken their toll in reduced real incomes and increased unemployment. Social and political tensions were on the increase in large parts of the developing world as 1983 drew to a close.

In an earlier study of the debt problem of developing countries I argued that over the long run the risk of debt failure was small, provided the present crisis was successfully handled.[1] Most of the heavily indebted countries have proved that they can absorb modern technology, organize efficient production, penetrate the international market at extraordinary speed, and give priority to meeting their external financial obligations under most circumstances. This argument still stands. I also emphasized that over the short and medium term the risk of transfer difficulties and interruptions in payments was acute in many cases because of the adverse movements in the terms of trade, a large overhang of

short-term debt, excessive interest rates on the part of the debt, uncertainties concerning future capital market lending, insufficient access to product markets, and lapses in domestic financial policies. This risk has now materialized. I also stated that the extent and duration of the transfer problem would depend in part on the willingness of the international community to cope with the present liquidity crisis and in part on the willingness of debtor countries to improve on their performance in several critical areas, and it was concluded that a failure to resolve the short-term problem quickly and decisively might affect adversely the long-run future.

The need for a comprehensive program has now become even more urgent. Failure to adopt it will lead to a further sharpening of the internal difficulties in some major debtor countries because of the pressure of debt-service payments on an already weakened structure; it will prolong the present chaos in external financial flows of many developing countries and raise further the uncertainties concerning stability of major parts of the international financial system; and it could harm the future capacity to pay of a number of developing countries, as a continuing low level of investment would adversely affect their competitive capacity in the international market.

AMOUNTS AND PROPORTIONS

The aggregate external disbursed public and private debt of all maturities owed by developing countries was of the order of US$750-800 billion at the end of 1982. The long- and medium-term portion was estimated at about US$600 billion.[2] The short-term debt, of a maturity under one year, was estimated at US$150-160 billion.[3] This latter amount may well be an understatement: In most recent liquidity crises the actual amounts of short-term debts turned out to be higher than the estimates.

About 70 percent of the aggregate debt and an even higher proportion of debt service are accounted for by twenty countries. The individual country figures are set forth in Table 1.1.

The largest debtors in absolute amounts--Brazil, Mexico, Argentina, South Korea, and Venezuela, together accounting for US$290 billion or almost two-fifths of developing-country total debt--do not invariably carry the largest debt per capita or as a proportion of gross national product (GNP). Debt per capita is highest in Israel (US$5,437), followed at a considerable distance by Venezuela (US$2,139), Chile (US$1,594), and Portugal (US$1,424). Argentina, Mexico, and South Korea are farther down. Brazil is in the middle of the list (US$771), and Indonesia, Pakistan, and India are at the end, with the latter at US$29 per capita. As a proportion

Table 1.1 Largest Debtor Countries (debt in billions of U.S. dollars)

	Aggregate Disbursed Debt (long-, medium-, and short-term)		Long- and Medium-Term Debt	
	Mid-1983	End 1981	Disbursed Debt End 1981	Debt Service Paid in 1982
Brazil	93.0	70.0	65.6	18.5
Mexico	85.0	72.0	54.4	15.2
Argentina	40.0	35.7	20.0	4.9
South Korea	39.0	32.8	20.8	4.8
Venezuela	33.0	18.9	14.9	7.8
Israel	21.5	18.0	--	--
India	20.0	--	19.4	1.7
Indonesia	20.0	--	18.2	3.4
Philippines	20.0	15.8	9.5	2.1
Yugoslavia	20.0	20.0	16.8	4.7
Algeria	18.0	17.8	17.0	4.8
Chile	18.0	15.0	12.3	3.3
Turkey	16.2	15.5	14.1	1.9
Egypt	16.0	15.0	14.0	2.4
Portugal	14.0	10.0	--	--
Nigeria	13.0	--	6.0	1.9
Peru	11.6	9.7	7.3	1.9
Morocco	11.0	--	8.0	1.9
Colombia	10.0	--	6.0	1.1
Pakistan	9.0	8.8	8.8	--

Source: Organization for Economic Cooperation and Development, _External Debt of Developing Countries: General Survey 1982_ (Paris, December 1982); press reports.

of GNP, debt is again largest in Israel (105.0 percent), followed by Chile (62.3 percent) and Morocco (61.2 percent). South Korea, Peru, Egypt, and Portugal follow. The median value is slightly above 50 percent, with Mexico marginally above (53.1) and Brazil (34.7), Yugoslavia (31.8), and particularly India (11.3) substantially down. Tables 1.2 and 1.3 in the chapter appendix provide details. Changes from the earlier study are marginal.[4]

The newly industrializing countries carry most of the debt, but they are not the only debtors. The low-income countries (under US$600 capita) owe US$110 billion or 18 percent of the total developing-country medium- and long-term debt (at the end of 1982). The proportion of their exports absorbed by service on this debt (debt-service ratio) amounted to 23 percent in 1982, barely lower than for the newly industrializing countries and higher than the 19 percent average for the developing countries, including the Organization of Petroleum Exporting Countries (OPEC), as a group (see Table 1.4 in chapter appendix). In addition, it is in the low-income

countries where most of the payments arrears are encountered: Twenty of the thirty-three countries specifically identified as having arrears at the end of 1982 were at or below US$600 per capita income.[5]

The rise in debt and debt service reflected in part the great inflation of the last decade. It was accompanied by a sharp increase in the nominal and real value of output and exports in most cases. Debt and debt service rose even faster, however. As a result, the debt-service ratio rose by some 50 percent between the early 1970s and the early 1980s (Tables 1.4 and 1.5 in the chapter appendix). Its average level in 1981-82 of 20-25 percent on medium- and long-term debt was not out of line with the ratios recorded for Canada, Australia, Argentina, and the Union of South Africa--the traditional successful borrowers--in the early 1900s and the 1920s.[6] The ratios were much higher, however, when the repayments of short-term debt are included: In five cases, aggregate debt service exceeded the total value of debtor-country exports in 1982.[7] The continuing rollover of short-term debt and long-term capital inflow without interruption are crucial for the maintenance of debt service in such a situation: The breakdown in these and the collapse of world trade led to massive defaults in the 1930s, at an even lower level of debt-service ratios than at present (Table 1.6 in chapter appendix).[8]

DEBT-SERVICING TERMS

It is not the absolute amounts of the debt, but the unfavorable terms of servicing for maturity and interest that now pose the most formidable problems in most cases. First, periods of repayment are too short. At the amortization (repayment) rate of 1982, the aggregate medium- and long-term debt of developing countries would be retired in seven and a half years.[9] This is shorter than the life of most development projects. During the last few years, according to competent observers, there occurred a remarkable shortening of debt maturities in a number of countries, resulting apparently from the replacement of maturing medium-term bank credit by shorter-term loans.[10] Furthermore, short-term credit was withdrawn in a number of cases. Prior to 1981, short-term debt was almost automatically rolled over, as it financed mostly current trade. In the debt crisis of 1981-82 this practice stopped, and a number of developing countries experienced a sudden need to repay massive amounts out of dwindling or nonexistent exchange reserves. Particularly affected were interbank credit lines, but ordinary trade credits were not spared.[11] What was happening in recent years may be called debt reorganization in reverse: Longer-term debts were partly converted into short-term, and some of the short-term

debts were cashed in.

Second, real interest rates are at a level that an average debtor will find hard to sustain. More than US$300 billion of the debt of developing countries is now owed to banks.[12] Most of it is contracted at floating interest rates and is denominated in U.S. dollars. These rates, consisting of the base rate (mostly London Inter-Bank Offer Rate--LIBOR--and sometimes U.S. prime) and the margin to reflect "country risk," were running at 12 percent on the average in October 1983. The U.S. prices are now increasing at 3-4 percent per year, giving a real rate of interest of 8-9 percent. The real rate facing the developing-country borrowers is even higher, as their export commodity prices have stopped increasing on the average and their prices of export manufactures are probably falling. For these countries the nominal interest rate of 12 percent can be considered at least equal to the real rate.[13] At this rate the debt burden will be rising with almost mathematical certainty for most debtor countries. They will be compelled to borrow at 12 percent interest just to pay interest; and debt will increase faster than real output, resulting in a rising proportion of national income being absorbed by debt service abroad. The hopes of late 1982 and early 1983 that interest rates would fall toward their long-run real level of 2 percent did not materialize.

In 1982, service on aggregate medium- and long-term debt of developing countries (amortization and interest) amounted to US$125 billion or 21 percent of this class of debt principal (US$600 billion). Service on short-term debt is not known, but it must have been substantial. For 1983, service on all debt of the twelve largest debtors was estimated at the staggering sum of US$190 billion, or 44 percent of their aggregate debt principal.[14] Seven of these twelve debtors, including four of the top five, requested postponement of payments on a part of the debt or emergency financing.

PRODUCTIVITY OF LOANS

A view has been expressed by the GATT (General Agreement on Tariffs and Trade) Secretariat that current debt-servicing difficulties reflect unproductive use of funds rather than unfavorable external events and difficult debt-servicing terms: "A difficulty for the financial system is posed by the fact that a significant, though not precisely determinable, proportion of the additional indebtedness incurred in the 1970s represents what is best called 'deadweight debt'--that is debt to which there correspond no additional production facilities from which to service it."[15]

The World Bank has disagreed with this diagnosis and argued that on the whole the developing countries used

borrowed funds productively.[16] Essentially the same argument has been made by the Bank of England.[17] William Cline of the Washington-based Institute for International Economics in a recent study found that "it would be inaccurate to conclude that the bulk of the debt contracted has failed to go into productive investments; the evidence tends to indicate that most borrowing was productively used."[18]

In the earlier study I argued that the economic results achieved by the newly industrializing countries--the major debtors--have in most cases met the long-run debt-servicing-capacity requirements. The latter have been defined as a continuing growth in per capita production and the underlying process of rapid accumulation of productive capital, so that the incidence of debt service falls on a part of the increment in per capita income and allows the domestic consumption and investment to rise _pari passu_ with the growth of debt service. Specifically, I argued that over the preceding two decades:

1. The rates of growth of gross product, in the aggregate and per capita, had been impressive and sustained; the aggregate had surpassed the growth rates recorded in the industrialized countries by a substantial margin, and the per capita income growth, after a moderate lag in the 1960s, had exceeded that of the industrialized countries in the 1970s. An important exception had been the low per capita growth rate in the industrializing countries of South Asia and particularly in Africa south of the Sahara. For developing countries as a whole, the aggregate growth rate in the 1960-1980 period averaged 5.8 percent and the per capita rate 3.5 percent per annum.
2. The growth achievement had been a result of the capacity to absorb modern technology and to organize efficiently low-cost production, after an initial period of infancy. The share of manufacturing in gross domestic product (GDP) in Latin America, southern Europe, southern Asia, the Middle East, and northern Africa averaged some 23 percent in the late 1970s compared to 19 percent in 1960; it was approaching the share that obtained in the developed countries (27 percent). A number of developing countries had ceased to be the periphery of the world economy and had become industrial centers in their own right.
3. Accelerated industrialization led to diversification of the export structure of the newly industrializing countries. Manufactures in 1983 accounted for slightly more than one-half of the

total exports of eastern and southern Asia and southern Europe, compared to less than 30 percent twenty years before. The Latin American progress had been less rapid until a few years ago, but there had been a major upsurge in the late 1970s, led by Brazilian automotive exports. The developing countries' overall exports of manufactures had continued to grow in the 1970s, as they had in the 1960s, at an average annual rate of 12 percent (in constant 1978 prices), compared to 8.5 percent for total world trade in manufactures in the 1970s. It must be added, however, that vast areas of developing countries, including the newly industrializing ones, remain major commodity suppliers to the world markets and continue to be exposed to vicissitudes of demand and prices. This is particularly the case with Latin America, the Association of Southeast Asian Nations (ASEAN), and parts of the Indian subcontinent.

4. Investment had been increasing faster than aggregate production, indicating a rising share of the plowback into future capacity to produce. As a result, the rate of investment as a proportion of GDP in developing countries had showed an upward leap from 19 percent to 26 percent between 1960 and 1980; it was above the level in the industrializing countries by the late 1970s, in the reckoning of the World Bank.
5. National savings rates had risen on the average by a third. Within this, an enormous upward shift had occurred in eastern Asia, from under 10 percent of income in 1960 to almost 24 percent in 1977. A remarkable increase had also occurred in southern Asia, from 12.5 percent to 17.6 percent of income. In Latin America and southern Europe, national savings had only kept pace with income, at levels averaging about 20 percent.
6. For a successful outcome of a growth process financed partly by foreign borrowing, it is crucial that the gap between investment and savings, initially large, starts closing as growth proceeds, to be ultimately replaced by a surplus that will be used to retire the debt if necessary. If the gap starts falling as a proportion of income, the debt will cease to grow at a certain point, and the entire borrowing process will be self-liquidating. The available data suggested that despite the rise in the price of imported oil, the gap in the current account as a proportion of GDP had fallen in both eastern and southern Asia between 1970 and 1977. It had increased moderately in

> Latin America and more sharply in southern Europe. For developing countries as a whole, it had declined.[19]

Despite the above evidence, the GATT Secretariat has a point concerning wasteful use of foreign loans. For one thing, a part of capital inflow was offset by capital exports in some countries; it was used for purchases of military supplies in others; and there was inappropriate use of public funds for private benefit in an unknown number of cases. Private capital outflow from Mexico has been variously estimated at US$17-39 billion, Venezuela US$6-18 billion, Argentina US$8-11 billion, and Brazil US$12 billion (1982 alone).[20] Military purchases and fees in Argentina have been quoted at US$10 billion.[21] Second, free-trade policies, coupled with frozen exchange rates, led to a massive increase in imports financed by foreign borrowing, without a corresponding increase in domestic capital formation. Instead of resulting in improved resource allocation claimed for them, such policies led to excessive foreign competitive pressure on domestic production, increased unemployment, and large external debt. This happened in Chile.

Major commercial banks have not been anxious to sell their loans to major developing debtor countries. There is a limited secondary New York market in syndicated loans to Latin American governments. The sellers are small U.S. regional banks and the European banks. In early 1983 the discounted paper included Brazilian and Venezuelan loans, and the discounts ranged between 5 percent and 12.5 percent of face value. It was stated that the bigger banks are reluctant to sell because they do not want to take write-offs.[22] Another explanation, offered to me by a prominent London investment bank, was that large commercial banks wanted to stay in major developing debtor countries in view of their favorable long-run growth prospects even though the banks were reluctant to increase their current exposure. The Japanese banks, required by the government to set aside a special reserve against losses on their doubtful foreign loans, made only nominal provisions with respect to their major borrowers. It was unofficially reported that the banks set aside funds equal to around 50 percent of the maximum allowed in the cases of loans to Poland, Vietnam, Cuba, and Zaire; 25 percent in the cases of Bolivia, Honduras, Costa Rica, Romania, Senegal, and Sudan; 10 percent in the cases of Yugoslavia and Liberia; and only 5 percent in the case of loans to Mexico, Argentina, Brazil, and Venezuela.[23]

EXTERNAL FORCES 1981-1982

During 1981 and 1982 the developing countries were exposed to three shocks of major proportions and in rapid succession. They were the main cause of debt-servicing troubles in most major debtor countries. First, commodity prices fell sharply as the world recession became deeper and more widespread and as the upswing in interest rates forced sales from commodity inventories, the cost of carrying them having become increasingly prohibitive. Export commodity prices other than oil in 1982 were on the average 30 percent down from the average of 1980. The president of the World Bank estimated that between 1980 and 1982 the annual export revenue of developing countries dropped US$40 billion, as a result of falling prices of nonfuel commodities and stagnation of other categories of developing-country exports.[24]

Second, the upward shift in the international rate of interest not only meant a sharply increased cost of new borrowing but also led to a revaluation of charges on the existing debt contracted at floating interest rates (see the section on "Debt-Servicing Terms"). From 1978 to 1981, LIBOR doubled, and according to the managing director of the International Monetary Fund (IMF), interest payments by the nonoil developing countries on their long-term foreign debt alone rose by some US$23 billion. Furthermore, the average maturity shortened. The president of the World Bank estimated that the annual debt service for medium- and long-term debt went up US$37 billion between 1980 and 1982.[25] According to the Organization for Economic Cooperation and Development (OECD), the increase amounted to US$33 billion for non-OPEC countries and US$11 billion for OPEC, or a total of US$44 billion between 1980 and 1982.[26] A continuing appreciation of the U.S. dollar has been an additional element hardening the terms of debt servicing.

Third, in August 1982 international capital market lending to developing countries, mostly syndicated bank lending, nearly collapsed. In the period September-December 1982, this lending was running at US$19 billion annually, compared to US$51 billion in 1981, a shortfall of US$32 billion. For oil-importing countries alone, this shortfall amounted to US$30 billion.[27]

The aggregate adverse swing for non-OPEC developing countries, resulting from falling export revenue, rising debt-servicing costs, and the fall in capital market borrowing, amounted to about US$170 billion over the two years 1981 and 1982.[28] The situation in 1979 and 1980 was already quite difficult for those countries, as they had just sustained the second oil-price increase.

Although the oil-importing countries were carrying the brunt of the adversity, the oil-exporting countries did not escape it. The volume fell sharply following the 1979 price increase, the recession, and the chaotic

marketing conditions, leading to a large reduction of export and fiscal revenue. The exports of OPEC countries in 1982 amounted to US$213 billion, compared to US$295 billion in 1980, a decline of US$82 billion or 28 percent. The cumulative decline over the two-year period 1981-1982 amounted to US$105 billion.[29] The few surplus-oil countries recouped a part of their revenue decline through higher earnings of interest on their foreign bank deposits and similar assets abroad. For the majority of oil-exporting countries there was no such remedy, and they went through a deflationary experience similar to that of many oil-importing developing countries.

EXTERNAL FORCES 1983

Export commodity prices of nonoil developing countries improved during 1983 as economic activity picked up in the United States, with the associated increase in the U.S. demand for inventories. The price of oil stabilized, after much effort, through a collective action of OPEC and non-OPEC exporters, commonly concerned about the potentially disastrous financial effect of a continuing slide in the oil commodity market.[30] The commodity situation remained uncertain, however. In September 1983 the dollar price index of export commodities of developing countries other than oil was 16 percent higher than its bottom level of November 1982, but still 22 percent lower than the precrisis average of 1980. Prices of metals, which had led the price recovery in early 1983, started weakening again after the summer of 1983, perhaps presaging a new slowdown in the industrialized countries.[31] Nominal interest rates were lower than their peaks recorded from time to time in 1980-1982, but they remained high in real terms. Net bank lending to nonoil developing countries in the first half of 1983 was reported at US$5.8 billion, that is, at an annual rate half of that in 1982 and one-quarter of the precrisis level of 1981.[32] In summary, the international situation at the end of 1983 was somewhat easier than in 1982, mainly due to a partial recovery in commodity prices; but in the meantime the internal situation in a number of debtor countries had become worse as deflationary programs took their toll.

EMERGENCY ACTION IN 1982 AND 1983

A series of international measures was undertaken, swift under the circumstances, to cope with the most critical country situations. These measures, usually initiated by the U.S. government and orchestrated by the IMF, included assistance by central banks of some key creditor countries and some of their official agencies,

"involuntary" lending by creditor commercial banks, bridging assistance of the Basel-based Bank for International Settlements (BIS), and drawings on the IMF. The arrangements were short term, and the amounts provided were tight. The situation was shored up in different degrees for the time being, but further actions are virtually inevitable. The bankers' views on the continuing gravity of the problem leave little room for doubt:

> The international debt situation is far more serious than anticipated a year ago. Solutions were found for the major debtor countries, but they are strictly short-term. If we are lucky, the packages that were put together for 1983 will actually hold until the end of the year, but . . . this is not certain. Moreover, the arrangements that will have to be agreed on for 1984 for many debtor countries will be difficult to arrive at. . . . It is going to be extremely difficult to make the additional net funds available which will be necessary every year to keep the developing countries going.[33]
>
> Although only two of the recent restructuring agreements for lesser developed country debt have actually been signed, it is already clear that a second round of negotiations is inevitable. There are several lessons to be learned from these recent efforts before determining what to do next. First, debt problems will take much longer to work out than was thought originally. Second, fear is now mounting that a growing number of countries will be unable to cope with their post-rescheduling obligations. Some countries are already having trouble keeping their interest payments current, and are unlikely to meet their payment schedules once the grace period has elapsed. Third, present rescheduling mechanisms are inefficient. Creditors and key LDC policymakers have been so tied up in marathon sessions to patch up current reschedulings that they have been unable to address any of the long-term issues. Fourth, it has become clear that the debt problem cannot be solved in isolation from other problems. Any solution must address a much wider range of economic and monetary issues than is currently being considered, and packages must be paced to an actual increase in world trade, rather than simply based on the assumption that an increase will occur.
>
> The "rescue packages" hastily put together by Western governments, international organizations and commercial banks in the first months of 1983,

> cannot ultimately reduce the vulnerability of the international financial system so long as new money is used merely to pay interest. In order for growth to be resumed and for confidence in international banking to recover, ad hoc bail-outs must give way to long-term policies geared to a sustained recovery.[34]

> The flaw in the current strategy is that there is not enough _direct_ emphasis on LDC growth. We are all talking about growth, but there is too much risk that current policies won't be sufficient. Without faster growth, we are buying not only economic and financial chaos, in my view, but _de facto_ defaults on the order not yet seen.[35]

Carlos Alzamora and Enrique Iglesias have stressed that the "rescue schemes" have offered few prospects for economic growth as the additional resources committed by the banks, the IMF, and others have not been sufficient for payment of interest. Coupled with other unfavorable factors, primarily export crisis, this has led to domestic difficulties that have aptly been called "internationalization" of the world recession. Domestic interest rates in the debtor countries have skyrocketed to levels in real terms that do not seem credible: in some cases 30-40 percent per year. The domestic financial crisis is now increasingly seen as a more intractable problem than the inability to pay foreign creditors.[36] In fact, both are interrelated as resource drain to pay debt service is accompanied by domestic recession that leads to underutilization of capacity and unemployment of labor: The deflationary policy compounds their effect. Serious weakening of the finances and ability to grow of many enterprises in developing countries has occurred: High cost of borrowing, declines in sales due to both the domestic and the international recessions, and devaluations that have raised enormously the cost of debt servicing have caused corporate distress on a wide geographical basis--Argentina, Brazil, Chile, Ecuador, Korea, Mexico, Philippines, Turkey. Lag in new investment and replacement leads to obsolescence that will affect the capacity to compete in the international market: "Brazilian businessmen believe that, if the squeeze goes on much longer, the best of the country's industry will collapse."[37]

Uncertainty as to where the deflationary pressure on the developing debtor countries will ultimately lead has recently been expressed by the governor of the Central Bank of the Federal Republic of Germany, an institution not known for financial laxity:

> With remarkable flexibility and in a striking act of international cooperation a number of central

banks, the IMF and the large commercial banks averted the worst in August last year. Since then we have been in a period of permanent crisis management. I am not by any means using this term in a derogatory sense. We need crisis management in order to gain time to correct faulty developments on a durable basis; but we should not succumb to the illusion that crisis management itself is the solution.

An outstanding role in the process of crisis management is played by the International Monetary Fund. It has imposed tough conditions on the countries concerned. Their political and social consequences are not completely foreseeable, at least not for me. I can also understand that the question is increasingly being asked whether the IMF's philosophy is at all applicable to the problems of the countries with which we are now concerned. As we all know, the philosophy of the IMF was developed in 1944 in Bretton Woods for quite different cases, namely for overcoming temporary balance-of-payments disequilibria on the part of developed countries, whereas today's acute cases involve mainly long-term structural problems of developing countries. Current-account deficits are, of course, completely normal for rapidly developing countries such as Brazil or Argentina. It is only by this means that they are able to import real resources. This is why it is an unsatisfactory state of affairs that in the train of the adjustment process imports of capital goods, and hence the future growth potential of these economies, also have to be restricted. The exceptionally heavy debt-service burden, which in many cases is higher than export receipts, leads to the undesirable result that a transfer of real resources takes place in the opposite direction to the one that is necessary.[38]

INTERDEPENDENCE

The depression in major debtor countries has had adverse trade effects on the outside world and may have adverse effects on the international financial system. Cancellation and postponement of a number of major investment projects in Brazil, Mexico, Indonesia, Nigeria, Philippines, Venezuela, Yugoslavia, and Egypt, as well as in other countries of the Middle East, have affected the suppliers in both the more advanced developing countries and the developed countries. As capital-goods exports dominate the European sales, the latter have suffered: Exports to Mexico from the Federal Republic of

Germany in the first eight months of 1983 fell by 57 percent, to Venezuela by 48 percent, and to Brazil by 27 percent, compared to the first eight months of 1982.[39] British exports to Argentina in the same period fell by 91 percent, to Mexico by 51 percent, to Venezuela by 47 percent, and to Chile by 22 percent.[40] In the case of the United States, a wide range of manufactured and agricultural exports was affected. Total exports to non-OPEC countries fell by 46 percent between the first half of 1981 and the first half of 1983, and exports to Mexico by 52 percent. "The depression in the non-OPEC developing countries has had a much greater adverse effect on our [U.S.] exports than the appreciation of the dollar."[41]

Another victim of the debtors' depression has been the trade among developing countries: The import capacity of those affected by the crisis has fallen sharply while the capacity of developing-country exporters to provide export credit has been drastically curtailed in light of their own acute shortage of convertible foreign exchange. Brazil's exports to the rest of Latin America dropped from US$5.5 billion in 1981 to an estimated US$1.7 billion in 1983, and a Yugoslav oil exploration enterprise had to withdraw from projects in four countries.[42] The reduction in the intratrade and investment of developing countries came at a time when it was most needed to offset in part the consequences of slow growth in the rest of the world economy and to contribute to its recovery.

Loans to developing countries are a small proportion of total bank loans, but they are a large proportion of bank capital. In periods of payments difficulty, the attention inevitably shifts to the latter: It is bank capital that ultimately serves to meet depositors' claims if the loans the bank has extended fail. At the end of 1981, the U.S. banks had outstanding loans in developing and East European countries of about US$100 billion; this compared with total capital of the thirty largest U.S. banks of US$40 billion. The hundred largest non-U.S. banks had an estimated total of outstanding loans in the two areas of US$200 billion; against this they had total capital of US$120 billion.[43] The exposure of banks on the average was 200 percent of capital. Most of the U.S. banks' exposure is in developing countries; most of the East European debt is owed to non-U.S. banks.[44]

Loans to Mexico in mid-1982 amounted to US$64.4 billion, of which US$24.4 billion was owed to U.S. banks. As a proportion of capital the loans ranged, for ten major U.S. banks, from 40.0 percent to 66.7 percent.[45] It was with respect to one of these that "about noon on 19 August 1982 rumours swept through Wall Street that a major U.S. bank was going to fail. Bank stocks plunged. According to the rumours Mexico was about to default on its foreign debt, and this would undermine the unnamed bank. Could this be the beginning of a panic and

chain-reaction collapse?"[46] Rumors about Mexican exposure were enough to make Manufacturers Hanover, the fifth-largest U.S. bank in terms of capital, support the prices of its own bond issues on Friday, August 20, 1982.[47] By that time action was already well under way by the U.S. Treasury to inject funds into Mexico.[48]

In the case of Brazil, which owes to U.S. banks about US$22 billion, exposure to capital for major banks ranges from 43.9 to 77.7 percent.[49] Share prices of a number of these fell sharply in New York on October 21, 1983, apparently as a result of renewed apprehension that continuing difficulties in Brazil-IMF negotiations, sharpened by the conflict over the IMF insistence on a reduction of Brazilian wages, would make it impossible to reach agreement on a new "package" of financial and policy measures by a scheduled date in November.[50] A week later it was reported that commercial banks were exerting heavy pressure on the IMF to be more understanding of the political difficulties facing the Brazilian government in the implementation of its wage policy, and it was felt that Brazil should be given more credit for the austerity measures it had already undertaken.[51]

Cline has examined the possible effect on the U.S. financial system of serious debt difficulties and possible action by the debtors:

> For Western banks, repudiation of a substantial portion of loans to developing countries and Eastern Europe would be crippling. Even widespread moratoria could have a severe impact on the banks. . . . As a hypothetical illustration, consider what would happen if Argentina, Mexico, and Brazil were to miss one year's payment on principal and interest, and were to do so in a sufficiently aggressive way that it seemed appropriate to write off fully the payments missed. The complete loss of one year's payments due from these three countries would cause losses equal to 28 percent of the capital of the nine largest U.S. banks even after taking into account of offsetting profits on other loans. . . . These three countries owe US$31.3 billion to the nine largest banks, whose capital broadly defined is only US$29 billion. For 1983, debt service due (before recent restructurings) on this amount was US$13.7 billion. Profits of these banks in 1982 amounted to US$5.5 billion before taxes. Thus a loss of US$13.7 billion would cause total losses of US$8.2 billion or 28 percent of capital, and without offsetting items generating taxes, these losses would have to be fully absorbed out of capital. Although the resulting cut in capital would not cause insolvency, it would mean that the banks would have to begin to reduce their

total loans sharply in order to reestablish the 5 percent ratio of capital to loans required by regulators. The Wall Street Journal, June 10 and 20, 1983, pointed out that although the capital requirement for large banks has not been rigid, it is becoming more so as regulators respond to increasing congressional pressure. A new formal requirement of 5 percent capital backing for large banks was adopted in mid-1983. There would thus be a multiple reduction in loans. Potentially the nine largest banks would have to cut their loans outstanding by approximately US$160 billion as a result of a loss of US$8 billion of their capital from one year's loss of principal and interest from Argentina, Brazil, and Mexico under conditions where these losses had to be written off. Both because of loan cutbacks and because of the sharp increase in risk premium, the interest rate could be expected to rise, causing recessionary pressure. Even if the Federal Reserve loosened the capital backing of loans temporarily, the potential would exist for economic shock waves through reduced credit availability to American business and consumers and, as a result, increased unemployment. To a considerable extent, the sequence of events that would follow major bank losses because of country losses remains uncharted waters. . . . To the extent that central banks made loans to the affected private banks in an attempt to replace at least partially the repayments that otherwise would have been received from countries failing to make payments, there could be inflationary consequences. . . . Despite the fact that the Federal Reserve could respond in a crisis, there would be enormous economic risks from a large-scale banking crisis. If a wider front of country defaults were to occur, many major banks could become insolvent. For the nine largest banks this result would occur if just Brazil, Mexico and Argentina repudiated their debt, or if all developing and East European countries experienced sufficient difficulty that one-third of their debt had to be written off. Normally bank insolvencies are dealt with by merger, with a larger, sound bank absorbing the bankrupt concern. But in the situation just described, merger would be highly unlikely. There would be no banks larger than the failing banks to absorb them. In the past merger has tended to guarantee the deposits of all depositors. In a bankruptcy of the major banks, however, it is likely that only deposits covered by the Federal Depositors' Insurance Corporation would be guaranteed [in the United States], a maximum of $100,000 per

> account. For the U.S. banking system, deposit insurance covers only 73 percent of total deposit value. . . . A truly massive failure of external debt could bring down many major banks. Regardless of the emergency public measures that might be mounted in response, the potential economic consequences could be devastating.[52]

Another element that raises the risk of chain reaction among financial institutions is substantial interdependence of banks. Interbank deposits account for almost 40 percent of total Euromarket deposits; in the Asian dollar market, the proportion is 55 percent. Domino-style effects under these circumstances are almost inevitable.

The risks inherent in the situation are reflected in low prices of bank shares despite high bank profits, in some cases very high. As a multiple of profits, the share prices of major U.S. banks with a heavy foreign exposure amounted to 5:1 in late October 1983. By comparison, the average price-earnings ratio for all companies listed on the New York Stock Exchange was 14:1.[53] Almost all major bank shares, it was reported, were trading substantially below book value, in some cases at around half.[54] What bank shareholders were getting in dividends they were partly losing in market valuation of capital: An unsatisfactory situation reflecting market disbelief in the durability of profits derived not from prosperous borrowers but from a squeeze on their stagnating or falling incomes.

THE FUTURE

Three sets of proposals have been made to deal with the debt problem. The first suggests a continuation of present practices. The second calls for readjustment of debt terms through a takeover by a public agency of debts at a discount. The third proposal calls for an extended moratorium.

Continuation of present practices is the current official doctrine of most creditor countries. Their implications, with some modifications, were worked out by Cline in what he called "a containment strategy."[55] The strategy was based on the assumption that OECD growth would recover to 3 percent per year, that the debtor countries would have a lower growth rate than in the past (2.5 percent in 1983, 3.5 percent in 1984, and 4.5 percent in 1985 and 1986), and that the base real interest rate (London Inter-Bank Offer Rate--LIBOR) would fall from 11 percent in 1982 to 5 percent in 1983, 4 percent in 1984, and 3 percent in 1985 and 1986. Behind these assumptions was a belief that the reduction in the developing countries' current account deficit that has

already taken place due to shortage of finance and that has mainly affected imports can be sustained without major political upheavals and that the existing "rescue packages" are functioning well.[56] Cline proposed expansion of World Bank lending, expanded export credits, and the approval of the IMF quota increase; the latter is crucial for success of the strategy. Private banks should continue new lending at modest rates to countries in adjustment. In extreme cases new approaches may be needed such as the rescheduling of interest and the use of zero-coupon bonds (bonds issued at a deep discount on which no service is paid until maturity). Cline's model shows the current account deficit and particularly the debt-burden indicators falling over time; but for oil-importing countries the model implies a net resource outflow on a rising scale, with interest payments exceeding capital inflow and the debt still rising. The analysis has the merit of showing realistically the present position. It caused sharp reactions: that its main concern is the well-being of banks, that it will stretch to the breaking point the political and social fabric of debtor countries, and that it is based on too many things going right at the same time instead of providing for a lender of last resort.[57]

Many proposals have been made for a takeover of the existing debts by a new agency on terms that would involve a reduction of the principal or interest or both.[58] None of them seems to have been thoroughly considered by creditor-country governments, for three reasons: They would involve the establishment of a new agency calling for budgetary resources; they would involve losses for the banks; and debtor countries' bargaining power has not been behind them.

Throughout the debt crisis, debtor countries have been careful to preserve their good relations with the banks. A major, probably decisive, reason has been the need to preserve access to bank credit. It has been more expensive, but it had proven, until the debt crisis, more easily available and more freely usable than credit extended by governments or international lending agencies.[59]

A solution to the debt problem would have to be found that achieves the objective of facilitating substantially the debt-servicing burden and yet stays within two constraints. These are that it preserves access to bank credit and that it involves little, if any, budgetary outlays of developed countries.

One of the bases for the solution will need to be an understanding between the debtor countries and the banks that it is in their mutual interest to postpone amortization payments for several years, say three to five, while preserving intact the debt principal. Such a postponement would not affect the profit position of the banks or the value of their assets. On the other hand, if the

breathing space provided by the postponement of amortization is properly used for expansion and modernization of the production structure of the borrowers, their debt-servicing capacity will improve, and this ultimately represents the best guaranty of debt repayment.[60] Two corollaries follow. First, the banks need to be satisfied that productive investment will take place. Second, payment of debt-rescheduling fees and extra interest charges ceases to be justified: They are intended to compensate the creditor for increased risk, and the risk will have fallen.[61] For a rescheduling proposal to be seriously considered it would be necessary to identify the affected countries, creditors, amounts, classes of debt, the effects on the debtors and the creditors, the need for public support to banks suffering from illiquidity, and the role of international financial institutions.[62] Some organization of developing countries needs to do this work; a New York banker has suggested that the central banks of developing countries may establish a suitable body that would, among other things, organize and manage debt-rescheduling exercises.[63] Such a body could be a counterpart of the Institute of International Finance, recently established by major creditor banks. One of the aims of the institute is the provision of "a convenient forum through which individual country borrowers can present to lenders information concerning their borrowing needs." There is no reason why the borrowers could not do this collectively and why borrowing needs could not include postponement of amortization. An understanding would also need to be reached concerning modalities of revision of the arrangement and conditions under which amortization payments would be resumed before the expiration of the postponement.

Scaling down the rate of interest is crucial not only for the countries in debt-servicing difficulties, but for all developing countries that borrow abroad: Not only will their future debt-servicing burden be very large at present rates, but the range of investment projects that can be undertaken has narrowed down, thus dampening the rate of investment, growth, and the associated debt-servicing capacity. Furthermore, the issue of interest rates is critical for the developed countries as well: As long as the present rates last it is difficult to expect a revival of private investment, and government budgets operating under an enormous burden of interest payments (and armament spending) are not in a position to accommodate a satisfactory level of public investment.[64] Individual country actions to reduce the rate of interest are constrained under present conditions of international financial integration, as speculative capital movements would tend to defeat such individual efforts. An international solution to the problem must be sought. Both the theoretical basis and the practical modalities of any such international arrangement would

have to be worked out, but it is difficult to see how without such an effort the present unsatisfactory situation can be resolved. For the countries experiencing debt-servicing difficulties, an internationally arranged general reduction of interest rates would relieve the burden while simultaneously preserving their access to international credit. As stated in the 1983 annual report of the U.S. Council of Economic Advisers:

> The problems of the developing countries are not insoluble. If growth in the world economy resumes and real interest rates fall to historical levels, the debt burden of even the most heavily indebted countries will become much more manageable. Mexico and Brazil, among the most heavily indebted countries, both have debts well below half their GNPs. At a historically typical real interest rate of 2 percent, the real burden of debt service would fall to less than 1 percent of GNP--a fully manageable level in a growing economy.[65]

The trouble is that the present rates are over five times the historical rate.

As an interim solution, while debt rescheduling and international interest-rate policies are worked out, I have been proposing, since before the Cancun meeting in 1981, a large injection of Special Drawing Rights (SDRs) through a special issue, confined to developing countries.

> The effect of the special issue would be to gain time in which the existing debts and other obligations can be reorganized and suitable domestic policies of adjustment adopted, without going first through a massive deflation which is otherwise in prospect. . . . SDR allocation is normally without conditions. In this case, in view of the needed size [US$55 billion], it is suggested that the country allocation of the special issue be accompanied by conditionality and monitoring in which the developing countries would play a major role. Only the developing countries among themselves can successfully grapple with central issues of performance, such as capital flight, inappropriate use of public funds and unproductive expenditures. A procedure which would give them a great deal of authority would contribute to improvement in North-South relations in which conditionality and its administration have proven to be among the most difficult issues; and it would provide an experience in participatory management which, if successful, could offer valuable lessons for

future reform of international institutions.

The effects on the international monetary system of a large issue of SDRs may be of major importance. It would raise their share in aggregate reserve assets to a respectable level at which, with suitable modifications at a later stage to widen their marketability, their larger supply would in a sense create the demand for them. The national reserve currency standard has proven to have had an inflationary bias. It has conferred doubtful advantages on reserve currency countries, first the U.K. and then the U.S., as the short-run payments gains have been followed by long-run losses in competitive strength and ultimately deflationary pressures. Exchange rate instability in the world is increasing, and the world system now operates without a fixed point of reference. A growing role of international currency under appropriate international control is a necessary condition for economic growth with stability. It would also facilitate international monetary cooperation badly needed to stop the downward slide on which we now find ourselves.

Spotty and frequent rescheduling efforts now under way in many cases are not an alternative to decisive action: they will essentially only continue the agony, in addition to being very costly in terms of effort, charges and fees, and inability to plan beyond the next month.[66]

A continued absence of international action will inevitably raise the prospect of unilateral moratoria for an extended period. A "sovereign moratorium" has been proposed by the opposition party in Brazil. Speaking about the need for a moratorium lasting at least three years and covering both amortization and interest, Celso Furtado, former minister of planning of Brazil, stated that Brazil cannot continue to pay with the hunger of its citizens.[67]

APPENDIX

Table 1.2 External Debt Per Capita (in U.S. dollars)

	Aggregate Disbursed Debt Mid-1983 (billions)	Population Mid-1981 (thousands)	Per Capita Debt
Israel	21.5	3,954	5,437
Venezuela	33.0	15,423	2,139
Chile	18.0	11,292	1,594
Portugal	14.0	9,826	1,424
Argentina	40.0	28,174	1,419
Mexico	85.0	71,215	1,193
South Korea	39.0	38,880	1,003
Algeria	18.0	19,602	918
Yugoslavia	20.0	22,516	888
Brazil	93.0	120,507	771
Peru	11.6	17,031	681
Morocco	11.0	20,891	526
Philippines	20.0	49,558	403
Colombia	10.0	26,425	378
Egypt	16.0	43,290	369
Turkey	16.2	45,529	355
Nigeria	13.0	87,603	148
Indonesia	20.0	149,451	133
Pakistan	9.0	84,501	107
India	20.0	690,183	29

Note: The per capita debt figures are slightly overstated, as the aggregate debt data refer to mid-1983 and the population data to mid-1981. The overstatement is small, especially as in many cases debt data are incomplete.

Source: External debt totals used in the computation are from Table 1.1. Population data are from *1983 World Bank Atlas: Gross National Product, Population, and Growth Rates*, Washington, D.C.

Table 1.3 External Debt as Proportion of Gross National Product

	Aggregate Disbursed Debt Mid-1983 as % of GNP 1981	GNP (U.S. dollars)	
		(billions)	(per capita)
Israel	105.0	20.42	5,160
Chile	62.3	28.89	2,560
Morocco	61.2	17.96	860
South Korea	59.1	66.09	1,700
Peru	58.1	19.98	1,170
Egypt	56.8	28.16	650
Portugal	56.5	24.75	2,520
Argentina	55.4	72.12	2,560
Mexico	53.1	160.23	2,250
Philippines	51.2	39.01	790
Venezuela	50.7	65.08	4,220
Algeria	42.8	42.01	2,140
Brazil	34.7	267.73	2,220
Yugoslavia	31.8	62.93	2,790
Pakistan	30.2	29.80	350
Colombia	27.5	36.39	1,380
Indonesia	25.4	78.75	530
Turkey	23.1	70.21	1,540
Nigeria	17.1	76.17	870
India	11.3	176.66	260

Note: The GNP proportion figures are slightly overstated, as the aggregate debt data refer to mid-1983 and the GNP data to 1981. The overstatement is small, especially as in many cases debt data are incomplete, and GNP has been stagnating since 1981.

Source: Aggregate disbursed debt from Table 1.2. GNP data are from _1983 World Bank Atlas: Gross National Product, Population, and Growth Rates_, Washington, D.C.

Table 1.4 Country Group Debt-Service Ratios: Total Debt Service (DS) and Interest (INT) as Percentage of Exports[a]

Income Group		1970/71	1973	1974	1975	1977	1979	1980	1981[b]	1982[b]
Low-income countries	DS	12	14	13	16	14	14	17	19	23[c]
	INT	4	4	4	2	4	6	6	7	9[d]
Middle-income countries	DS	16	12	10	10	12	14	12	14	16
	INT	5	3	3	3	3	4	6	7	8
Newly industrializing countries	DS	15	13	12	15	18	21	18	21	24
	INT	5	5	5	6	6	8	9	11	13
Total non-OPEC	DS	15	13	12	15	18	21	18	21	24
	INT	5	5	5	6	6	8	9	11	13
OPEC countries	DS	6	8	4	4	7	8	7	10	14
	INT	2	2	1	2	2	3	2	3	4
Total developing countries	DS	13	11	8	10	12	14	12	15	19
	INT	4	3	3	4	4	5	5	7	9

[a]Service on medium- and long-term debt, public, publicly guaranteed, and private; service on short-term debt is not included. Exports include goods and services and net private transfers.

[b]Preliminary estimates

[c]Also 23 percent for the least developed countries

[d]8 percent for the least developed countries

Source: Organization for Economic Cooperation and Development, *External Debt of Developing Countries: General Survey 1982* (Paris, December 1982), table 13.

Table 1.5 Country Debt-Service Ratios: Interest and Amortization as Percentage of Exports[a]

Country	1971/72[b]	1975	1976	1977	1978	1979	1980[c]	1981[c]
Mexico	34	37	50	63	59	68	41	60
Brazil	51	37	43	47	55	60	57	58
Chile	20	34	32	31	45	32	34	45
Peru	23	28	27	32	32	26	36	42
Ivory Coast	10	9	9	11	17	23	36	39
Venezuela	6	5	5	11	15	17	26	37
Algeria	9	17	20	21	29	31	30	36
Morocco	10	7	10	13	22	26	28	35
Argentina	26	30	30	20	28	18	25	27
Philippines	9	12	16	13	23	20	18	24
Egypt	31	22	19	24	22	19	20	20
Yugoslavia	20	16	15	17	15	18	16	20
Greece	12	15	15	15	13	14	16	18
Turkey	12	10	12	12	16	18	14	17
Thailand	11	9	8	13	15	15	14	17
Korea (South)	19	12	10	10	11	15	14	16
Portugal	6	6	8	9	8	10	13	15
Indonesia	10	10	11	13	15	15	11	12
Pakistan	19	18	17	17	14	12	11	10
India	22	14	12	11	11	10	9	10
China (Taiwan)	5	5	5	5	6	5	6	6
Nigeria	3	3	4	4	6	4	4	4

[a]Service on medium- and long-term debt, public, publicly guaranteed, and private; service on short-term debt is not included. Exports include goods and services and net private transfers, including reported workers remittances.

[b]Average

[c]Preliminary estimates

Source: Organization for Economic Cooperation and Development, External Debt of Developing Countries (Paris, October 1981), table 11.

Table 1.6 Ratios of Total Debt Service to Merchandise Exports for Selected Developing Countries in the 1920s and the 1930s (Percentages)

	Argentina	Bolivia	Brazil	Chile	Colombia	Cuba	Peru	Uruguay
1926	10.0	7.3	13.2	5.5	2.7	3.1	2.6	7.6
1927	7.9	6.1	14.4	8.7	4.4	2.7	3.2	9.2
1928	8.9	8.5	14.6	9.5	8.1	3.3	6.0	8.5
1929	10.4	7.8	16.5	9.2	11.9	3.6	7.4	9.5
1930	18.2	13.5	23.5	18.0[a]	14.0	6.1	9.5[a]	9.7
1931[b]	22.5	24.5	28.4	32.9	15.6	13.4	16.3	22.4
1932[b]	27.6	50.0	41.0	102.6	21.8	18.1	21.4	36.3
1933[b]	30.2	38.5	45.1	81.9	29.6	22.4	21.7	31.3

[a]Probably underestimated

[b]Scheduled debt service as a proportion of exports. Bolivia, Peru, Chile, Brazil, and Uruguay stopped payments during 1931; Colombia during 1932; Argentina and Cuba partially in 1933.

Source: Dragoslav Avramovič, Debt Servicing Capacity and Postwar Growth in International Indebtedness (Baltimore: Johns Hopkins University Press, 1958), pp. 193-194.

NOTES

1. Dragoslav Avramovič, "The Debt Problem of Developing Countries at End-1982," Aussenwirtschaft, Schweizerische Zeitschrift für Internationale Wirtschaftsbeziehungen, St. Gallen, March 1983.

2. Organization for Economic Cooperation and Development (OECD), External Debt of Developing Countries: General Survey 1982, Paris, December 1982.

3. Estimates by the Federal Reserve Bank of New York as reported in the Wall Street Journal, November 5, 1982, and Journal de Genève, November 6, 1982; and by the World Bank in World Development Report 1983, p. 16.

4. Avramovič, "The Debt Problem of Developing Countries," p. 67.

5. International Monetary Fund (IMF), Exchange Arrangements and Restrictions, Annual Report 1983, p. 37.

6. David Finch, "Investment Service of the Underdeveloped Countries," International Monetary Fund Staff Papers, September 1951.

7. Argentina 179 percent of exports, Mexico 129 percent, Ecuador 122 percent, Brazil 122 percent, and Chile 116 percent (Morgan Guaranty Trust Company of New York, World Financial Markets, New York, October 1982).

8. Peterheinz Werhahn, Kapitalexport und Schuldentransfer im Konjunktur-Verlauf, Jena, 1937.

9. Amortization in 1982 amounted to US$70 million, and the debt outstanding at the end of 1981 amounted to US$530 million (OECD, External Debt of Developing Countries).

10. Azizali F. Mohammed, "Latin American Debt--A World Crisis?" North-South Roundtable, April 1983; Pedro-Pablo Kuszynski, "Latin American Debt," Foreign Affairs, vol. 61, no. 2 (Winter 1982-1983). Their findings refer to the Latin American countries, but they also apply to some other developing countries and to Eastern Europe.

11. Carlos Alzamora Traverso and Enrique V. Iglesias, "Bases for a Latin American Response to the International Economic Crisis," United Nations, Economic and Social Council, Doc. E/CEPAL/G.1246, May 16, 1983, pp. 31-32.

12. According to Paul A. Volcker, chairman of the Federal Reserve Board, the debt to banks of non-OPEC countries amounts to US$285 billion (BIS [Bank for International Settlements] Press Review, October 28, 1983). The debt to banks of OPEC countries probably exceeds US$50 billion.

13. No index of prices of export manufactures of developing countries is available. However, export prices of South Korea fell sharply through mid-1983, and they probably reflect the general trend.

14. Georges Corm, "Ménaces sur le Système Financier International," Le Monde Diplomatique, March 1983.

15. General Agreement on Tariffs and Trade (GATT), *International Trade 1981/82*, Geneva, 1982, p. 19.

16. World Bank, *World Debt Tables 1982-83 Edition*, February 1983, p. ix.

17. Statement by Lord Richardson, governor of the Bank of England, of April 12, 1983 (*BIS Press Review*, April 21, 1983).

18. William R. Cline, "International Debt and the Stability of the World Economy," *Policy Analyses in International Economics*, no. 4, September 1983, p. 29.

19. These findings are mainly based on: World Bank, *World Tables, The Second Edition*, 1980; World Bank, *Annual Report 1982*; and United Nations Conference on Trade and Development (UNCTAD), *Trade and Development Report 1982*.

20. *Financial Times*, January 12, 1983; *Inter-Press Service*, October 15, 1982, quoting an IMF estimate; *The Economist*, April 30, 1983; Cline, "International Debt," p. 27; Pedro-Pablo Kuczynski as reported in *International Herald Tribune*, November 5, 1983.

21. *Financial Times*, October 28, 1983.

22. Statement by Martin Schubert, chairman of Eurinam International, New York (*Financial Times*, May 13, 1983).

23. *Wall Street Journal*, June 8, 1983. The required set-aside reserve is equivalent to between 1 percent and 5 percent of the outstanding loans to "problem" debtor nations, held by the banks.

24. Statement at the GATT ministerial meeting in Geneva on November 24, 1982.

25. Statement at the École supérieure in Cergy-Pontoise, France, on November 26, 1982.

26. OECD, *External Debt of Developing Countries*. A part of the increase should be attributed to a normal rise in debt, but the latter was distorted due to capitalization of interest at rising rates.

27. For 1982 as a whole, bank lending to nonoil developing countries amounted to US$25 billion, compared to US$51 billion in 1981 (Richard Williams, Peter Keller, John Lipsky, and Donald Mathieson, *International Capital Markets: Development and Prospects, 1983*, IMF Occasional Paper 23, July 1983, p. 46).

28. Cline, "International Debt," estimates the swing at US$140 billion, exclusive of shortfall in bank lending (p. 25). His estimates and mine are thus almost identical.

29. IMF, *International Financial Statistics*, October 1983.

30. The interactions between the financial and commodity markets have recently attracted attention. See Carlos F. Diaz-Alejandro, *International Financial and Goods Markets in 1982-83 and Beyond*, March 1983 (manuscript).

31. UNCTAD, *Monthly Commodity Price Bulletin*, October 1983.

32. BIS report as quoted in Financial Times, October 19, 1983, and International Herald Tribune, October 19, 1983.
33. A prominent Swiss banker, in a private communication of July 20, 1983.
34. Christine B. Bindert, "Talks Point to Troubles down the Road," International Banker, July 27, 1983, and "Debt: Beyond the Quick Fix," Third World Quarterly, vol. 5, no. 4 (October 1983), p. 828. Bindert is a vice president of an investment banking firm in New York.
35. Jeffrey E. Garten, "Sovereign Debt: Next Steps," International Monetary Conference, Brussels, May 18, 1983. Garten is from Lehman Brothers Kuhn Loeb Inc., New York.
36. "Debtors' Depression," The Economist, August 6, 1983.
37. Ibid.
38. Address by Karl Otto Pöhl of October 19, 1983, BIS Press Review of October 31, 1983.
39. Ibid.
40. Financial Times, November 2, 1983.
41. Edward L. Bernstein, Brookings Institution, as reported in International Herald Tribune, November 5, 1983.
42. Financial Times, November 2, 1983.
43. Data on outstanding loans are from Common Crisis North South: The Brandt Commission 1983, p. 48; data on bank capital, Financial Times, October 15, 1982.
44. At the end of 1981, East European debts to U.S. banks amounted to US$7.3 billion and to non-U.S. banks US$53.1 billion (Common Crisis).
45. Cline, "International Debt." A wider range, from 38.7 to 77.6 percent, is shown for the end of September 1982 in Financial Times, December 9, 1982.
46. John Odell, "The IMF Meeting: Banking for Rich and Poor," International Herald Tribune, October 16, 1982.
47. Financial Times, August 23, 1982.
48. "Stanley Wilson, America's LDC Troubleshooter," Institutional Investor, March 1983.
49. Cline, "International Debt."
50. Journal de Genève, October 22, 1983; International Herald Tribune, October 22, 1983.
51. Financial Times, October 28, 1983.
52. Cline, "International Debt," pp. 36-40.
53. Leonard Silk, "Banks Face Public-Relations Problem in Seeking Support for Their Rescue," International Herald Tribune, October 22, 1983.
54. Financial Times, November 1, 1983.
55. William Cline, "A Containment Strategy That Should Work," Financial Times, October 12, 1983. The details are given in Cline, "International Debt."
56. Cline, "International Debt," p. 43.
57. Letters to Financial Times by Stephany Griffith-Jones and Michael Lipton, October 18, 1983, and by Stephen McClelland, October 20, 1983.

58. Reviews of the proposals are contained in Bindert, "Debt: Beyond the Quick Fix," and Cline, "International Debt."

59. The Brandt Commission Papers, chapter on Debt, Geneva, 1981, p. 122.

60. I am grateful to Professor Ivo Fabinc, University of Ljubljana, Yugoslavia, for this point.

61. The refinancing terms of Brazil's latest debt rescheduling, agreed in principle in October 1983, have provided for reduction of fees and interest charges in recognition of this principle, and the same is expected for the next Mexican refinancing (*Financial Times*, November 4, 1983).

62. It is reported that the World Bank is studying the possibility of establishing a new affiliate with a paid-up capital of US$0.51-1.0 billion and the gearing ratio of 10:1 (compared to the commercial banks' 20:1), which would thus be able to mobilize up to US$10 billion. The paid-up capital would come from the bank's ample cash reserves, and loans could be made to the countries in debt difficulties (*Journal de Genève*, October 14, 1983; *Tribune de Genève*, October 17, 1983; *Financial Times*, September 30, 1983).

63. George J. Vojta, "Appropriate Intermediate Objectives for the International Financial System," *North-South Roundtable*, Istanbul, August 1983. Vojta is from Solomon Brothers, New York.

64. In the United States, interest on the national debt amounted to US$129 billion in the fiscal year 1983. This was 66 percent of the budget deficit of the federal government of US$195 billion.

65. The annual report of the Council of Economic Advisers, February 2, 1983.

66. Avramovič, "The Debt Problem of Developing Countries," pp. 77, 79, 80, 81.

67. *Le Monde*, November 2, 1983.

2
The World Crisis and the Outlook for Latin America

Víctor L. Urquidi

It is common knowledge that during the 1970s, which were considerably dynamic years, Latin America's GDP rose at an annual rate of 5 to 6 percent, following the trend of previous years. However, during this same period a number of changes began to take place that have not been taken fully into account in much of the current discussion. First, import substitution was broadened and intensified: It encompassed heavy industry on a scale larger than before, and gaps in the industrial structure began to be filled with extensive production of intermediate goods. Import substitution in Latin America has been both accidental and deliberate and therefore has never been adequately planned. It was introduced through a number of governmental initiatives aimed at modifying industrial structure, as in the case of Brazil, Mexico, and, to a lesser extent, Venezuela. It was also generated spontaneously as a consequence of protectionism and reinforced by devaluation, tariffs, import and exchange controls, and other measures designed to create a protected market for the manufacture of consumer goods (household durables and motor vehicles) and later on other products. However, a number of areas remained unaccounted for, particularly that of chemicals and other intermediate products. These areas were partially covered during the 1970s.

At the same time the industrial structure began to change in order to supply international markets. The increase in manufactured exports undertaken by several Latin American countries, including a number of the smaller nations, was outstanding. This was due partly to the diversity of international demand, to competitive advantages, and to a determined effort on the part of countries with export capability.

An earlier version of this paper was given at a conference in Avilés, Oviedo, Spain, organized in August 1983 by the Ibero-American Cooperation Institute of that country.

The fact that many Latin American countries were obliged to import petroleum products at the higher 1970s prices obviously obliged them to intensify their efforts to export manufactures. This meant that a transition became necessary from a highly protected manufacturing industry of doubtful productivity and competitiveness to one competitive in the international market in order to sell to the industrialized countries and to compete with the latter in other Latin American and Third World countries. This required either substantial technological innovation and adaptation or considerable efforts to promote trade as well as to negotiate at the international agencies in order to take advantage of modest changes occurring in the trade policies of the industrialized countries, such as the general preference schemes.

In the early 1970s a substantial improvement in the terms of trade took place, particularly--though not exclusively--on account of oil. Oil is usually considered separately from other commodities, but its price did rise for the oil-exporting Latin American countries. For example, the impact on Mexico of this improvement in the terms of trade was really extraordinary. There were good periods for other commodities, although toward the end of the decade they began to decline. It should be recalled, on the other hand, that for oil-importing Latin American countries the overall favorable change in the terms of trade was less obvious and that toward the end of the decade it was actually negative.

The oil shock of 1973-74 and particularly that of 1979-80 had both positive and negative effects on Latin America. The major adverse effect was felt by Brazil, because for a long time the Brazilian economy had been completely adapted to the use of relatively cheap imported oil and because manufactured exports were on the rise. Brazil was forced to absorb the oil shock as if it were a rich country with a high level of technology and great industrial capacity within the OECD, and this explains largely why the Brazilian miracle came to an end and why this economy could not continue to grow at the same rate as before, particularly in the industrial sector. Brazil had to adopt a policy incorporating the real international oil prices into its economy. The smaller countries in Central America, some Caribbean islands, and a number of other countries were obliged to do the same, although under different circumstances and in different ways. All were affected adversely. In the case of Costa Rica, for example, the situation was acute despite the narrow economic structure and industrial capacity. In the case of Brazil, a simulation study that I am familiar with shows that the need to import expensive oil is one of the main determining factors that will prevent Brazil's future growth at the past rate, unless new oil is discovered or unless one of the possible alternatives suggested in Brazil--which do not

appear to have matured yet--comes true.[1]

As to the positive aspects of the two oil shocks, there were five net oil-exporting countries: Mexico, Venezuela, Ecuador, Trinidad, and Bolivia. With the rise in export prices, these countries obtained unexpected and huge additional foreign-exchange receipts. This was the basis for a vast expansion of the public sector, of public and private industry, and of the oil industry itself. The effect on the economy was widespread in Mexico and Venezuela, where the state-owned oil industries provided fiscal resources that otherwise would not have been available. By a "positive" effect is meant that exerted on the real economy and on the prospects for exports in general. Undoubtedly, however, in the case of Mexico the negative aspects of the sudden great inflow of foreign currency and of the spending psychology generated by the oil (or any other boom experienced in Mexico's history) should also be considered; in the 1950s, for instance, Mexico had begun a dynamic spending process with revenue from cotton exports, as it had done in the distant past with revenue from mining and so forth.

It should be mentioned, when dealing with the effects of the oil shock, that several countries that were able to supply their own needs to a great extent (such as Argentina, Colombia, and Peru) found themselves in an intermediate position without an acute problem of foreign payments but not without the need to incorporate much higher real prices into their economy or to subsidize these while they adapted to the new economic situation. (Mexico in fact--and Venezuela to an even greater degree--maintained excessive subsidies on domestic oil prices, with the result that the financial position of the state oil companies was weakened and all notion of conservation and economic use of fuel was disregarded.)

The crisis in Latin America's agricultural sector, which arose as a result of many different factors, was another important aspect of the transition of the 1970s. Several of the contributing factors were agrarian, that is, related to the system of land tenure. Others arose from domestic policy relating to relative prices, by which agriculture was "punished" in favor of industrial development. However, the feedback from this policy affected agricultural output adversely because farmers were obliged to purchase equipment (such as tractors) and other inputs from protected industries--a consequence of import substitution--at very high prices. Generally speaking, the need to create adequate incentives to stimulate agricultural output was neglected (of course, this is not the case in every country nor in certain favored zones).

Food-deficit countries (there were several in Latin America before the 1970s, to which a large country, Mexico, was added) found themselves in the very difficult position of having to import foodstuffs at the time of

the food-price "shock" of 1974. At this time the international price of cereals rose, as a consequence of massive buying of U.S. output by the Soviet Union and subsequent policies designed to keep the price of farm products high. There were a few factors to be considered in this process, one of which was that the importation of foodstuffs did not replace rural income, even though it did supply a country with these products. On the other hand, the effect on the balance of payments for some countries was severe. The food deficit can be interpreted as the result of the lack of policies designed to encourage agriculture, combined with changes in consumption patterns, organizational problems, and the urban-rural income differential. Furthermore, the effect in urban centers of modernization in food systems must be taken into account: Processed foods, advertising, and a highly elastic market for high-quality foodstuffs all created the need to import inputs that had previously not been imported, in order to produce animal protein foods increasingly in demand by the urban population.

During the 1970s, on the other hand, "Latin American economic disintegration" began to occur. In the last few years we have not only witnessed the crisis but the virtual collapse of the whole structure of common and integrated markets. We have seen the passing away and the discreet burial of the Latin American Free Trade Association (LAFTA), which has now been replaced by the Latin American Integration Association (LAIA), which may be labeled "a feeble-trade association." Profound crises have also arisen in the Andean Pact, which at one time was offered as a very advanced and intensive integration scheme. The Central American Common Market eventually collapsed not only because of the political unrest in the area but also as a result of a series of other previously existing circumstances. Moreover, the Caribbean Common Market is weak and has almost ceased to function. Very little remains for two fundamental reasons: first, because the economically stronger countries never took regional and subregional integration very seriously (even Mexico, which had been very enthusiastic to start with, ended up by losing interest); second, because the manufactures of several of the larger countries were absorbed by the international market. Having established this relationship, it was much easier to export outside Latin America than it was to make the tremendous effort of trading with the rest of Latin America, a process that, apart from much red tape, meant passing through the Lima clearinghouse and being faced with tension and internal resistence. This is not the right place to go into an analysis of the integration problems of Latin America, but it is important to point out that there has been disintegration and a neglect of cooperation possibilities among the Latin American countries, although the formal

schemes were maintained.

Another significant aspect of the 1970s was that very conflicting short-term policies were introduced in response to the inflationary process. On one hand, the dimensions of the problem grew. It was not the same to cope with a rate of inflation of 10 percent as with one of 50 percent or more, or with an even higher rate compared to one of, say, 30 percent in previous years. This situation was aggravated by special or difficult external circumstances in many countries. For example, in the case of Mexico and Venezuela, the relationship of increased real expenditure (both investment and consumption) to the inflationary process was not fully realized. Several of the elementary aspects of Keynesian economic analysis were forgotten. The heterogeneous nature of each nation's economy, that is to say, scarcities, lack of productive capacity in many areas, excess capacity in others, and segmented labor markets, was not recognized either. Added to this, governments were incapable of controlling public-sector deficits and of undertaking appropriate tax policies for the implementation of an antiinflationary policy. In some countries where the rate of inflation was particularly high (Brazil, Argentina, and Chile), an acute crisis in short-term policy arose, although the attempted solutions to the problem were different. Brazil decided upon indexation, which was doomed to failure and collapse in the medium term, even with the minidevaluations introduced in order to aid exports. In Argentina and Chile, monetarist policies and exceedingly open economies, with overvaluation of national currency in relation to the dollar and European currencies, ended in failure, as they tended to repress the real economy and make revival of growth impossible.

Mexico and Venezuela, under excessive growth rates of real expenditure (in investment as well as in consumption), also made the mistake of maintaining overvalued currencies, which led to such gigantic current account balance-of-payments deficits that they had to resort to indiscriminate external financing, much of it short term. In the light of the well-known fact of Argentina's stagnant economy, as well as that of Chile (even though for a short period it showed a certain amount of growth), it is obvious that the appropriate balance between short-term and development policies was not achieved.

Yet another extraordinary phenomenon of the 1970s is worth noting: the sudden easy access to international bank loans, particularly from countries of the North, bypassing the multilateral financial agencies. At first there was a considerable flow of medium-term credit, with appropriate periods of grace and reasonable interest rates, for specific industrial projects and for creating infrastructure. Toward 1979 and 1980, a rise in international real interest rates occurred that coincided with

further balance-of-payments problems of domestic origin. At the same time access to short-term foreign bank credit, considered by many to have been rendered too easy, was taken advantage of injudiciously and was actually encouraged by foreign banks on the basis of their ample liquidity. This led to a situation that by 1982 had become supercritical, as the banks would not or could not renew the greater part of the shorter-term maturities.

To the critical financial factors must be added the continued political instability of many Latin American countries, or at least the existence of a considerable number of cases of repression in which the probability of change taking place sooner or later was high. The least that could result under these circumstances was restraint in domestic private investment, irrespective of what the public sector did to promote growth. The obvious contrast is Mexico with its political stability and regular six-year changes in government. There were in fact times when the private sector was inhibited, but with the oil boom and the euphoria that ensued in 1977-1981, the private sector also participated to excess in the expansion of the economy and, like the government, did not assess the overall economic prospects sufficiently. The private sector in Mexico also had access to foreign credit as never before and committed the very same mistakes as regards the indiscriminate use of short-term credit.[2]

Within this whole panorama there is a wide range of situations. It is hardly necessary to emphasize the special characteristics (which go a long way back) of Brazil, Mexico, Venezuela, and other countries. The cases of Argentina, Chile, and Peru and the pathetic cases of the Central American region each have distinctive features. Studies undertaken by the UN Economic Commission for Latin America (ECLA) tend to overgeneralize. For example, in recent studies (those that were used as the background for important meetings in 1983) and in the report signed by the executive secretaries of ECLA and of the Latin American Economic System (SELA) at the request of the president of Ecuador,[3] this excessive generalization is evident. For reasons that may be easily explained, the position of each country--or at least each major country--is seldom examined individually or is examined very superficially. The tendency to treat Latin America globally results in overlooking some of the most important events that are occurring in the region. In the statistics supplied by ECLA on "Latin America," at times one is not sure of the coverage of figures because occasionally two or three countries are omitted or some country or other may have been omitted for the purpose of the analysis. Of course, it may be assumed that the position of six or seven of the major countries, because of their combined GDP, is indicative of the overall picture, but there are

significant differences among them also.

DEVELOPMENT STRATEGIES FOR LATIN AMERICA

Let us now consider some of the strategic elements in the prospects for Latin America.

The first is related to the nature of industrialization in Latin America, which has not been analyzed or evaluated adequately. This applies to the most important country cases, as well as to the general characteristics and implications of industrialization undertaken within the context of an import-substitution policy, indiscriminate protectionist measures, and absence or insufficiency of planning. At the same time, the domestic market was left open to transnational corporations, which brought with them new technology and which produced goods that were important for the countries, such as tractors and electric motors, but also saturated the local market with a vast range of consumer goods--durables and others--for which the technology used has at times been excessive in relation to the basic needs of Latin America. A good example of this is the fourteen-speed blender made available to the middle-class housewife, when there are low-income families still using the traditional methods of grinding and mixing whose needs would be satisfied with a single-speed blender of the kind available twenty years ago. This kind of excessive "technification" of consumption designed for highly developed societies and introduced into Latin America has been a waste of resources, encouraged by commercial advertising and television. The diversion of resources to these areas reduces the amounts available to fulfill basic needs.

For the most economically important Latin American countries at least, overprotected industrialization gives rise to the problem of how to achieve the capacity necessary to compete on the international market, assuming the aim of exporting manufactures to the highly industrialized countries and to other parts of the world. Due to the employment created, this would be a valuable supplement to the export of basic products. This is a problem that should be analyzed further, as its solution will be essential to development strategy from now on.

A second aspect of industrialization is the real cost of energy. In countries endowed with abundant natural resources of this kind, the pace of industrialization has been maintained partly through subsidies for energy consumption by industry in several different ways: for example, by offering natural gas and diesel almost without cost (Mexico), applying subsidies to the cost of electricity (several countries), and creating very favorable transport conditions by subsidizing gasoline. These factors have been beneficial to industry, trade, and services. Nevertheless, these subsidies can no longer

be financed. The oil and electricity industries, and governments themselves, have had to back down and eliminate a large proportion of the subsidies. Even so, in Mexico in mid-1983, for example, the real price of oil products was barely one-fifth of the international price. This situation cannot continue for any length of time because it encourages neither the economic use of energy nor the introduction of changes in industrial equipment to substitute for that based on the use of cheap energy. Sooner or later even those countries with abundant hydrocarbon reserves will have to incorporate the real (opportunity) cost of energy into their development process.

Industrialization in Latin America has also been based on easily obtainable foreign technology, at least as far as the major modern industrial branches are concerned. This technology has been introduced and incorporated in the investment of transnational corporations or has been acquired through licensing agreements and contracts for the use of foreign industrial technology. A certain amount of control does in fact exist, and evaluations have been made of the cost of contracts. Restrictions have been established in some instances and a certain amount of leeway has been achieved in the restrictions imposed by the contracts themselves. However, technology substitution has been only slight because sufficient overall efforts have not been made to develop or adapt technology locally through public-sector research institutes and laboratories or by means of innovative research within enterprises themselves. Needless to say, there are exceptions in Latin America, and any one of us could mention some specific case of elaboration of technology or of adaptation of foreign technology for local use. Several Latin American countries also export technology. However, the technological foundations of Latin America itself are still very weak. What happens is that foreign technology is simply brought into the countries irrespective of its cost and of the harmful effect that this may eventually have on local scientific and technical development.

Latin American industrialization is also characterized by the lack of attention paid to medium and small industry. The greater part of industrial development has concentrated on the large industrial complexes, both private and public. Perhaps with the exception of Argentina, subcontracting to small business, as is done particularly in Japan and Europe, hardly exists in Latin America. Small industry is badly neglected from the point of view of technology, organization, financing, and the training of labor. This sector is also poorly organized as a whole. However, it could become a good source of employment, partly counteracting the labor-saving trends of big industry with its imported technology.

In considering development strategy, we must return to the agricultural sector and to the relationship of the rural to the urban industrial economy. There are, of course, cases of very prosperous farming and of very refined traditional agriculture, like the growing of coffee in Central America and Colombia. However, as stated earlier, there is no assurance of incentives for the farming sector as a whole. This does not mean necessarily advocating support for private farming as opposed to systems of communal land tenure and agrarian reform. It simply means that there must be incentives to encourage improved farming, the production of necessary foodstuffs, and the generation of adequate marketing, credit, and so on, for there is plenty of idle land and there are also outstanding examples of increased output and yields. In the majority of Latin American countries, however, farming performs badly. Perhaps Brazil has the possibility of exporting farm products and together with Argentina might help to solve the problem of Latin America's food deficit, although until now there has been insufficient evidence to support this idea.

The third factor in the development strategy that I would like to underline, which is related to the other two, is the problem of income distribution and the pattern of public expenditure in the face of social pressure that has had considerable influence on both. No matter how the distribution of income is measured, in almost all Latin American countries it is extremely uneven. Consequently, this situation does not ensure the creation of the large domestic market that has been the basis of industrial development in the major advanced countries. Inequality has its origin in the unequal distribution of property, differences in productivity and education, and many other factors, be they social, political, or whatever. As long as inequality exists, there cannot be an adequate domestic market. Moreover, the structure of public expenditure is unfortunately not making the creation of a large rural market any easier. Why? Because public expenditure in Latin America is organized on the basis of pressure from certain groups or vested interests, which is as far from any sort of planning as anyone could imagine. Large amounts are spent on education because this has to be done, for children must be sent to school and the system of education must be established and developed. But at the same time the quality of education at all levels has declined. Much is spent on creating infrastructure, sometimes with success, but more often with mediocre results and low productivity. Health budgets are large but most of the money is spent on enormous hospitals and very little on improving basic health, on preventive medicine, or on providing rural health care, which would help increase productivity and create future sources of income for the rural sector. And so on.

Quite apart from the vast and inefficient bureaucracies, public expenditure does very little to improve the distribution of income; in fact it may even make it worse. Military expenditures of many Latin American countries have a negative effect both domestically and on external accounts. There are studies that attempt to show that provision of education, health, and other services free of charge to low-income people partly compensates for their relative poverty. Nevertheless, this has not been proven; among other things, the tax systems, in the form of indirect taxes, fall more heavily on the income of poor families. The social-security systems, which are as expensive as in wealthy countries, are deficient in that sense and barely able to sustain themselves financially.

Among the strategic factors is also to be found the relative lack of good fiscal policies in the broader sense of including not only taxation but also the pattern of expenditure and the ways of financing budgets. Even during the booms, adequate fiscal reform ensuring a broad tax base, independently of the tax schedules established, has not been achieved. If introduced, it would at least cover the financing of current public expenditure. During the boom in Mexico during 1977-1981, the tax system became inelastic, for it was left almost untouched; indeed, on the contrary, enormous fiscal and other kinds of subsidies were granted.

Let us move on to what may be termed "slow-acting factors" that, taken together, become important to the whole prospect. We are used to thinking of any rate of 3 percent as being insignificant but, if this rate is applied to population, it means a doubling over a period of only twenty-three years. The birthrate in Latin America has in fact declined, as a consequence of socioeconomic and organizational factors and of deliberate family-planning policies. Birthrates are still high, however. In Mexico, for example, the number of births per thousand has fallen from forty-five, ten years ago, to thirty-one at the present moment. If mortality is calculated at seven per thousand, population growth is still 2.4 percent per annum. The fall in Latin American population growth has been achieved through the joint contribution of socioeconomic factors and policies established for this effect. However, this rate is higher than the average for Third World countries and has had, and will continue to have, repercussions as new cohorts stream into the labor market. In actual fact, Mexico's problem, which can be extended to Venezuela, Colombia, Brazil, and the Central American countries, is that despite economic growth, and assuming adequate patterns of expenditure, it is not absorbing into employment (nor is it capable of absorbing) the increase in the labor force. If we add to this the fact that women are increasing their participation in the work force--a

cultural and social factor--and that in many cases they are preferred for certain types of work, we see that a situation of permanent oversupply of labor is being created, reinforced by many other factors related to the rural economy, the continual introduction of labor-saving technology, and so on. Mortality will continue to fall, which is often forgotten. There are countries in Latin America where the infant mortality rate is very high, particularly in the vast rural areas. As the mortality rate falls, the real probability of achieving the same population growth as Europe becomes more and more remote.

Because of the nature of the educational system and other factors, including the rural origins of the labor force, the oversupply of labor will be mainly unskilled. This situation partly explains, in Mexico, the intense international migration of the labor force toward the north. A main attraction in this case is also the wage differential offered by the United States together with the demand for workers for certain specific occupations. Massive migration can also be expected from Central America toward Mexico and the United States, although economic incentives are obviously not the only cause. These are all long-term factors; we must not be influenced by what happened yesterday or last year but must take note of the trends. Concurrently, there has been very heavy internal migration, as in Brazil toward São Paulo, which will continue well into the future. In Mexico internal migration was effective while Mexico City and other industrial cities were able to absorb part of it. However, this process could become inefficient and even contribute to social instability in the future.

A new slow-acting, long-term factor is the environment. Eleven years ago in the United Nations Conference on the Human Environment, in Stockholm, a Brazilian delegate publicly declared that Brazil wanted pollution because it meant industrialization. The Brazilians obviously must now regret having made this statement and, in fact, have changed their policy. The impact of industrialization, urban concentration, and modern farming on the environment has begun to make itself felt, and solutions are bound to be costly. This is another real cost incurred as a result of development that the economy will have to absorb. There is no local solution to this problem, for the science and technology required to counteract the negative effects on the environment are not locally available, but must be brought in from abroad. There is no use stating that solar energy will replace hydrocarbons, for Latin America is far from being able to introduce solar energy on a large scale.

Another slow-acting factor that has both positive and negative aspects is the evolution of the educational systems. During a meeting of experts at the Inter-American Development Bank some years ago, an Argentine economist argued that by 1990 all school-age children in

Latin America would be actually enrolled in primary education.[4] However, the dropout rate is still very high in most countries. But he added that the sequel to this social evolution and population growth would be an eventual "university explosion." Unfortunately, this would be an explosion from the point of view of numbers and not of knowledge. Furthermore, it is doubtful whether there is a single case in Latin America where it could be stated that, in the last fifteen years, the standard of university education has not declined, despite modernization and the linking of teaching and research in some departments and postgraduate schools or institutes. Moreover, the overall level of research is very low. There are literate people, more educated people, more who have had technical education, and more people going through university. But there is something desperately wrong with the aims of the educational systems and with the quality of education and teaching, the libraries, the laboratories, and so forth. Apart from this, there are almost no scholarships, nor books, nor services.

Behind all this is the theory of human capital from which it is inferred, not always logically, that all investment in education is worthwhile. But one must also consider the real outcome of such investment, and this is a serious problem that cannot be solved in the short run, especially not in countries with the dynamic population growth that, as pointed out earlier, is characteristic of the majority of Latin American countries.

The lack of scientific and technological research constitutes yet another slow-acting factor, but one that is cumulative in the negative sense. We have been discussing this problem now for ten to fifteen years. We have at our disposal all the literature on the subject, all the national science and technology councils, and the influence of the UN Educational, Scientific, and Cultural Organization (UNESCO), the OECD, and other international agencies. However, the work done in science and technology in Latin America, particularly research, except for a few remarkable exceptions, is very poor. No country has ever reached a high level of development without concentrated efforts being made in research in basic science and applied technology. In Latin America we are still not doing this, even though there are a number of instances where considerable effort is being made.

Among the slow-acting factors there is also health. One needs merely to quote the figures for nutrition in Latin America: Roughly a third of the population--120 million people--is undernourished; in certain areas and certain countries the proportion is even higher. The incidence of undernourishment on disease; the lack of drinking water, waste-disposal services, and even elementary hygiene; overcrowding in urban dwellings and marginal urban areas; and contamination, all of which are

important elements in many large cities, contrast with the modern system of hospitals and the emphasis placed on curative as opposed to the expansion of preventive medicine. Although there has been an improvement and mortality has declined, the consequences of these problems are very important, especially the economic ones.

There are both positive and negative aspects in all the preceding questions. It must be emphasized that these are slow-acting factors. The 3 percent rate, sometimes considered to be insignificant, over a period of twenty years can become enormous and is capable of creating inflexibility in the systems and of altering parameters.

LATIN AMERICAN INTERDEPENDENCE

We in Latin America are faced with a problem of enormous complexity. We are not in the same situation as in the 1930s, exporting a few primary products, importing all kinds of manufactures, and having very few problems involving financial interaction with the exterior. Today Latin America is intertwined in a whole series of international and domestic complications, and a lack of data sometimes makes it very difficult to evaluate the situation. The fact is that we have become deeply involved in a system of interdependence (whatever the value judgment about this term). This is at least true for the major Latin American countries. Unfortunately we have never taken advantage of the real international context of this interdependence that could be used to our favor externally. On the other hand, we have utilized it to excess in the negative sense in, for example, external financing and the ease with which we have imported the necessary and the superfluous with these funds, even technology, while we have neglected long-term development strategy and technological substitution.

We are interdependent and vulnerable in this crisis of the last few years, in a completely different way than in the past. If we do not continue to act within this interdependence, we shall be unable to continue growing. This deserves more study and consideration.

THE PROSPECTS FOR LATIN AMERICA

Several remarks may be ventured in relation to the prospects. The deterioration of the external sector lends itself to a more interesting analysis by individual countries than for the region as a whole, due to the wide variety of conditions. There are countries like Mexico, Brazil, Argentina, Venezuela, and Chile, for example, that have a larger debt but a greater capacity to negotiate and come to terms with international agencies

and with creditors. Others, whose foreign debt per capita is large but whose aggregate figures are relatively small, are faced in any event with serious problems of liquidity and have a very reduced capacity to service the debt: Costa Rica is an example.

In this respect, to treat Latin America as a whole would appear to be particularly difficult, because it would probably lead us to adopt a very pessimistic attitude regarding the region's overall capacity to face the financial and external debt. However, if the problem is examined country by country, the external aspect is practically solved. Renegotiation, rescheduling of the debt, renewed confidence, and improvement in domestic policy have been achieved in order to face the problem. Mexico is an outstanding example. In the case of Brazil, there are still disagreements to be ironed out with the International Monetary Fund. Chile and Argentina are working toward a solution. A number of difficulties still persist in Venezuela. However, these aspects of the situation can be expected to sort themselves out, especially if economic recovery in the industrialized countries becomes steady. Undoubtedly, there will be very difficult problems for some of the smaller Latin American countries, but the outlook for the major countries should not inspire pessimism.

Unfortunately, I see no short-term prospects of reaffirming Latin American integration policies from the point of view of schemes for common markets, free-trade areas, and so on. Other aspects of Latin America cooperation that have been developed mainly through the SELA are still too weak. Some efforts have arisen as a result of the emergency situation but have not met with much confidence on the part of the major countries. However, bilateral or trilateral action could be undertaken among Latin American countries (in some cases this has been done), which may turn out to be important. Perhaps this is the course the major Latin American countries should take in the next few years in order to avoid the treaties, the agreements, and the rhetoric and to turn to real reciprocally advantageous action. (In the case of Central America this would depend on many other factors.)

In the medium term, what we should be worried about is Latin America's capacity to redefine its objectives as regards development, not necessarily for the region as a whole but more in terms of individual countries or groups of countries. These objectives would have to be long-range but would have to be expressed in medium-term programs, which in turn would have to be reconciled with short-term stabilization and adjustment policies currently being defined and being put into practice. Obviously, such policies have their difficult and even dangerous points, for all adjustments of the present type imply repressed expenditure, particularly in investment, which slows down economic growth, generates a high level of

unemployment, and forces large sectors of the economy to accept lower real incomes.

In my opinion, the most important problem facing us is how to reconcile the implementation of short-term programs, social agreements, and adjustments, with the resumption of former trends, or the 5 to 6 percent growth rate that Latin American countries were accustomed to, and at the same time to redefine the objectives related to development so as to avoid getting caught again in the same situation. Unfortunately, in most of Latin America this is not being tackled in a clearly defined way.

Let us assume that in the longer run, say over the next ten years, the economy of the industrialized countries picks up. The question is, at what rate? At present the rate of recovery is being exaggerated because it is being calculated from a very low base and from previous declines. If the medium-term GDP forecast for the OECD countries is 2 to 3 percent per annum, it is doubtful that this would have much effect on Latin America or other parts of the Third World, except perhaps to steady somewhat the prices of some basic commodities. It must not be overlooked that the industrialized countries themselves compete in the international market for basic commodities and that they are not overly concerned about protecting the interests of developing countries. The oil market would also not appear to indicate a future real price increase exceeding about 1 percent per annum over a period of several years. Therefore, the effects of the recovery of the developed countries on the trade of the developing countries--Latin America in particular--would probably not be very noticeable.

The consequences for the North-South relationship would be that Latin America would have to find a pragmatic course in order to take advantage of all the openings provided by the lowering of tariff and non-tariff barriers, the GATT, general preferences, and so on and to obtain special agreements with the European Economic Community (EEC), Japan, and others. It will be necessary to try and penetrate the barrier of protectionist restrictions and discrimination established by the northern countries. This would be an important aspect, not for global negotiations or for those on the New International Economic Order that have been the subject of so much rhetoric at the United Nations and in the Third World, but simply as part of the strategy of each individual country or group of countries. I do not feel that a "concerted Latin American effort" would work under current external conditions.

Second, we should explore even further the possibility of establishing links with the rest of the Third World, which is something that has been sorely neglected. There have been many cases of exports to African and Asian countries, of exchange programs and technical cooperation. But this potential has only just begun to

be explored and could be very profitable for the development of Third World countries. There is a tendency in Latin America, and even in ECLA, to act as if the rest of the Third World did not exist. We tend to forget that there is India, that China is important, that two or three of the African countries have great industrial potential, that Southeast Asia is fast growing, and that the Arab countries also show promise. It would be of considerable significance if specific posibilities for cooperation and interchange and for interrelation in trade, technology, financing, and other areas were to be found other than by the formal signing of treaties and agreements. The interrelation between countries of the Third World would place the latter within a strategy of self-reliance, but at present it has not gone beyond wishful thinking and rhetoric; that is to say, it has not materialized in the form of specific action. In the meetings of the nonaligned countries, in the Group of Seventy-Seven at UNCTAD, one fails to discover what is meant in practice by collective self-reliance or real cooperation among Third World countries. Similarly, what is said in certain regions, such as Africa, amounts to little more than declarations, signing of agreements, and so on, with very little application--as in Latin America today. Nevertheless, Latin America--at least those countries that are willing and capable of doing so--must make an effort to open up to the rest of the Third World, to selected countries in those areas, in order to benefit from the useful effects of interaction.

The framework for such relationships may seem pessimistic, but, at bottom, I do not feel that the South can expect very much from the North. The northern countries have their own structural problems and conflicts among themselves, massive unemployment, policies of recovery that may fail, and disillusionment over the cooperation with the South, despite the first and second Brandt reports (which do not appear to have had much impact). The industrialized countries are looking inward. We in Latin America, along with Africa and Asia, will have to do the same, for there is no alternative. We shall have to continue industrialization with import substitution, while paying closer attention to international competitiveness. We shall have to continue to protect ourselves in the presence of the GATT and the idea of economic openness coming from the North. We shall have to make a much greater internal effort, evaluate our problems more deeply, and stop expecting the solutions to our problems to come from outside. In this context, Latin America (one speaks in general terms but thinks, of course, of a few countries with larger capability) possesses the elements necessary for positive action, as is the case with many countries in Africa and Asia.

Lastly, there is the relationship between Latin America and the European socialist economies whose trade with Latin America has followed essentially the old colonial model of importing raw materials and exporting equipment (and very little else). Financing has been more in keeping with the interests of these countries and not with the needs of Latin America or the Third World in general. However, if these countries are able to limit their expenditure on defense and make their civil economy more efficient, they will also have the potential to participate in the selective interchange and relationship that Latin America could establish pragmatically, without the need for general agreements. It is a well-known fact that the socialist countries are also faced with structural problems in industry and other basic activities, as are the Western market economies. These are problems that they will have to solve among themselves and with the West, and they are more important than the problems they may have with the South, at least in the field of economic relations.

NOTES

1. See Víctor L. Urquidi, "América Latina y el Orden Económico Internacional: Población, Alimentos, Energéticos," Demografía y Economía, vol. 13, no. 4 (40) (El Colegio de México, 1979), pp. 393-404.

2. For data on the Mexican boom and its background, see Víctor L. Urquidi, "Perspectivas de la Economia Mexicana ante el Auge Petrolero," _Revista de Occidente_, no. 14 (Madrid, June-July 1982), pp. 45-64; also Víctor L. Urquidi, "Not by Oil Alone: The Outlook for Mexico," _Current History_, vol. 1, no. 472 (February 1982), pp. 78-81, 90.

3. Carlos Alzamora Traverso, for SELA, and Enrique V. Iglesias, for CEPAL (Comisión Económica Para América Latina), _Bases para una Respuesta de América Latina a la Crisis Económica Internacional_, United Nations, Economic and Social Council, Doc. E/CEPAL/G.1246, May 16, 1983.

4. José Dagnino Pastore, "Nivel y Estructura de los Costos y del Financiamiento Educativo en Latinoamérica," in Mario Brodersohn and María Ester Sanjurjo, _Financiamiento de la Educación en América Latina_, México, 1978, pp. 144-197.

3
The International Scene and the Latin American External Debt

Luciano Tomassini

The force with which the current international crisis has hit Latin America and the region's high external debt are, fundamentally, consequences of the changes that have taken place in the international system over the last fifteen years and of the transformation of the Latin American economies and societies, including the changes in the ways in which they both participate in the world economy. The situation is also undoubtedly a consequence of the domestic policies followed by these countries in recent years; however, these policies represent a response--right or wrong--to the new conditions prevailing during this period on both the regional and the international scenes. The external indebtedness of these countries may be viewed as a variable that depends on other, more far-reaching factors. This means that the causes of the phenomenon may be interpreted in a variety of ways and, moreover, that more comprehensive, longer-term solutions may be sought than when only financial considerations are taken into account.

Since the late 1960s the rigidly hierarchical world that emerged from World War II, where international relations revolved around the concept of security, has begun to be eroded by a strong trend toward a fragmentation of world power and a vigorous process of transnationalization. As a result, the interests of the various national societies now overlap each other in an increasing variety of ways, thus promoting the flow of international relations. The international economic crisis, the first symptoms of which go back to the late 1960s, altered the evolution of productivity and the traditional distribution of specializations in the industrialized countries, putting an end to the cycle of unprecedented expansion of the previous twenty years and paving the way for the producer countries to raise the price of oil; this in turn led to a large surplus of liquidity and created a climate of extraordinary international financial permissiveness. In the meantime, some of the developing countries, including the larger countries of

Latin America, progressed more rapidly than others, achieving an intermediate stage of development and becoming more closely involved in the international economy. This made it possible--and even inevitable--for them to take advantage of the opportunities and assume the risks posed to them by the international environment much more intensely than in the past. This explains why the current international economic crisis has had such an unusually strong impact on the Latin American countries, far greater than the impact of the crisis of the 1930s, at which time these countries were in a much better position to disconnect themselves from the external cycle.

This chapter includes an analysis of the changes that have occurred in the international system, the characteristics of the current world economic crisis, and how the Latin American countries have been exposed to these factors as a result of the transformations they have undergone during the past few decades. In the last section, some conclusions are drawn with regard to the causes and characteristics of the external indebtedness of Latin America, and finally, some extremely tentative suggestions are made regarding possible responses to that problem in the light of the aforementioned analysis.

THE TRANSFORMATION OF THE INTERNATIONAL SYSTEM

The international system that emerged from World War II and lasted until the late 1960s has since then undergone a complete transformation.

During the immediate postwar period, the structure of world power was rigidly hierarchical and bipolar and was strongly influenced by the cold war. That structure began to change significantly as a result of (1) the relative decline of U.S. power; (2) the appearance of tensions within the trilateral system and, in particular, the Atlantic alliance; (3) the internal difficulties experienced by the Soviet bloc and the exhaustion of the model it represented; and (4) the increasing development and external projection of certain Third World countries and the trend toward fragmentation of the international system, a phenomenon that makes it necessary to seek formulas for collegiate management of the system.

According to the "new orthodox" school of thought,[1] the power of the United States in the world declined sharply during the 1970s, particularly vis-à-vis the Soviet Union and the Middle East; this may explain the concern revealed by the fact that in 1980 "a 42% plurality of Americans named foreign policy as the 'most important problem facing the country today'--ahead of the economy and substantially ahead of energy concerns."[2]

Paradoxically, the decline of U.S. power has gone hand in hand with the appearance of a profound malaise in the socialist camp. Although Soviet military power has

increased at a rapid pace so that it is at least comparable with that of the United States, looked upon from a longer-term structural point of view, this increase may be a sign not of strength but rather of weakness. The instability of the Soviet presence in the Third World, the invasion of Afghanistan (considered a defensive measure that the Soviet empire had to take on its own border), and the strong challenge that Poland represents for the survival of the political and social system on which the entire Soviet bloc is built are matters that raise very serious questions that have not yet been adequately weighed.[3] To these are added the difficulties that the Soviet economy has consistently had to face, both as regards its food base and as regards the production and distribution of consumer durables and the urgent need to acquire Western technology.[4] The Soviet model as an alternative for the construction of other societies, particularly in the Third World, would appear to be vanishing amid the frustration of the populations of the socialist countries and the growing militarization of those regimes.

The tensions that have arisen within the trilateral system constitute another factor of change. The most recent indication of this may be seen in the conflicts that have arisen within the Atlantic alliance. The fact that the United States has unilaterally substituted a new version of power politics for détente has alienated its European allies. It should be remembered that détente has produced positive results, in both economic and political terms, for the Europeans, but not so much for the United States. Moreover, the globalism of U.S. foreign policy is incompatible with the European approach, according to which détente can be "divided," depending on which questions and regions are at stake. The conflict generated by the Soviet gas pipeline issue reflected this tension.[5]

The emergence of the Third World on the global scene, around the middle of the postwar period, constitutes a new factor of instability and change. Today this group is represented by over one hundred countries, half of which became independent during this period. Many of them have reached intermediate stages of development and have promoted accelerated industrialization processes, thus becoming more closely integrated in the international system. The movement of nonaligned countries, the Group of Seventy-Seven, and OPEC have come into being, and the newly industrializing countries (NICs) are now an essential part of the world economic and financial picture. The viewpoints of the various regions of the developing world must now be taken into account in the management of international relations while conflicts of regional origin are increasingly affecting the stability of the world in general. This latter circumstance is aggravated by the repeated attempts

of the two superpowers to view these situations within the context of the East-West conflict.[6]

All these factors have brought about a phenomenon of "diffusion of power," giving rise to a more interdependent but also more fragmented world. This new structure of world power presents the developing countries--and especially the Latin American countries--with a complex balance of limitations and opportunities.

These trends have led us to the point where we are moving from a world dominated by strategic security considerations and by confrontation between the two superpowers to a world characterized by a certain degree of détente and by an atmosphere that is more propitious to the pursuit of other interests--economic, technological, social, ecological, and cultural--in relations between nations. To the fragmentation of world economic and political power are added the increasing complexity and dispersion of strategic conflicts. This process has also been stimulated by the appearance of global problems--such as energy, the environment, stagflation, or external indebtedness--on the solution of which depends the welfare of ever-larger sectors of the national societies.

These societies in turn are also undergoing transformations. The prolonged period of economic growth, social development, and democratic strengthening experienced by the industrial societies during the postwar period has steadily raised the standard of living and promoted the strengthening and diversification of the civil societies of these countries. Under pressure from their societies, the national states have committed themselves to a wider and wider range of objectives that include, in addition to national security, economic development, the raising of incomes, the maintenance of employment, the preservation of the environment, and the protection of the cultural identity and quality of life of the society concerned. These objectives have become a decisive force in the external relations among states. At the same time, as the civil society has grown and become articulated into many different interest groups, the latter have aspired to take into their hands an increasing proportion of the issues that concern the community. As responsibilities have been transferred from the state to the civil society and nongovernmental groups have therefore proliferated, in a world in which the performance of such responsibilities depends more and more on international factors, these groups have often had to seek the satisfaction of their interests at the external level.[7]

These new trends, which may be seen at both the worldwide and the national levels, reveal the fact that a transition is underway from the international system dominated by the concepts of "power" and "security" that generally prevailed during the immediate postwar period to one based on "interdependence" and aimed at maximizing

the domestic welfare of national societies.[8]

The "realistic" approach to international relations that prevailed earlier during the postwar period was based on several assumptions. The first was that international politics were centered on the interests of the superpowers and that the smaller states should align themselves with one or the other of them; this gave rise to the formation of blocs or spheres of influence within which the hegemonic power settled conflicts and imposed a certain order. Relations between the blocs consisted of a precarious coexistence governed by certain rules. The second assumption was that national societies were relatively simple units from the standpoint of their external projection, with their actions depending on a limited number of objectives, which were usually subordinated to the need to maintain peace and security. The third assumption, one that followed from the first two, was that the agenda of international affairs was limited to a small number of items and that these were ranked according to a rigid order of priorities, with the question of security indisputably holding the first place. The fourth assumption was that the agents acting in international life were basically homogeneous and that they were represented by national states that did not recognize the legitimacy of any other agents having the capacity to act between or within states. It is not surprising that the fifth assumption was equally limited in that it held that the repertory of ways in which a state could use power to influence another state was limited mainly to political and military matters and that the arenas in which such power could be deployed were also limited, well defined, and well known.

All these assumptions were called to question as a result of the newly emerging trends. At this point one might venture to propose the hypothesis that, contrary to the case in the past, (1) international relations are currently run by a growing number of centers of power; (2) the external action of these centers of power is aimed at meeting a much broader range of objectives than in the past; (3) the agenda of international affairs is more diversified, more complex, and less hierarchical; (4) international matters are managed by many new state and private agents; and (5) these agents can use power resources in a large variety of nontraditional ways and in a much wider range of arenas that are more likely to change and to be interrelated than before.

These trends have given rise to a new type of transnational system in which one may reconstruct the structure and operation of many "spheres," "games," or "circuits" that operate on the basis of the hypothesis just described, using the agents and power resources contained in it and that link in many new and diverse ways the different national societies in the pursuit of a wide range of specific interests. From this perspective,

one might postulate that transnationalized circuits have arisen in the fields of energy, food, industry, technology, finance, strategy, science, ideology, culture, and religion. Each of these circuits has certain very specific features. The conditions under which the different countries have access to each of them and a country's relative position within a circuit do not depend exclusively on its position within the international hierarchy (whether in the context of the East-West conflict or of North-South relations) but rather on its relative position with respect to the interests at stake in the circuits and to the division of labor established within each circuit to attain these interests.[9] The international structure is becoming more fluid and interdependent, but paradoxically it is also becoming more fragmented and unsettled. The crisis with respect to the development style prevailing in the industrialized countries, discussed next, tends to accentuate this trend. Within this scenario, the developing, and especially the Latin American, countries that are more integrated in the international system have become more vulnerable to external influences even though at the same time their maneuvering room has expanded, so that they must juggle a complex set of risks and opportunities.

THE CRISIS IN THE WORLD ECONOMY

The prevailing postwar style of development, which was based on the ideology of modernization and growth and on the global projection of such a model through the demonstration effect brought about by the transnational corporations and their supportive institutional apparatus, was made possible by the international structure that prevailed during the early postwar period. The main features of this structure were the hegemony of the United States and the predominance of considerations centered on the maintenance of that nation's strategic security, as well as that of the other countries with which it had defense commitments within the context of the cold war. This international structure made possible the extension of a development style that both expressed and promoted the interests of the United States and, as time went on, of its main allies. As the structure of the international system broke down, so did the attempt to expand and disseminate the development style developed by its central power.

Hence, since the late 1960s the world economy has entered into a state of profound crisis. There can no longer be any question that the crisis is structural--rather than merely cyclical--in nature. It has dealt a serious blow to the developing world, particularly to the Latin American countries that had become more integrated in the international economy. The first manifestation of

this crisis took place in the ecological foundation of the economic growth process; it later became evident that the crux of the problem was the industrial transformation of the advanced societies; finally, and over the shorter term, the virulence of the crisis was fully manifested in the financial disequilibria that occurred at the world level and that have had a particularly strong impact on the developing countries, especially in Latin America.

Although according to this hypothesis the breakdown of the prevailing postwar development style stemmed from the industrial transformation of the advanced countries, it must be stressed again that the first signs of the problem were to be found in the disequilibria that affected the ecological base. These disequilibria were caused, among other things, by the recent trends in population growth, the various factors limiting efforts to increase foodstuffs' production, the uncertainty and increased costs involved in the supply of energy and industrial raw materials, the problems posed by the excessive concentration of industrial growth in a few geographic areas, and the threat of environmental pollution, generated fundamentally by the high density of urban population and economic activity.

The first report on these issues, published under the sponsorship of the Club of Rome, started a debate that gave rise to a number of reactions at the theoretical level. The decisions adopted by OPEC in 1973 in respect to international oil trade sounded the alarm at the level of reality.[10]

Thus, it began to be recognized that the rate and concentration of growth in the large industrial centers had taken place at the expense of the environment, the natural resources base of economic development in general, and the countries' ecological capacity to sustain productive activity. An awareness arose of the physical limits to economic growth.

In the final analysis, the awareness that such limits did exist was one of the signs that the advanced societies were reaching the frontiers of their postwar industrial development. "The crisis of the world economy is above all an industrial crisis," begins one of the most recent reports on the world economy's prospects, written from a European viewpoint.[11] One might argue as to whether the weakening of the momentum of industrial growth that has been evident in recent years in most of the developed countries is leading to a postindustrial society or to the industrialization of services, in which this tertiary sector will become the moving force behind economic growth and ensure the dissemination of the technological transformations on which the progress of these societies is to be based. One may also argue as to whether the world economy has entered a prolonged stage of slow growth or whether the rapid adoption of technological changes already underway will lead it to

recover its past dynamism. One may attach a great deal of importance to the limitations imposed by the supply of energy and natural resources or may take an optimistic view of the potential of recent technological developments in connection with energy and the production of new materials. Whatever the predictions may be with regard to these questions, the fact remains that world industry is going through a profound transformation, that recent technological advances are very important, and that humankind is on the threshold of an industrial revolution the like of which has not been seen since the late eighteenth century.

The extraordinary growth of international trade during the early postwar period was fundamentally the result of the increased demand for those consumer durables that made it possible to adopt the "American way of life" --and to spread it all over the world, a demand met by increasing specialization among the industrialized countries in accordance with Ricardian principles. Thus, each country attained a predominant position on the market in certain industrial sectors, and this situation led to constant price increases. These, along with the reconstruction of Europe and the emergence of Japan as a great industrial power, stimulated competition and transformed the range of specializations already achieved by the different countries. At the same time, the growth of the demand for durables that had been the basis for the development of the more dynamic industries during the immediate postwar period began to weaken toward the end of the 1960s and was followed by a substantial contraction, while the composition of the demand changed as the markets for durables became saturated.

A factor contributing to this was the change in the preferences of the public in a growing number of social sectors as a result of the profound sociocultural transformations that have been changing life-styles in the industrial societies that have led to the spreading of attitudes attaching less importance to having more of the same and more oriented toward values relating to the quality of life. These trends have been associated with the decline of productivity in the industrialized countries, the fall of investments and the reduction of the profitability of enterprises, the appearance of idle capacity in a growing number of industries, the slowdown in the rate of technological innovation, the increased operating costs of systems of production and of societies themselves resulting from increases in wages and in public expenditures, and, in general, the loss of competitiveness in an ever-greater number of productive activities.

The aforementioned process of transnationalization, which allowed for the extension of the prevailing postwar development style, also allowed for the subsequent changes in the market structure, in the pattern of technological

innovation, and in the form of organization that world production began to adopt in order to adjust to those changes. Here there tends to be a new international division of labor; although its future shape cannot yet be clearly perceived, it is already causing conflicts among developed countries and could alter the ways in which the developing countries have traditionally participated in the world economy.

The developed countries had to make major adjustments in order to cope with these changes. The adjustments were even more painful in the case of the developing countries that had become more integrated in the world economy. They had dependent and precarious economic structures and lacked resources to palliate the negative effects of the crisis on their economic growth or to finance the transformations the crisis made necessary. Both types of countries tried in different ways to make these adjustments as smooth as possible by making massive use of external financial resources. This was possible because of the extraordinary liquidity of the world economy from the beginning of the 1970s, when after almost half a century a rebirth of the private financial markets began as a result of the weakening of the dollar and of the accumulation of surpluses by OPEC countries.

THE TRANSFORMATION OF THE DEVELOPING COUNTRIES

The remarkable growth rates of an increasing number of developing countries throughout the last twenty-five years and their gradual integration into the international economy have given rise to profound changes in their economic, political, and social systems, as well as in their relations with the industrialized countries. As has already been noted, in the early 1950s no one had much hope that the development of the countries of the periphery might be brought about by stimuli from the external markets and go hand in hand with their gradual integration into the world economy. Instead, it was argued that they should promote industrialization policies based on import substitution together with mechanisms aimed at regulating the international markets for raw materials.

During the early stages of industrialization, many developing countries tried to replace imports of manufacturers by domestic production, particularly in the case of Latin America. Import substitution was aimed at increasing the proportion of national consumption that was satisfied by local production. One of the immediate reasons for adopting this strategy was that the developing countries were experiencing chronic balance-of-payments crises because of the structural situation of external strangulation in which they found themselves. This strategy was also in line with the long-term political

objectives of the national governments. On the one hand, it was hoped that import substitution would make it possible to reduce outlays in foreign currency and increase the autonomy of those countries. On the other, the governing elites found that the demands of certain social sectors whose bargaining power was increasing as a result of the development process itself could be satisfied by applying a policy designed to encourage simultaneously growth, income distribution, and employment.

To the extent that domestic demand allowed for the creation of new industries that might some day--and this consideration has now become a very important one--be able to compete with the external producers displaced, it was possible to justify the levels of protection applied with the arguments that had been put forth in favor of infant industry in the past. Naturally, to the extent that this condition was not met, the import-substitution strategy was bound to come up against serious limitations. In other words, industry had either to begin to generate the foreign exchange required for its subsequent development or to adjust its growth rate to the availability of foreign exchange generated by primary production, which in certain cases had been given second priority in the context of these economic strategies. In practice, what usually happened was that imports of consumer goods were replaced by imports of capital goods and inputs required for the operation and expansion of the new industrial parks.

In time, many countries acknowledged that the tendency to use foreign exchange without generating it was not inherent to manufacturing, and one after another they reached the conclusion that they should place less emphasis on protection and more on efficiency, competitiveness, and export promotion. Since the mid-1970s (and even earlier in the case of island states or entrepôt city states that had no alternative) many countries have begun to try out, at different rates and in different ways--some of them clearly exaggerated, as in the case of some Latin American countries--new strategies based on the liberalization of the domestic market and the opening up of their economies to the exterior.

Although this transition has often been portrayed as a struggle between rival schools, the perspective of time has now enabled us to realize that these stages should not in fact be considered as alternatives, but rather as complementary processes. For many Third World countries, the import-substitution strategy was the only option available at a given historical moment, in light of the stage of development at which they found themselves and the existence of an adverse external situation. In many cases, import substitution provided a basis not only for industrialization but also for the consolidation of a country's national identity. Moreover, not only did they not see at the time any essential conflict between

producing for domestic and external markets, but their domestic markets often served as a springboard for reaching the international markets. Although it is true that the growth strategies and forms of external relationship of the developing countries did subsequently undergo changes, it is no less true, as the Brandt Commission's report pointed out a few years ago, that these changes did not take place overnight:

> They cannot accomplish these changes suddenly; but since the 1960s many developing countries have moved towards strategies to promote exports and to offset disadvantages due to the insulation of their domestic markets. . . .
>
> A number of countries which have introduced export-oriented policies have been able to exploit their comparative advantage in world markets. They include some Latin American countries with a fairly long history of national independence, and some island and city state economies which were from the outset obliged to rely on export demand. Once industrialization has taken root, it is not only in labour-intensive industries like clothing or leather products, but also in moderately capital-intensive industries like electronics, steel and shipbuilding, that they can become highly competitive in world markets.[12]

As a result of the implementation of the strategies, as the same report mentions, all in all manufactures are looming much larger in the total exports of developing countries. In 1955 they made up only 10 percent of their nonfuel exports; ten years later they were 20 percent; and in 1975 they passed 40 percent.

This growth of exports evidently reflects more complex transformations in the economies that have reached intermediate stages of development, although it is true that this growth was concentrated in a limited number of countries. In view of the above, I must comment, even though in general terms, on the increasing differentiation that has occurred in recent years among the countries of the periphery and on the situation of the developing countries that are at an intermediate stage.

The literature on the subject has proliferated in recent years. The first report on the evolution of the international economy, prepared by the World Bank in 1978, provides a useful, although controversial, point of departure for a discussion of the question:

> The developing countries have grown impressively over the past twenty-five years: income per person has increased by almost 3 percent a year, with the annual growth rate accelerating from

> about 2 percent in the 1950s to 3.4 percent in the 1960s. Contrasted with what little can be gleaned of the experience of these countries before 1950, this is a substantial improvement over the historical record. Moreover, it compares extremely favorably with the growth rates achieved by the now developed countries over the period of their industrialization.[13]

The report went on to note, however, that there had been marked differences in the performance of individual developing countries in this period: "Growth rates have generally been lower in the low income countries of Africa and Asia, where the majority of the world's poor live. In countries accounting for half the population of the developing world, income per person has risen by less than 2 percent a year."

It must be borne in mind, therefore, that the developing countries differ greatly as regards the size of their economies, their income levels, their resources, their economic structures, their organizational forms, their technical capabilities, and their links with the world economy. Thus, a legitimate distinction may be drawn, at least, between: (1) the oil-exporting countries, (2) countries that are at intermediate stages of development, and (3) the less developed countries, or low-income countries, that make up the so-called Fourth World. There are also great differences among the low-income countries: In this regard, the World Bank has established a distinction between mining economies and predominantly agricultural economies.

The World Bank report used per capita income as the fundamental indicator for distinguishing between the latter two categories of countries. Other analyses take into account, in addition to per capita income, the share of manufactures in total exports, the per capita value of industrial exports, and the share of "complex products" in such exports. "Simple" industrial products usually include textiles, clothing and footwear, and chemicals that are obtained mainly from the elementary processing of other primary products; all other industrial goods are considered "complex."

The fact is that in recent years some Latin American, Asian, and southern and eastern European countries have rapidly emerged as producers of manufactures that are very competitive on the international market. This phenomenon, sometimes described as "the emergence of two or three Japans" in the field of trade, is becoming increasingly important. In Anglo-Saxon literature, these countries are referred to as newly industrializing countries (NICs). OECD includes in this category Hong Kong, South Korea, Singapore, Taiwan, Brazil, Mexico, Portugal, Turkey, and Yugoslavia. A United Kingdom Foreign and Commonwealth Office report entitled _The Newly Industrialising Countries_

and the Adjustment Problem, published in London in 1979, also lists the Philippines, India, Iran, Malaysia, Pakistan, Thailand, Argentina, Spain, Greece, Israel, Malta, Hungary, Poland, and Romania.

A feature common to all these countries is that they all have a substantially higher growth potential than the less developed countries and consequently have more opportunities for raising the living standard of the poor; these opportunities are not exclusively concentrated in the rural sector. Another feature of these countries is the high growth rate of their industrial exports over the last fifteen years and their increasing access to international credit in the most recent period. This means that their development is much more dependent upon international trade and the world capital markets than that of the poorer countries and that their economies are much more sensitive to trends in the industrialized countries.

It is not surprising that in order to maintain their economic growth or to palliate the impact of the international crisis on this process, some of these countries should have required substantial external financing, on the one hand, or that they should have obtained access, to an unprecedented degree, to the international capital markets, on the other. At the same time, it must also be noted that because of the defects in their accumulation processes and the social inequalities inherent in their political systems, the public and private sectors of many of these countries used this external credit inefficiently and inequitably and considerably aggravated the consequences of their external indebtedness.

THE EXTERNAL INDEBTEDNESS OF LATIN AMERICA

The above-described changes in the international system provided the necessary, although not sufficient, conditions for the Latin American countries to reach such a high level of external indebtedness.[14]

Indeed, throughout the last ten years, the external debt of the Latin American countries rose more than tenfold, reaching a total of around US$300 billion, a figure that represents almost half the external debt of the developing countries as a whole. From another point of view, one might say that whereas in 1970 the external debt of the Latin American countries represented a little under 12 percent of the gross domestic product of these countries, toward the end of 1982 it represented 30 percent of that product. At the same time, as a result of the combined effect of the increase in the level of the debt and the increase in interest rates, the service of the debt, which in 1970 represented around 7 percent of the value of exports, represented almost 40 percent of the value of exports at the end of 1982. Moreover, since most of the new credits obtained by the Latin American

countries came from private sources, the repayment terms were much shorter than ten years earlier, so that the short-term external debt became dangerously higher than the amount that might reasonably be expected to be incurred in connection with the financing of trade. It should be remembered that, whereas in the early 1970s around 80 percent of Latin America's external financing came from public sources, at the beginning of the 1980s exactly the same proportion came from private sources. It should also be borne in mind that since most of these debts are subject to fluctuating interest rates, it has been impossible to make any forecasts at the time of signing the loan agreement about the future service costs that in the late 1970s have shot up abruptly. At more or less the same time as the flows of direct foreign investment to Latin America have fallen, Latin American countries found themselves in the sudden financial squeeze.

The level and characteristics of Latin America's external indebtedness may be explained by both international and domestic factors, the relative weight of which is very difficult to assess as yet. On the one hand, the fact that this external indebtedness has affected countries that have followed very different economic policies would seem to underline the importance of external factors in explaining the phenomenon. On the other, the circumstances that the external sector of Latin America seems to have been affected more than other developing regions that had achieved a considerable degree of integration in the world economy, such as Southeast Asia, would seem to indicate that domestic policies had a great deal to do with what happened in Latin America. Still it must be kept in mind that the Latin American countries have very distinct economic, social, and political structures and hence are very different as regards their capacity to adjust to the external cycle.

It is worthwhile noting three of the factors that led to such an abundance of external resources during the past decade. The first has to do with the impact of the two large oil-price increases and the resulting accumulation of financial surpluses in the hands of the OPEC countries, which had to be recycled by the private banks. The second is related to the fall in the rate of investment and the application of anti-inflationary monetary policies by the main industrial countries, in the context of a protracted period of recession, which meant that these countries could not absorb surpluses as dynamically as they had been able to do in the past. The third has to do with the fact that the strengthening of the role of the private banks and the increasing use of mechanisms such as syndicated loans obtained on the Eurocurrency market (which accounted for over 90 percent of capital flows to the developing countries during the last decade) led to a lowering of standards for creditworthiness.

This is because these markets operate on a global scale and feel that, at that level, they do not need to analyze specific operations very carefully; it was therefore possible to increase operations dramatically, lowering costs in exchange for risks that are now coming to light in very complex ways. The fact is that during the 1970s the banks competed for customers to whom they could loan their surpluses and that previously ineligible clients, including the relatively more advanced developing countries, became eligible for loans.

At the same time, the demand for international credit in the Latin American countries rose abruptly as a result of the aforementioned trends. Many of these countries had to undertake considerable changes in order to adjust to the shifting conditions of the international economy--whether to meet the higher cost of oil or to penetrate the markets more efficiently--while at the same time they had to press on in their struggle against inflation. That is why many Latin American countries tried during this period to transform their economies, revising the incentives offered, their tariff policies, and their financial, tax, and social-security systems, among others. In the process, enterprises had to seek credit, either to stay in the market if they had been unfavorably affected by the changes or to expand if their competitive position had improved. This generated pressures that raised domestic interest rates and created a strong incentive to obtain credit abroad, where interest rates were more favorable. The demand for external credit rose to unprecedented levels as a result of the increased public expenditure that some Latin American countries undertook in order to finance expansion plans based on projects that were either subject to a long period of maturity or very large in scale, particularly in the case of the oil-exporting countries. In other cases the excessive expenditure of the private sector, a process that was accompanied by a strong preference for consumption and a deterioration of the investment process, brought the demand for external credit to formerly unknown levels.

The development strategy based on external indebtedness that was followed by the Latin American countries during that period seemed reasonable at the time because the loans were granted on very flexible terms and at negative or very low real interest rates and long maturities. In fact, this strategy made it possible to palliate for some time the impact of the international recession on the Latin American countries and for most of the past decade enabled them to grow at a considerably higher rate than the industrialized countries. However, the advocates of these careless policies of external indebtedness underestimated the risk that fluctuating interest rates and short maturities might raise the cost of servicing the debt above and beyond the short-term

repayment capacity of the countries concerned, reversing the trend toward permissiveness of the international banks and beginning a period of expensive and restricted credit.

The risks implicit in such situations were aggravated by the surprising lack of regulation of the international financial markets during this entire period. As has been mentioned, the international private banks played a major role in recycling the financial surpluses accumulated during those years, whereas the role of the international financial institutions was drastically curtailed. For example, International Monetary Fund financing, which in the 1960s was equivalent to 16 percent of the value of world trade, in the late 1970s only represented 3 percent. Likewise, in the case of Latin America, loans authorized by the Inter-American Development Bank, which had amounted to the equivalent of 25 percent of the deficit on current account of those countries during the period 1965-1970, dropped to 11 percent during 1975-1980, and the World Bank's share dropped from 21 percent to 12 percent between those two periods. The deterioration of the role of public agencies in providing external financing for Latin America had very serious implications, inasmuch as, when faced with the crisis, the international private banks proved to be very unreliable and to lack vision: They cut down on credit and, taking advantage of the fact that the debtor countries were forced to renegotiate, shortened maturities and increased the cost of loans (i.e., raised interest rates and commissions) precisely at a time when the debtors were experiencing difficulties and despite the fact that the renegotiations reduced the banks' risks.

This leads to a final observation--one that is directly related to the purpose of this chapter--concerning the links that exist between the external indebtedness of Latin America and the general trends of the world economy and of world politics. I am referring to the responsibility that the international community should assume with regard to the debt problem. So far, the search for ways of dealing with the crisis has been left almost entirely to the creditors, while national monetary authorities and international financial institutions have played a very limited role and other sectors, either economic or political, have been virtually excluded. In referring to the interests involved in the crisis, U.S. Secretary of the Treasury Donald Regan pointed out the following:

> It is right for American citizens to ask why they and their government need be concerned about the international debt problem. Why should we worry if some foreign borrowers get cut off from bank loans? and why should we worry if banks lose money? Nobody forced them to lend, and they should live with the consequences of their own decisions like any other business. . . .

> If all the U.S. government had in mind was throwing money at the borrowers and their lenders, it would be difficult to justify using U.S. funds on any efforts to resolve the debt crisis, especially at a time of domestic spending adjustments. . . . But of course, there is more to the problem, and to the solution. First, a further abrupt and large-scale contraction of LDC [less developed country] imports would do major damage to the U.S. economy. Second, if the situation were handled badly, the difficulties facing LDC borrowers might come to appear so hopeless that they would be tempted to take desperate steps to try to escape.[15]

It must be recognized that the current situation is a consequence not only of the policies applied by the debtor countries but also of the inconsistent behavior of private sources of financing that was aggravated by the lack of regulation of the international financial markets. Hence, it must also be acknowledged that the entire international community is responsible for dealing with the crisis.

In the first place, in the future the servicing of the debt will have to be scheduled in accordance with the requirements of the development processes of the debtor countries and the exigencies of world economic recovery; to this end, the renegotiation of existing loans or the granting of new international loans must be carried out with these objectives in mind. In the second place, the disposition of private bankers to operate with borrowers in the developing countries must not be subject to sudden changes; to this end, the banks should work in closer contact with the debtors themselves, with the monetary authorities of their own countries, and with the international financial institutions. Finally, measures must be taken to enable these agencies to work effectively to ensure the necessary compatibility between international financing and the reasonably smooth behavior of the world economy, without neglecting the role of the developing countries in it.

In this regard, it is essential to strengthen the link between financing and trade, which has been seriously weakened by the deterioration in recent years of the terms of trade for most Latin American export commodities, by the strong protectionist measures adopted by the developed countries, and by the general breakdown of the rules that governed the system of international trade. Helmut Schmidt, former chancellor of the Federal Republic of Germany, had this to say on the subject: "Credit creates trade, trade secures credit. Major developing countries balance-of-payments problems cannot be cured if we shut our markets to them. In many respects the developing countries are now in a position similar to

that of the German Reich in the 1920s: Germany could not meet its 'reparation' payments because the allies were not prepared to tolerate German trade surpluses. So Germany could not meet its debt repayments and lost its credit-worthiness."[16]

It is to be hoped that, given the present circumstances, the international community will be more far-sighted about Latin America and the rest of the developing world than it was about Germany after World War I and that it will thus be able to prevent the social disorders that would inevitably break out, albeit under new forms, if greater pressure were to be put on the debtor countries.

NOTES

1. So called by Stanley Hoffmann in the New York Review of Books, April 16, 1981. In this regard, see also Robert W. Tucker, "The Purposes of American Power," Foreign Affairs, vol. 59, no. 2 (Winter 1980) and his "America in Decline: The Foreign Policy of 'Maturity,'" Foreign Affairs: America and the World 1979, vol. 58, no. 3 (1980). See also: International Institute of Strategic Studies (IISS), Strategic Survey 1980, London, 1981.

2. D. Yankelovich and L. Kaagan, "Assertive America," Foreign Affairs: America and the World 1980, vol. 59, no. 3 (1981).

3. See S. Bialer, "Poland and the Soviet Imperium," Foreign Affairs, vol. 59, no. 3 (1981); and S. Bialer and J. Afferica, "Reagan and Russia," Foreign Affairs, vol. 61, no. 2 (Winter 1982). See also W. G. Hyland, "Clash with the Soviet Union," Foreign Policy, no. 49 (1982-1983).

4. See Marshall Goldman, USSR in Crisis: The Failure of an Economic System, New York, 1982.

5. See Josef Joffe, "The Enduring Crisis," Foreign Affairs, vol. 59, no. 4 (Spring 1981); and Eliot A. Cohen, "The Long-Term Crisis of the Alliance," Foreign Affairs, vol. 61, no. 2 (Winter 1982). See also David A. Andelman, "Struggle over Western Europe," Foreign Policy, no. 59 (1982-1983).

6. See Christopher Bertram, "Introduction," in Third World Conflict and International Security, Adelphi Papers no. 166, London. See also, on Latin America, Estudios Internacionlales, America Latina Después de las Malvinas (entire issue), no. 66 (Santiago, October-December 1982).

7. See Organization for Economic Cooperation and Development (OECD), The Welfare State in Crisis, 1981; and L. Thurow, The Zero-Sum Society: Distribution and the Possibilities for Economic Change, New York, 1980. For a Latin American viewpoint, see F. H. Cardoso, Las

Políticas Sociales en la Década del 80: Nuevas Opciones, Santiago, 1982, as well as the articles published in Crítica y Utopía, no. 6, under the heading Sociedad Civil y Autoritarismo, especially A. Flisfisch, "Notas Acerca del Reforzamiento de la Sociedad Civil."

8. Some of the earliest studies of this phenomenon, in the field of economics, are Richard N. Cooper, "The Economics of Interdependence and Foreign Policy in the Seventies," World Politics, vol. 24, no. 2 (January 1972). Fundamental books, from the standpoint of international relations, are Power and Interdependence: World Politics in Transition by Robert O. Keohane and Joseph S. Nye, Boston, 1977; and the earlier work by the same authors entitled Transnational Relations and World Politics, Cambridge, Mass., 1972. For other literature on the subject, see R. Rosencrance and A. Stein, "Interdependence: Myth or Reality?" World Politics, vol. 28, no. 1 (1976); and the many papers on the subject published by International Organization, such as H. Alker, "A Methodology for Design Research on Interdependence Alternatives," vol. 31, no. 1 (1977); R. Rosencrance, "Whither Interdependence?" vol. 31, no. 3 (1977); and K. J. Holstie, "A New International Politics? Diplomacy in Complex Interdependence," vol. 32, no. 2 (1977). Some of these papers, as well as others, are collected in R. Maghrori and B. Ramberg, Globalism Versus Realism: International Relations' Third Debate, Boulder, Colo., 1982. Finally, see also J. N. Rosenau, The Study of Global Interdependence: Essays on the Transnationalization of World Affairs, New York, 1980.

9. This concept has been studied by a working group on interdependence and national development of the Program for Joint Studies on Latin American International Relations (RIAL). I have published a paper entitled "Interdependencia y Desarrollo Nacional," El Trimestre Económico, no. 200 (October-December 1982); see also K. R. Mirow and H. Maurer, Webs of Power: International Cartels and the World Economy, Boston, 1981 (which includes an interesting reference to Brazil).

10. D. H. Meadows, et al., The Limits to Growth, Washington, D.C., 1972. See also E. J. Mishan, The Economic Growth Debate, London, 1977; K. D. Wilson, Prospects for Growth: Changing Expectations for the Future, New York, 1977; W. Leontieff, "The Future of the World Economy," Études et Expansion, no. 273 (New York, July-August-September 1977); and C. Freeman and M. Jahoda, World Futures: The Great Debate, London, 1978.

11. CEPII, Économie Mondiale: La Montée des Tensions, Paris, 1983.

12. Independent Commission on International Development Issues, North-South: A Programme for Survival, London, 1980.

13. International Bank for Reconstruction and Development, World Development Report, 1978.

14. For a Latin American perspective on this problem, see the document prepared by ECLA for the Bogotá high-level meeting held in May 1983, entitled "La Crisis Económica Internacional y la Capacidad de Respuesta de América Latina." See also Enrique V. Iglesias, "Reflexiones sobre en economio latinamericana en 1982," CEPAL Review, no. 19 (April 1983); and the articles collected under the heading Crisis y Deuda en América Latina, Estudios Internacionales, (Santiago, no. 64 October-December 1983).

15. Donald Regan, Statement to the United States Congress, 7 April 1983, Washington, D.C., 1983.

16. Helmut Schmidt, "The World Economy at Stake: The Inevitable Need for American Leadership," The Economist, February 26, 1983.

4
External Debt Problems of Latin America

Enrique V. Iglesias

By the end of 1983 the total external debt of Latin America amounted to approximately US$310 billion (Table 4.1). It is estimated to have grown by 7 percent during the year, a rate that was much lower than the 12 percent of 1982 and far below the growth rate of around 23 percent, which was the average between 1979 and 1981. The net flow of external capital to Latin America fell from a peak of US$38.0 billion in 1981 to US$16.6 billion in 1982 and US$4.5 billion in 1983 (Table 4.2).

This sharp drop in the growth rate of the debt was mainly the result of the restrictive policy adopted by the international commercial banks with respect to Latin America. In 1983, these banks granted virtually no new autonomous loans to the region, channeling their credit through the renegotiations of the external debt initiated by several Latin American countries. Under such circumstances, a substantial part of the increase in the debt was accounted for by the fact that the banks capitalized interest payments. This was partly a result of pressure brought to bear by the International Monetary Fund to induce the banks to refinance part (usually around 50 percent) of the interest earned, as a contribution to the adjustment program sponsored by the Fund.

The need to refinance a considerable portion of the interest payments becomes obvious when one takes into account the tremendous burden that they represent for most of the countries of the region. Indeed, despite the fact that in 1983 interest payments fell, mainly as a result of the slight decline in the prevailing rates on the main international financial markets, they still amounted to the equivalent of 35 percent of the value of exports of goods and services for the region as a whole (Table 4.3).

The share of the banks in the region's external indebtedness has of course increased notably. In the 1960s it was relatively insignificant, whereas in the 1980s it was over 50 percent and in some countries (Argentina, Brazil, Chile, Mexico, Venezuela) amounted to

Table 4.1 Latin America: Total External Debt
(end-of-year balance in billions of U.S. dollars)

Country	1981	1982	1983[a]
Latin America	257.890	289.437	309.800
Oil-exporting countries	116.777	128.948	134.500
Bolivia[b]	2.450	2.373	2.700
Ecuador[c]	5.756	5.788	6.200
Mexico[d]	72.007	81.350	85.000
Peru[c]	8.227	9.503	10.600
Venezuela[c]	28.377	29.934	30.000
Non-oil-exporting countries	141.113	160.489	175.300
Argentina[d]	35.671	38.907	42.000
Brazil[c]	65.000	75.000	83.000
Colombia[d]	8.160	9.506	10.300
Costa Rica[b]	2.345	2.603	3.050
Chile[d]	15.542	17.153	17.600
El Salvador[c]	980	917	1.200
Guatemala[d]	765	858	1.000
Guyana[c]	687	689	800
Haiti[c]	326	765	800
Honduras[b]	1.055	1.198	1.500
Nicaragua[b]	2.163	2.789	3.400
Panama[b]	2.333	2.733	3.100
Paraguay[c]	1.120	1.195	1.300
Dominican Republic[d]	1.837	1.921	2.000
Uruguay[d]	3.129	4.255	4.250

[a]Preliminary estimates subject to revision

[b]Public debt

[c]Includes officially guaranteed public and private external debt, plus nonguaranteed long- and short-term debt with financial institutions reporting to the Bank for International Settlements

[d]Total public and private external debt

Source: Economic Commission for Latin America, on the basis of official figures and publications of international financial agencies.

more than two-thirds of the total debt. Obviously, debts with private banks reached these proportions because of the willingness of the banks in question to finance most of the region's deficit on current account from 1974 on. In actual fact, bank loans have been available in abundance, except during a short recession in the mid-1970s. Recently, however, the banks have become much more cautious about making new commitments in general and particularly in respect to granting loans to the developing countries.

Table 4.2 Latin America: Net Financing Available After Payment of Profits and Interest (billions of U.S. dollars)

Year	Net Inflow of Capital (1)	Net Payments for Profits and Interest (2)	Net Available Financing (3) = (1)-(2) (3)	Net Real[a] Available Financing (4)	Exports of Goods and Services (5)	Net Available Financing/ Exports of Goods and Services[b] (6) = (3)/(5) (6)
1973	8.1	4.4	3.7	8.3	30.3	12.2
1974	11.6	5.3	6.3	11.9	46.0	13.7
1975	14.5	5.8	8.7	15.0	43.7	19.9
1976	18.3	7.0	11.3	18.7	49.9	22.6
1977	17.3	8.6	8.7	13.5	58.7	14.8
1978	26.4	10.5	15.9	22.9	64.5	24.7
1979	29.0	14.2	14.8	19.0	85.8	17.2
1980	29.9	19.0	10.9	12.3	110.9	9.8
1981	38.0	29.1	8.9	9.2	119.6	7.4
1982	16.6	36.8	-20.2	-20.4	109.0	-18.5
1983[c]	4.5	34.0	-29.5	-29.5	107.6	-27.4

[a]Obtained by deflating column 3 by the U.S. wholesale price index, base 1983 = 100

[b]In percentages

[c]Preliminary estimates subject to revision

Source: International Monetary Fund, Balance of Payments Yearbook (several issues); Economic Commission for Latin America estimates on the basis of official figures.

Table 4.3 Latin America: Ratio of Total Interest Payments to Exports of Goods and Services (percentages)

Country	1977	1978	1979	1980	1981	1982	1983[a]
Latin America	12.4	15.5	17.4	19.9	26.4	38.3	35.0
Oil-exporting countries	13.0	16.0	15.7	16.5	22.3	31.1	31.0
Bolivia	9.9	13.7	18.1	24.5	35.5	43.5	35.5
Ecuador	4.8	10.3	13.6	18.2	24.3	29.3	25.5
Mexico	25.4	24.0	24.8	23.1	28.7	37.6	38.0
Peru	17.9	21.2	14.7	16.0	21.8	24.7	31.5
Venezuela	4.0	7.2	6.9	8.1	12.7	21.4	19.0
Non-oil-exporting countries	11.9	15.1	18.8	23.3	31.3	46.2	39.0
Argentina	7.6	9.6	12.8	22.0	31.7	54.6	51.0
Brazil	18.9	24.5	31.5	34.1	40.4	57.0	43.5
Colombia	7.4	7.7	10.1	13.3	21.6	22.7	21.5
Costa Rica	7.1	9.9	12.8	18.0	25.5	33.4	43.5
Chile	13.7	17.0	16.5	19.3	34.6	47.2	37.5
El Salvador	2.9	5.1	5.3	6.5	7.5	11.1	10.5
Guatemala	2.4	3.6	3.1	5.3	7.5	7.6	7.5
Haiti	2.3	2.8	3.3	2.0	3.2	2.3	3.5
Honduras	7.2	8.2	8.6	10.6	14.5	22.5	16.0
Nicaragua	7.0	9.3	9.7	15.7	15.5	31.7	36.0
Paraguay	6.7	8.5	10.7	14.3	15.9	14.9	15.5
Dominican Republic	8.8	14.0	14.4	14.7	10.5	22.6	25.0
Uruguay	9.8	10.4	9.0	11.0	13.1	22.4	32.5

Note: Interest includes interest payment on short-term debt.

[a]Preliminary estimates subject to revision

Source: 1977-1982: International Monetary Fund, *Balance of Payments Yearbook*; 1983: Economic Commission for Latin America on the basis of official information.

Many factors are responsible for this tighter attitude on the part of the commercial external credit institutions. In the first place, the cyclical decline in the industrial economies has weakened the bank markets in their countries of origin, causing national clients to meet with payments difficulties or to go bankrupt while at the same time increasing the demand for credit; moreover, many of the banks' clients in developing countries have experienced payments problems. Other factors accounting for the banks' lack of interest in granting loans to developing countries include a more generalized attitude of circumspection concerning the diversification of their portfolios and disequilibria in the relation between their capital and their assets.

The payments problems of the developing countries with regard to the private banks have been especially apparent in Latin America. In 1982 there were serious payments crises in Mexico and Argentina, which were among the leading bank debtors, and also in Bolivia, Ecuador, and Costa Rica. In addition, other countries, such as Cuba and Venezuela, announced that they were to reschedule their next payments.

THE ORIGINS OF THE PROBLEM

The International Recession

More than at any other time since World War II, after 1982 the growth of the periphery in general and of Latin America in particular was heavily conditioned by constraints deriving from the poor economic evolution of the center. It is true that causes of internal origin--such as those linked to the unsatisfactory management of fiscal and exchange policies and to problems of an extra-economic character--account for most of the big decreases in the product in the countries of the Southern Cone, for decline of GNP in several Central American economies, or for the stagnation of economic activity in countries such as Mexico. Nevertheless, the major external constraints stemming from the recession in the industrialized economies constituted a brake that had a generalized handicapping effect on the economic growth of the entire region.

Thus, the main origin of the problem is to be found in the international recession, which has been unusually drawn out. In practice, the recession in the industrial countries has reduced the aggregate demand of the central countries and consequently has brought down the price of Latin American exports; to make matters worse, the developing countries have sought to offset the drop in prices by exporting larger volumes, a move that produces an even greater glut on the market and lowers prices in its turn. Here again, the countries as a whole must step

up their efforts simply to remain in status quo. In any case, the recession has an eroding effect on what looks like a means of paying off the debt (i.e., exports) and affects the banks' opinion of the solvency of countries, to the detriment of the real source of payment (i.e., loans granted on reasonable terms).

Although the recession in the industrialized economies in 1974 and 1975 was more critical than its counterpart today (the gross domestic product of the OECD countries fell by 1 percent in that period), it lasted only two years. Instead, 1982 was preceded by a period of meager growth in the center, in which real interest rates fluctuated around 6 percent, and in which OECD's volume of imports decreased or only marginally expanded. Continuing this trend, 1983 was also a year in which the prices of the primary commodities produced by the periphery fell again and the sixth consecutive year in which the terms of trade deteriorated for the non-petroleum-exporting developing countries.

To this set of unfavorable circumstances was added yet another of particular significance: the above-mentioned reduction in absolute terms of the net flow of capital into the periphery. This decline was especially severe in the case of the non-petroleum-exporting countries of Latin America.

This situation was linked, in turn, to the unexpected duration of the recession in the center. Its prolongation, and the repeated postponement of the first signs of recovery beyond the anticipated date, brought about a liquidity crisis in the industrialized economies that made itself felt in an upsurge of demand for credit, which was no longer due to the prevalence of inflationary expectations--since, as already shown, the rate of inflation had decreased--but stemmed from the need to supplement the low cash flows caused by the continuous and unexpected reduction of sales. As this heavy demand for credit coincided with stabilization policies centering on monetary restrictions, it generated unprecedented real interest rates and led to declines in production, particularly in the sectors most sensitive to the rate of interest (such as those producing capital goods and durable consumer goods) and to reductions in inventories.

Unfortunately, primary commodities, which constitute the periphery's staple exports, are among the goods for which adjustment to a contraction in demand is made mainly through a fall in prices. In other instances they constitute inputs for industries that are particularly hard hit by a recession in the center (for example, metal products for the motor vehicle and construction industries), or again their inventories are liable to be drastically reduced when the rate of interest rises.

Viewed from this angle, the persistence of deflationary policies in the center has especially affected the periphery's export prices but only partly hit

domestic prices in the center itself. Consequently, downward price rigidity as regards the goods produced in the industrialized countries has aggravated the deterioration of the periphery's terms of trade.

Of course, there is nothing new about the fact that stabilization policies applied in the central economies are more prone to bring down the periphery's terms of trade than to reduce inflation in the center. What is new is that because of the unexpected prolongation of the recession a liquidity crisis occurred that kept real interest rates exceptionally high--in contrast with what happened in 1974 and 1975, when the real interest rate was negative--and that also made for restriction of the net flow of capital into the periphery, a circumstance that likewise implied a significant difference from what had occurred during the 1974-1978 crisis and again in 1980.

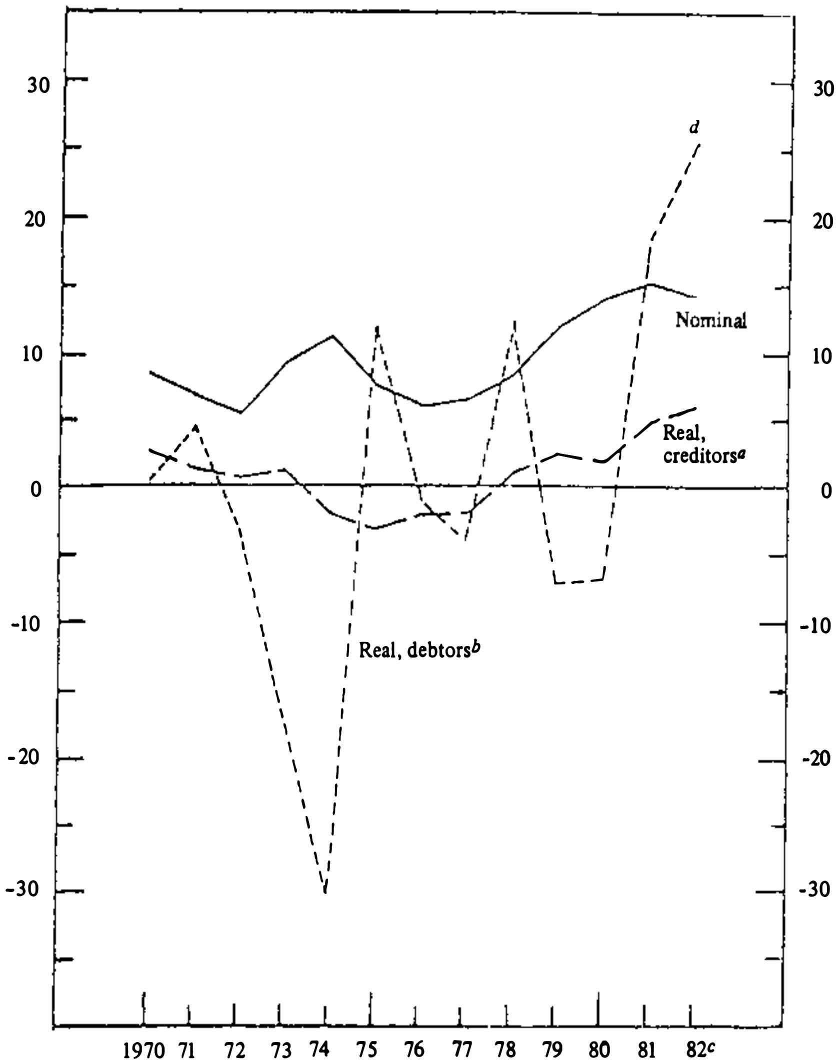
As was already said, this decline was partly due to the high levels of indebtedness reached by the developing countries and to the slower expansion of bank capital and partly to the reluctance of the international banking system to increase its loan to the periphery at a time when the value of the latter's exports was diminishing. The perverse nature of this change lies in the fact that the reduction in the value of the periphery's exports was due not to a contraction in their volume (in fact it expanded) but to the very marked fall in export prices. Thus, since the banking system took as the index of the periphery's capacity of payment the current value of its exports--and not their future value, which would incorporate more normal terms of trade, capital movements tended to aggravate rather than to alleviate the external crisis.

The High Cost of Credit

All the indicators suggest that the terms on which Latin America contracts its debts have reached a point where new loans barely provide minimum relief from the burden of indebtedness. Thus Figure 4.1 shows that interest rates have become very positive in real terms in the past years, after having been negative, also in real terms, ever since the mid-1970s.

However, from the point of view of the debtor countries, the high interest rates must primarily be considered in relation to the prices of the region's exports. It can then be seen that the real cost of credit for Latin America increased spectacularly between 1981 and 1982, since the LIBOR rate rose unusually high while at the same time there was a sharp drop in export prices (Figure 4.1). This clearly shows the extent of the deterioration in the region's external debt-servicing capacity due to exogenous factors.

Figure 4.1 Evolution of London Interbank Offer Rate (LIBOR), Nominal and Real



[a]Nominal LIBOR for 6 months, deflated by industrialized countries' consumer prices
[b]Nominal LIBOR for 6 months, deflated by the unit value of Latin America's exports
[c]Up to September
[d]Provisional estimates

Source: LIBOR: Morgan Guaranty Trust Co., World Financial Markets (several issues); consumer prices: IMF, International Financial Statistics, Yearbook, 1981 and December 1982; unit value of exports: ECLA, on the basis of official data.

The available data also show that the effect of the high basic interest rates since 1981 has been even further aggravated by the rise in the variable component of interest on loans in Eurocurrencies to developing countries, which, in turn, reflects the greater risk run by the banks in lending money to the countries in question. The negative effect of the high basic interest rates is, moreover, twofold in that they increase not only the cost of new loans but also that of loans previously contracted at variable interest, which have increased notably in Latin America since the beginning of the 1970s.

The recent interest-rate trends have thus given rise to a new phenomenon, that of interest rates being a debt burden in themselves. Thus, it is estimated that in 1983 interest payments amounted to the equivalent of 35 percent of export earnings of Latin American countries and almost to 4 percent of these earnings in the case of the non-oil-exporting countries of the region.

The second cause of the increase in the cost of indebtedness has to do with the evolution of the average time in which the loans mature. Even in the absence of complete data on debt repayment periods for 1982, it seems likely, to judge by trends in the preceding year, that they were shorter, thus accelerating debt-servicing payments and putting pressure on the countries' capacity to pay.

It is interesting to observe that Brazil has opted for longer payment periods at the cost of accepting much bigger margins of interest. Because of this, its interest payments have increased to such an extent that they have given rise to balance-of-payments problems. Mexico, on the other hand, has accepted shorter payment periods but smaller margins of interest in recent years; consequently, the main feature of its indebtedness crisis has been the maturing of a large number of loans within very short spaces of time. Thus, both Brazil and Mexico have experienced severe debt-servicing difficulties, although the pressure point has been different in each case.

Contracting short-term debts is usually symptomatic of payments difficulties: Debtors need new loans in order to serve their debt, but the entities granting the credits, in consideration of the greater risks involved, are unwilling to grant long-term loans. This increases short-term lending and means that there is a greater accumulation of debts that have fallen due. Even though it is still difficult to obtain accurate data concerning short-term indebtedness, provisional data suggest that it amounted to 30 percent of Latin America's total debt in 1981, a figure that probably rose in 1982.

The increase in short-term indebtedness, combined with the shorter maturities of medium-term instruments, means that it is necessary to refinance progressively larger proportions of the debt each year. However, as has already been stated, the burden in terms of interest

payments has already reached serious proportions. In addition, the traditional rescheduling of amortization payments would scarcely relieve the country in these circumstances. Moreover, the greater the share of the debt to be paid to the banks, the greater their risk, which makes it even more difficult to obtain new loans on reasonable terms.

Development Strategy Based on Indebtedness

During the 1970s, Latin America opted for a development strategy based on indebtedness. For a number of years the result was positive. Although after 1974 the expansion of the world economy was feeble, the economic growth of Latin America was relatively brisk and considerably greater than that of the OECD economies. In addition, this strategy seemed eminently reasonable since indebtedness was "cheap," with very low or negative real interest rates, lengthy payment periods, and servicing payable in dollars, whose real value was being eroded.

However, those who argued in favor of rapid entry into international capital markets and the concomitant strategy of growth based on indebtedness may have underestimated the real cost of credit; during the period nominal costs did not reflect the implicit risks of debt-servicing problems should a conflict arise between the increase in liabilities with commercial banks and the limits set by those institutions in respect to their commitments. These implicit risks obviously became greater owing to the fact that the structural problems of the OECD countries caused their economic growth rates to fall during the 1970s (by comparison with those recorded in the preceding decade), which meant that Latin America had to contract even more debts in order to maintain its high growth rates at a time when general economic conditions were not propitious for creating the capacity to cope with the accumulation of the bank debt.

From another point of view, the inflation unleashed in the mid-1970s was unexpected, so that the low real cost of loans was a temporary and artificial phenomenon; once the creditors' expectations became more realistic, the cost of credit more than recovered. Another factor related to the strategy of growth based on indebtedness was that some countries obviously obtained more credit than they could use productively: External loans took the place of domestic saving and facilitated an increase in consumption, speculation, and the purchase of weapons.

Although much of this state of affairs may be attributed to erroneous indebtedness strategies, there can be no doubt that the structure of the international banking market also helped to create the problem. In the initial phase of the loan cycle, the banks granted a large number of loans, with the aim of rapidly investing

their surplus on account of competition and excess liquidity. However, there was often some asymmetry between what the banks were able to loan and the capacity of the countries to absorb the funds obtained efficiently. Thus, the combination of low interest rates, the prestige gained by attracting international credit, and the ease of obtaining bank loans when a large dollar reserve existed persuaded some countries to borrow more than their possibilities for investment warranted and to postpone making of internal adjustments.

The Weaknesses of the International Financial System

In 1974 the international banking system became, de facto, a kind of central bank for the world economy. However, it was not in a position to perform this function and, at best, was able to assume it only for a very short time. Its operation was relatively satisfactory during 1974 and 1975, when its net initial commitments with the developing countries were still very low; today, on the other hand, in view of the high level of its commitments in the Third World, considerations attaching to loan risks and the need for banks to obtain profits stand in the way of efficient recirculation of liquidity.

Moreover, in practice the banks do much to accentuate the cyclical movements of economic activities at both the national and the international level. Although in the 1970s those cycles were not closely synchronized in the Third World, they are now. This synchronization is due not only to the prolonged OECD recession but also, and largely, to the lack of interest shown by the banks in granting new loans, the factor that at one time, as has been seen, was decisive in stimulating the economic growth of the region.

THE ADJUSTMENT EFFORT

In 1983, Latin America made a tremendous effort to reduce the disequilibria that had been accumulating in the external sector since the late 1970s. Thus, to the higher exchange rates adopted by numerous countries of the region in 1982 were added, in 1983, new devaluations, various other measures aimed at controlling imports and encouraging exports, and strict fiscal, monetary, and wage policies aimed at reducing domestic expenditure.

As a result of these adjustment policies, and despite the unfavorable trends in world trade and external financing, in 1983 the region achieved a large surplus in its merchandise trade, notably reduced its current account deficit, and also considerably reduced the negative balance on the balance of payments.

External Trade and the Terms of Trade

As already mentioned, however, the 1983 surplus of over US$31 million was only achieved through a drastic reduction of imports, which fell by almost 30 percent, after having fallen by 20 percent in 1982. Since the unit value of imports did not vary in 1983 and since it had fallen slightly in 1982, the decline of the volume of imports was just as drastic as the decline of the total value of imports.

In particular, in countries such as Venezuela, Uruguay, Mexico, Peru, Argentina, and Chile, the contraction of the volume of imports was so spectacular as to reveal clearly the enormous magnitude of the adjustment effort that had been made. Thus, the quantum of imports fell by 60 percent in Venezuela; declined by 39 percent in Uruguay and by 36 percent in Mexico, after having already dropped by 30 percent and 41 percent, respectively, in 1982; fell by 27 percent in Peru; and declined by 17 percent in both Argentina and Chile, in both of which imports had already fallen by around 40 percent in 1982.

In contrast to the unusual reduction in the volume of imports, the volume of exports rose by 7 percent in the region as a whole and by 9 percent in the non-oil-exporting countries. As was the case with respect to the real decline of imports, the increases in the volume of exports mainly reflected the adjustment effort made by the Latin American economies through measures aimed at modifying the relative prices of tradable and non-tradable goods and reducing domestic expenditure.

Nevertheless, the unfavorable evolution, for the fourth year in a row, of world trade and the considerable drop in the international prices of oil and other commodities prevented this relatively satisfactory increase in the volume of exports from bringing about a similar increase in their value. In fact, the value of exports fell slightly in the region as a whole and by almost 6 percent in the group of oil-exporting countries. Indeed, although the drop in the international price of oil had a lot to do with the drop in the unit value of exports in 1983, it also resulted from the decline of the international prices of the region's major export commodities, such as coffee and sugar, and of a good number of minerals.

Since the unit value of exports fell much more than that of imports, Latin America's terms of trade declined by slightly over 7 percent, after having fallen by 5 percent in 1982 and by 7 percent in 1981. During the last two years, the decline of the terms of trade was more pronounced in the oil-exporting countries than in the other economies of the region. Among the oil-exporting countries, the deterioration in the terms of trade during 1981 and 1982 did not offset the remarkable advance that had been made during 1979 and 1980. On the contrary,

since the terms of trade of the latter biennium had already deteriorated sharply over the previous five years, not only was the relevant index around 30 percent lower in 1983 than in 1978, but it reached the lowest level of the last half century. Indeed, during the period 1980-1983, it was much lower, on average, than it had been during 1931-1933, the most critical period of the Great Depression.

The Balance of Payments

Because the value of imports fell much more than that of exports, the merchandise trade balance underwent another significant change in 1983. After the radical turnabout of 1982, when the US$1.6 billion deficit of 1981 had been replaced by a surplus of over US$9.7 billion, 1983 brought an extraordinary growth in the trade surplus to more than US$31 billion, over three times that of the previous year. This was, in particular, the result of the enormous increases in the trade surpluses of Venezuela, Brazil, and Mexico and of the considerable changes in the merchandise trade of Argentina, Chile, Peru, Ecuador, and Uruguay. The drastic contraction of imports was also the main cause of the new increase in the trade surplus achieved by Argentina, the increased surplus obtained by Ecuador, and the substitution by Peru of a small surplus for its deficit of the previous year.

By contrast with what happened in 1982, when the impact of the change in the trade balance on the current account was neutralized to a large extent by the sharp increase in payments for interest and profits, in 1983 the part played by the increased trade surplus in reducing the disequilibrium on the current account was reinforced by a decline in foreign remittances. Such payments, which had more than quadrupled over the previous five years, rising from US$8.6 billion in 1977 to almost US$36.8 billion in 1982, fell a little to under US$34 billion in 1983. This was a result of the limitation on the payment of profits caused by the sharp contraction of domestic economic activity and the slight decline of interest payments brought about by reduction of nominal interest rates on the international financial market.

Under these circumstances, the deficit on current account--which in 1982 had already dropped by 10 percent, after having reached a record high of US$40 billion in 1981--fell spectacularly to under US$8.5 billion in 1983. Nevertheless, in 1983 the net inflow of capital was also lower than the deficit on current account, a situation that had already occurred in both 1981 and 1982. Consequently, the global balance of payments closed with a deficit for the third year in a row.

The External Financing and the Real Transfer of Resources

As has been noted, the abrupt adjustment of the balance-of-payments current account that took place in 1983 was forced, to a very large extent, by the no less violent contraction of the net inflow of capital. Indeed, in 1983, the total inflow of capital was barely one-fourth that received in 1982 (which had already been very low) and only 15 percent of the average inflow of capital during the four-year period 1978-1981.

The negative impact of this sharp drop in the net inflow of capital becomes even more obvious when one compares the amount of capital received with the amount represented by net payments for interest and profits, which in 1983 exceeded, for the second year in a row, that of net loans and investments received. Consequently, as in 1982, instead of receiving a net transfer of real resources _from_ abroad, Latin America made a net transfer of resources _to_ the rest of the world. Thus, a situation was provoked that, considering the relative development of the region, may be described as perverse.

The amounts involved in this transfer, moreover, were very high: US$20 billion in 1982 and almost US$30 billion in 1983, magnitudes equivalent to 19 percent and 27 percent of the value of exports of goods and services and between 2.5 percent and 4 percent of the gross domestic product. Considered from another angle, the reversal in the direction of net financial payments that took place between 1981 and 1983 was equivalent to a deterioration of one-third in the terms of trade.

Thus, the spectacular change in the direction of net financial flows played a decisive role in the widespread contraction of economic activity in Latin America and in the difficulties that some countries experienced in servicing their external debt. As may be clearly seen from the data in Table 4.2, up to 1981 the gross amount of capital received by the region was well in excess of its amortization payments, investments abroad, and payments for interest and profits. Indeed, during the period 1973-1981, this transfer of resources was equivalent, on average, to 16 percent of the value of exports that, in turn, increased during that period at an annual rate of around 20 percent. Under such circumstances, Latin America was able to make amortization and interest payments on its external debt and on profits earned by foreign capital through the new loans and investments it received each year.

Nevertheless, the magnitude of this net transfer of resources began to fall in 1979, when the increases in the net inflow of capital were more than offset by the even larger increases in payments for interest and profits. This trend reached a peak in 1982 and 1983, when the net inflow of capital dropped sharply and the region had to meet the bulk of its payments for interest

and profits from resources originating in the trade surplus or from the international reserves it had previously accumulated. As has already been explained, however, because of the unfavorable external situation, the trade surplus was produced not by an increase in exports but rather by an extremely severe contraction of imports, and this in turn had a negative effect on economic activity. Because of this chain reaction, the drastic reduction in the net inflow of capital had a definite effect on the levels of production and employment. At the same time, the fundamental cause of the decline in net loans and investments that took place during 1981 and 1982 was the procyclic reaction of the international commercial banks--Latin America'a main creditors--vis-à-vis the unfavorable external situation with which the region was faced.

This attitude on the part of the banks was clearly evident for the first time in 1982 and persisted in 1983. Thus, according to figures provided by the Bank for International Settlements, new loans granted by private banks to Latin America (excluding Venezuela and Ecuador) fell from US$21 billion during the second half of 1981 to US$12 billion during the first half of 1982 and barely US$300 million during the second half of 1982. During the first half of 1983, the banks granted loans amounting to US$3.7 billion. Nevertheless, this improvement was not the result of a "spontaneous" response on the part of the banks but rather was accounted for by the banks being pressured by the International Monetary Fund to contribute to the "rescue packages" designed by that institution to facilitate the adjustment process in a number of Latin American economies.

PROBLEMS AND PROSPECTS

The Unique Profile of the Latin American Economic Crisis

The figures given so far show the unusual scope and depth of the recessive crisis that almost every Latin American country is experiencing and leave no doubt that, for the region as a whole, 1983 was the worst year in the last half century. For most of the countries, the reduction of income during the period 1982-1983 has meant going back to the standard of living of several years ago.

It was already said that in many cases the crisis was partly the result of domestic factors related to ill-advised economic strategies or policies, the prolonged application of which was facilitated by the accelerated growth of external indebtedness and by the national financial permissiveness that prevailed during the 1970s. It is no less true, however, that the serious balance-of-payments crisis with which Latin America has been faced

in recent years may be attributed, to a large extent, to external causes that by their very nature were beyond the control of the countries of the region. Such was the case of the spectacular drop in the terms of trade, the high nominal and real interest rates, and the severe contraction of the net inflow of private capital. Even more unpredictable were the intensity and the duration of this phenomenon, a situation clearly atypical by comparison with what has happened in the large central countries during previous recessions.

In any event, it is obvious that at this stage of the game the solution to some of the most serious problems facing the region will depend mainly on external factors over which the region has little or no control. That is why the domestic economic policy options open to the countries are so complex and fraught with difficulties and also why the prevailing atmosphere is one of uncertainty and perplexity.

In order to deal with the balance-of-payments crisis, beginning in 1982 many Latin American countries implemented drastic and painful adjustment measures with which imports were reduced dramatically, to the point that in many cases the volume of imports fell by over 50 percent during the last two years. In addition, the sharp devaluations made by many countries in order to balance their external accounts contributed to the reinforcement of inflationary pressures that, after some time, led to the application of stabilization policies. Thus, the recessive effect normally produced by such policies over the short term was added to that produced by the sharp drop in imports.

The combination of these factors had another serious consequence: Investment fell very sharply, and in some countries a significant proportion of installed capital deteriorated or was destroyed, as many enterprises went out of business. The social consequences of the current situation have been no less serious. Indeed, in many countries, employment and real wages have reached the lowest levels since the Great Depression and in some cases have nearly reached the critical limits of social tolerance. In some countries the situation has been further aggravated by unusually severe natural disasters, which have accentuated the loss of income and the slowdown of the economy caused by the general crisis.

Nevertheless, not everything was negative during the last years. Some countries that had already followed cautious policies with respect to foreign debt were able to cope with the negative aspects of the international situation. Many other countries of the region have implemented programs aimed at adjusting their balance of payments and in this effort have received some cooperation from the international financial community; this has prevented the immediate effect of the crisis from worsening. Moreover, a relatively calm atmosphere has been restored

on the immediate financial scene; this, of course, does not mean that the problems have been solved or that the risk of serious financial crisis has been eliminated.

These and other aspects of the situation discussed in this chapter show that the Latin American recession has a profile of its own. The situation of Latin America is different from that in other regions of the Third World and, as a matter of fact, from any similar situation that has arisen during the entire postwar period.

The Questions of the Moment

Latin America has undoubtedly shown an extraordinary sense of responsibility in the way that it has responded to the challenges posed by the current external crisis. Suffice it to recall that in the last few years many of the countries implemented sharp real devaluations with a view to promoting their exports, replacing essential imports, and eliminating nonessential imports. To reduce excessive domestic expenditure and fiscal deficits, they also have substantially raised the prices of many public utilities and reduced a number of subsidies. Nevertheless, these measures--which, in fact, are not easy to implement, politically speaking, and which were oriented toward reallocating resources to the production of tradable goods--were taken on the assumption that a reactivation of the international economy would facilitate exports and restore the terms of trade and bring interest rates back to levels closer to those that had historically prevailed.

Unfortunately, this was not the case. Although 1983 saw the beginning of a recovery in the main central economy--the United States--this has not benefited Latin America through any of the above-mentioned mechanisms. Moreover, over the last few years, and especially in 1983, the region has been affected by yet another unfavorable change on the external scene: the drastic reduction of the inflow of capital, the effect of which has been equivalent to a deterioration of one-third in the terms of trade.

That is why domestic adjustment had to be recessive in nature and why it was based on an unprecedented reduction of imports--even essential ones--and not on an increase in exports. Thus, precisely at the worst time--during an international recession--the region was obliged to generate a substantial trade surplus, to become a net exporter of resources to the central countries, and to accept additional and exceedingly burdensome costs in order to be able to refinance part of the external debt it had accumulated.

It therefore seemed only natural at the end of 1983 to ask ourselves the following questions: What can Latin America expect, over the short term, of the current

reactivation of the international economy? How long can the indispensable domestic reactivation be postponed if the present situation of the international economy continues to prevail? After the profound traumas of the last few years, will moderate rates of economic recovery be adequate to deal with the serious social problems that have arisen as a result of the recession of the last three years?

In the first place, how steady are current indicators of international economic recovery? International public opinion views the economic recovery of the United States with satisfaction, but also points to the contradictions and puzzles posed by the phenomena that accompany it. On the one hand, the so-called locomotive theory, according to which the U.S. economy would be dynamic enough to pull along the other industrial centers, shows no sign of having been confirmed at this point. On the other hand, there are still three elements that are vital if the international recovery is to have any significant effect on the countries of the periphery and, in particular, on the Latin American economies.

First, in the field of trade, the terms of trade of Latin America continued to deteriorate--with some exceptions--during 1983 and no substantial increase in commodity prices seems to be in sight in the near future. Moreover, as a result of certain well-known phenomena, some of which have to do with the high level of real interest rates, protectionist trends in the central countries have persisted and even increased; this detracts from the transparency and dynamism of international trade and particularly hinders the growth of new exports.

Second, in the financial field, real interest rates continue to be very high, as a result of many factors: the fact that the governments of some industrial countries have used the financial system to cover their substantial fiscal deficits; the nature of the anti-inflationary policies applied in the large central economies; the disappearance of the liquid surpluses of the oil-exporting countries; the pressure to attract savings in order to deal with new capital-intensive investment; and others. Thus, hardly anyone thinks that in 1984 there will be any substantial reduction of real interest rates, a phenomenon of fundamental importance to the management of the external debt of the developing countries.

Third, in the field of capital transfers, there has been a drastic reduction in the net inflow of capital, which, after reaching an unprecedented level of US$38 billion in 1981, fell to barely US$4.5 billion in 1983; this drop would have been greater had not the International Monetary Fund prevailed on the commercial banks to increase somewhat their loans to Latin America.

The behavior of these variables in the reactivation process is fundamental to the viability of the current adjustment processes. It should be remembered that if

the terms of trade had been similar in 1983 to what they were in 1980 (25 percent higher) and if at the same time real interest rates had been similar to those prevailing when the bulk of the debt was contracted (on average, four points lower than at present), the region would have had US$25 billion more during 1983; with this amount it could easily have met its commitments without having to reduce its imports so drastically and without having to resort to new external indebtedness. In other words, if normal conditions were restored in the area of trade and finance, Latin America would be able to meet its external commitments without having to sacrifice its potential for growth.

On the other hand, Latin America cannot continue to contract its economy. It must be made quite clear that the region cannot continue applying the current adjustment mechanisms for much longer under the existing external conditions. This could lead, at least in some countries, to situations that would be difficult to control, both economically and socially, and could give rise to tensions that would jeopardize the very capacity of the economies to recover and hence to service their accumulated debt on time. It is advisable, therefore, to ask what the main limitations of the current adjustment processes are.

We should distinguish, first, among adjustment and overadjustment. In recent years, the region has had to carry out what essentially amounts to a twofold adjustment. The first and better known one is the adjustment to the extremely unfavorable trend in the terms of trade and in real interest rates. The second one has been the adjustment aimed at dealing with a more recent but no less serious development, the massive contraction of the net inflow of private capital. Thus, because the sluggishness of international trade and the "financial depression" have occurred simultaneously, the region has not only had to adjust but has had, in actual fact, to overadjust.

Second, we have to realize that there is a perverse process of transfer of resources. Because the net inflow of capital fell so sharply and payments for profits and interest were so high, Latin America--first in 1982 and again and to a greater extent in 1983--made net transfers of resources to the exterior that amounted to US$20 billion and US$29 billion respectively. This situation, which contrasts sharply with what had historically been the case in the developing countries, has become a key element in the profound depression of Latin America and one that will also be a decisive factor in the establishment of any economic recovery policy to be pursued in the future.

We should consider, third, the asymmetry of the cost of adjustment. There are other elements that have contributed to the aggravation of the balance-of-payments

problems. Among these, special mention should be made of the high costs and the bank surcharges that are involved in the renegotiation process, which have been added to the negative effects of the high interest rates. This increase in the financial costs, which contrasts with past experiences and with the crisis measures that banks normally apply to any enterprise, has aggravated external imbalances and has meant that virtually all the cost of adjustment has been transferred to the debtor countries. Indeed, this procedure is tantamount to an abdication, on the part of the international commercial banks, of their share of the responsibility for triggering the payments crisis with which the region is now faced.

Thus, Latin America cannot prolong the current process of recessive adjustment; instead, what it needs is to carry out a growth-oriented adjustment. Insofar as it must for some time generate a trade surplus, it will have to achieve this by increasing exports--by resorting to a factor that helps raise the rate of economic growth--rather than by again reducing imports, which would only make the recession worse.

The Inevitable Recovery

One of the most puzzling questions of the moment is the prevailing uncertainty about the possible modalities of and the prospects for international recovery. However, if the current situation with respect to prices of raw materials, real interest rates, and transfers of private capital continues, two different courses are open to the economies of the region during 1984. Some countries whose external situation is better and whose domestic adjustment programs have been relatively successful may see a modest recovery in their economic growth rate. However, because the service of their external debt represents such a heavy burden, they have little room for the recovery of domestic expenditure and hence of employment levels. Other countries that face more serious external situations and in addition have to deal with heavy inflationary pressures may see a persistence of recessive trends, and this will aggravate the critical economic and social situation that has prevailed in recent years.

In actual fact, neither of these two options is acceptable. Indeed, what Latin America needs is a firm and vigorous recovery policy. There is no question, however, that any recovery process aimed at strengthening the deteriorated regional economy will be conditioned by both external and internal factors.

Among the former, rescheduling of the external debt is the most important and the one that in the last analysis determines, over the short run, the maneuvering room that most of the Latin American governments will have for implementing their economic recovery. Over the

medium term, on the other hand, the key element for enabling Latin America to achieve rapid and persistent economic growth is the expansion of its external trade, both within the region and with the rest of the world.

Two of the internal factors that condition the effort to put more dynamism into the economy seem to be dominant: (1) recovery programs must be made compatible with the abatement of inflationary pressures, both traditional and recent; and (2) the patterns of growth must be restructured over the medium term in order to make it possible to achieve, among other objectives, a substantial increase in the exporting capacity of the region. The latter is, moreover, a prerequisite for enabling the region to pay the service of its accumulated debt on time.

External Factors: A New Mechanism for Rescheduling the External Debt

It is important to stress that not all the Latin American countries are in the same situation as regards the servicing of the debt under the current adjustment mechanisms; moreover, the unfavorable international situation does not affect all of them in the same way. That is why it would be very difficult to arrange for a joint rescheduling of the external debt of Latin America. Nevertheless, because of the absolute necessity of conditioning the service of the debt to the requirements of domestic recovery and economic development, the time seems to have come, for many countries, to make global proposals for changes in the existing rescheduling mechanisms. To this end, in accordance with the proposals made by the Group of Twenty-Four, joint action should be undertaken in international forums such as the International Monetary Fund and the World Bank to promote measures to improve the existing international financial mechanisms and to improve the international environment in which the adjustment processes are carried out.

It is also important to consider the possibility of the countries of the region jointly proposing to the international financial community certain minimum conditions that must be met in the immediate future in connection with the adjustment processes, until such time as the conditions on the international financial commercial markets improve. These conditions should include, among others, the following:

1. In no case should a country devote to the service of its external debt resources amounting to more than a prudent percentage of its export income, guided by the need to maintain the minimum level of imports required for its economic recovery and development.
2. The cost of making adjustments should be distributed more evenly by drastically reducing the

current financial costs that are added to the high interest rates. Consideration should also be given to the possibility of using provisional mechanisms such as the interest-rate subsidies that were studied during the 1960s, especially for international loans from public sources, which would considerably alleviate the financial burdens, so vital to the current adjustment process.

3. Amortization periods should be extended considerably in order to avoid in future the persistence of a perverse transfer abroad of resources.

4. Firm commitments should be made to obtain additional resources in order to provide for the refinancing of a higher proportion of interest payments, to facilitate the expansion of trade in the countries of the region, and to ensure the financing of satisfactory levels of domestic investment. In this regard, renewed support for the efforts of the World Bank, the Inter-American Development Bank, and other regional financing agencies will be fundamental.

In recent times, long-term global solutions have been proposed that have not yet been given proper attention by the large financial centers of the world. Nevertheless, if the current international situation continues for much longer, the force of circumstances might make some of these alternatives viable. In particular, it would be worthwhile to consider the possibility of converting a substantial part of the accumulated debt into long-term bonds, with real interest rates being brought back near to historical levels and with grace periods being granted for their servicing. This would enable the countries to gain time for undertaking the necessary domestic adjustments and for ascertaining the effect of the measures aimed at increasing their export capacity and substituting imports.

In any event, the management of the debt under existing international circumstances presents the region with a difficult dilemma. On the one hand, in order to eliminate the perverse transfers of resources abroad so as to sustain domestic recovery programs, it would be necessary to obtain new net credits that would raise the already high level of the existing external debt. On the other hand, in order to meet part of the service of the debt with resources generated through a trade surplus, it would be necessary, in the absence of a significant increase in exports, to again reduce the already low volume of imports, and this would work against any effort to reactivate the economy. That is why, over the short term, any effort that is made in this regard must provide for both an inflow of new resources and a substantial abatement of financial costs.

Internal Factors

The Recovery of International Trade. The current preoccupation with the problems pertaining to the management of the external debt has led the countries to overlook the close linkage that exists between their debt and their trade problems. As is well known, in the last analysis the final solution to existing and future balance-of-payments problems can only be found by expanding trade and increasing export income.

To achieve this, it will of course be necessary to increase the countries' exporting capacity; however, it will also be necessary to create an international environment in which the markets for Latin American exports can be expanded and the prices of these exports can be improved.

The protectionist practices that have increasingly been applied in the central countries certainly do not make it easy for these conditions to be met.

The Protection and Expansion of Regional Trade. Concomitant with the contraction of Latin America's trade with the rest of the world, there has been a sharp deterioration of regional trade and a recrudescence, in by no means a few Latin American countries, of defensive measures of protectionist nature arising from the difficult balance-of-payments situation faced by almost all these countries.

This situation must not continue. In order to reverse it, it would be necessary, in the first place, to put a stop to the imposition of new measures that hinder intraregional trade and, in the second place, to adopt various measures of a preferential type, such as ad hoc agreements of limited scope or the utilization of the purchasing power of state governments to promote trade. To this end, it will also be essential to expand the existing regional financial mechanisms and promote a more imaginative role for Latin American financial institutions, some of which are already implementing programs to support the expansion of intraregional trade.

These and other joint policies that might be adopted by the region under the present circumstances, both in order to promote collectively the adoption of measures at the international level and to accelerate and give greater depth to the regional cooperation processes, were studied in January 1984 in Quito during a meeting (proposed by the president of Ecuador) of heads of state and their personal representatives at the ministerial level.

Domestic Factors That Condition Recovery. I shall not discuss this matter in detail here. I did so at the session of the Economic Commission for Latin America (ECLA) held in April 1984; on that occasion, the ECLA Secretariat presented its views on this matter. Nevertheless, I cannot neglect now to mention that in the very

near future the region will have to deal with a series of factors that will force it to take a serious look at the development policies and strategies that have been applied up to now. This is essential if a degree of economic dynamism is to be achieved that will enable the region to respond to its serious social problems, which, as was mentioned above, have been aggravated by the current recession.

The rather difficult changes that may have to be made in international finance and trade; the burden of the accumulated debt--which is, in a way, a mortgage on Latin America's future development; the continuation and, in some cases, aggravation of old structural rigidities; and inflationary pressures, the solution to which is only with difficulty compatible with schemes for development and social justice, are some of the elements that will require revision of some ideas and the seeking and formulation of new policies. In this regard, as has been illustrated by recent experience, it is important to remember the risks involved in development strategies that are indiscriminately linked to international finance and trade. These risks are now obvious, considering the violent, prolonged, and unpredictable changes that have occurred in the international parameters in which we have been trusting.

Nevertheless, it is also of crucial importance to make it quite clear that the current crisis is one of liquidity and not one of solvency and that the region has the capacity to respond and the means to deal in future with its main problems.

It is to be hoped that the international financial community, recognizing the unique profile of the Latin American crisis, will cooperate intelligently, bearing in mind the existing circumstances, and will help the region overcome these problems of liquidity so as to prevent a real crisis of solvency from developing.

5
Coping with the Creeping Crisis of Debt

Albert Fishlow

INTRODUCTION

The total debt of developing countries, short and long term, stood at more than US$800 billion at the end of 1983, according to one recent estimate. The non-OPEC, non-OECD developing countries most affected by the instability of the international economy in the past decade account for some 80 percent of the total. More than 30 percent of their gross national product is owed abroad, and in 1982, before reschedulings became the order of the day, probably close to 50 percent of their export earnings was earmarked to meet debt service and rollover of short-term credits. Such aggregates, and the thirty or so countries forced to reschedule their debt payments since 1981, make clear that the debt problem penetrates deeply and broadly.[1] Indeed, the anxiety of creditors now extends--as well it might--to such OPEC members as Nigeria and Venezuela, whose oil resources had earlier been an assurance of creditworthiness.

After all, it was the dramatic inability of oil-rich Mexico to meet its obligations in August 1982 that first moved dry statistics relating to external debt from the obscurity of financial pages to the headlines. Mexico was the second-largest developing country debtor at US$80 billion and with proven oil reserves of seemingly unlimited value. If it could not service its debt, what of other countries less favored? With abrupt suddenness, the degree of exposure of the banking systems of the industrialized countries became a matter of grave concern. Although a relatively small proportion of total assets--little more than 10 percent--loans to developing countries far exceeded the capital bases of the largest money center banks. Interruption in debt service threatened to provoke systemic financial instability. Beyond that loomed potential adverse real repercussions on the economies of the United States and of the other industrialized countries through loss of developing-country markets. Interdependence was

transformed from a rhetorical slogan to a practical imperative.

It was no wonder that the Federal Reserve Bank, the other central banks largely working through the Bank for International Settlements, and the International Monetary Fund responded with a sense of urgency to the Mexican crisis. Fortunately, they also responded with imagination. Emergency credits were made available while an adjustment package was readied. The IMF boldly conditioned its own finance on commitments of new money from the commercial banks and designed its policy recommendations on the basis of assured total capital inflows rather than projected private-sector participation. Instead of counseling the Mexican government to adopt policies that might succeed in attracting new loans from the private sector, the IMF required the banks to put up new money as an integral part of a feasible adjustment package. Conditionality now was imposed on the banks as well as the countries.

These unprecedented arrangements soon became the order of the day through repetition in the cases of Argentina and Brazil as the fall of 1982 unfolded. There was no alternative, given the importance private creditors had assumed. In little more than a matter of months, but not without elaborate negotiations involving hundreds of banks, more than US$50 billion of debt had been rescheduled, about half as much short-term debt rolled over, and more than US$20 billion in involuntary new loans contracted for these three countries. Overall, probably US$100 billion in reschedulings have occurred. By far the most difficult problem was Brazil. Renegotiation of unrealistic targets originally agreed upon with the Fund and the banks earlier in the year extended until November 1983, when the government accepted additional austerity measures.

In the same month, a recalcitrant U.S. Congress, after a considerable delay, finally approved a US$8.4 billion appropriation to fund an enlarged IMF quota and expansion of the General Agreement to Borrow. It came with little time to spare, as the Fund was running out of resources to meet potential new needs of developing countries. The initial lag of the Reagan administration in recognizing the seriousness of the Mexican problem, and the failure to use the September 1982 IMF meeting as an occasion to mobilize support for the Fund, almost proved very costly. Scant weeks later, as Brazil tottered, Secretary of the Treasury Donald Regan became a convert to the cause of a more active role for the Fund. Conservatives in the Congress, more in tune with the earlier lack of enthusiasm of the administration for multilateral institutions, proved more difficult to persuade. It required almost a year, and liberal support, to obtain passage of the measure.

The relief occasioned by approval of the quota increase and resolution of Brazil's long-pending renegotiation with the Fund, in conjunction with signs of economic recovery in the United States and the other industrialized countries, has given rise to a certain optimism. The first significant shock to the spontaneous system of international lending that evolved in the 1970s has been weathered, and modest repairs to the institutional framework are in process. Talk of more elaborate reforms is less fashionable, and everyone seems to want to hope for the best.

But the crisis may linger on--if not for the financial system, then for the developing countries that are bearing the brunt of the adjustment. As the Wall Street Journal succinctly put it, "Despite the recent rescue efforts, debt-ridden developing countries face some bleak prospects for the years ahead: anemic export earnings, sluggish investment and crushing interest costs. The total foreign debt of developing countries that don't produce oil, now estimated at $664 billion, is expected to double by 1990."[2] That reality introduces new elements of medium-term political, as well as economic, viability into the debt picture. Will countries accept the burden, particularly if the magic of economic recovery is less powerful than has been claimed?

Moreover, the future of the financial system is far from certain. The very success of the short-term crisis response ironically also signals the end of the market system of Euromarket financial intermediation that had flourished for more than a decade. Only by vigorous official intervention have private banking arrangements been salvaged. More than a new relationship between the IMF and the commercial banks is involved. Within the United States, the Federal Reserve Board has been called upon to persuade recalcitrant regional banks of the necessity to continue to lend to developing countries when their desire is to reduce their exposure. Few anticipate, even with improved economic circumstances, a return to the buoyant capital markets of the 1970s that served so well to recycle the petrodollar surpluses. Can, or should, the quasi socialization of international lending we have seen under the auspices of the IMF replace it?

Questions, and the debt problem, thus persist. In this chapter, I focus on four of its aspects. First, I examine the origin of the problem in the disequilibrium of the international economy in the 1970s and in the responsive domestic policies of the developing countries. From that basis I consider the possibility of industrialized-country recovery as a solution. Third, I take up the appropriateness of the IMF adjustment packages now in place in many countries, with regard to both their economic and political viability. Finally, I evaluate the adequacy of the existing institutional framework for

coping with the debt problem, and the financial needs of the developing countries, in the medium term.

THE ORIGIN OF THE DEBT PROBLEM

From Debt-Led Growth to Growth-Led Debt

The expansion of the Eurocurrency market in the 1960s was, on the whole, of little significance to developing countries. European central banks and transnational corporations were the principal transactors. Only as the decade was drawing to a close, largely under the impulse of a recession-induced declining conventional demand for loans, did money center banks begin to search out new prospects. They found a hitherto untapped clientele among the rapidly growing countries of the developing world that later would be christened the "newly industrializing countries": Brazil, Mexico, and Korea, among others. Capital began to flow to finance the increased imports required by accelerating economic expansion. Such loans, and not merely export promotion, were the basis of a more elastic supply of foreign exchange facing these countries and permitted a more aggressive and accelerating growth strategy. Brazil's economic miracle in particular was characterized by such debt-led growth.

The sudden injection of petrodollars into world financial markets in 1974 altered both the pace and the purpose of borrowing. OPEC exporters realized a current account surplus in that year of almost $70 billion as a result of the quadrupling of oil prices and placed much of it in short-term deposits with commercial banks. Those dollars were loaned for a longer term to countries that were importers of oil in order to finance their much larger balance-of-payments deficits. Amid predictions of impending doom and disaster, private financial markets found a way not only to keep the global economy afloat, but within short order, to fuel renewed expansion. That way was unprecedented increase of external debt, especially on the part of the developing countries.

Countries did not have to borrow at that time. They could have reduced their purchases of oil, or failing that possibility, have restricted other imports. But such responses would have implied passing along the oil tax in the form not only of lower real incomes but also of diminished output and employment. That was an unpopular choice for most governments, especially when they were taking credit for improving economic performance. The other option was to accelerate the growth of exports to offset the increased cost of imports; although no less a reduction of real income, such a strategy at least promised to be less contractionary than policies aimed primarily at import reduction. That choice again seemed

dubious when recession in the industrialized countries was slowing aggregate trade growth in 1974 and 1975.

More gradual, debt-financed adjustment was therefore attractive to many countries, an option rendered the more alluring by its cheap cost. Not all countries were eligible. Those that had the luxury of borrowing were predominantly the ones that had already established prior links to the market: They turned from debt-led growth to growth-led debt. In the earlier period they could count on an elastic supply of foreign capital and could, and did, set ambitious growth targets independent of a foreign-exchange constraint. In the later period, they operated under greater restriction. Although they borrowed more, countries were not facing unlimited supplies of credit: Their growth rates had to be set more modestly, with larger debt financing the larger needed import requirements.

Not all eligible countries chose such a path. Taiwan and Singapore, for example, accepted a more immediate adjustment and realignment of real wages to remain competitive in exports. The more dependent economies were upon their exports, the more inclined they were to favor aggressive efforts to expand market shares rather than to accept continuing debt-financed balance-of-payments deficits. In such small open economies, import substitution was not a prominent part of medium-term adaptation, and export competitiveness was best accomplished by short-term flexibility.

Enough countries opted for deficit finance to permit financial markets to sustain world demand. By making money cheap the banks induced borrowers to maintain and expand their imports to offset the export surplus of the oil producers. In this fashion, a classic potential oversavings, non-full-employment solution to the surplus problem was averted, and global recovery could build upon the continuing growth of the middle-income developing countries. Increased indebtedness thus had positive externalities.

From a national perspective, this sort of strategy also produced favorable results. The select group of countries that were able to borrow experienced better economic performance. The poorest countries, on the other hand, had to adjust immediately and painfully, despite larger official lending mobilized in their behalf. As a consequence, a wider gulf opened between the middle-income and the low-income countries in the 1970s, even as it narrowed between semiindustrialized and industrialized countries. Per capita income grew between 1970 and 1980 at an annual rate of 3.2 percent in the middle-income countries, 2.4 percent in the industrialized countries, and not at all in the low-income countries other than India and China.[3]

Table 5.1 confirms this dominant role of the NICs in credit markets in the immediate aftermath of the oil-price

Table 5.1 Developing-Country Debt[a] (in billions of U.S. dollars)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
Non oil exporters	130.1	160.8	190.8	228.0	280.3	334.3					
						300.7[b]	354.5[b]	421.4[b]	492.6[b]	551.3[b]	585.6[b]
NICS[c]	51.3	66.2	82.3	101.5	122.7	149.5					
						115.9[b]	135.0[b]	160.9[b]	185.4[b]	211.9[b]	217.7[b]
Brazil	13.8	18.9	23.3	28.6	35.2	48.4	57.4	66.1	75.7	88.2	97.0
Mexico	8.6	12.8	16.9	21.8	27.1	33.6					
Korea	4.6	6.0	7.3	8.9	11.2	14.8	20.5	26.4	31.2	35.8	42.0
Southern Cone	10.1	12.4	12.7	13.0	14.9	19.2	27.5	38.3	51.3	55.2	60.0
Argentina	6.4	8.0	7.9	8.3	9.7	12.5	19.0	27.2	35.7	38.0	42.0
Chile	3.7	4.4	4.8	4.7	6.2	6.7	8.5	11.1	15.6	17.2	18.0
Low income	26.4	30.9	34.6	40.1	48.6	54.8	62.7	71.4	75.2	81.8	88.0
Selected oil exporters	15.4	17.9	21.2	27.3	35.3	47.1	58.2[b]	65.2[b]	70.5[b]	78.3[b]	90.0[b]
							99.0	119.0	137.5	160.3	173.0
Algeria	2.9	3.3	4.5	5.8	8.3	12.7	14.9	15.1	15.3	14.8	17.0
Indonesia	5.7	7.1	8.9	11.0	12.8	14.5	14.9	17.0	18.0	21.0	23.0
Mexico							40.8	53.8	67.0	82.0	83.0
Nigeria	2.2	2.2	2.1	1.8	1.9	3.6	4.7	5.6	7.9	11.2	17.0
Venezuela	4.6	5.3	5.7	8.7	12.3	16.3	23.7	27.5	29.3	31.3	33.0
Total	145.5	178.7	212.0	255.3	315.6	381.4	453.5	540.4	630.1	711.6	758.6
All developing countries					329.3	398.2	472.0	559.9	646.5	724.8	767.7

	Sources of Change (percentages of total)				
	1973-1976	1976-1978	1978-1980	1980-1982	1983
NICS	45.7	38.1	28.3	29.8	12.3
Southern Cone	2.6	4.9	12.0	9.9	12.3
Low income	13.4	11.7	10.4	6.1	13.2
Oil exporters	10.8	15.7	24.1	24.1	27.0
			(11.4)[b]	(7.6)[b]	(24.9)[b]

Table 5.1 (cont.)

[a] Developing countries include IMF definition of nonoil developing countries plus Algeria, Indonesia, Nigeria, and Venezuela; includes Mediterranean European countries. Debt includes short- and long-term debt, including nonguaranteed. Excludes loans from IMF.

[b] Excludes Mexico

[c] Major exporters on manufactures, less Argentina, but including Mexico

Sources: Nonoil countries, 1973-1976: International Monetary Fund (IMF), _World Economic Outlook, 1983_; NICs, 1973-1976: IMF, _World Economic Outlook, 1983_, plus short-term debt estimated as .45 times total nonoil short-term debt; low income 1973-1976: IMF, _World Economic Outlook, 1983_, plus short-term debt estimated as .05 times nonoil short-term debt; all developing countries, NICs, low income, nonoil countries, 1977-1983: IMF, _World Economic Outlook, 1984_; Brazil, Mexico, Korea, Argentina, Indonesia, and Venezuela, 1973-1982: W. Cline, _International Debt and the Stability of the World Economy_ (Washington, D.C., 1983); Nigeria and Algeria, 1973-1982: World Bank, _World Debt Tables_ and _World Financial Markets_, June 1983; Chile, 1973-1982: R. Zahler, "Recent Southern Cone Liberalization Reforms and Stabilization Policies: The Chilean Case (1974-82)," _Journal of Interamerican Studies and World Affairs_, November 1983, and _World Financial Markets_, June 1983; Brazil, Mexico, Korea, and Argentina, 1983: Organization for Economic Cooperation and Development, _External Debt of Developing Countries, 1983 Survey_; Chile and Venezuela, 1983: _Euromoney_, March 1984; Algeria, 1983: Economist, _Quarterly Economic Review_, no. 1, 1984; Indonesia, 1983: Economist, _Quarterly Economic Review_, no. 1, 1984 (estimate of incremental loans); Nigeria, 1983: _Wall Street Journal_, February 21, 1984.

shock. They accounted for over two-fifths of the increase in all developing-country debt between 1973 and 1976. Mexico and Brazil, together, accounted for about a quarter. All low-income countries could manage little more than 10 percent, almost exclusively from official sources. Five of the nonsurplus-oil exporters virtually matched that participation.

For some of the borrowers, the new credits became habit forming, even after real prices of oil began to be eroded and industrial-country growth recovered after 1975. Balance-of-payment deficits declined only gradually, as bank willingness to continue to lend opened up new possibilities for public spending. The data in Table 5.1 reveal a continued high level of participation of the NICs in total borrowing and expansion of the role of the oil-exporting countries. Although borrowing had its origins in the oil crisis, it took on a life of its own, one influenced by the higher price not merely of oil but also of manufactured imports.

Since banks preferred official guarantees, and these could more readily be given on public loans and indirect borrowing of state enterprises, private international credit markets imparted a significant bias toward public-sector expansion. This, too, favored those middle-income countries with a more pervasive network of state enterprises and interventionist tradition. Countries found the speed and less exigent requirements of the private banks a welcome contrast to the rigidities of official loans.

Banks, on their side, found their new customers an important source of profits. Banks made their money on the higher up-front commission fees and spreads for loans to developing countries, and low real interest rates, or even negative rates, were no worry. Indeed, they were welcome in minimizing the debt-servicing problems of the developing-country borrowers. As long as bank depositors were willing to accept negligible returns, and surplus-oil producers had such a preference for liquidity that they were, the arrangement was quite satisfactory.

As a result, developing-country debt grew at a rate of about 20 percent a year from 1973 to 1978, increasingly weighted by the floating-rate loans of banks. Lenders bore the risk of a mismatch between overnight deposits and six- or eight-year loans; borrowers bore the risk of changing interest rates and had their costs pegged to the London Inter-Bank Offer Rate (LIBOR). In addition, countries were exposed to the high rates of loan turnover implicit in the short-maturity structure of commercial loans. This translated into debt-service ratios that far exceeded previously conventional standards, without providing comparable access to increased real resources.

A relatively small number of countries thus embarked on a strategy of growth-led debt in the 1970s subject to special vulnerabilities. They were financing medium- and

long-term capital formation on the basis of short-term credits with an uncertain and variable price. Inherent in any debt strategy was an inability to know its real return because the future prices of exports were an important determinant of the potential benefits. Compounding it in this case were an uncertain cost of debt and a dependence upon future conditions of supply of credit required to roll over existing loans.

Yet up to the second oil-price shock, the gamble was worth taking. Export growth was sustained in world markets at favorable prices despite worries about protectionism. As a consequence, the ratio of debt outstanding to export proceeds was more favorable for non-oil developing countries in 1979 than in 1970-1972 (although assisted by rising oil revenues for some new exporters in the group). Debt service, even if claiming a larger share of exports than earlier (as grace periods expired and interest rates crept upward), was still a modest 19 percent for the group as a whole. Short-term loans were not yet much in evidence and posed no cash-flow problem. The ratio of reserves to debt outstanding at the end of 1979 was a third more satisfactory than the level in 1970-1972.[4]

In the meantime, as noted earlier, those developing countries with access to the financial market succeeded in sustaining their rates of growth far more effectively than those forced to do without. They did so because they utilized increased foreign savings to finance higher levels of investment. Evidence on the consumption behavior of a number of the major debtor countries is reported in Table 5.2.[5] It confirms the productive application of the much larger foreign capital inflows in the period after 1973.

In the first place, despite the acceleration in borrowing, the propensity to consume out of net foreign proceeds in 1965-1978 was not statistically significantly greater than in the prior period. If foreign resources were not all applied to investment, neither were they diverted to consumption in proportions different than they had been. Second, the share allocated to savings from foreign borrowing in 1965-1978 was significantly greater than the allocation from gross national product for Korea; for both Brazil and Mexico, the deviations are in the right direction although falling short of statistical significance. Indeed, for these three largest debtors, the savings coefficients from net capital inflow are high enough so that the hypothesis that all borrowing was saved cannot be rejected. At the margin, for these countries, debt translated more than proportionally into investment. Third, even after the second oil shock in 1979-80 provoked further uncertainties and reduced growth and investment, there was no systematic tendency toward greater consumption out of borrowing. Some countries did show a rise, Brazil most

Table 5.2 Consumption Behavior of Debtor Nations

	Marginal Propensity to Consume from National Product	Marginal Propensity to Consume from Foreign Capital	
	1965-1981	1965-1978	1979-1981
Argentina	.76	.82	1.02
	(21.39)[a]	(2.49)	(1.20)
Brazil	.79	-.02	.90
	(48.24)	(.04)	(1.91)
Chile	.86	.95	.51
	(33.92)	(2.84)	(1.62)
Colombia	.73	.69	.20
	(35.68)	(2.67)	(.50)
Indonesia	.67	1.00	.76
	(37.80)	(6.84)	(4.63)
Korea	.68	.20	.48
	(34.87)	(1.82)	(1.97)
Mexico	.76	.43	-.51
	(36.26)	(1.30)	(1.54)
Venezuela	.46	.54	.38
	(1.16)	(7.40)	(1.72)

[a] *t*-values in parentheses

Source: Data on national accounts from International Monetary Fund, *International Financial Statistics*, various issues.

prominently, but the only statistically significant change was Mexico's in the direction of greater saving. Finally, the pattern of expenditures in a nondebtor country like Colombia is not much different from that in the largest debtors.

This conclusion of no gross displacement of domestic saving is corroborated by IMF studies comparing changes in average ratios of saving to GNP with relative changes in the current account between the late 1960s and the 1970s. Taking into account as well simultaneous investment increases, the "increases in external deficits can in most cases be accounted for by expansion of investment (relative to total output) rather than by growth of consumption."[6] The cross-sectional methodology leads to the stronger result that debt had its principal application in investment, not true in my sample for such borrowers as Argentina, Chile, and Indonesia. What seems clear is that countries did not borrow in order to increase their consumption ratios, although their absolute consumption may have risen.

Although some countries encountered difficulties and were forced to reschedule and although some analysts remained skeptical of the magic of the market, the consensus judgment about developing-country debt until the second oil shock was a positive one. Rapidly growing

debt was a solution rather than a problem. Even in 1980 it could be stated in an IMF Occasional Paper:

> In sum, the overall debt situation during the 1970s adapted itself to the sizable strains introduced in the payments system and, in broad terms, maintained its relative position vis-à-vis other relevant economic variables. Though some countries experienced difficulties, a generalized debt management problem was avoided, and in the aggregate the outlook for the immediate future does not give cause for alarm.[7]

A Changed International Environment

Even as those lines were being written, the bases for optimism were being eroded by a deteriorating global economy. In the first instance oil prices soared again under the impulse of uncertain supplies as war broke out in the fall of 1979 between Iran and Iraq. After considerable volatility in the spot market, the new average 1980 oil price settled at a level almost two and a half times greater than its 1978 value of US$12.83 a barrel. The immediate impact, reminiscent of the first oil-price shock, was a large OPEC surplus offset by a large nonoil-developing-country deficit.

Once again there was a recession in the industrialized countries, as contradictory policies sought to contain inflation, but this time more seriously. The impact on developing-country exports and terms of trade was to prove longer lived. Finally, there was a new element in the formula: Real interest rates began an upward ascent. Where before the capital market facilitated deficit finance, it now penalized not only the flow but also the stock of past debt contracted on a floating basis to boot.

Table 5.3 quantifies the approximate contribution of each of these three adverse factors to the current account deficit realized by the group of nonoil developing countries as a whole. The role of the oil-price shock, even allowing for the favorable impact on such countries as Mexico, Peru, Egypt, and a few others, is shown as paramount in timing and magnitude. In second place is the recession-induced reduction in export earnings, the result of both slower growth in volume and deterioration in price. This negative influence is most pronounced in 1982. By that time the severity and length of the slowdown in the industrialized countries produced a volume decline as well as an increasing cumulative price effect. It is not surprising that by 1982 countries found themselves in more and more balance-of-payments difficulty.

Higher interest rates, despite the attention they have received, are of lesser, but accelerating, importance

Table 5.3 Sources of Deterioration in the Current Account of Nonoil Developing Countries, 1979-1982 (billions of U.S. dollars)

	1978	1979	1980	1981	1982	Cumulative 1979-1982
Actual trade balance	-36.6	-51.3	-74.3	-79.6	-52.2	
Adjusted trade balance		-46.3	-57.3	-47.8	8.8	
Oil effect		5.0	17.0	18.6	14.8	55.4
Recession effect				13.2	46.2	59.4
Export volume					23.2	23.2
Terms of trade				13.2	21.3	34.5
Debt service (gross)	-19.4	-28.0	-40.4	-55.1	-59.2	
Interest Rate effect (gross)		-1.1	.5	11.4	23.0	33.8
Interest rate effect (net)		-.5	.2	6.5	14.0	20.2
Current account	-41.3	-61.0	-89.0	-107.7	-86.8	
Adjusted current account	-41.3	-56.5	-71.8	-69.4	-11.8	

Source: Actual trade balance and current account based on International Monetary Fund, *World Economic Outlook, 1983*; adjusted trade balance: actual minus sum of oil and recession effects; oil effect: actual cost of net imports of oil (using oil import price of industrialized countries) minus estimated cost using oil price that varies after 1978 with export prices of oil-importing countries; recession effect: composite of terms of trade and volume effects (does not add because of interaction); export volume: nonoil export value times cumulative negative percentage deviation between actual export volume of oil-importing countries and volume predicted by 3.2 percent OECD growth in 1980-1982; terms of trade: cumulative negative percentage deviation between actual nonoil terms of trade (export prices of nonoil, oil-importing countries, import prices of oil-exporting countries in 1973-1974, 1979-1980, nonoil countries in others) and terms of trade predicted by 3.2 percent OECD growth and deceleration of industrialized country inflation at one percentage point per year; debt service (gross): based on International Monetary Fund, *International Financial Statistics*; interest-rate effect: based on a 1975-1978 average real prime rate (measured using the December to December price index) of .75 applied to short-term loans, and for effect net of earning assets, to short-term net liabilities. Interest on long-term and medium-term loans was calculated by using the real prime rate with a weight of one-third and the OECD long-term fixed interest rate with a weight of two-thirds, corresponding to portfolio weights reported in Organization for Economic, Cooperation and Development, *External Debt of Developing Countries* (Paris, 1982). Rates were applied to average annual debt, obtained by using average of year-end debts. This method approximates well actual gross and net interest payments reported in International Monetary Fund, *World Economics Outlook*. Adjusted current account: actual minus sum of oil effect, recession effect, and net interest effect.

in explaining the deterioration in the current account. One reason for their limited power is the offsetting effect of developing-country assets on which earnings would have been lower had real rates not increased abruptly in 1981 and 1982. This is reflected in the smaller net improvement for current account for 1982 compared to the adjusted current account, as shown in Table 5.3.

But this does not capture the full significance of the rise in the interest rate. The increase not only contributed to the current account deficit but also had immediate adverse effects on the debt-service ratio. Between 1978 and 1981 interest payments on the debt rose from $19 billion to $55 billion for all nonoil developing countries, and the ratio to exports increased from 7.3 to 11.9 percent. The change for Latin American borrowers was much greater, as the ratio of interest service to exports climbed from 14.9 to 25.4 percent. Only declining amortization kept the overall debt-service ratio within bounds. Potential lenders were concerned. That the higher nominal rates at first were partially equivalent to shorter maturities, because they were compensating for inflation rather than signaling a deterioration in the capacity to pay, did not always register.

Such higher rates thus exacerbated the crisis and were a crucial factor in making developing-country adjustment more difficult just when export demand was falling off. Recession in the industrialized countries in the past had at least been partially offset by more abundant and cheaper loanable funds. Higher rates had a further effect: They determined the inertial growth of the debt, an inertial growth that would have to be offset by export surpluses that reversed the real resource flow to developing countries. I explore this consequence in the next section.

The new real-interest-rate regime was largely the consequence of conscious policy in the industrialized countries. Tighter money became the principal instrument to reduce inflation. Reaganomics carried the process a further step by marrying lax fiscal policy and an insistence on lower inflation; the predictable consequence was higher deficits, interest rates, and unemployment. Restrictive policy also produced other consequences that reinforced the tendency for interest rates to rise. Reduced surpluses were realized by oil producers facing a softer and more competitive market, so that former source of savings to finance the deficits of the oil importers was no longer available.

International capital markets magnified the shock. Banks, concerned about their exposure, raised premiums to oil-importer borrowers; more importantly, they became more reluctant to lend. They began to prefer shorter loans--ostensibly trade credits, but in reality, like all lending, balance-of-payments finance. Estimated debt of

less than a year doubled between 1977 and 1982 while medium- and long-term finance increased by about 50 percent.

As the data in Table 5.3 suggest, the cumulative effects of the external shocks experienced after 1979 were sufficient to convert the large 1982 deficit of $87 billion to one of $12 billion. In the absence of these cumulative effects, the sometimes drastic efforts on the part of countries to curtail their imports would have led to significant improvement in their payments situation rather than the severe difficulty actually experienced.

All together, the total value of imports was cut back by some $40 billion in 1982. That was the inevitable consequence of confronting mounting debt-service ratios with first claim on foreign-exchange receipts. For the largest debtors--Argentina, Brazil, and Mexico--debt service in 1982, excluding rollover of short-term debt, averaged about 80 percent of export earnings.

But the data in Table 5.3 also make it clear that the sharp initial rise in the deficit from its 1978 level must be explained on other grounds. By 1980, even leaving aside the oil-price shock and the price of exports, the current account deficit had risen by a third. It is a mistake to blame the oil-price and recession shocks alone for what was also an inadequacy of the functioning of capital markets.

For one thing, as the data in Table 5.1 showed, there was much increased borrowing by Chile and Argentina as they pursued more open capital markets as an integral part of their new international monetarist stabilization experiments. Between 1978 and 1981 their previously moderate debt almost trebled, as they alone accounted for some 12 percent of increased developing-country indebtedness. High domestic interest rates in conjunction with preannounced and--in the case of Chile--fixed exchange rates encouraged rapid capital inflows that were translated into larger imports, but without the same proportion saved as was true of the earlier NIC borrowing in the aftermath of the 1973 oil shock.

For another, oil exporters, and in particular Mexico, relied heavily on external finance to sustain high rates of growth of product and, disproportionately, of imports. The very initial shock of higher oil prices worked to their advantage. They borrowed not to accommodate to adverse external circumstances, but rather to exploit their new riches. Needless to say, they were attractive clients for banks again flush with Eurodeposits in search of application.

Finally, some oil-importing countries, prominently Brazil, became habituated to debt-financed adjustment, understated the different and more persistent international recession, and took few precautionary measures. Brazil chose for internal political reasons to expand in 1980 at the expense of a deteriorating payments position.

It was checked early on by an increasingly inelastic supply of credit. As a consequence its debt expanded relatively less than that of its Latin American neighbors.

Between 1978 and 1981, the principal debtors in Latin America were responsible for more than 40 percent of the increased debt tabulated in Table 5.1, compared to an initial participation of 30 percent. Almost all of the new debt was accumulated on a floating-rate basis, and progressively the cheap interest rates became unavailable. For many, prudent import policies might have averted some of the later grief. A prominent exception was Brazil, whose large outstanding debt absorbed virtually all of the foreign exchange borrowed and whose real imports remained compressed. Brazil was also exempt from the capital flight that complicated debt management in Argentina, Mexico, and Venezuela. The excess of debt change over the current account deficit and reserve accumulation amounted to some $45 billion between 1979 and 1982. Public-sector obligations financed accumulation of private assets abroad in these cases.[8]

This country variability is lost in the aggregation of Table 5.3. The countries with relatively large reserves that gained from higher interest rates are not those most affected by payments problems because of lagging exports. Nor did prices for all products move uniformly. The terms of trade of Asian oil-importing countries fell by 5.5 percent between 1980 and 1982; those of the Latin American countries by 13.6 percent.[9] However much external events impinged, nevertheless (as they impressively did), domestic policies and international negligence were also components of the seriously deteriorating situation that finally became patent in 1982.

Global equilibrium in response to the second oil shock was achieved at lower levels of real income. Instead of buffering the impact as before, developing-country debt now transmitted it. Only so long as growth-led debt was compatible with developed-country aversion to recession and with OPEC willingness to hold Euro-currency deposits yielding low or negative real rates could the strategy be effective. It made little difference that current account deficits in the early 1980s would have been in line with the trend of modest improvement had the external environment remained stable. What counted was that the strategy chosen was no longer viable, but also not easily reversible. Once in debt, it was more difficult to maneuver.

A LIQUIDITY CRISIS?

By the fall of 1982 there was widespread agreement that there was a debt problem. _Time_ magazine, perhaps with an overeagerness to sell copies, made the situation a cover story and christened it a "debt bomb." Others

more sober and analytically inclined differentiated between a liquidity crisis and a solvency problem: a short-term interruption of cash flow versus a long-term ability to repay debt. The majority view, including that of bankers, government officials, and independent observers, inclined to the former. The World Bank, in its 1983 report on external debt, stated it as follows:

> There is no generalized debt crisis: rather, the mutual difficulties of developing countries in servicing foreign borrowing and of commercial banks in obtaining service payments on foreign lending are an outgrowth of the broader economic problems that grip all of the world's economies. The resolution of these difficulties lies in a restoration of economic health to the global economy and a resumption of strong growth in international trade.[10]

There is basis for such a characterization in the magnitude of the effects set in motion by the oil-price shock in late 1979 and the policy response to it, as Table 5.3 has already brought out. There is also persuasive evidence from casting the perspective forward rather than backward. As the IMF's medium-term scenarios show, as Morgan Guaranty's balance-of-payments model confirms, and as William Cline's more recent projections for nineteen of the largest debtors reemphasizes, "If this growth rate [3 percent annually for industrialized countries] can be achieved, the debt problems of the developing countries should be manageable and should show considerable improvement. . . . The central result of this analysis is that the debt problem can be managed, and that it is essentially a problem of illiquidity, not insolvency."[11]

I am partial to this assessment. Yet at the same time it requires qualification in two important respects. For one, the analogy of countries to firms is not entirely adequate. Solvency for a firm is defined by an excess of assets over liabilities; otherwise it is bankrupt, and its creditors may benefit from the dissolution. On the other hand, countries do not cease to exist, nor can their assets, at least any more, be seized for distribution. Second, the technical requirement for solvency at a country level--a zero cumulative balance of payments over a very long time horizon, in order to guarantee repayment of accumulated intervening debt--is of limited practical significance. Since policies are variable, such a condition in principle could always be met over a suitably long period. So can the additional requirement that the real return on borrowing repay its cost, since capital in the developing countries remains relatively scarce.

A more relevant solvency criterion is therefore not the eventual capacity to pay, but the medium-term prospect for decelerating the increase in debt relative to exports. Such a criterion incorporates availability of foreign exchange rather than saving as the determining constraint in meeting external obligations.[12] It also substitutes the existence of a limiting debt-export ratio, with continuous growing debt, for the condition of debt full repayment.

For the debt-export ratio to converge to a maximum, with developing countries still recipients of a net resource transfer from the industrialized, requires that export growth exceed the interest rate.[13] If it does not, the further borrowing necessary to cover both interest payments and import purchases will exceed the increase in exports and force the debt-export ratio to continuously higher levels. With imports and exports exactly equal, the rate of growth of the debt is simply equal to the uncovered interest costs that must be borrowed. If exports do not grow at the interest rate, the debt-export ratio rises.

Only by running a merchandise surplus (i.e., transferring real resources to creditor countries) can debtors prevent the debt-export ratio rising when interest rates exceed export growth. That, of course, is what many such countries have been forced to do since 1982, but that does not make them solvent. Rather, it amounts to their acceptance of the present disequilibrium as a permanent state and their refusal to see beyond the temporary favorable balance of payments to the longer-term implications. Estimates suggest that such a transfer of real resources from the Latin American countries amounted to US$20 billion in 1982 and US$30 billion in 1983, representing 19 and 27 percent respectively of the value of exports of goods and services. "Thus was prolonged a situation that, taking into account the relative degree of development of the region, can only be qualified as perverse."[14] More generally, for all the countries in the World Bank reporting system, the positive net transfer of $16 billion in 1981 was converted to a negative US$7 billion in 1982 and a larger negative $21 billion in 1983.[15]

Favorable medium-term projections of the balance of payments, without regard to the necessary transfer of resources to the developing countries, are thus no *ipso facto* guarantee of solvency. Nor are even demonstrations of declining debt-export ratios, if they are achieved through premature graduation to export of real resources. Such exercises ignore the magnitude of the sacrifice entailed for the developing countries. They assume that ability to pay is equivalent to willingness to pay regardless of the costs.

But I have an additional objection to the prevalent characterization of the debt problem as a simple

liquidity crisis. My concern is that the balance-of-payments projections underlying such a diagnosis are overly optimistic. They place an undue emphasis upon economic recovery in the industrialized countries as a solution to the debt problem of the developing nations.

Careful attention to the quantitative estimates put forward is therefore in order. Because of both their care and their influence, I focus upon William Cline's recent detailed projections.[16] He started with a statistically estimated relationship of total OECD imports to industrialized-country income growth. He made this applicable to all nonoil-developing-country exports by adding a 1 percent higher trend rate of growth. That translated a 3 percent annual growth in OECD income into a 6 percent real increase in developing-country nonoil exports. It also implied a higher elasticity of three between percentage changes in industrialized country income and exports. Volume effects were only half of the story. Favorable terms-of-trade effects, higher prices from dollar devaluation, and enhanced developing-country competitiveness owing to aggressive real devaluation made up the difference. The terms-of-trade estimates were country specific where possible, unlike the volume estimates.

It was necessary also to estimate import requirements. For all countries, an import elasticity of unity was assumed for nonoil imports, with a cyclical adjustment for increasing growth. To these nonoil trade balances were added imports and exports of oil, both of which were held constant in volume terms. Finally, the service balance, including interest obligations, was added to arrive at the current account deficit. With additional assumptions about reserve accumulation and foreign investment, one arrives at net borrowing needs.

In accordance with the earlier discussion, special attention should be directed to the estimates of export growth. I have reestimated export volume for non-oil-importing countries as a whole as well as for some subgroupings directly as a function of industrialized income growth. I have done the same for real export prices, introducing the real interest rate, the change in the rate of inflation, and variation in the value of the dollar as additional relevant variables. The latter two are especially significant. Table 5.4 presents the responsiveness of export volume and the terms of trade with respect to the growth, and changes in the growth, of the industrialized countries. Underlying estimating equations are presented in the Appendix to this chapter.

The data in Table 5.4 suggest in the first instance that Cline's estimates, and others constructed similarly, overstated the sensitivity of real growth of developing-country exports to conditions in the industrialized countries. Whether for nonoil countries as a whole or for subgroups, for the longer period or for the shorter

since the first oil shock, these directly estimated elasticities are smaller than three. The sole exception is the country-specific estimate for Korea, whose much higher export growth produces a higher value. As a result, industrialized-country recovery has a much less dramatic impact on export performance. Whereas Cline implied a doubling of nonoil export growth from 3 to 6 percent if industrialized countries moved from a 2 to 3 percent rate of expansion, the comparable effect for non-oil countries as a group is a much more limited rise from 4.7 to 5.7 percent; for oil-importing countries in the period after 1973, the estimate is a difference between 5.0 and 6.7 percent.

What these more modest responses reflect is the strength of developing-country exports in recent years even in the face of international recession. As output growth in the industrialized countries slowed continuously from 4.1 percent in 1978 to -.3 percent in 1982, exports of the oil-importing countries continued to increase at high rates well in excess of world trade generally. In 1980 they grew at 9.2 percent; in 1981, at 5.3 percent; declining finally by 1.1 percent in 1982. That is shown in the small weight attributed to export volume shortfalls in Table 5.3. By Cline's formula, growth rates should have stood at .9, .6, and -3.9 percent respectively.

Developing-country exports were able to hold up better because of increasing competitiveness in industrialized-country markets that made sales more independent of total demand. They also could because developing-country demand was better sustained, at least through 1980. Something between 20 and 25 percent of all nonoil exports were sold to other developing countries. The sharp falloff in trade in 1982 reflected the closure of such markets as income decreased.

Recovery in the industrialized countries will therefore make a difference to the performance of the developing countries, but perhaps less centrally than has been maintained. In particular, it is far from obvious that the more rapid expansion now anticipated for 1984 will have the further beneficent effects presumed, especially since developing-country growth will continue to lag. My quarrel is with exaggeration of the sensitivity rather than with the order of magnitude of export growth if recovery should proceed at 3 percent. Something like 6 percent is a reasonable level consistent with my estimating equations.

Reduced export volume is not, as we have seen, the most important factor responsible for softer developing-country earnings. Rather, despite rather successful efforts to export, the prices of their products have fallen dramatically in recent years. During 1981 and 1982 prices of primary commodities exported declined by more than 25 percent. Even developing-country exporters of manufactured products encountered diminishing prices

Table 5.4 Elasticities for Developing-Country Export Volume and Terms of Trade with Respect to OECD Income Growth and Changes in Income Growth

Export Volume	
	Industrialized Country Growth
Nonoil developing countries, 1963-1982	1.08
Brazil, excl. coffee	1.83
Brazil, incl. coffee[a]	
Korea (1964-1982)	4.30
Nonoil, oil-importing countries, 1973-1982	1.73
Exporters of manufactures	2.46
Low income[a]	
Asia	2.29
Western Hemisphere	1.51

Terms of Trade[b]	
	Changes in Industrialized Country Growth[c]
Nonoil developing countries, 1964-1982	1.37
Brazil, excl. coffee	1.46
Korea (1965-1982)	.77
Nonoil, oil-importing countries, 1974-1982	1.27
Exporters of manufactures	1.18
Low income	1.86
Asia	1.29
Western Hemisphere	2.50

[a] Standard errors greater than coefficient

[b] Terms of trade measured by percentage change in developing-country export unit prices minus percentage change in developed-country export prices

[c] Average of current and lagged responses to changes in growth rates; terms of trade improvement realized over only a two-year period

Source: For data 1963-1982: International Monetary Fund (IMF), *International Financial Statistics, Handbook*, 1983; 1973-1982: IMF, *World Economic Outlook*, 1983; for underlying regressions, see Appendix to Chapter 5.

and deteriorating terms of trade.

Projections of exports must therefore take into account the evolution of prices as well as quantity. Cline's estimates of considerably improved terms of trade were on shaky ground. The relatively high elasticity of three that he obtained with respect to a one-percentage-point increase in industrialized country growth is not corroborated in Table 5.4. There, most elasticities with respect to changes in industrialized-country growth are smaller, especially for the categories of high-volume growth. This response is cyclical, leading to improvement in the terms of trade as a result of accelerating income growth without continuing gains in spite of stable, higher levels. I have presented the average impact on the terms of trade, realized over a two-year period since both current and lagged changes in income growth enter, of a one-percentage-point acceleration in growth. One of the reasons for Cline's higher responsiveness is semantic: He apparently summed the two-year effect. Another is that one of his few statistically significant estimates was for Brazil, which showed a large impact, and that the average was then applied to countries without information. The group results are more reliable.[17]

These terms-of-trade estimates are an intermediate stage in the forecast of developing-country export and import values. Cline proceeded to such absolutes by first projecting the export prices of the industrialized countries as the sum of general price inflation and dollar depreciation. This gave import prices. Then he added the estimated improvement in the terms of trade to get export prices. All told, these factors add about 20 percent to the value of exports and are thus the most important source of improvement in foreign-exchange earnings in 1984.

The implicit assumption is that depreciation of the dollar will affect exports and imports fully and therefore neutrally. But the joint rise in prices of traded goods will act to ameliorate the burden of a debt denominated in dollars. The real interest rate denominated in export prices will be forced down to lower levels as will the outstanding principal. Some of the consequences of disinflation are thus reversed.

Such neutrality is not confirmed by the experience with a variable dollar during the 1970s. Although developing-country import prices almost reflected fully the combined effects of inflation and changing valuation, export prices did not. Indeed, the statistical measurement of the effects shows a perverse tendency. There is a positive, rather than neutral, relationship between the annual terms of trade and dollar appreciation, other relevant factors held constant.

More concretely, in the last case of significant dollar depreciation in 1978, when industrial-country income growth was at a rate of 4.1 percent, export prices

of primary commodities fell considerably. Export unit value of major developing-country exporters of manufactures failed to rise as rapidly as the value of manufactured exports of the industrial countries. As a consequence, the aggregate terms of trade of oil-importing countries declined by 3.4 percent.

The response to dollar appreciation depends upon the underlying demand and supply conditions of developing-country imports and exports. Only if non-U.S. supply is perfectly elastic over the relevant range will the dollar price change of imports exactly reflect dollar appreciation or depreciation. The same is true for developing-country exports, for which an additional determinant is the share of non-U.S. demand in world demand in the absence of such a perfect elasticity. In short, there is no theoretical reason to impose neutrality in the face of opposing empirical evidence.[18]

Beyond the material already presented, I have also examined the quarterly changes in prices of Latin American export commodities since 1973, because annual changes obscure the within-year movements. These regressions--various forms were tried--do not replicate the more than unitary elasticity of prices with respect to the dollar exchange rate found by IMF studies.[19] The coefficient is much smaller and insignificant, although of correct sign.

The implications of dampening the price increase for Cline's estimates, and those of Morgan Guaranty that assume a 25 percent increase in prices of nonoil commodities between 1982 and 1985 (and now more concentrated because of the failure of significant recovery in 1983), are quite important. Table 5.5 maintains the assumptions of a 10 percent depreciation of the dollar and a 5 percent inflation and adjusts import prices by slightly less than their sum in accord with past responsiveness.[20] It merely substitutes an assumption of no terms-of-trade increase over the 1984-1986 period, a generous reading of the recent experience, in which dollar depreciation would more than offset the initial cyclical effects of higher growth in 1983 and 1984 and some modest increase in inflation with recovery. Further, it makes no allowance for the potential additional effects of country devaluations on the export volume of the aggregate. Part of the supply effect will be offset by compensating removal of internal subsidies, as well as on the demand side by substitution among developing-country suppliers as they compete with each other. There is a fallacy of composition in simply aggregating individual country responses without regard for the policies of others. Moreover, the projection is intended to bring out the tendencies inherent in the external environment, rather than possibilities of changed domestic policies.

The data in Table 5.5 reveal how sensitive Cline's optimism was, not with respect to international recovery, but to the valuation of exports. Elimination of the

Table 5.5 Alternate Balance-of-Payments Projections for Large Oil-Importer Debtors (in billions of current U.S. dollars)

	1983	1984	1985	1986
Exports	125.2	149.5	166.4	185.2
Imports	135.4	157.2	172.1	192.0
Interest	29.3	30.1	30.7	32.6
Fishlow				
Current account	-30.9	-28.3	-26.7	-28.6
Debt	327.6	354.3	377.6	403.0
Net debt/exports	1.88	1.86	1.78	1.71
Cline				
Current account	-30.9	-20.2	-12.6	-12.6
Debt	327.6	346.6	355.8	365.5
Net debt/exports	1.88	1.55	1.40	1.28

Source: Exports: 1983 base year times real growth of 6 percent times price increase of 12.6 percent in 1984 and 5 percent subsequently; imports: 1983 base year for nonoil imports times Cline's real growth times price increase of 12.6 percent in 1984 and 5 percent subsequently (oil imports from Cline); interest: based on debt at end of previous year, with rate weighted at two-thirds of LIBOR plus premium, one-third at fixed rate, less income on reserves (Cline's methodology); current account: incorporates services calculated using Cline's methods and his estimates of transfers and merchandise balance and interest as above; debt: current account less Cline's direct investment and reserve acquisition of .2 times change in imports (Cline's methodology).

surge in exports he projected in 1984 with more rapid growth, large dollar depreciation *and* significant improvement in the terms of trade means that debt would have to grow almost twice as rapidly as originally indicated. Debt-export ratios fall, but much more slowly, making obvious the continuing precariousness of the situation if the scenario is even marginally less favorable. Export price increases serve as the medium for recreating the inflationary environment of the 1970s and lessening the burden of the debt.

Cline's emphasis upon the virtues of developed-country recovery, even at the expense of high interest rates, was therefore equally overstated. At the lower elasticities estimated in Table 5.4, the immediate impact on value of exports of a one-percentage-point increase in industrial country growth is much closer to 3 percent than to 6. Hence the margin of superiority over the foreign-exchange savings of a single-percentage-point reduction in interest rates is halved to 2.5 rather than the 5 claimed.[21] Moreover, the proportional decline of a single percentage point in interest rates is much smaller than a similar one-percentage-point increase in growth rates and much easier directly to negotiate.

Because the effect of industrialized-country growth on exports is cumulative, continuing expansion at reasonable rates implies much larger levels of future foreign-exchange earnings and hence capacity to service debt. The policy issue, however, is not a tradeoff between recovery and high interest rates; rather, it is the concern that the ballooning U.S. public deficits, despite a positive effect on demand, will stifle expansion by raising rates. Nor should it be forgotten that the continuing high real rates are equivalent to a deterioration in the terms of trade: Offsetting that deterioration by volume increases still means lower income for the developing countries.

And interest rates enter critically, as pointed out earlier, in preventing debt from accumulating inertially. Cline's projections satisfied the condition of a higher export growth than interest rate both by a low real rate by vigorous export response by oil importers. Indeed, the debt-export ratio converges to zero as larger and and larger merchandise surpluses would be obtained. The amended results in Table 5.5 do likewise, although at a much slower rate. Yet it is essential to emphasize that neither meets an amended solvency requirement that allows for a continuing transfer of resources, on commercial terms, from the rich to the poor countries. That would call for debt to expand at higher rates, or interest payments to proceed at a lower. Under conditions of a resource transfer equivalent to 1 percent of nonoil-developing-country income, and a gross interest rate of 10 percent, debt would have to expand initially at an annual rate of almost 13 percent. With export growth at 12 percent, the debt-export ratio would initially climb, converging to a value of 2 from its 1982 level of 1.4. For countries with lower than average export-income ratios, the level would be even higher. Rapid expansion of exports, however necessary as a component of solvency, should not be made into a mechanism for premature capital export.[22]

The consequences of the modest restatement of the rate of nominal export growth in Table 5.5 should introduce equal caution about other optimistic scenarios. I am not alone. The Data Resources, Inc. (DRI), and Wharton projections of developing country exports have been less buoyant than those of Cline or Morgan Guaranty. So, too, have been the expectations of the IMF.[23] That such a difference is possible through very limited alteration of export projections reveals the inherent vulnerability of the debtor countries and the precariousness of the present situation.

There is basis for concern on grounds other than careful examination of recent experience. Extrapolation of past trends, if anything, may be too optimistic. We may not return to such favorable relationships in the future.

In the first place, it is by no means assured, with the higher unemployment rates now prevalent in the industrialized countries, that recovery will be as trade intensive as it was after 1975. Protectionist tendencies are much stronger as a consequence and are additionally fed by an asymmetric pattern of growth among the industrial countries. A lagging and increasingly less competitive Europe is a source of special concern. But so is a United States in which election-year politics strengthen the hands of special interests. Within a single week in January 1984, four escape-clause actions were filed, not alleging unfair trade, but merely injury; during the preceding three years only five such cases had been brought. Note as well that developing countries competitive in heavy industries (they tend to be the NIC debtors) are a special target. Under the formula proposed for carbon-steel imports, for example, the share for Japan and the European Economic Community would hardly be affected, while that for developing countries would decline from a current market share of about 10 percent to a mere 3 percent.

In the second instance, the present commitment to restrain inflation reduces the likelihood of replicating the commodity booms of the last decade. Demands for stocks are unlikely to expand as rapidly with real recovery. Increasing prices will also encounter resistance from purchasers who will see them as changes in relative prices, rather than as accompanying general inflation. High real interest rates will have the same effect of moderating demand.

In the third place, an exclusive focus on recovery in the industrialized countries ignores the consequences of debt-imposed depression in the developing countries upon their trade growth. Currently, intra-developing-country trade is responsible for about a fourth of developing-country exports. This market is most rapidly growing for the manufactured products many of the largest debtors are especially able to supply. Finally, there are even some who question the likelihood of continuing recovery, especially if U.S. budget deficits persist beyond 1984.

These concerns are more than theoretical. It is relevant to note that the initial stages of the industrialized-country recovery in 1983, more vigorous at 2.5 percent than had been predicted and therefore a larger change in income growth than projected for 1984, had little positive effect on the value of developing-country exports. Preliminary results for the most indebted Latin American countries showed continuing deterioration in the terms of trade, along with absolute declines in export prices.[24] To be sure the dollar continued to appreciate, but many analysts, because of prospective high interest rates, were less inclined to predict significant depreciation in 1984. That will have

its repercussions upon export prices and further erode the benefits of OECD recovery.

Despite lack of buoyant export demand in 1983, the balance of payments of the principal debtors did not deteriorate. On the contrary, the current accounts improved, especially those of oil exporters like Mexico and Venezuela. These countries had little alternative but to compress their imports dramatically to adapt to the lack of credit. They did so at the expense of income growth. For the oil exporters, it meant learning the necessity and possibility of import substitution practiced earlier by the oil importers.

The reason for this detailed treatment of Cline's projections is not to substitute another set, nor even to question the manageability of the crisis with developed-country recovery *and* developing-country adjustment. Rather it is to emphasize that the responsibility for adapting to the overhanging debt seems likely to fall disproportionately upon the debtors, with only partial amelioration from the magic of industrialized-country growth. The IMF says as much:

> . . . the results of Scenario A are less favorable as far as growth is concerned, and imply stronger adjustment efforts, than those presented last year. In part because of a lower flow of bank lending, the new Scenario A envisages . . . a lower deficit . . . despite conditions that would be less favorable for exports. The result is that the aggregate real GDP of non-oil developing countries in 1986 is now expected to be about 5½ percent less than previously estimated. The volume of their imports is projected to be nearly 13 percent less.[25]

Optimism about international recovery has the luxury of ignoring the implications for the willingness of developing countries to pay under adverse conditions. Realism requires a closer look.

THE IMF ADJUSTMENT PACKAGES

The Economics of Stabilization

Whatever the future may hold, the recent past has been unambiguous in forcing adjustment programs upon many debtor countries, as well as on others adversely affected by the downturn of the world economy. Such adjustment has been under the aegis of the IMF in both instances, but with a crucial difference. For the debtors, these arrangements have included a crucial component of continuing, if reduced, bank lending. The

IMF has thus taken on an enhanced role, quite apart from the impressive quantitative expansion of its commitments.

The emphasis on developing-country adjustment in arriving at such agreements speaks to a structural component of the debt crisis that adherents to a sheer liquidity view tend to ignore. If the issue were one of mere temporary balance-of-payments difficulties of the debtor countries, owing to unanticipated external circumstances, the Fund's own criteria would call for compensatory finance rather than the conditionality imposed in fact.

That conditionality is based on the premise that many debtor countries have adjusted incompletely and imperfectly to a new and harsher external environment. For the IMF, the failure arises from excess aggregate demand as well as from an allocation of expenditure that is biased against exports. Whatever the variability in the specifics of particular programs, these elements are the central ones.

First, identification of balance-of-payments problems with excess demand entails a need for restrictive policies to restrain domestic expenditure. In particular, the public sector is typically singled out for deficits that contribute not only to demand but also to domestic credit creation. Elimination of subsidies, increased taxes and prices of public services and of products produced by state enterprises, and reduced outlays are typically recommended. The emphasis on fiscal policy is augmented by insistence upon controls over expansion of domestic credit. Before it gained wider academic fashionability, the Fund pioneered in the monetary theory of the balance of payments that relates changes in net international reserves to internal monetary policy. Starting from that premise means that financial balance is as important as control over expenditures. In practical terms, it means advocacy of high real interest rates to eliminate financial repression and encourage domestic saving.

Second, a further consequence of the Fund outlook is to link domestic inflation directly to balance-of-payments performance. Although it is possible significantly to attenuate that link by a flexible exchange rate that does not become overvalued, as the Fund itself has conceded by backing away from the fixed-rate regimes it insisted upon in the 1950s and 1960s, attainment of price stability is a principal objective. Inflation is not regarded as neutral, because its acceptance reduces discipline of the public sector as well as inevitably leading to inefficiencies in resource allocation. A direct implication is containment of nominal wage increases and rejection of indexing arrangements that carry forward past inflation.

The exchange rate is the third key price that must be set right. Real devaluation, in which the Fund still

believes, if not the neoorthodox international monetarists, has two effects. In the first instance, it reduces real income by increasing the price of tradable goods and thereby contributes to the objective of decreasing expenditure. In the second place, the relative price change makes exports and import substitutes more profitable and imports more expensive. Realignment of production improves the trade balance, which--given the restrictions on supply of external capital and continuing high interest rates--is the only source of improvement of the foreign accounts.

The package is a formidable undertaking, particularly when combined with other efforts to dismantle controls and to rely more fully on market incentives. For all the emphasis upon aggregate demand in devising adjustment programs, there is an implicit, if simple, theory of supply: Supply responds elastically to market signals. For efficiency's sake the signals must be the right ones. The programs may thus be exigent, but nothing less will work. The Fund goes farther in their defense, suggesting that the adverse effects of conditionality--criticized since the 1950s by Latin American structuralists--should not be exaggerated.

> It is sometimes contended that the restrained demand management policies--which are always central to Fund programs--are inimical to growth. . . . However, an analysis of 26 recently approved stand-by and extended arrangements reveals that, in a great majority of the cases, real growth rates are projected to improve even during the first program year by comparison with the two years prior to the program; only in 7 of the 26 cases is growth expected to decline.[26]

Since such programs typically are adopted in the midst of decline, such a statistic does not preclude a legitimate concern for the output consequences of demand restraint under conditions now prevailing in many of the debtor developing countries. In principle, were the diagnosis of generalized excess demand correct and demand for exports very elastic, the IMF policies would lead to reduced real income, but not at the expense of unemployment or excess capacity. Growth could and would resume, led by production of exports and of import substitutes, even as the balance of payments improved and inflation diminished. In 1982 and 1983 there was scant evidence for such a conclusion, as the countries most afflicted by the debt crisis and following policies of restraint experienced significant declines in growth, accompanied in some cases by accelerating inflation.

The reasons are related to structural characteristics of many of these developing countries. Instead of the stable and responsive aggregate supply function

presumed by Fund orthodoxy, and therefore ignored, supply conditions are a critical factor influencing the effectiveness of stabilization attempts.[27]

In the first instance, adjustment lags between expenditure reduction and output reallocation are important. Reduced fiscal deficits, even accompanied by devaluation, do not necessarily translate quickly, and in the right proportions, into private decisions to employ labor and capital to produce exports. Nor is such labor and capital fully mobile. Export supply is not perfectly elastic. The direct adverse output results of expenditure contraction are felt immediately whereas the indirect beneficial effects take longer to work themselves out.

In the second place, the contraction in domestic credit and rise in interest rates will create shortages of working capital and lead to curtailment of output--not merely demand. Firms will find it more profitable to speculate financially than to produce. Adding to this impulse is the effect of reduced imports. Because inputs are not perfectly substitutable, imports are an important determinant of potential supply. Balance-of-payments improvement obtained by cutting back on essential imports soon has ramifications that extend throughout the productive system.

In similar fashion, drastic retrenchment of the public sector can be costly. The most flexible components of public budgets, of central and local governments as well as of state enterprises, are investment expenditures. Capital formation, frequently complementary to private production, is sacrificed for immediate economies, with implications for subsequent productive capacity.

Aggregate supply is therefore not continuously forthcoming at the point of full employment as demand is reduced, with the effects of restraint falling solely on the rate of inflation. In fact, inflation is fed by the reforms introduced. Corrections of distorted public-sector prices, removal of subsidies, increases in taxes, and so on all lead to a once for all increase in prices. So do the increase in real interest rates and the rise in import prices following from devaluation. These cost components of inflation may be extended in two ways. Wages may be indexed to the inflation rate, and so also rise. Increased interest rates, and devaluation, will also force up government payments on internal and external debt respectively. These, of course, place additional demands upon domestic credit and further pressure on interest rates.

Disinflation, in other words, is much more complicated than simply reducing demand and carries with it the risk of exacerbating output declines. The very instruments of structural reform through relative price change make it more difficult to accomplish. Concentrating on inflation, at the expense of real balance-of-payments and production targets, may be counterproductive.

Eliminating index links and influencing expectations more favorably make the task of dampening inflation easier. The former is easier and more reliably done for wages than the interest rate or the exchange rate, with adverse consequences for the distribution of income. Convincing the public of declining inflation, in the midst of contrary inertial tendencies and historical evidence, may also lead to serious distortion of the exchange rate, with eventual adverse consequences for the balance of payments. That is certainly one lesson of the Southern Cone experience, in which preannouncing (and, in Chile, fixing) the exchange rate became the centerpiece of neoorthodox policy. Preoccupation with the wrong target proved costly, not least in contributing to the accumulation of excessive debt.

The Fund's approach to inflation makes it too central a goal, while at the same time giving inadequate attention to the potential short-term inconsistencies between adjustment and disinflation. In establishing its inflation targets, and hence credit limits, it errs, apparently deliberately by the testimony of one of its staff, on the side of unrealism: "In general, corrective policy programs should aim at reductions in the rate of inflation that are perceived as significant--even if they do not appear particularly realistic--in order to influence expectations in the right direction."[28] But such a strategy contributes to inadequate, excessively stringent monetary policy and to expectations that cannot long be maintained. It is surprising to see the Fund rely upon irrational expectations to make its policies work.

On the positive side, the Fund program is designed to encourage and, now, to require continued capital inflow to lessen the costs of adjustment. But equity investment, now being emphasized as a substitute for borrowing, is actively discouraged by the declines in income and makes no contribution. Nor is new money in the form of loans flocking to countries in the midst of wrenching internal contraction.

This discussion of the orthodox adjustment programs now being undertaken by the largest debtor countries makes clear two essential points. One is that they may be costly in their output consequences over some time, although attaining their balance-of-payments and inflation targets. Of these, a favorable trade account is much more certain, if only because the constraint of limited external finance makes it a necessity. Moreover, the very decline in national production reduces import demand and becomes the basis for the trade improvement registered. Even in failure, the interests of the creditors are guaranteed priority.

In the second instance, granted fully successful adjustment, there will still be a devaluation-induced loss in real national income. Changed relative prices

for labor and capital as wages are restrained and interest rates raised may also provoke a possible deterioration in its distribution. In addition, the public sector's role will have diminished. Direct expenditures will have been reduced, and state enterprises curbed. In short, the impact of adjustment will have significant and differential effects upon important interests and therefore necessarily a significant political content.

The Politics of Adjustment

It should come as no surprise after this discussion that stabilization policies encounter significant popular resistance. More than a decade ago, Richard Cooper calculated that currency devaluation approximately triples the chance that the responsible finance minister will be gone within the following year and doubles the probability that the government will fall.[29] If contemporary statistics are perhaps more favorable, it does not reflect a change in popular reaction, but rather speaks to the durability of authoritarian regimes whose claim to power partially rests on the willingness to impose the unpopular.

Austerity programs understandably encounter resistance because they affect established interests and claims on income. Workers resist erosion of wages and mounting unemployment. Employers complain about higher taxes and interest rates and about reduced subsidies. It is not difficult to construct a coalition of opposition to policies that seem to guarantee certain present losses, while only holding out the probability of eventual benefits. To a beleaguered citizenry, stabilization appears a negative-sum game, even in comparison with the deteriorating economic conditions that provoked it in the first instance.

But to frame the matter in terms of perceived self-interest is to characterize the opposition too narrowly and materialistically. If it were not for past experience, more replete with stop-go cycles than successful stabilization, and a respectable literature skeptical of the excessive costs of orthodox policies, dissent would not run as deep.

What has been added to these traditional responses this time is the further conviction that the origins of the problem are external. This is a crisis manufactured in the boardrooms of New York banks, requiring payments due despite an industrialized-country recession and high interest rates. For even the oil importers, the effects of the oil shocks recede in favor of these factors that have weighed more heavily in 1981 and 1982. There is also a conviction that the burden is being shared unequally, without regard to the cost imposed on

poorer countries ill equipped to bear it.

A recent letter to the Economist from Brazil made the point more eloquently than the rhetoric of formal statements:

> Citizens of the "first world" refuse to understand that recession, for us, means more starvation, more children abandoned by miserable parents and a sharp increase in infant mortality and illiteracy. . . . Yesterday I helped a man who had an epileptic fit. He had told his doctor he was taking only half of the prescribed quantity of medicines in order to make them last longer. . . . If this illiterate Brazilian finds out that the loss of his job was caused by a recession provoked by the obligation to pay back the money which first-world bankers enticed us to borrow, plus interest, he will certainly become a sort of Sandinist, or worse.[30]

Under mounting social consequences of adjustment, and in conjunction with external interest payments that exceed new borrowing, default--or at the least unilateral renegotiation--becomes an ever more attractive option. Both Mexico in 1982, and Argentina after the election of President Alfonsin have essentially imposed a moratorium without repudiating their obligations. The precedent has been lost on others, although it has not diminished the zeal of the IMF in its conditionality or the preference of the banks for case-by-case treatment.

Rigid stabilization programs and seeming bank intransigence do not fit well with the new political effervescence in Latin America. A civilian president rules in Argentina with a majority mandate. In Brazil, the military is beating a retreat to the barracks in disarray. In Chile and Uruguay, pressures for greater popular participation are mounting. The present crisis does not have its roots in populist excesses or democratic failures: It is the product of a now increasingly repudiated technocracy that deemed economic management above and beyond political control. It does no good to insist upon the technical quality of the adjustment package and to ignore these new realities nor to flaunt external intervention at a time when restoration of national pride is a central source of legitimacy for the new civilian politicians.

These new political realities in some of the largest debtors, and not alone in Latin America as the Philippines exemplify, cannot help to influence responses to the debt crisis. Up to a point, austerity can improve the prospects for meeting obligations by generating trade surpluses and hence the ability to pay. But applied too long and too painfully, austerity can provoke a hostile rejection of international claims in favor of domestic

pressures. Seemingly rational calculations that demonstrate the futility of default because of the penalties of interrupted potential future capital flows and interference with current merchandise transactions carry less weight in the face of social disruption. An uncertain future may seem less adverse than the known depression, against which conventional reactions seem futile.

Even were the prospects for trade to improve, more popular governments cannot fully ignore the magnitude of the transfers they are being asked to make out of national income. As the external debt mounts to more than half of total product in Argentina, Mexico, Peru, Korea, the Philippines, and Chile--in the latter to 90 percent--high real interest rates impose a palpable effect on the standard of living. At a 7 percent rate, in the Chilean case in 1984, the interest payments amount to more than the equivalent of the income of the poorest fifth of the population. If the impact is less dramatic for others with lower debt-income ratios, the reduction in national income still remains significant and sensitive to reigning interest rates set abroad.

I raise the issue of the potential diminished willingness to pay contractual debt service without concluding, as some erroneously may, that a return or continuation of authoritarianism can avert the problem. It can assure only illusory stability. Effective medium-term economic adjustment requires a flexibility in the face of changing conditions that military regimes have rarely, rather than commonly, shown. The capacity to engage in continuing income transfers of large magnitude ultimately depends upon informed consent rather than force. Even in the short term, discredited authoritarian governments have shown little capacity to manage stabilization programs.

Moreover, the new political forces have learned from the errors of the past. Few political leaders in the large debtors believe in easy populist solutions. There is broad recognition that although most countries erred by excessive and asymmetrical integration into world capital markets in the 1970s, export promotion and expansion are an indispensable commitment in the 1980s to reduce dependence. In the second place, there is no illusion that foreign resources will be available in the future in the proportions of the recent past; internal saving will be required. Third, there is widespread appreciation that sheer expansion of the public sector does not constitute an acceptable development strategy any more than full reliance upon market signals. Finally, there is little faith in the possibility of massive income redistribution in the short term.

These are important bridges to a more consensual stabilization strategy whose prospects for minimizing the real income decline turn critically upon the capacity to distribute the losses equitably. The apparent success in the Mexican stabilization program stems from the

ability not merely to enforce lower real wages but to limit the effects of inflation on the prices of certain essential products for the mass of the population. Another element, of course, was the immediate and substantial debt-service relief by restructuring short-term debt and putting off amortization until 1985.

Such a consensual strategy, ironically, may involve measures more drastic than the conventional ones imposed by the Fund. In a depression of this magnitude for Brazil and Argentina, and with inflation well in excess of three digits, more dramatic efforts may well be necessary to deal with an internal debt whose interest payments alone are the principal pressure on public-sector borrowing requirements; to reduce real interest rates that have sharply curtailed private investment; to halt the unleashed spiral of rising prices and costs. These are not easy tasks, and it would be wrong to minimize their difficulty or to ignore the potential problem of reconciling austerity and legitimate popular claims. Only if there are degrees of freedom for domestic policymakers to act can adjustment be achieved. If the balance of payments and debt service take absolute priority, internal disequilibrium will persist and will be a constant provocation for unilateral default that could well be inimical to restoring global recovery in the 1980s.

THE INSTITUTIONAL FRAMEWORK

The Policy Matrix

At the beginning of 1984, the elements in place to deal with the debt problem were little changed from what they were in August 1982. What had been added was additional resources from the quota increase of the IMF and the considerable experience gained by the repetitive tasks of renegotiating debt and of hammering out country adjustment packages on a case-by-case basis. That there was so little change derived less from satisfaction with the policy matrix than from lack of consensus on the appropriate more far-reaching reforms. Financial circles were far from tranquil. *World Financial Markets*, in its June 1983 assessment, found wanting the "relatively optimistic, laissez-faire school that assumes the current debt situation is a fairly short-term liquidity issue" to be solved primarily through LDC (less developed country) adjustment along with some OECD recovery. "By ignoring long-term structural elements of the international debt problem or overstating the prospects for global recovery, this approach risks forcing excessive deflationary costs on borrowers. It is also overly optimistic about market forces providing ample new borrowing."[31]

The present situation derives its stability from the tenuous mutual interests of creditor banks and debtor countries in this moment of crisis. Banks are committed to extending additional credits to countries currently in difficulty only because they perceive such a policy to be in their self-interest. They are not development institutions. Banks are lending involuntarily in order to avert defaults that would expose the precariousness of their balance sheets and with some hope of ultimate repayment under better future conditions. Their "lending trap" is the counterpart of the "debt trap" ensnaring countries that must borrow to meet their interest payments, increasing their debt without counterpart resources for adequate imports to underwrite recovery or even export expansion. Countries continue to pay because they fear the immediate losses from trade potentially interrupted as a result of default and hope for resumption of needed capital flows in the future.

Such a situation serves each party badly. It has led banks to short-sighted efforts to obtain larger profits to compensate for their perceived greater risk. This has taken the form of increased margins in the form of one-time fees and of ongoing premiums over the deposit rate. For the reschedulings completed for Latin America, amounting to some US$44 billion for seven countries, banks have obtained commissions of between 1 and 1.25 percentage points, as well as revised spreads that have usually added about a full percentage point to previous ones. These earnings might have added between US$70 million and US$130 million to profits of the largest nine U.S. banks, depending on the relevant marginal tax rates. They translate into an increased return on loans to those seven countries of about 25 percent in comparison with previous terms, quite independently of higher spreads being charged on new loans.[32]

Ironically, the absolute effect on total profits is relatively small, as is the effect on the borrowers. The cost of the higher premium over LIBOR to Mexico is less than 1 percent of foreign-exchange earnings, for example, since what is relevant to the country is the total interest rate and not the margin. But the ill will is considerable of arbitrarily imposing increased costs of servicing on an already burdensome debt. Such charges are not market determined because the lending is involuntary; pressed by Mexico, Argentina, and Brazil, the banks in fact subsequently agreed to reduce their spreads somewhat. The countries were joined in their protests by Paul Volcker, motivated by concerns of system stability rather than immediate profits.

At the same time, of course, the large money-market banks are themselves not pleased by the demands on them. Citibank, in particular, seems to have reacted against Volcker's intervention, although all these banks are being

forced to set aside larger loan loss reserves to satisfy bank examiners and a Congress concerned with excessive bank exposure. Large U.S. banks must also cope with second-tier banks who have much less to gain from a continued lending relationship with developing countries and do not want to renew outstanding loans, even at higher spreads. Michigan National Bank has even taken Citicorp to court over the involuntary extension of a US$5 million participation in a Petróleos Mexicanos (PEMEX) loan. For new money, the money-market banks can no longer count on tapping their regional colleagues.

On their side, as we have seen, the countries have fared badly. For all of Keynes's oft-quoted dictum about the advantage of large rather than small debts in dealing with creditors, the countries have been able to extract only modest additional resources from financial markets and that at the expense of austerity programs. They have been forced to give priority to merchandise surpluses and in the dominance of a single policy objective have failed to design as yet more adequate and longer-term responses to their situation.

The Fund has performed three essential functions in making this delicate arrangement work. For one thing, it has offset individual bank prudence that would call for a reduced commitment and shorter maturity by imposing proportional lending targets. This new conditionality imposed on the banks defeats the free-rider problem inherent in a pure market relationship. Each bank would hope the others would participate, making it better off; such behavior, because none would, would make them all worse off. For another thing, the Fund has devised adjustment programs that assure the lenders of developing-country efforts to meet their obligations and thereby avoid the moral hazard of countries simply borrowing more without an intention to repay. Finally, the IMF, in conjunction with the BIS, central banks, and industrial-country governments, has made available public resources to satisfy immediate liquidity requirements and to supplement the private market.

Central authority has thus been indispensable to a continuing bank-country relationship. The principal virtue of this implicit tripartite debt regime has been its capacity to blunt serious repercussions to the financial system of the debt shocks that have occurred. Strains have been evident. Countries have reacted against the discipline imposed by the Fund, and in the case of Venezuela, no agreement has yet been possible. Banks have, in the case of Brazil, found the Fund so preoccupied with the integrity of its own stabilization package that their loans were in danger of being declared nonperforming. Until the program was approved, they could not lend Brazil the money needed to cover the overdue interest payments. Still, because both banks and the countries need the Fund, this case-by-case framework has

survived.

As successful as this ad hoc arrangement has been thus far in responding to crisis, it has two serious deficiencies. For one, it has contributed to a continuing short-term mentality. The banks still see their advantage in a minimum amount of additional lending or renegotiation they are prepared to undertake. They, and even the Fund, prefer to see the country on a short leash and constantly accountable. Although the arrangement may eliminate the moral hazard problem, it does so at the risk of miscalculating the provocation to default. And, of course, it is precisely that uncertainty that reinforces the preference for dealing not only with one country at a time, but also one year at a time. The structure is thus potentially unstable.

In the second place, current policies fail to address the adequacy of the long-term supply of capital. Quasi socialization of the international banking system by the Fund in an emergency is one thing; continuing imposition of broader systemic goals is quite another. There is no reason to believe that the private profit calculus will produce the right amount of capital for the right developing countries in the future. One of the causes of the present crisis is precisely such market failure.

Voluntary lending will not recuperate quickly, according to all present signs and past historical reaction to external debt problems. Present U.S. economic policy makes the prospects even bleaker. A recent quarterly report of the Bank for International Settlements called attention to the evolution of a segmented financial market. "On the one hand, Western banks have now virtually stopped all voluntary lending to the third world and Eastern Europe, because of concern about repayment. But business transactions among the industrial nations appear to be picking up briskly as American banks accelerate their borrowing from other Western countries to finance America's payments deficit."[33]

Dealing exclusively to avert the worst is not necessarily equivalent to the good, let alone the best. The present policy context is fraught with dangers. Recovery may not continue at its present pace, placing more demands upon a potentially unstable bank-country relationship. Social costs in some of the developing countries may lead to failure to live up to stabilization targets. The continuing pattern of adjustment via trade surpluses may evoke even more pronounced tendencies toward protectionism, with significant consequences for the structure of the trading system. Reaction against rapidly rising imports from the NICs can spill over to imports from industrial-country competitors. These possibilities, and with them slowed industrial-country growth, are real. That reality contributes to a pervasive uncertainty, itself a constraint on recuperation of the

global economy in the 1980s.

More Radical Alternatives

In the aftermath of the Mexican shock, when prospects seemed much dimmer for muddling through and the perils more immediate, a variety of more radical reforms were suggested.[34] Despite differences among them, many shared common characteristics. One was reduction of current debt service to developing countries in a decisive fashion, thereby alleviating the foreign-exchange constraint that forced sharp reduction in economic growth. Another was reduction of the total debt burden faced by the countries through a transfer of resources from creditor banks and/or industrial countries, either in the form of writing down the debt or rescheduling on favorable terms. A third was an enhanced role for a public presence in financial markets to monitor and influence lending and borrowing as well as country adjustment.

The most common means offered for achieving these objectives was purchase of bank developing-country loans by an existing, or new, international agency. Banks would sell their loans at a discount in exchange for the securities of the agency, thus substituting a known but limited loss for their present uncertain exposure. The agency in turn would recontract the debt of the countries at longer maturities and lower prices, passing along the bank write-down and possibly additional concessions from special governmental appropriations. The new arrangements would thus improve the quality of bank portfolios, shift the debt to an international development institution whose concerns would be broader, and distribute the costs of excessive debt accumulation more equitably among banks, industrial countries (through forgone taxes on potential bank profits and capital contributions to the agency), and developing countries.

Another approach, analogous to corporate reorganization, would substitute for present bank loans fixed shares in country export earnings, thus a virtual equity participation. Countries would pay only a ceiling percentage of export receipts for debt service, and creditors would share in the benefits of recovery by larger absolute repayments.

These plans have been criticized for their shortcomings.[35] Most salient has been the failure explicitly to provide for flows of new capital once past debts have been reorganized. Another is the volume of public resources required to fund purchase of the bank loans, even if capital is only fractionally paid in. Although the agency would issue its own securities, as the World Bank does, and no actual expenditure would need to occur, an appropriation for capital would be necessary and subject to the resistance recently encountered in the

expansion of IMF quotas. A third criticism is that their generality encourages even sound debtor countries to relax their adjustment efforts in favor of unneeded debt relief.

These observations, although they have merit, exaggerate the deficiencies inherent in the plans. The failure to assure new lending in the needed amounts is, after all, one of the indictments of the present situation. In this respect, the plans share the optimism of those who believe that in the long term capital markets can be trusted to provide the necessary resources. It would not be difficult to assure continuing involuntary lending of banks since their entire portfolio would not be eliminated, nor would the requirements be as great with reduced debt service. Interestingly enough, other proposals that do emphasize guarantees to underwrite capital flows have fared no better.[36]

Nor is the issue impossible levels of public expenditure. Had an appropriation of the magnitude extended to the Fund been applied to purchasing debt, it could have made possible, with paid-in capital of 10 percent, a transfer of almost US$300 billion in loans, close to the entirety of bank exposure.

Finally, the potential excess alleviation of the burden on developing countries by substituting debt relief for adjustment is easily managed. Characteristic of these reforms is an expanded, rather than reduced, public presence in developing countries. Indeed, by redistributing the portfolio of debt _ex post_, it compensates for the excessive reliance on private institutions to resolve a development problem.

The real issue is not the technical adequacy of one proposal versus another. Designs can be perfected, and additional features added. Nor is it even the specific distribution of costs to be shared among banks, developing countries, and industrialized countries. These will determine the preference for one or another approach and are a matter for negotiation. Indeed, we have already seen how the banks have lowered their spreads in response to pressures on them; other concessions, like a cap on interest payments that converts costs above a specified rate into automatic--and cheaper--rescheduling, may also emerge.

But neither these changes, nor more far-reaching reforms that would involve larger transfers of resources, are encouraged by the present debt regime. Banks are unwilling to opt for modifications even if both they, and the system, could be made better off. To admit the need for change is to confirm the inadequacy of present arrangements and to risk testing them. All along the banks have been saying that the problem is minimal, even while agreeing to reschedule some $100 billion in debt. To call for help that did not come would be counterproductive; at best therefore, banks are reactive and

limited to short-term palliatives under their control.

Developing countries are not much better situated. The leading debtors must proclaim their commitment to the present system and the unfailing integrity of their obligations if they are to have access to the assistance they need. For all the talk of a "debtor's OPEC," incentives for individual compliance are much stronger than group repudiation. Differing individual circumstances and prospective lack of a united front make any other policy a risky one. Foreign ministers may jointly advocate general resolutions, but individual central bankers continue to pay periodic visits to New York to deal with the problem.

In the last analysis, lack of leadership by the industrialized countries, and especially the United States, rather than the inability to devise a better framework for dealing with the debt problem, explains the present inaction. The Reagan administration is self-confessedly skeptical of the multilateral Bretton Woods system and even of extensive cooperation among the industrialized countries. In the election year of 1984, as the crisis atmosphere of 1982 receded, case-by-case emergency care rather than systemic analysis gained in allure. Making the debt issue a narrow liquidity problem conformed to such a mind-set. Absent a financial collapse, the costs remain implicit rather than budgetary: Taxpayers pay through slower growth and increasing alienation of the developing world rather than by appropriations.

It is not a unique predicament. Keynes, in the midst of the Great Depression, wrote a less cited passage appropriate to present circumstances:

> It is as though two motor-drivers, meeting in the middle of a highway, were unable to pass one another because neither knows the rule of the road. Their own muscles are no use; a motor engineer cannot help them; a better road would not serve. Nothing is required and nothing will avail, except a little clear thinking. So, too, our problem is not a human problem of muscles and endurance. . . . On the contrary, it is, in the strictest sense, an economic problem or, to express it better, as suggesting a blend of economic theory with the art of statesmanship, a problem of political economy. I call attention to the nature of the problem, because it points us to the nature of the remedy. It is appropriate to the case that the remedy should be found in something which can fairly be called a <u>device</u>. Yet, there are many who are suspicious of devices, and instinctively doubt their efficacy. . . . But the lorries of these people will never, I fear,

get by.[37]

It required the Great Depression of the 1930s for Keynesian counsel finally to be adopted, and then imperfectly. Billions of dollars of potential output were irrevocably lost. The developing countries are confronting no less an economic tragedy in the 1980s. So far it has not much influenced official perceptions in the industrialized countries. "Clear thinking" remains sporadic and limited to short-term crises like the response to the Mexican situation in August 1982, a by-product of which was easing of U.S. monetary policy. Ideological insistence upon the magic of the market dominates pragmatic adaptation to its failures. The debt problem we confront is testimony to limitations of market forces. An active participant in lending concedes as much by affirming, "while the international debt situation is manageable, it will not manage itself."[38]

We have failed once. Three years ago, I wrote of the then looming crisis:

> The principal danger is not the wholesale default by developing countries and the possibility that it may bring the world financial system crashing down. The principal danger is that available international finance will be inadequate to maintain a reasonable level of world economic growth in the 1980s. If the supply of funds proves inadequate, it will be the largest debtors--many of them Latin American countries--who will be most in danger. They will have to bear the brunt of the adjustment burden themselves. . . . The developed countries may not react to strengthen the system in time to avoid slowing of growth of their exports to the developing countries. The burden will fall primarily on the developing countries. Interdependence is still asymmetric.[39]

That prognosis unfortunately has proven accurate.

The apparent limited impact upon the U.S. recovery, and that of other industrialized countries now showing signs of more rapid growth, is the wrong lesson to draw from this experience. The right one is that there is still time to act to deal with the problem before the economic and political consequences become irreversible. There is no shortage of practical proposals, or "devices." Even in the absence of U.S. leadership and larger resources for official lending or transferring some of the debt, the World Bank and the International Monetary Fund can help break the impasse by extending the horizon of developing-country adjustment and bank participation beyond the current preoccupation with the immediate term. More flexibility in the design of adjustment programs, undertaken in closer collaboration with the commercial

banks, and more political sensitivity would make a significant difference.

The largest banks, in their own self-interest, could take more initiative in proposing changes in current lending practice, such as accepting more of the risk of interest-rate variability, making renegotiations more automatic in the event of adverse external shocks, renegotiating larger sums for longer periods, and so forth. Continuing passiveness is a formula for developing-country discontent and ongoing uncertainty in financial markets. The banks' stake need not be left to others to defend.

In the last analysis, the debt problem is a development problem, not one of liquidity or solvency or even of the vulnerability of the financial system. As such, it is not exclusive to the performance of the developing countries alone, but has ramifications, increasingly if still unequally, for the developed as well. Nor is the issue a technocratic one, devoid of political content. Until this realization becomes more pervasive, we shall continue to cope with the creeping crisis of debt rather than confronting and resolving it.

APPENDIX

Table 5.6 Estimating Equations for Export Volume Elasticity in Table 5.4

Percentage Change in Export Volume of:	Constant	Percentage Growth of Industrialized-Country Product	D-W	Adjusted R^2
Nonoil developing countries, 1963-1982	2.5	1.08	1.61[a]	.10[a]
	(2.4)[b]	(.52)		
Brazil, excl. coffee	6.0	1.83	2.25	.04
	(5.8)	[c]	(1.40)	
Brazil, incl. coffee			-.03	
Korea, 1964-1982	10.2	4.30	1.42	.26
	(6.5)		(1.59)	
Nonoil, oil-importing countries, 1973-1982	1.5	1.73	1.50	.64
	(1.4)		(.41)	
Exporters of manufactures	2.1	2.46	1.71	.71
	(1.7)	(.51)[c]		
Low income			-.10	
Asia	3.9	2.29	1.95	.49
		(2.5)	(.74)	
Western Hemisphere	1.1	1.51	1.78[a]	.31[a]
	(3.8)	(.73)		

[a] One observation omitted to adjust for autocorrelation of the residuals

[b] Standard errors in parentheses

[c] *t*-value less than one

Source: Nonoil developing countries: International Monetary Fund (IMF), *International Financial Statistics, Yearbook, 1983*; nonoil, oil-importing countries: IMF, *World Economic Outlook, 1983*.

Table 5.7 Estimating Equations for Terms of Trade[a] in Table 5.4

	Constant	D73,74	Change in Industrialized-Country Growth Rate	Change Lagged	Inflation Rate	Interest Rate	Dollar Appreciation	D-W	Adjusted R^2
Nonoil developing countries, 1964-1982	.4	8.0	1.21	1.53	1.63	-.30	.73	2.21	.89
	(.9)[b]	(2.1)	(.29)	(.25)	(.45)	(.27)	(.17)		
Brazil, excl. coffee	-.2	13.9	.87	2.05	.22	-.23	.70	2.49	.28
	(3.2)	(7.8)	(1.08)	(.91)	(1.64)	(.99)	(.61)		
Korea, 1965-1982	4.0	-5.7	1.85	-.32	3.30	1.56	.22	1.20	.07
	(3.2)	(7.9)	(1.11)	(.92)	(1.67)	(1.01)	(.62)		
Nonoil developing countries, 1981-1982	1.5		1.58	1.45	2.51	-.52	.73	1.70	.86
	(1.3)		(.49)	(.37)	(.59)	(.42)	(.21)		
Brazil, excl. coffee	.4		1.96	2.04	2.47	.001	.57	2.30	.15
	(4.5)		(1.69)	(1.29)	(2.04)	(1.46)	(.74)		
Korea	3.30		2.07	-.59	2.81	1.40	.23	1.84	.54
	(1.99)		(.74)	(.56)	(.89)	(.64)	(.32)		
Nonoil oil-importing countries, 1974-1982	-.3		1.16	1.38	1.75		.86	2.81[c]	.95[c]
	(1.3)		(.22)	(.20)	(.30)		(.11)		
Exporters of manufactures	.8		1.26	1.10	1.85		.76	2.61	.91
	(.7)		(.31)	(.23)	(.37)		(.13)		
Low income	-1.9		.95	2.78	.62		1.06	2.02[c]	.95[c]
	(2.9)		(.30)	(.27)	(.42)		(.16)		
Asia	.8		1.24	1.33	2.24		.86	2.69	.58
	(1.81)		(.88)	(.64)	(1.01)		(.36)		
Western Hemisphere	1.1		2.17	1.83	4.18		1.36	2.17[c]	.86[c]
	(10.1)		(.58)	(.54)	(.84)		(.30)		

[a] Percentage change in export unit values of industrialized countries

[b] Standard error in parentheses

[c] Corrected for autocorrelation

Source: Nonoil developing countries: International Monetary Fund (IMF), *International Financial Yearbook, 1983*; nonoil oil-importing countries: IMF, *World Economic Outlook, 1983*.

NOTES

1. See Table 5.1 and sources indicated there, as well as Organization for Economic Cooperation and Development (OECD), External Debt of Developing Countries: General Survey 1982, Paris, 1982, for debt estimates at the end of 1982. The US$800 billion estimate is from A. W. Clausen, president of the World Bank, as cited in the New York Times, January 26, 1983, p. 45. Such a total presumably incorporates a broader developing-country definition than the other sources cited, in view of their estimate of approximately US$700 billion outstanding to developing countries at the end of 1982 and of a slowing flow of additional private loans in 1983.

2. Wall Street Journal, November 25, 1983, p. 1.

3. World Bank, World Development Report 1982, p. 21.

4. International Monetary Fund (IMF), World Economic Outlook, Washington, D.C., 1983, p. 200.

5. These data cover the period 1965-1981. During that interval the combination of export opportunities and access to credit gives reason to suppose that simple least squares captures a savings function unconstrained by foreign-exchange shortage. To avoid problems of appropriate deflators, the functions are estimated in ratio form:

$$S/Y = a + b1/Y_r + c_1CA + c_2CA$$

where S is gross national savings, Y is gross national product, Y_r is real gross domestic product, and CA is the current account deficit. The coefficient 1-a is the estimated marginal propensity to consume out of gross national product, and c_1 and c_2 are the period-specific propensities to consume out of the deficit for 1965-1978 and 1979-1981.

6. IMF, World Economic Outlook, p. 143.

7. IMF, External Indebtedness of Developing Countries, Occasional Paper no. 3, Washington, D.C., May 1981, p. 11.

8. See my "Causes and Consequences of the Latin American Depression of 1979," MS, October 1983, for a detailed discussion of the impact of external and internal conditions upon the expansion of the debt of the region and of principal debtor countries.

9. IMF, World Economic Outlook, table 14, pp. 183-184.

10. World Bank, World Debt Tables, 1982-83, Washington, D.C., 1984, p. vii.

11. William R. Cline, International Debt and the Stability of the World Economy, Washington, D.C., September 1983, p. 71.

12. That is, it takes as the appropriate constraint for developing-country repayment the capacity to generate foreign-exchange earnings rather than domestic saving.

For an example of the latter, see OECD, External Indebtedness of Developing Countries, app. 3.

13. Specifying the following equations:

$$X_t = X_0 e^{gt}$$

$$M_t = (1+a)X_t$$

$$dD = M_t - X_t + iD_t$$

we can solve for debt, D_t, $= a/(g-i)X_0(e^{gt} - e^{it})$. Then the limiting debt-export ratio, $D(t)/X(t) = a/(g-i)$.

14. Economic Commission for Latin America, Balance Preliminar de la Economía Latinoamericana Durante 1983, Santiago, December 1983, p. 29.

15. World Bank estimates reported in the New York Times, January 26, 1984, p. 45.

16. Cline, International Debt, pp. 46-71.

17. See Arthicus R. Cline, "Developing Country Debt Under Alternative Global Conditions: 1983-86," in International Debt: Systemic Risk and Policy Responses, Washington, D.C., 1983, where he reports in table A-1 very low unadjusted R^2 for his country estimating equations. The largest is for Brazil: .31. The regressions in the Appendix do consistently better and are a better basis for assessing the evolution of trade for developing countries taken together.

18. The analysis of the effect of changes of the value of the dollar on the prices of developing-country exports has to start from the demand and supply curves for industrialized-country imports expressed in dollars. A changing value shifts the non-U.S. demand, because prices are different, and supply originally is expressed in non-U.S. currency in similar fashion. Only if developing-country supply is all expressed in non-U.S. dollar terms, and perfectly elastic, will appreciation and depreciation be fully reflected in dollar prices. But a large proportion of supply is contracted in dollar terms and is not necessarily elastic in the short term.

19. IMF, World Economic Outlook, app. A.9, pp. 154ff. The commodity price index in question can be found in Inter-American Development Bank, Economic and Social Progress in Latin America, Washington, D.C., 1983. Petroleum was excluded.

20. For determining the price of developing-country imports in the presence of both dollar depreciation and general price increase, I have used the estimating equation:

$$\underset{}{OECDP} = \underset{(2.63)}{4.9} + \underset{(.41)}{1.18DCP} - \underset{(.12)}{.79DI} + \underset{(.09)}{1.03CP} \qquad R^2 = .94, \quad D\text{-}W = 2.07$$

where the constant is for 1973-1974 only, CP is inflation in the industrialized countries measured by the consumer price index, DCP is change in inflation, and DI is change in a dollar index against other currencies in accord with

the IMF weights. Standard errors are in parentheses.

21. Cline found an elasticity as great as seven based on the aggregation of country estimates, and a value of five derived from the elasticity estimates of his projection model. See International Debt and the Stability of the World Economy, p. 65. The actual simulations show a wider divergence because the sharp decline in the debt-export ratio reduces the relative importance of interest payments.

22. One percent of developing-country GDP is approximately equal, on average, to 4 percent of exports. Using the 1982 export-debt ratio and the current interest rate yields the result in the text.

23. See the Wharton World Economic Outlook, October 1983, and the DRI results for the Latin American principal debtors, both quoted in Thomas O. Enders and Richard P. Mattione, Latin America: The Crisis of Debt and Growth, Brookings Discussion Papers in International Economics, no. 9, Washington, D.C., December 1983.

24. Economic Commission for Latin America, Balance Preliminar, table 11.

25. IMF, World Economic Outlook, 1983, p. 20.

26. Ibid., p. 16.

27. For a recent review of stabilization policies, see R. Dornbusch, "Stabilization Policies in Developing Countries: What Have We Learned," and R. C. Porter and S. I. Ranney, "An Eclectic Model of Recent LDC Macro-economic Policy Analyses," both in World Development, vol. 10, no. 9 (Oxford), 1982.

28. Manuel Guitian, in T. Killick, ed., Adjustment and Financing in the Developing World, p. 95.

29. Richard N. Cooper, Currency Devaluation in Developing Countries, Essays in International Finance, no. 86, Princeton, N.J., June 1971.

30. The Economist, October 15-21, 1983, p. 4.

31. World Financial Markets, June 1983, pp. 11, 12.

32. These estimates start from the terms and sums rescheduled as reported in Latin American Weekly Report, May 20, 1983, plus subsequent news accounts. On average, spreads were 1 percent higher than during the period when the loans were initially contracted in the late 1970s, allowing for intervening grace periods. Commissions for rescheduling ranged between 1.25 and 1.5 percent, of which 1 percent was regarded as profit (taking into account the World Bank typical commission payment of .25 percent).

Commissions are presumed to be paid initially, even if not accounted in bank earnings in that fashion, and to yield a return of 10 percent a year. The average annual value, spread over the life of the loan, is therefore greater than the simple average (approximately twice as large).

To the before-tax annual earnings obtained by summing incremental spreads and the average annual value

of commissions, alternative marginal tax rates are applied to arrive at after-tax profits. These are then compared to the approximate share of loans to these countries in total bank assets to assess the increased returns on their holdings.

Equivalently, one can approximate the result, excluding commissions, by noting that the spread on rescheduled loans has doubled. Since such rescheduled loans are about one-fourth of the total extended by banks to these countries, the effect is about a 25 percent rise in after-tax earnings.

The calculations are reported in the Wall Street Journal, December 5, 1983.

33. New York Times, January 26, 1984.

34. Among the authors of various swap proposals are Peter Kenen, Felix Rohatyn, and Richard Weinert. I myself advanced a similar proposal much earlier that the World Bank absorb some of the commercial bank portfolio of developing-country loans in exchange for World Bank bonds. See Albert Fishlow et al., Rich and Poor Nations in the World Economy, New York, 1978, pp. 67-68. The exchange of debt for export participation shares has been advocated by Norman A. Bailey. Many of these plans are cited in Cline, International Debt and the Stability of the World Economy, pp. 114-115.

35. These criticisms and others are summarized in Cline, International Debt and the Stability of the World Economy, pp. 117-119.

36. Among those advocating such policies are Harold Lever, William Bolin, Jorge del Canto, and financier Minos Zombanakis. For detailed references see ibid., p. 117.

37. J. M. Keynes, Essays in Persuasion, vol. 11, Collected Writings of J. M. Keynes, London, 1972, pp. 335-336.

38. World Financial Markets, June 1983, p. 15.

39. The Political Economy of the Western Hermisphere: Selected Issues for U.S. Policy, Joint Economic Committee, 97th Congress, 1st Session, September 18, 1981, p. 163.

6 Latin American Debt: Act Two

Pedro-Pablo Kuczynski

INTRODUCTION

Although events have not changed my earlier two assessments,[1] it is appropriate to consider whether fundamental changes have occurred in recent months, as of the end of 1983.

First, it is clear that the economic recovery in the United States has not so far been accompanied by an equivalent recovery elsewhere in the industrialized world. As a result, the recovery in the growth of world trade is still slow, and the growth of the industrialized world is still below what was envisaged by a number of observers as one of the key ingredients for major debtors to be able to meet the interest on their external debts.[2] Furthermore, although some commodity prices have rebounded from the depths of 1982, others--particularly minerals--are still extremely depressed, so that the terms of trade of a number of developing countries are well below the peak levels of two or three years ago.

These two discouraging trends, which are related, may well change for the better. But a number of factors lead one to question whether such an improvement would be a sustained one: the continuing high level of real interest rates; the lag of investment, particularly as a result of sick heavy industries in North America and Europe; and therefore the possibility that the world faces a long cycle of slow economic growth, with the Latin American countries left with a large debt incurred in a past inflationary and high-growth era.

The third important feature of the last months has been the extent of belt-tightening and austerity in a number of countries. Mexico has been the most visibly successful, and its efforts have been aided by the close links of Mexican trade and services to the United States and have therefore benefited from the economic recovery there. The adjustment effort in other countries has been very large also. In part, of course, it has been the unavoidable result of the lack of international loans and

the shortage of foreign currency. The current account deficit of Latin America has fallen from US$38 billion in 1981 to my estimate of US$18 billion in 1983, largely as a result of the squeeze in imports. At the same time income per person has declined sharply, by as much as 10 percent in the three-year period 1981 through 1983. The size and suddenness of the adjustment give rise to questions about whether it is sustainable for very long from a political point of view, particularly if it is considered that the bulk of the adjustment probably falls on urban lower-income groups. The fact that, given the lack of resources, there is no alternative to belt-tightening does not mean that it will necessarily be accepted or that the economic managers who are implementing it will be kept on.

The additional factor to weigh in the outlook is that new capital flows are very difficult to mobilize. Although the external financing needs of Latin America have for now shrunk sharply, the availability of external finance has fallen even more. In the analysis that follows, I estimate that net commercial bank loans--after repayment or refinancing of amortization to Latin American countries for 1983--would be on the order of US$8 billion, compared to about US$25 billion annually in the period 1979-1981, an admittedly unsustainable rate. But now it appears that the net new lending in 1983 will only be about US$6 billion or less because disbursements on major loans accompanying restructurings, especially in the cases of Argentina and Brazil, were delayed for several months when those countries were unable to meet various targets in the stabilization programs agreed with the International Monetary Fund. In fact, periodic renegotiations of programs and targets have in several cases cast doubt on their viability and implementation. Of the larger countries, only Mexico met the agreed program and lowered its public-sector deficit from 17 percent of GNP in 1982 to about 8-9 percent in 1983, a giant step accompanied by a 5 percent decline in per capita income. Major program renegotiations have taken place in Argentina, Brazil, Chile, and Peru, and further renegotiations may well be necessary.

No large-scale expansion of net lending from official sources has yet taken place to offset the shortage of funds, although there are beginnings both at the multilateral agencies and at national export credit agencies, while private investment capital flows obviously remain at very low levels. As a result, some countries have had to "finance" the gap by delaying payments, and large arrears of interest and trade payments have built up.

Despite this somewhat unsatisfactory picture, both lenders and borrowers have shown that they can overcome major obstacles successfully, in the sense of averting an international financial crisis. "Muddling through"

appears to have worked, at least so far. However, the potential political and social cost to debtor countries has been high. There has not been enough emphasis on this cost; much discussion in the mass media of the industrialized countries has focused on such questions as whether the debt can be "paid back" (not the real issue for capital-importing countries--the key issue being the payment of interest) or whether the international banking system is severely endangered (unlikely, although some banks face potential earnings problems). Although everyone recognizes that major adjustment is necessary, focusing on ways to ease the cost of adjustment in the debtor countries might help to create the climate in which mechanisms could be established to prevent the eventualities that lenders fear most. Among them would be a prolonged suspension of interest payments by a major debtor country, which would force lenders to place such loans on a nonaccruing basis and would be particularly painful for the banks that have not so far made enough reserve provisions for such loans, particularly in North America.

A more centralized approach to the study of such mechanisms should be contemplated, with a larger role for the governments of lenders and borrowers rather than exclusive reliance on the present market arrangements. Among areas of priority are acceleration of disbursements and new lending from official sources and ways to diminish the interest burden, given the fact that at present general interest levels, including the cost of refinancings, Latin America is spending close to 45 percent of its export income to meet interest payments.

It is difficult to judge the likelihood of a breakdown in the present system in the case of major debtor countries. Even though it obviously should be avoided--it would be harmful to both borrowers and lenders--and there are economic signs that it could be avoided, it is to a considerable extent a matter of people and politics. Politics lags behind economic trends. So far, there has been little political backlash to economic problems in major debtor countries. But trends argue for an attitude of readiness rather than mere hope: sharp income declines; rapid inflation and growing unemployment; increasing malnutrition; and last, but not least, a perceived loss of sovereignty. It is to be hoped that the so-called debt problem will in time disappear as other crises have, but a more deliberate approach would be a useful way of making such a hope come true.

LATIN AMERICAN DEBT: ACT TWO*

There is a distinct rumble. Is it the noise of an impending second crisis of Latin American and other developing-country debtors, or is it the start-up of world economic recovery, which will gradually pull away lenders and borrowers alike from the edge of a financial abyss?

In this chapter, I will update what has happened since the fall of 1982, when the financial world awoke to the possible consequences of the inability of Mexico to meet the principal repayments on its external public and private debt. I will then look at the present status of the refinancings and of the debtor economies, and what the prospects for the future appear to be.

The debt problem of developing countries is largely a Latin American one.[3] The relative size of the debt of the region is much larger than in the case of other developing areas; its composition--two-thirds from commercial banks--gives it short maturities and commercial interest rates; and export earnings with which to service the debt are modest in relation to the burden of debt service. These features mean that the grave economic problems that have been facing most Latin American countries in the last year or so are unlikely to spread, at least with the same force, to other developing areas. On the other hand, the regional concentration of the problem means that virtually all countries in Latin America and the Caribbean are viewed as one by commercial bank lenders, an attitude that has drastically cut capital inflows to the region, regardless of country differences, and thus makes the task of recovery much more difficult. The fact that the external debt has been built up over the last decade, but especially in the last four years, shows that the problem is not only a cyclical one but a longer-term one. As in a natural catastrophy, the first step is emergency action, followed later by reconstruction and recovery.

The high interest rates of 1981-82, together with the unexpected depth and duration of the international recession, which led to a sharp deterioration of the terms of trade of developing countries, were the critical factors that sparked the debt crisis of 1982-83. In the wake of Argentina and Mexico, international commercial bank lending ground to a halt, forcing, as foreseen, the renegotiation of part of the external commercial bank debt of Brazil, Chile, and Venezuela, as well as Ecuador, Peru, and Uruguay.

---

*"Latin American Debt: Act Two" is the title of my article in the Fall 1983 issue of Foreign Affairs, as well as the title of this chapter.

DIMENSIONS OF THE DEBT PROBLEM

In 1983 the interest payments on the external debt of the Latin American and Caribbean countries are expected to be close to US$40 billion, as long as international short-term interest rates do not increase above their level at midyear. This number has to be set against projected merchandise exports of about US$96 billion, compared to US$110 billion in 1981. Even with a significant immediate recovery of export earnings as a result of renewed economic growth in the industrialized countries, the interest burden would still be very heavy, likely to continue into 1984 and 1985, unless there is a major offsetting inflow of capital. The problem for the major Latin American debtor countries is therefore simple and stark: major outflows without comparable inflows.

Even though developing countries, regardless of their levels of income, suffered heavily from the international consequences of the 1981-82 recession, the debt aspect of the problem is basically concentrated in Latin America. Other developing areas have major balance-of-payment problems, of course. For example, much of sub-Saharan Africa has been engulfed in a chronic balance-of-payments problem since the oil-price increases of the early 1970s. Today some important oil-exporting countries, such as Indonesia and Nigeria, are caught in a financial and economic squeeze as a result of the drop in oil prices and the cuts in exportable volumes. Others, such as Korea, the Philippines, and Yugoslavia, have been hard hit by the international recession. However, the major problem brought on by the international recession and the high interest rates of 1981-1982 is concentrated in Latin America. Only the Philippines, among the countries shown in Table 6.1, has levels of debt that are comparable to those of the major Latin American borrowers.

The question is not only a statistical one. The fact that most international banks have cut back very sharply on new loans to Latin America almost regardless of country differences--other than operations that are tied to reschedulings and to stabilization programs supported by the International Monetary Fund--has tended to precipitate payments problems. Even countries with low debt burdens, such as Colombia and Trinidad and Tobago, are not finding it easy to obtain new loans. Fortunately, these attitudes of lenders, who have gone from optimism to pessimism, have not extended to the economies of Asia, so that at present there is little risk of a generalized debt crisis.

The fact that the debt problem is largely, although not exclusively, a Latin American one is illustrated by repeating two simple comparisons, which are illustrated in the table:

Table 6.1 Estimated Debt Burden of Some Major Developing Countries (in billions of U.S. dollars)

	(1) Total External Debt, Including Undisbursed, at End 1982	(2) Short-Term[a] Debt as % of (1)	(3) Estimated 1983 F.O.B. Merchandise Exports	(4) Ratio of (1) to (3) Debt to Exports	(5) Estimated Interest Due 1983 as % of Exports (3)
Argentina	39	25	9	3.9	50
Brazil	86	20	22	3.9	46
Chile	17	19	4	4.5	50
Mexico	86	30	22	3.9	46
Venezuela	33	45	14	2.3	29
Total Latin America[b]	330	25	96	3.4	42
Algeria	15	5	12	1.3	14
Indonesia	22	13	19	1.2	21
Korea	37	28	24	1.5	18
Philippines	21	38	5	4.2	48
Nigeria	11	27[c]	12	0.9	11
Total other LDCs[d]	350	--	330	1.1	12

Note: These are estimates, subject to error, and should be used with care.

[a] Original short-term debt; excludes refinanced amounts in 1983 and also excludes portions of longer-term debt falling due within one year

[b] Including Caribbean and other countries not listed

[c] Excluding trade payment errors

[d] All other developing countries except centrally planned economies and Middle East OPEC countries

Source: Derived by the author from Bank for International Settlements, Maturity Distribution of International Bank Lending (July 1983); Morgan Guaranty Trust Co., World Financial Markets (June 1983); International Monetary Fund, International Financial Statistics, various issues; and World Bank, various Annual Reports.

- The ratio of the stock of outstanding debt to the flow of merchandise export earnings, which provide the foreign exchange to service the debt--admittedly an oversimplified measure of the weight of debt[4]--is more than three to one in the case of Latin America compared to about one to one for the rest of the developing world.
- As a result, in 1983 Latin American and Caribbean countries as a group will need to devote, at present interest rates, about 42 percent of their merchandise export earnings to pay interest on their external debt, compared to 12 percent on average for other developing countries. The ratio approaches 50 percent for the large debtors such as Argentina, Brazil, and Mexico. It is as if a homeowner had to devote half his monthly income to interest payments on his home mortgage. These numbers assume that world interest rates do not rise for the second half of 1983, and that export earnings are on target. While the latter is nevertheless a good possibility in view of the improved competitiveness of Latin American exports as a result of the large devaluations of the last year, the outlook for interest rates is uncertain. Obviously, repayments of principal are not counted in these numbers. On the medium- and long-term debt, principal repayments represent approximately another 20 percent of export earnings for Latin America as a whole, after the refinancings committed or under discussion so far in 1983.

TRENDS IN THE DEBT PROBLEM

Since Mexico announced in August 1982 that it was unable to meet the repayment of principal on the external debt of its public and private sectors, a number of major events and trends have unfolded. At the risk of oversimplification, these trends can be grouped into negative and positive, although the interrelationships are quite complex.

Perhaps the most striking on the negative side has been the virtual interruption of new commercial bank lending to almost all Latin American countries. According to the last annual report of the Bank for International Settlements, the net flow--after repayments--from commercial banks to Latin America in the second half of 1982 was only about US$5 billion, mostly because of the disbursement of earlier commitments to Brazil, compared to an annual rate of about US$25 billion starting in 1979 and up to the first half of 1982.[5] Net flows

have fallen further in 1983, and are likely to be much above US$8 billion, mostly as a result of net lending associated with debt rescheduling. The music has indeed stopped. Net flows, in the other developing countries, mostly in Asia, have also declined but at a slower pace.

Since commercial banks provided more than two-thirds of the capital inflow into Latin America, not just for the last three years but for the last decade, the interruption creates major adjustment problems. The interruption of net new lending adds to the inability of Brazil to meet its principal repayments after December 1982 and to the subsequent similar problems of Venezuela, Chile, Ecuador, Peru, and Uruguay, in addition to the existing problems in Argentina and Mexico. It is equally true that lending was proceeding at an unsustainable pace, much faster than the growth of the capital of the lending banks, and that large fiscal deficits in most borrowing countries were a major cause of excessive borrowing.[6]

A second and related development has been the cut-back in trade financing. Lenders, particularly the smaller banks, have naturally enough reduced their lines of credit for export and import financing and in some cases eliminated them altogether. Official export agencies, which play a key role in medium-term equipment financing, have also cut back. Although clear statistics are not available, the dearth of new financing, combined with the drastic economic recession in virtually all Latin American and Caribbean countries, has led to a sharp drop in the exports from the industrialized countries to Latin America, and also in the exports between Latin American countries and between them and other developing countries. In the case of Brazil, for example, one-third of exports in 1981 went to the rest of Latin America and to other developing countries, primarily in Africa and the Middle East, all of them depressed markets at present.

Exports from the industrialized countries to Latin America, which accounted for one-third of their exports to non-OPEC developing countries, fell by 21 percent in 1982 and were still falling in 1983. U.S. exports in Latin America, which were in 1981 equivalent to two-thirds the value of U.S. exports to Western Europe and double those to Japan, also fell by the same proportion in 1982. This fall in export sales from US$42 billion in 1981 to US$34 billion in 1982 had a cost of between 100,000 and 130,000 direct jobs lost in the United States, and is continuing in 1983.[7] Even though Latin America absorbs only about 7 percent of the exports of the industrialized countries, the sharpness of the drop in exports, which affects in particular already depressed industries such as equipment and machinery, is undoubtedly a drag on world economic recovery. For some European countries, the fall in sales to developing

countries could, in 1983, make the difference between a mild economic recovery and no growth at all.

A third related point is the extent of the economic depression in Latin America. For a time in 1981, some economies, particularly Mexico, shielded themselves from the world recession by massive external borrowing to finance public investment and consumption. As the lending stopped and long-delayed adjustment measures, such as devaluation and public spending cuts, had to be taken, the recession hit with double force. Devaluations had to be much larger than if they had been taken in time, giving a tremendous impetus to inflation, which is running well above 100 percent annually in the three largest economies of Latin America. For example, Mexico has had a devaluation of about 400 percent (in terms of pesos per dollar) in the last eighteen months. Comparable devaluations have taken place over the same period in Argentina, Chile, Brazil, and Venezuela.

The effect on the industrial private sector, which in all these cases had been encouraged by the policies of the authorities to borrow abroad, has been devastating: Domestic sales in some cases have fallen by 30 to 40 percent in real terms as incomes have lagged behind inflation. This has sharply cut the ability of enterprises to generate cash flow, while the amount needed in local currency to service external debt has increased three or four times in the last year. It is not an exaggeration to say that a major portion of private large-scale industry in Latin America--not to mention chronically sick state enterprises--is today in effect bankrupt. The worldwide intensification of trade barriers, a direct result of the international recession, aggravates the problem.

The policy of stimulating economies through public spending reached its peak in 1982, when the public-sector deficits of several countries reached records. In Argentina, Brazil, and Mexico, the public-sector deficits as a proportion of the Gross National Product peaked at 14, 12, and almost 17 percent respectively. Deficits of this magnitude, leading to large subsequent exchange-rate devaluations, have pulled up annual rates of inflation so far in 1983 to perhaps 300 percent in Argentina, about 130 percent in Brazil, and over 100 percent (although declining) in Mexico. Such stratospheric numbers eventually lead to major social and political strains. Inevitably, the process of strengthening public finances creates for a while even more inflation and discontent, as public enterprise prices and taxes are raised.

No one can deny the urgent need for major financial surgery, particularly on exchange rates and public finances. However, the suddenness and size of the measures required, together with the fact that they have not been backed up by a significant external capital inflow to help the adjustment, are creating a potentially

explosive mixture of failing incomes, rising unemployment, and galloping inflation. For example, for Latin America as a whole 1983 will be the third successive year of declining real income per person. I estimate that over the period 1981-1983 real income per head will have fallen by about 10 percent, and by larger percentages in the lower middle-income groups, such as government workers and nonunionized service workers. Unemployment rates, which are admittedly very difficult to measure in Latin America, are probably hovering close to 20 percent in major industrial centers such as Buenos Aires, Mexico City, São Paulo, and Santiago de Chile, without counting the indirect unemployment of people working part time or selling lottery tickets and knickknacks on street corners.[8] With the gradual weakening of the system of extended families helping their kin, and without any unemployment insurance, such numbers are not sustainable for very long.

Why has there been no social explosion so far? There is no easy general answer. In the case of Mexico, for example, the rapid income growth until 1981 has provided some cushion, as has temporary or permanent migration to the United States. A well-disciplined political organization and tradition, with close control over the major trade unions, has enabled the government to keep wage adjustments behind price increases, a key element in the fight against inflation. In other cases, the lack of apparent reaction may come from the suddenness of the change, which has left populations stunned, so to speak. Another element has been the increasing discussion of economic issues in the press which, as a result of growing literacy in urban areas, has created an awareness of the magnitude of the economic problems being faced. The new Peruvian finance minister, for example, got an unexpectedly sympathetic public response earlier in 1983 to his program to cut public spending to the bone. In general, however, if there is no bread on the table, these positive developments can over time be offset by great social strains. The combination of inflation, unemployment, and declining real incomes provides a breeding ground for such tensions. Explosions are usually not announced.

On the positive side of the ledger, the most important development in the last year has been the unquestioned desire of most governments to put their financial house in order. Brazil took that decision as early as December 1980, but it takes time and a hospitable international environment to succeed. All the governments of the major economies of the region have taken significant and, in some cases, drastic economic steps in the last six to nine months. Undoubtedly, the interruption of significant new lending by commercial banks has been the major stimulus for such measures. But that interruption is also the biggest question mark on whether the stabilization programs can succeed in a

reasonable period of time. We will look at that crucial question later.

The other positive but also qualified development is the decline in world interest rates since mid-1982. The London interbank rate for six-month deposits, which has been the base rate for most international bank loans, has fallen from a peak of 16 percent in June 1982 to about 10 percent in the last quarter of 1982, the level which it had in July 1983, at the time of writing. Two points qualify this progress: the significant increase in bank charges above this base rate, and the uncertainty surrounding future interest rates.

The increase in bank charges is particularly important in the case of Mexico, which was paying very low margins over the interbank rate. On the basis of the new charges, Mexico is paying about 13 percent as of mid-1983 on its refinanced debt (a total of about US$40 billion out of US$60 billion in variable rate debt). This level results from three changes: The base rate is now (at the option of the lenders) the prime U.S. lending rate, which is generally higher than the interbank rate (which is a deposit rate); the spread above that base rate has been substantially raised; and various additional fees have been attached to the refinancings and the new loans associated with them. Similar charges are included in the refinancings negotiated for Argentina, Brazil, Chile, Ecuador, Peru, and Uruguay.

Most of these countries were already paying higher costs than Mexico, so that the effect on them of the changes is smaller. Furthermore, there are reasons for the changes; management fees for new loans are normal (although the new charges are on the high side), and the shift to a U.S. prime rate base option was important in order to convince smaller regional banks in the United States to remain in the loans. On the other hand, the argument that higher charges are justified because debtors had become riskier is more debatable. For one thing, the risk becomes difficult to measure when a debtor cannot service his debt; no premium can compensate that risk. In fact, in the case of major U.S. and Canadian corporations which have undergone debt restructurings in recent years, the interest rate charged by banks during the reorganization period has often been _below_ market rates. These corporations have been represented by financial advisers independent of the banks: So far most major Latin American debtors have not wanted to antagonize lenders by hiring independent financial advisers, although the history of the refinancings so far shows that there might have been merit in an outside opinion on realistic debt-servicing possibilities.

The other uncertainty concerns the trend of U.S. short-term interest rates, which are the preponderant influence on rates in the Eurocurrency market. Already in the second quarter of 1982, the interbank Eurodollar

rate was up by about 1 percent, adding on an annual basis US$2.2 billion to Latin American interest payments abroad. If short-term U.S. rates were to go up another point or so in the second half, as some economists predict, because of the effects of the U.S. budget deficit, the total increase in debt-servicing cost for Latin America since the spring of 1983 would have been close to US$5 billion on an annual basis, a very significant sum at a time of sharply reduced capital inflows.

A third positive development, which flows from the decline in imports and in interest payments, is the sharp reduction in the current account deficit of the region, namely the requirement for external finance that remains after current inflows, principally exports of goods and services, have been used to pay for current outflows, mainly imports and interest. The very nature of developing economies, which need to import capital in order to supplement their inadequate domestic savings, means that they have a current account deficit and thus a need to borrow abroad and attract investment capital. However, Latin America and the Caribbean, largely as a result of the drop in incomes and the sharp decline in imports of the last year, has greatly reduced its need for external finance. The current account deficit of the region has fallen from US$38 billion in 1981 to US$33 billion in 1982, and is expected to fall to about US$18 to 20 billion in 1983, as long as international interest rates remain at midyear levels. If interest rates were to rise again, the financing gap would begin to rise again. A return to the interest rates prevailing in mid-1982, for example--even though it is highly improbable--would entirely wipe out the improvement in the current account deficit of the last year.

The uncertainties about how Latin American and Caribbean countries will finance themselves over the next couple of years are undoubtedly a crucial concern of both lenders and debtors. Even though the financing gap has been sharply cut, the availability of external resources has declined even more. The future trend of commercial bank lending is uncertain and a part of the new loans that have accompanied recent reschedulings of commercial bank debt is being used to finance the higher charges above the base interest rate. Foreign direct investment, which until recently covered about one-fifth to one-quarter of the current account deficit, has slumped in the wake of the recession both in the industrialized countries and now in Latin America. The return of flight capital that left a number of major Latin American economies in recent years could be important, but will take time. Finally, as we will discuss later, the multilateral development institutions --such as the World Bank and the InterAmerican Development Bank--face resource constraints. Identifying sources of net capital inflows--including about US$8 billion of

commercial bank lending, approximately US$2 billion of net disbursement from the Multilateral Development Bank, and an equivalent amount of supplier credits previously negotiated--leaves a significant financing gap, larger than what can be covered from private investment. Thus, even though the overall financing gap has declined, the problem of covering it has become far more acute.

Is it reasonable to expect countries to work their way out of their present economic and financial predicament? In recent months various projections[9] have been constructed to show how and whether major debtors can work their way out of their present problems. Most of these projections show that *if* the industrialized economies grow at a reasonable rate (say 3 percent per year), *if* interest rates do not increase beyond mid-1983 levels (10 percent for the six-month Eurodollar interbank rate), and, most especially, *if* a modicum of capital inflows can continue, *then* most of the major debtors could resume economic growth and service their external debt more or less comfortably by about 1986. But there are many uncertainties. Most projections highlight the very limited room to maneuver in the next two or three years.

The relationship between lenders and debtors has created an unusual degree of interdependence. This is particularly the case with commercial banks, which have provided the bulk of external capital to Latin America in the last decade. The relationship is a little like that of two people on a see-saw: If one jumps off suddenly, both are likely to get hurt. Very large losses could affect major international commercial banks if countries are unable to work their way out of trouble. The problem does not only concern U.S. banks, but also banks in Europe, Canada, and Japan as well as part of the debt to suppliers. However, given the large share of the Latin American debts held by U.S. banks (about 45 percent of the debt to commercial banks), it is likely that leadership on the issue will have to come from the U.S. side. Sizable reductions in net income could affect some large banks if significant loan loss reserves had to be set aside for major Latin American debts, in the event that interest payments lagged substantially behind schedule. Banks have already set up such reserves for some of the debts owed by the Latin American private sector.

For problems to be worked out, there is a clear need to change the perception of hopelessness that permeates the international climate at present, particularly as seen by debtor countries. This pessimism could encourage some debtors to leave the hard road of financial discipline and adjustment and be tempted by apparently easier solutions such as a "cartel" of debtors. Export more? Import quotas on yarn, orange juice, specialty steels, which are just three recent examples, are conveying the wrong message. More official funds? The

quota increase for the IMF is having an uphill battle in the U.S. Congress. Economic recovery in the industrialized world? High and rising real interest rates could slow down the recovery. As lenders and borrowers look for solutions, they find closed doors and blocked paths.

Another important need is to maintain an atmosphere of calm. Each new confrontation creates an air of crisis that makes it difficult to maintain a flow of lending from banks less involved internationally. Smaller and so-called regional banks, which account for about 15 percent of the international commercial bank debt outstanding of Latin America, undoubtedly want to get out of these loans, a trend that would put great pressure on the larger banks to increase their exposure even more than planned. So far a confrontation has been avoided, but any rumors of an impending crisis in a particular country obviously make the task more difficult.

The sensitivity of individual countries' problems is illustrated by the case of Brazil, which faces a fairly drastic adjustment program with the IMF. As of this writing, it appears that the IMF has restored the ability of Brazil to draw under the facility agreed earlier in the year, after Brazil implemented a new, tough set of anti-inflationary measures mainly to keep wage adjustments below inflation. This has avoided, for the time being, a major problem for Brazil's lenders, whose disbursements on a US$4.4 billion loan are tied to disbursements on the IMF facility. However, the dearth of additional capital inflows continues to make it difficult for Brazil to service interest on time. As problems are aired publicly, including the initial well-publicized requirement by the Bank for International Settlements that Brazil had to repay an earlier emergency loan on time, the task of avoiding confrontations and possible crises becomes more difficult.

STIPULATIONS FOR DEBTORS AND LENDERS

Until now, market mechanisms have handled the problems of debtor countries as they arose. But it is not clear whether such mechanisms can continue to be effective by themselves, without leadership by the governments of the major industrialized countries. For the lending banks, a serious dilemma arises: On the one hand, it is quite clear that they cannot continue lending at anything like the breakneck pace of 1979-1981; on the other hand, if net lending does not expand moderately and lending does not continue, it will be very difficult for lenders to collect interest on past loans. For debtor governments, most of which clearly recognize the need for tough belt-tightening measures, the problem is that austerity may be too costly in social and political terms and that a gradual approach may not be feasible because

of the lack of external finance and the delay in the recovery of export earnings.

Rather than discussing whether we are or are not in a crisis, or whether it is an issue of insolvency (that the borrowers can "never" pay) or illiquidity (that they cannot pay now), which are questions of degree and definition, it is more useful to outline the preconditions for both the debtors and the lenders to work their way out of the problem.

First, it is useful to distinguish between the immediate future and the longer term. The coming year is probably the critical one, since export income of the debtors will still lag for a time until an international recovery is in full swing, while large interest payments will continue at a time of very limited capital inflows. This is not to say that there is not a longer-term problem, as the refinancings being arranged now start becoming due in three or four years. Moreover, there are historic reasons, summarized later, which suggest that the pattern of development of Latin America cannot easily be changed. Nevertheless, from the practical point of view of dealing with the most urgent problems first, it is important to analyze possible action in terms of what is politically feasible now, not a year or two from now. Anyone familiar with the mood of parliaments in major industrialized countries, especially the U.S. Congress, has to recognize that there is no room for quick big-scheme solutions where taxpayers would directly or indirectly have to put up substantial new funds.

Second, no single party can carry the whole load of adjustment. Any arrangements must involve some effort on the part of both the lenders and the borrowers. This has been the case so far, although the degree of effort by each side--namely continuing some positive net flow of lending by the banks, and financial discipline and austerity on the part of the debtors--is viewed suspiciously by the other. It is doubtful if serious problems can be avoided in the future without some intervention by the governments of the main lenders to help stimulate a larger capital inflow.

Third, any way out thus has to emphasize the restoration of capital inflows. To be sure, these flows cannot over time rely only on commercial bank funds. A better balance than in the last decade has to be found between investment capital and loans. Obviously direct and portfolio investment will take some time to revive.

Finally, it is essential to remove the obstacles to the revival of export growth. The extent to which the growth of protectionism in recent years has affected Latin American economies is not clear. Countries in South and East Asia have been affected as much, if not more. But it is clear that special interests in North America, Europe, and Japan, for what are locally very understandable reasons, but which affect only a relatively

small percentage of labor forces and of commerce, are gaining strength as the effect of the recession gets translated, after a lag, into political processes. Governments are applying remedies that may no longer be needed by the time they are implemented but which could have proportionately significant effects in the ability of debtors to sell abroad and earn foreign exchange.

In looking at the immediate future, the most urgent measures are to keep up an inflow of capital, to reduce the burden of interest payments, and to stop the rise of protectionism. The role of the governments in the major industrialized countries is crucial in all three actions, although the extent to which governments are politically able to commit themselves, hopefully in a concerted approach, is quite limited.

PROPOSED SOLUTIONS

The ability of the international financial fire brigade, the International Monetary Fund, to function is crucial. It is essential to put in place as soon as possible the increase in the resources (paid-in quotas of countries) of the IMF. Several points should be made. First, available IMF resources are nearly depleted. If any large industrialized country were to need special assistance from the Fund now, a distinct possibility, the resources of the Fund would be exhausted. Second, even the quota increase contemplated, of about 50 percent, simply catches up with past world inflation and would not contribute significant new real resources. Third, the Fund is not as some politicians appear to think a give-away to developing countries. It is a currency pool, which makes foreign exchange available to _all_ member countries--the United States has been a borrower in the past--under rather strict conditions, in order to replenish the foreign-exchange reserves of countries facing balance-of-payments problems. It is not a provider of long-term capital. Finally, since the quota increase will probably take at least until mid-1984 to be put into place, there is still a need for a temporary special facility, financed by the existing General Agreement to Borrow or some other form of cooperation among capital surplus countries.[10]

If the quota increase of the IMF cannot be approved as proposed, even if the approval takes many months, such a negative would be a clear signal, both to debtors and to lenders, that the major countries of the world do not consider the present problems important enough. Some debtors would be tempted to default, and lenders would then wind up knocking at the doors of their central banks for what could then amount to a costly bail-out. It is unfortunate that the increase in the resources of the IMF, which was needed anyway, has coincided in time with a

political debate, especially in the United States, on whether the debt problem should be laid at the door of the lenders or the debtors, both of which are seen as villains.

A second avenue that should be explored quickly is how to stimulate more lending by the World Bank and the InterAmerican Development Bank. Unfortunately, the net resource transfer--disbursements less payments of principal and interest--of the World Bank to Latin America in the fiscal year ended in June was only about US$500 million, a relatively modest sum, and has stayed at approximately that level since 1980. Even though disbursements rose in fiscal 1983 to US$2.3 million, because of a larger proportion of sector support loans, amortization and interest absorbed the whole of the increase. The InterAmerican Development Bank, which has a lower cost mix of funds because of the concessional Fund for Special Operations supported mainly by the United States, has been able to raise the net transfer moderately from about US$600 million to US$800 million over the same period. In order to increase World Bank lending, which is tied to projects, many of which have either been suspended or been sharply slowed down in the last two years, there is a need for greater resources and for more flexible lending policies. The United States has basically opposed such policies, which would emphasize sector-support or "structural adjustment" loans, although it has recently toned down its opposition somewhat.

The entry of China into the Bank, and the uncertainty of future contributions of industrialized countries, particularly the United States, to its concessional window--the International Development Association--has drawn Bank funds away from possible loans to Latin American borrowers. Latin American countries are thus giving special support to the InterAmerican Development Bank. With its recently approved increase in capital, the regional bank can now significantly expand its activities, although some redirection of lending policies may be needed for the difficult two or three years ahead.

In both the case of the World Bank and the InterAmerican Development Bank, a quick-fix solution to future funding has been promoted by those who recommend a doubling of the so-called gearing ratio, which is the ratio of capital contributions by the major creditworthy members of the institution (basically the OECD countries) to the outstanding borrowings. The solution envisaged is thus simply to borrow more without providing more guarantee capital. This is not a worthwhile course. The fact that deposit-taking commercial banks have a ratio of paid-in capital to assets in the United States of about 5 to 6 percent is not relevant to a long-term development institution that has to borrow the bulk of its resources in the capital markets. Bondholders, who rightly view the obligations of both institutions (and

the Asian Development Bank as well) as guaranteed by the United States, Japan, Germany, etc., would now begin to look instead at their loans to developing countries. The resulting downgrading of the bonded debt of the World Bank and the regional multilateral development banks would be costly to borrowers and would end up being an irreversible step.

It is easier to increase as soon as possible the capital of the World Bank--and restore funds to the Fund for Special Operations of the Inter-American Development Bank--particularly since the capital increases require little cash. The recent InterAmerican Development Bank capital increase involved only 4.5 percent in cash. In essence, the development banks are thus already like insurance or guarantee schemes organized to pass through relatively low-cost funds to their borrowers. It is probably easier to increase their callable capital, or "guarantee" capability, than to establish a whole new guarantee scheme, although that idea should not be discarded if it becomes absolutely necessary to stimulate a net flow of commercial lending.

New lending by the multilateral agencies, as long as it can be targeted at the real problems faced by countries, is preferable to more emphasis on cofinancing with commercial banks. In the present market cofinancing with commercial banks will not work simply on the basis of cross-default clauses, such as the World Bank and Inter-American Development Bank have provided between their loans and the related commercial bank loans. The whole of international bank lending is cross-defaulted; namely a default on one loan can trigger a legal default on all the debt and guarantees of a particular borrower, yet that has not prevented payment delays and de facto defaults. In the present market, only a guarantee will work, but in that case both the international institutions and the countries are better off with straight lending at the less-than-commercial rates that the multilateral development banks can provide.

Third, it is urgent to reduce the interest burden, but the problem is complex. Much depends of course on the course of international interest rates themselves, which are closely linked with U.S. rates and difficult to predict. But even if basic rates remain at their mid-1983 level, it is clear that the interest burden is very heavy indeed. This has stimulated a number of proposals[11] to refund the debt of some (or all) developing-country debtors into long-term obligations at less than market interest rates. Unfortunately, most of the schemes are unlikely to be feasible politically and would probably also have negative side effects, principally in drastically reducing new commercial bank lending for a long time.

It is quite unlikely that any of the schemes so far advanced to reduce the load of debt could be implemented

in the next year, since they all require, in varying degrees, the multilateral approval of governments. Opinion in creditor countries is generally not sympathetic to such schemes. Progressives look upon these ideas as a bail-out of imprudent lenders, and conservatives as a bail-out of irresponsible debtor governments. Notwithstanding the need to study and define possible general arrangements for the medium term, remedies and palliatives are needed now rather than later since the coming year is probably the most critical one.

The schemes, in the improbable event that they were economically and politically feasible, also run into the problem that they would probably stop further bank lending for a very long time. The charge against bank earnings would be too large because the loans could not be recycled except at very large discounts. Moreover, the idea that official institutions, such as the IMF, which are having a hard time raising additional resources for their established operations, should bear this additional burden seems impractical.[12] Yet the recycling schemes do make the important point that the debt-service burden is too high.

Perhaps it is possible to combine, in a contingency plan that would be activated in an emergency, a temporary reduction of the interest burden without damaging the prospects for continued lending on a moderate scale. For the banks, many of which would obviously resist such a move strongly, it would at least have the advantage of reducing the increase in their lending, since at present, before Latin American export growth revives and new sources of capital inflows can be developed, an additional dollar of interest service by the borrowers is financed (in simplified terms) by an additional dollar of bank lending and exposure. It may be better, at least during the immediate recovery period, for lenders to sacrifice about fifty to sixty cents of net after-tax earnings which a dollar of added interest income provides, in exchange for not having to put up an extra dollar of lending.

It is worth considering whether the banks might not be better off working out a temporary arrangement on interest charges than having to come up with last-minute financing packages in the midst of a crisis. I stress that such an arrangement would have to be temporary and could not be done below the market costs of funds, if the central objective of keeping some flow of lending is to be maintained. Under several of the refunding schemes proposed so far, the interest reduction would be below the cost of funds to the commercial bank lenders. Let us, for the purpose of argument, assume that the new rate under these schemes were set at 9 percent. The savings to the Latin America debtors in interest per year, at today's cost of money, would be about US$7 billion. That saving, however, would greatly if not irreparably damage

the chances of financing the remainder of the current account deficit of Latin America. A more modest proposal to reduce interest charges, for example, to no more than 1 percent over the London interbank rate, including all other charges, for a period of about two years--until world recovery begins to pull up Latin America foreign-exchange earnings--would still save debtors at present rates about US$4.5 billion annually without damaging to the same extent the chances for new lending.

It is unlikely that bank lenders would by themselves accept such a scheme, even if it were proposed on a contingent basis. There would no doubt have to be some government persuasion. Given the time constraints, direct persuasion, as has occurred in the recent refinancings, may be better than a large international conference, which requires much preparation. If interest rates look at all as if they are again on the rise, consideration of some sort of scheme to reduce the interest burden at least temporarily will become urgent. Otherwise, as export earnings failed to recover in the wake of the negative effects of higher interest rates on recovery in the industrialized countries, lenders would find themselves facing the dilemma of having to lend more in order to get paid the higher interest due.

A related point is whether a quid pro quo for the reduction in interest charges might be necessary, such as some form of medium-term international or government guarantee for net new lending. Even if this were politically feasible, however, it would take time to put such an arrangement in place. Perhaps the understanding that a guarantee would, as a last result, be given serious consideration by governments would be enough stimulus to arrange a contingent scheme to reduce interest costs in the immediate future. That and the continuation of net capital inflows are the only avenues of action open for the short term, together with the continuation of difficult austerity measures in the borrowing countries.

Medium-Term Solutions

For the medium term, the proper emphasis should be to continue to find ways to stimulate new capital flows, especially in the immediate years ahead. To do that within the short time available is extremely difficult. No one scheme or source of flows will do. Complicated new arrangements are unlikely to be feasible. Nor can new flows simply be blank checks to underwrite a revival of state enterprise deficit spending in borrowing countries.

Long-Term Solutions

It is clear that the policies that could yield results soon are difficult to enact. Moreover, something is needed on each front, especially on replenishing the resources of the IMF and on lowering the interest burden without jeopardizing new flows, a most difficult task. In order to put all the pieces of the package together, some form of concerted action by the governments of the major money and capital markets of the world is needed. Of course, each month that passes without a major crisis reinforces the feeling in some quarters that the worst is over and that eventually the problems will evaporate in the wake of world recovery. Such a view gives an uneasy comfort but is not consistent with the problems as seen from the debtor countries, which face enormous problems.

So far, the temptation to stray from the path of IMF-supported austerity has been avoided by the governments of Latin America. But the present equilibrium is a tenuous one. It is quite conceivable that the government economic teams that have followed such policies could be jettisoned in the face of strong political opposition. The refinancings linked to the IMF credit facilities would then be called into question and a period of confusion could well follow. At that point some governments may be tempted to talk and think of a debtors' cartel, in the sense of a coordinated suspension of debt service. The idea is at present viewed by financial policymakers in most countries as a product of the lunatic fringe. But if these officials and their policies do not receive enough external support now, there is the risk that the lenders might face a very different cast of characters. That is why it is important to focus in a more concerted fashion on possible solutions while the problem appears to be in remission.

Besides the areas already mentioned, there are others that could be of great importance to economic recovery, although not immediately. The longer horizon does not mean that the necessary policies should not be put in place now. Two important areas are private investment and credit insurance. Private investment is not a promising source for the next year or two, but could be of great importance once economies revive. In the early 1960s, private direct investment provided about 40 percent of the net capital inflows into Latin America, particularly into Brazil and Mexico. In recent years, the proportion has fallen to 20 to 25 percent. In 1981-82, net flows were about US$6 to 7 billion annually, a sum that has fallen in 1983. It is essential to establish the preconditions now for an investment recovery later. Mexico has already begun to take measures, for example by reducing in practice the requirements for domestic ownership. Peru is breaking away from the Andean Group's ill-conceived restrictions on foreign

direct industrial investment. Multilateral investment guarantee schemes, which have been under study for many years at the World Bank and elsewhere, deserve another look. Of equal or even greater importance is private domestic investment, since its revival would pull back into Latin American countries part of the large sums which have fled in 1981-1983. For example, perhaps US$20 to 25 billion is estimated to have left Mexico and Venezuela, the two most notable cases, in that period. While some of what has gone out will stay out, more realistic exchange rates, political stability, and a revival of domestic markets would, in time, begin to attract some of the flight capital. Unrecorded flows of this type could make a big difference once the beginnings of improvement are visible.

Since it is important to keep some bank lending going, albeit on a more controlled scale, several schemes have been advanced under which a multilateral credit insurance facility could be established, to be run on an agency basis by the World Bank or the IMF, or a combination of the two. The facility would cover additional lending. Setting up a multilateral arrangement is probably desirable but politically difficult and time-consuming. In the meantime, individual export credit agencies, working with the World Bank and the Inter-American Development Bank, could more quickly get themselves organized.[13] The resources are there: For example, as of May 1983, the U.S. Export-Import Bank had barely committed one-tenth of its authorized lending for fiscal 1983, largely because of the cutbacks in development projects around the world. Commitments for the full fiscal year are wholly to be well below authorizations. Of course, changes in legislation would in some cases be required, but they would probably be easier to obtain than for a multilateral scheme and could be set in motion while a multilateral arrangement is designed and evaluated. On the multilateral front, the idea of an Export Development Fund[14] has much appeal, especially if it could be expanded from lending to developing countries for capital goods imports to helping to finance the exports of these countries, which represent, in general, transactions that are liquid, usually secure, and suitable for commercial finance.

By definition, the most urgent task is to confront the more immediate problems. There is, however, only limited time to put into effect policies which would produce results by 1986-87, when the first big repayments on the recent refinancings are due. The struggle into recovery will not be easy, since the economic problem in the case of the major Latin American countries is not simply a cyclical one but arises in part from their historical stage of development. For countries such as Argentina, Brazil, Mexico, and Venezuela, with relatively large internal markets in comparison with the export-

oriented East Asian economies, the thrust of development has been industrialization for domestic consumption and the building of infrastructure for a rapidly growing population. In that sense, the pattern of development has some similarities with that of the United States a century ago, which also emphasized infrastructure and industry for a growing internal market. The difference is that real interest rates were then at the historic norm of about 3 percent in real terms, whereas today, for Latin American borrowers, the real rate on their commercial debt is closer to 9 percent in real terms. Moreover, three-quarters of this external commercial debt is owed by the public sector. The railroad and steel barons of a hundred years ago have been replaced as borrowers by inefficient state enterprises, and the widows and orphans of the British Empire as lenders by large and powerful banks. The balance of negotiating power has therefore significantly changed.

Another important feature has been that the major Latin American economies have not in the last three decades been able to provide enough jobs, particularly for the growing lower middle class, which wields increasing political power. Political pressures have thus built up to provide jobs through the government and state enterprises. Similar pressures act to maintain overvalued exchange rates and interest-rate subsidies--which help middle-class consumption--all of which tends to build up budget deficits, stimulate borrowing, and hold back the growth of export earnings. This set of policies also tends to hold back employment, particularly in manufacturing, where advanced social legislation for a minority of the labor force tends to push up wage costs to levels that are uncompetitive internationally.

Such policies underlie, with periodic changes in emphasis, much of Latin America's rapid economic growth in the postwar period and will not change quickly. There is therefore a long-term aspect to the debt problem beyond the admittedly more pressing cyclical problem.

CONCLUSIONS

A clean and simple, conceptually satisfying scheme to "solve" the debt problem obviously has intellectual appeal, while the present muddling through is fraught with danger. For the time being, however, political realities, especially in the United States, make it very difficult to envisage an all-encompassing scheme. There is far more political concern within the United States on Central America than on the debt question, although the long-term effects of the latter could turn out to be very serious. As long as nothing explodes, there will be little interest in setting up contingency mechanisms. Only a real crisis, which hopefully will not occur but

is unfortunately a distinct possibility, will powerfully concentrate the minds of policymakers other than the central bankers and Treasury officials who have already been involved. In the meantime, everyone would be better off if lenders, authorities in the lenders' countries, and major borrowers work together in setting up a concerted program to help existing official institutions to do more and to establish contingency plans to lower the interest burden of commercial debt, if necessary, in the event that the debt burden cannot be managed.

Both lenders and debtors face a critical period. While there are indeed some chances that the problem will gradually be overcome by world economic recovery, the risk of major crises ahead are high indeed. It is therefore vital to anticipate these problems in a concerted fashion, well ahead of time, rather than run the risk of facing them at the very last minute.

NOTES

1. The article that appears in this chapter was in the Fall 1983 issue of Foreign Affairs. It is reprinted by permission of Foreign Affairs, Fall 1983. Copyright 1983 by the Council on Foreign Relations, Inc. The article was written some months earlier, following a first article on the same subject published in the same journal in the Winter 1982-1983 issue. Foreign Affairs has given permission for the reproduction of the paper here. I am indebted to Elizabeth K. Rabitsch of First Boston for help with background for the article. The views expressed are personal.

2. See, for example, William Cline, International Debt and the Stability of the World Economy, Washington, D.C., September 1983.

3. "Latin American Debt," my article in Foreign Affairs, Winter 1982-1983.

4. Comparing stocks to flows can be misleading. However, since interest is a proportion of the debt outstanding, the comparison is of some use. Also, it could be argued that all exports, including services (such as tourism), should be taken into account. Since Latin America as a whole has a negative balance on services, the concept of export of goods and services seems an inappropriate measure.

5. Bank for International Settlements, Fifty-Third Annual Report, Basle, June 1983, p. 116, showed only US$100 million. However, a later estimate of July 1983 showed US$5 billion of net flows for the second half of 1982, largely for the reason noted. The first quarter of 1983 showed no net loan flows to Latin America other than those associated with the Mexico and Brazil refinancings.

6. See "Latin American Debt," pp. 354-357, 359.

7. My estimate, based on a ratio of about twelve thousand to fifteen thousand jobs per US$1 billion in sales.

8. Official statistics, which are sometimes based on narrow statistical amounts in Argentina, Brazil, and Mexico, show lower numbers, however.

9. For example, among others, Morgan Guaranty Trust, _World Financial Markets_, June 1983; William R. Cline, _Developing Country Debt Under Alternative Global Conditions, 1983-86_, Washington, D.C., 1983. The largest international banks have their own projections, as has the Federal Reserve Bank of New York.

10. See "Latin American Debt," pp. 362-363.

11. For example, Felix Rohatyn of Lazard Freres (in _Business Week_, February 28, 1983) suggested that a major portion of credits be turned into long-term low-interest bonds, under the aegis of the IMF. Peter Kenen of Princeton University (_New York Times_, March 6, 1983) proposed that a special agency buy the loans from the commercial banks at a discount with the proceeds of long-term bonds. A proposal along similar lines, but using the World Bank, has been made by Richard Weinert in _Foreign Policy_ (Spring 1983). Minos Zombanakis has proposed a Loan Guarantee Fund in the IMF (_The Economist_, April 30, 1983). There are a number of other interesting proposals.

12. For a discussion, see Yves Laulan, "A New Approach To International Indebtedness," the _Banker_, July 1983.

13. See, for example, Harold Lever, "The Lever Plan," _The Economist_, July 9-15, 1983.

14. See William H. Bolin and Jorge del Canto, "LDC Debt: Beyond Crisis Management," _Foreign Affairs_, vol. 61, no. 5 (Summer 1983).

7
Capital Market Financing to Developing Countries

Ariel Buira

The world economy has faced serious difficulties in recent years. These have been related essentially to the external debt problems that have arisen in an important number of developing countries, which have threatened the stability of the international monetary system. Thus far, the system has been able to adjust to these problems in such a way as to avoid its breakdown. Nevertheless, there is an urgent need to adapt it to the new circumstances prevailing in the world economy, if the emergence of recurrent crisis is to be avoided. In this context, the search for new mechanisms for recyling financial resources from surplus to deficit nations to ensure the appropriate supply of funds for balance of payments and development finance has been of particular concern. The purpose of this chapter is to put in perspective the origins of the present difficulties and their implications with regard to future financing for LDCs, and possible solutions.

ORIGINS OF THE CRISIS

Until recently, the number of developing countries with access to the international capital markets was limited and the amounts they received did not represent a substantial proportion of the markets concerned. The rapid expansion of international lending to LDCs can be associated with the growth of the Eurodollar markets in the 1970s.

As late as 1970-1972, external financing to the developing countries was still largely provided through non-debt-creating flows from official sources and long-term capital investment from private sources. However, in the years following the quadrupling of world oil prices at the end of 1973, the international capital markets experienced an explosive growth--by some estimates growing from US$200 billion in 1973 to US$2,000 billion in 1982--becoming the single most important channel for

the transfer of savings from surplus to deficit countries.

A large part of the resources for this expansion was provided by short-term bank deposits of the governments of oil-exporting countries, and the largest part of the markets' assets were private bank credits to the governments and official entities of deficit countries. The flexibility of the Euromarkets and the relative ease with which they were able to transform short-term deposits into medium-term loans determined their strong growth.

The increase in the demand for credit generated by the sharp rise in oil prices was more than matched by an inflow of funds into the market, and until mid-1979 spreads were generally falling, interest rates were barely positive, and credit conditions in the international capital markets tended to favor borrowers. As a result of these factors, the share of financing provided by official creditors--both government and multilateral development finance institutions--to nonoil LDCs diminished in relative terms from some 67 percent in the period 1967-1970 to about 35 percent by 1982; likewise, private markets supplied approximately half of the capital needed by these countries to finance their current account deficits in 1981-82.

Borrowing by the developing countries tended to be heavily concentrated in some individual nations; although some forty to forty-five countries gained access to the markets, the two largest borrowers, Mexico and Brazil, accounted for about 40 percent of all the funds raised in 1978-1981, and the five largest averaged 67 percent in the same period. In 1982, Brazil and Mexico together accounted for 26 percent of the total LDC debt service, and the share of the five largest debtors amounted to 40 percent.

The role played by the international financial markets has to be underscored. In bridging the large current deficits, the private markets made it possible for industrial countries to meet the higher world oil prices without a deeper and longer recession than they suffered. The more advanced nonoil developing countries were able to borrow heavily to maintain their levels of investment; thus, their economic growth was sustained at about the average trend rate of 5 percent. In so doing, this group of countries helped sustain international trade and activity in the world economy.

However, since commercial bank loans are characterized by higher interest rates and shorter maturities than credits provided by official sources of development finance, this change in the structure of finance was to give rise to a more than proportional increase in the debt-service burden of borrowers. This, coupled with the sharp increase in lending to LDCs, was bound to give rise to questions regarding the long-term viability of this pattern of finance and of the creditworthiness of the developing countries. Nevertheless, the conditions in

the international capital markets, along with the expanding world trade, allowed the postponement of the problem.

These favorable trends were reversed in 1979. The sustained increase in world energy demand, together with the existence of negative real interest rates in the international capital markets--which made it more profitable to keep oil in the ground, set the conditions for a second oil crisis. This led to a sharp deterioration in the balance-of-payments position--and thus the creditworthiness--of the oil-importing countries, especially those among the developing group.

Furthermore, as a response to the inflationary pressures generated by the oil-price increase, most of the major industrial countries adopted restrictive monetary policies after late 1979. Thus, the cost of borrowing, as indicated by LIBOR plus average spread, which had fluctuated between 6.5 and 7.75 percent in the period 1975-1977, averaged 13 percent in 1979, nearly 18 percent in 1981, and around 15 percent in 1982. These historically high rates of interest, in both nominal and real terms, were to result in a sharp increase in the burden of debt-service payments of the developing countries.

Since 1980, the tightening of credit conditions has also been reflected in a widening of spreads and a greater risk differentiation among borrowers. Maturities on new borrowing, particularly for the major borrowers, were shortened. Thus, the ratio of short-term to total debt for the group of nonoil developing countries rose from 15 percent in 1978 to 18 percent in 1982; for the four largest debtors, such ratio increased from 16 percent in 1978 to more than 25 percent by 1982.

The restrictive stance of the monetary policy adopted by the United States and other major industrial countries was to have other significant effects on the level of international economic activity and the external environment. The volume of world trade, which had grown at annual rates of 9-10 percent in the 1960s and 6 percent in the 1970s, has remained stagnant since 1979. In addition, the deep and protracted recession in the industrial countries was to result in a sharp fall in commodity prices, which in some cases fell to their lowest levels in real terms since records exist. On average, commodity prices fell by more than 30 percent between December 1979 and November 1982; since then, they have followed a moderate upward trend, increasing by some 15 percent in the ten months to September 1983.

As a result of falling commodity prices and continued inflation, the terms of trade of nonoil developing countries deteriorated sharply.[1] Moreover, the recession and resulting unemployment in industrial countries have given rise to strong protectionist trends, which have been particularly apparent in a number of sectors in which developing countries have a comparative advantage.

In an effort to sustain economic growth under such extremely adverse external conditions, nonoil LDCs increased sharply their external indebtedness. Total outstanding debt of these countries is estimated to have increased from US$130 billion in 1973 to US$390 billion in 1979 and to more than US$600 billion in 1982 (see Table 7.1). In relation to the group's output and exports, external indebtedness rose to record levels and for an unprecedented number of countries the debt-servicing burden reached critical proportions, as reflected in the record number of debt rescheduling (see Table 7.2) and the sharp rise in external payment arrear.

By the middle of 1982, intense concern arose in the international community regarding the ability of some of the larger borrowers to meet their external financial commitments; thus, a growing reluctance of banks to extend new credits was apparent. Another factor that contributed to the tightening of market conditions was the sharp decline and virtual disappearance of OPEC surpluses in 1981 and 1982. Furthermore, some estimates show that even if the price of oil does not fall below US$29 a barrel--the benchmark price agreed upon in March 1983--the OPEC countries will experience a deficit of between US$25 and US$35 billion for 1983 and of some US$10 to US$20 billion in 1984.

One effect of the reduction of OPEC surpluses has been a decline in the amount of resources available to the international financial markets. Although OPEC surpluses have been replaced by a greater volume of deposits by firms and corporations of industrial countries, banks tend to regard these deposits as less permanent and more volatile than those of surplus-oil-exporting countries and therefore tend to manage these funds more cautiously.

As a result of these factors, it is estimated that net bank lending, which had increased from US$26 billion in 1978 to more than US$50 billion in 1981, was cut back to some US$25 billion in 1982, and a further drop has been registered in 1983. According to the BIS, new credit to Latin American countries fell from US$11.7 billion in the first semester of 1982 to only US$300 million in the second. Statistics show an increase in new credit to Latin America of US$3.7 billion in the first semester of 1983; however, such loans were mostly supplied in association with financial programs supported by the IMF.

After a long period of rapid growth, the abrupt slowing of credit commitments by the private banking system generated the concern that the inability of a few major borrowers to refinance maturing loans could give rise to a liquidity crisis in these countries. Given the high exposure of the private banking in these nations, serious fears arose with respect to a possible collapse of the international financial system.

Table 7.1 External Debt of Nonoil Developing Countries

	1978	1979	1980	1981	1982	1983[a]
Total outstanding debt (billions of U.S. dollars)						
All nonoil developing countries	336.3	391.1	467.6	550.8	614.2	659.1
Major borrowers[b]	233.4	276.0	330.5	400.0	445.3	474.6
Latin American countries[c]	119.1	143.5	176.6	218.0	231.1	254.5
Ratio of external debt to exports of goods and services						
All nonoil developing countries	130.2	117.2	111.0	123.8	143.6	145.1
Major borrowers[b]	175.5	162.8	156.1	172.9	199.4	200.5
Latin American countries[c]	186.7	168.6	164.9	190.7	224.4	230.0
Ratio of external debt to GDP						
All nonoil developing countries	27.9	26.8	26.9	30.4	35.8	37.8
Major borrowers[b]	30.7	29.0	29.5	34.3	41.1	43.8
Latin American countries[c]	28.6	27.8	27.9	32.1	38.6	40.0
Debt service ratio						
All nonoil developing countries	19.0	19.0	17.6	20.1	23.4	19.3
Major borrowers[b]	28.9	30.6	28.0	32.7	38.4	30.1
Latin American countries[c]	38.3	37.2	32.9	38.4	48.8	42.0

[a] Estimated

[b] The twenty major borrowers among the nonoil developing countries are Brazil, Mexico, Argentina, Korea, Chile, Yugoslavia, Philippines, Greece, Portugal, Malaysia, Israel, Thailand, Hungary, Peru, Turkey, Egypt, Romania, Colombia, Ecuador, and Morocco.

[c] Includes the Caribbean countries; external public debt.

Source: International Monetary Fund (IMF), *World Economic Outlook*; IMF, *International Financial Statistics*; IMF, *Recent Economic Developments*; Merrill Lynch Economics Inc., *Latin American Quarterly*.

Table 7.2 Multilateral Debt Renegotiations, 1974-1983

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
Argentina			C							C
Bolivia									C	C
Brazil										C
Central African Republic							P			
Chile	P	P								C
Costa Rica										P,C
Cuba										C
Ecuador										C
Gabon					P					
Ghana	P									
Guyana						C			C	
India	A	A	A	A						
Jamaica						C		C		
Liberia							P	P	C	
Madagascar								P	P	C
Malawi									P,C	
Mexico										C
Nicaragua							C	C	C	
Pakistan	A							A		
Peru			C		P,C		C			
Poland								A	C	C
Romania									P,C	P
Senegal								P	P,C	C
Sierra Leone				P			P			
Sudan						P		C	P	P
Togo						P	C	P		P,C
Turkey					A	A,C	A		C	
Uganda								P	P	
Yugoslavia										C
Zaire			P	P		P	C	P		
Zambia										P
Total number of renegotiations	4	2	4	3	4	7	8	13	14	17

(continued)

Table 7.2 (cont.)

Note: This table does not include some cases for which sufficient information was not available.

A: Aid consortia renegotiations
C: Commercial bank agreements
P: Paris Club agreements

Source: World Bank Debtor Reporting System.

The responsibility for the current difficulties is widespread. Part of the current debt problems can be traced to bank lending practices. Underpinned by the confidence that a country could not go bankrupt or disappear, bank analyses of countries' debt-servicing capacity and prospects were often perfunctory and the traditional yardsticks of credit appraisal were not applied.[2] Nevertheless, credit expansion was stimulated by the higher average profitability of international lending operations, the good record of foreign borrowers, and the fierce competition among banks.

It is equally clear that a number of important country borrowers did not undertake sufficiently large and timely adjustment efforts, believing that the recession would be short-lived and that demand for their exports would soon recover. Moreover, they did not expect real interest rates to remain at very high levels for such a lengthy period. In fact, they would not have, had major industrial countries adopted a more balanced fiscal and monetary policy stance.

The current liquidity problems in the developing countries may be attributed more to the sharp rise in interest payments than to the increase in external debt outstanding. While interest payments on the external debt of nonoil LDCs increased almost ninefold between 1973 and 1982, amortization payments only increased approximately fourfold. Indeed, at more normal levels of interest rates of, say, around 3 percent in real terms, and with annual rates of economic growth of 4 percent, those nations maintaining a constant external debt-to-GDP ratio would be able to finance significant current account deficits and to cover their interest payments without difficulty.

Corrective policy measures are already under way in many countries, and the external current account deficit of the nonoil LDCs appears to be moving into a more viable range. However, the scale of the dependence on external financing for many nations is such that the situation cannot be turned around overnight without the risk of severe internal disruption for the countries concerned, as well as worrisome implications for the world economy. There is a danger that the cutback in capital flows to developing countries may be so sharp that it may not only prevent orderly positive adjustment, but may prove destabilizing, initially to the countries but soon after to the banks, who would suffer losses that would impair their capital base.

The strains that have recently become apparent in the financial system--namely the high exposure of the private banking system to the largest LDCs, the difficult current situation and prospects faced by most developing countries, the increased nervousness of the market, and the recent shift in banker's attention toward a greater political analysis of potential borrowers--suggest that

in the future commercial banks will not continue performing the role of major financial intermediaries in the recycling of funds from surplus to deficit nations that they have played in the recent past. At the same time, the elements of instability that such a pattern of recycling has introduced to the international monetary system have generated doubts about the desirability of its continuation.

Consequently, a need arises for designing new financial mechanisms for recycling. The issue is twofold: (1) in the short run, to ensure that financial flows to countries with serious debt or liquidity problems continue at an appropriate rate, so as to avoid a world liquidity crisis; and (2) given that present problems arise to a considerable extent from an absence of adequate sources of development finance that has forced LDCs to resort to short- and medium-term financing, a second issue still remains for the medium and long terms, that of appropriate development financing.

THE PROVISION OF ADEQUATE SHORT-RUN FINANCIAL ASSISTANCE

Notwithstanding all the difficulties and uncertainties still inherent in the current situation, the threat of a liquidity crisis in the world economy appears to have been considerably diminished in recent months. The fears of an interruption or even reversal of private capital flows to LDCs seem to have been averted by collective lending agreements, involving the authorities of the affected countries, the private banks, and international institutions--mainly the IMF and the BIS.[3] Nevertheless, a strengthening of the international financial system's ability to cope with such a potential liquidity crisis would be the best way to avoid its occurrence, since it would increase substantially the confidence in the system.

Indeed, the International Monetary Fund has an important role to play in this overall process. However, Fund resources--presently around 2-3 percent of the value of international trade--are clearly insufficient to allow it to play this role to the extent required. The need to increase the size of the Fund has been widely recognized. In practice, however, this process has been considerably hindered by a lack of cooperation on the part of the industrial nations. The decisions taken regarding the Eighth General Review of Quotas, which will serve the international community through much of the present decade, are a clear example of such situation.

Notwithstanding the technical studies supporting the need for an increase in quotas of 100 to 125 percent and the demands of the developing nations, agreement could not be reached for an increase of more than 48

percent. It is evident that such an increase will be insufficient to allow the IMF to meet the financial requirements of member countries during the coming years. As a result, the Fund has been forced to supplement its resources by borrowing from member countries.

It is important to note that the Group of 10 decided in early 1983 to increase their aggregate commitments under the General Agreement to Borrow (GAB) from SDR6.4 billion to SDR17 billion. They also agreed that, in the future, GAB's resources would be available for purchases by those members--including non-GAB participants--whose payments difficulties might endanger the international monetary system. Obviously, this may be considered as a mechanism that alleviates the possibility of payments difficulties by one or two major debtor countries giving rise to a world banking crisis. However, the enlargement of the GAB does not benefit all LDCs, since only the largest among them may endanger the international monetary system. It is also important to note that the widening of GAB raises some questions regarding the decision-making process of the Fund, since the Group of Ten has a veto on the approval of loans under such agreements. Thus, it is obvious that the increase of resources under the GAB can under no circumstances be considered as a substitute for an increase in quotas.

The recent experience of countries that have faced a liquidity crisis and resorted to the BIS shows that when rapid financial support is needed the Fund cannot provide it under existing policies. However, since BIS support is often conditional on a Fund-supported adjustment program, the question comes to mind whether the Fund should not itself provide such support. There is no certainty that the BIS will in the future assist non-BIS countries; thus, an increased capacity of the Fund to deal with emergency situations at short notice would appear necessary.

In addition to increasing its resources, therefore, the Fund would have to modify its policies to make drawings available in a matter of days rather than months. The need to establish a new facility, which had been informally considered in the past in connection with problems caused by capital fight, should be recognized in the light of current problems. Access to this facility would be limited to those countries facing a liquidity crisis as a result of capital outflows or of a very sharp decline in access to external credit. In such cases, if the Fund were not satisfied that the stance of the country's current economic policies was in broad terms appropriate, it would require a policy statement by the authorities similar to that required at present for upper credit tranche drawings.

Obviously, the commercial banks must continue to play an important role. The resources of multilateral institutions should be seen as complementary and

supportive of financial flows on commercial terms rather than competitive with them. Equally important is the adoption of cooperative and responsible attitudes on the part of the private banking community and the authorities of creditor countries leading to rescheduling of debt-service payments and to refinancing important amounts of short-term debt at longer maturities. This would contribute importantly to avoiding a potential liquidity crisis.

MEDIUM- AND LONG-TERM FINANCIAL NEEDS OF LDCs

The present debt crisis has resulted to a considerable extent from an excessive dependence of LDCs on short- and medium-term external financing, a situation that has been determined by the absence of adequate sources of development finance. It is apparent that the continued usage of medium- and short-term financing is bound to give rise to liquidity problems in the medium term for countries that rely heavily upon it, even if the financing is all destined to sound investment projects.

The situation is even more serious presently, since the structural nature of the economic adjustment requirements faced by LDCs calls for larger amounts of longer-term financing. Furthermore, payments on a large proportion of the external debt of LDCs will be falling due in the medium term; therefore, if no additional measures are taken, recent debt-rescheduling agreements could, through the bunching of maturities, compound the external debt problems in the coming years.

The Current Economic Adjustment Problems

Profound economic adjustments have become necessary in developing countries in recent years, partly as a result of the important changes in technology and in the structure of markets, but mainly because of the changes that have taken place in relative prices--in the fields of energy, raw materials, and manufactures--and the unprecedented levels reached by interest rates. It is evident that adjustments are much more difficult to achieve in a world suffering from stagnation than in an expanding economy.

This is the problem that must be addressed by adjustment programs today. To do so, it is not sufficient to restore or maintain a certain balance between aggregate supply and aggregate demand. It is also necessary to restructure the economy in such a manner that it will permit an increased production in certain strategic sectors and the diversification of exports, so as to restore economic growth.[4] This process must be accompanied by an increase in the rates of savings and investment.

External debt service requires the generation of substantial trade surpluses in the debtor countries. However, it is essential to distinguish between: (1) the strengthening of the balance of payments that results from a reduction in growth and economic activity (i.e., from a deflationary policy), and (2) attaining a solution to balance-of-payments problems compatible with acceptable rates of growth and viable over the medium term.

That is to say, it is necessary to distinguish between a temporary improvement in the balance of payments that results from a depressed cyclical position and a more lasting structural adjustment compatible with higher levels of activity and employment. This distinction suggests that adjustment programs require, besides a prudent management of demand, an increase of investment and production in certain key sectors of the economy that play a strategic role in its restructuring. Evidently, this type of adjustment needs substantial financial resources.

There exists a number of LDCs where economic disequilibria have been generated predominantly by growing public-sector deficits. In fact, a great deal of the foreign borrowing by such countries resulted from pronounced increases of their fiscal deficits, creating a strong link between debt service and fiscal policy. If the governments of these nations are to pay the service on their external public debt, they must either extract an excessive share of resources from the private sector or reduce expenditures. Thus, the service of the external debt in these cases requires a sharp reduction of fiscal deficits. Nevertheless, substantial amounts of longer-term external financing must be directed to these countries if their growth prospects are not be seriously impaired. These financing flows will also help to reduce the risk of a possible default on external payments.

Furthermore, the recovery of world trade may be hindered if the adoption of excessively deflationary adjustment programs in LDCs generates a substantial decrease in these countries' imports. It is essential, therefore, that the developing countries implement policies leading to the required structural adjustment of their economies, consistent with the maintenance of international trade flows. Consequently, the financial requirements of the group must be placed within the framework of the international adjustment process and recognized as a problem of the international community.

The Role of External Debt Rescheduling

In general, external debt rescheduling may provide benefits of two kinds. In the first place, as has already been described, it may contribute substantially

to the solution of short-run liquidity problems. Second, by spreading external payments over longer periods, it may alleviate the pressures on the external sector of LDCs and faciliate the adoption of an orderly program of economic adjustment; indeed, the final purpose of rescheduling should be the restoration of the debtor country's creditworthiness. The benefits of the first kind have already been evident in the present crisis. However, it seems less certain that the reschedulings recently agreed will allow a substantial improvement in the capacity of LDCs to service the external debt.

So far, a substantial amount of the external payments falling due in the short term has been renegotiated by the major borrowers. The terms in which the operations have been settled comprise, in general, an interest rate of LIBOR plus two points or more and amortization periods of around six to eight years, with grace periods between two and four years. This suggests that many LDCs will face a very heavy concentration of amortization payments in the near future. In order for these countries to be able to cover the repayments falling due, their balance of payments and economic conditions would have to experience major improvements over a relatively short period of time.

However, in a number of cases external as well as internal factors may prevent those countries from reaching such an improvement within the time span allowed by current rescheduling agreements. On the one hand, the moderate economic recovery of the developed countries and the persistence of protectionism are likely to undermine the developing countries' ability to sustain a large export expansion. On the other hand, the structural nature of the economic imbalances faced by most developing countries requires, besides large amounts of development finance, periods of adjustment longer than those involved in many of the rescheduling agreements that have been agreed.

Obviously, if the length of the adjustment period is not enough to permit the structural changes required, the creditworthiness of these countries will not be fully restored, and therefore the main condition of a successful rescheduling will not be reached. In such an event, the rescheduling operation would merely represent a postponement of the problem for the near future.

Although commercial banks seem to earn record profits out of the debt-rescheduling exercise, for the debtor countries successive debt-restructuring exercises imply a high cost. They are often seen as a new failure to meet international obligations and create an atmosphere of uncertainty, if not of recurring crisis, that hinders the recovery of confidence, gives rise to capital flight, discourages investment, and disrupts economic life.

Moreover, unless debtor countries can greatly expand their exports, the fulfillment of debt payment obligations

may turn them into substantial capital exporters. Interest payments at prevailing rates of interest alone on a total external debt of the order of US$300 million would require Latin America to generate a trade surplus of some US$35 billion a year. In that event, and after several years of costly economic adjustment, it is possible that LDCs governments would face growing political pressures to direct export surpluses to offset some of the negative social effects of the adjustment programs instead of using them to pay their international creditors; that is, the willingness to pay of some LDCs might decrease.

Assets that are within a debtor's jurisdiction are not liable to claim by the banks. Thus, debtor's willingness to pay is the factor that ultimately determines the reimbursement of credit sources. Willingness to pay has not been a major issue in the process of international lending, because the net transfer of resources--which has a negative relation with interest rates--was positive until 1982. Since then, it has been negative; nevertheless, the rescue packages have kept net exports of capital from LDCs at low levels. It would appear that the reduction in net flows resulting from the elimination of these packages together with the high spreads charged by commercial banks on the restructuring of debt and the new money lent and the persistance of adverse external developments--related essentially with the evolution of world economic recovery, interest rates, and protectionism in the industrial countries--could bring the willingness-to-pay issue to the forefront of the lending process.

POSSIBLE OPTIONS FOR THE FUTURE

Although the financial difficulties of LDCs generally reflect a liquidity rather than a solvency crisis, it is evident that the avoidance of recurrent liquidity problems in this group of nations requires the adoption of measures oriented toward a structural adjustment of their economies and an improved functioning of the international monetary system. The debt problem, therefore, cannot be separated from the issue of development finance. Indeed, the solution of these problems seems to be one of the major challenges facing the world economy in the 1980s.

Obviously, the best long-run solution to the debt crisis would be for the countries concerned to "grow out of debt." This would require, besides the continuation of the serious adjustment efforts already under way in many LDCs, a sustained recovery in the world economy, a decrease in international interest rates, and the reversal of the protectionist tendencies in the industrial countries. A continued expansion of LDCs' exports would make the external debt situation of these nations much

more manageable and, at the same time, would provide them with the foreign exchange they require for their development.

Nevertheless, whether the LDCs will face such a favorable external environment in the next years is still uncertain. As a result of a combination of factors, the pace of expansion in the world economy over the medium term is likely to remain slower than during earlier periods. Likewise, the prospects of large fiscal deficits in certain industrial nations generate serious concerns regarding the future evolution of interest rates. Such a scenario does not suggest the rapid elimination of protectionist barriers in the developed world.

It would appear, therefore, that the solution to present debt difficulties requires securing sufficient financial flows to LDCs on longer maturities. As has been stated, at present it seems unlikely that the capital markets will satisfy such needs spontaneously. Furthermore, the possibility that collective lending agreements--involving the commercial banks, international institutions, and the authorities of the affected countries--would become a permanent arrangement is almost nil, since this would imply long periods of outside supervision of the debtor country's economic policies, and because it is doubtful that it will be possible to secure the continued participation of hundreds of small banks in such an exercise over a number of years. The political strains that such a situation could create are enormous.

In this context, the need to design alternative mechanisms for providing LDCs with adequate flows of financing seems evident. The increase of foreign direct investment has been frequently mentioned as one possible option.[5] In fact, risk capital provided a large share of the finance required for the development of LDCs during the nineteenth and early twentieth centuries. The commercial banking system has assumed this role in recent years. Given the current problems, it would seem desirable, from a financial point of view, for equity to play a much larger part in development finance today. The potential threats to the stability of the world's financial system would decrease if risks were shared by thousands of investors, whose capital or equity could become nonperforming without the risk of spreading to others.

However, the balance-of-payments and financial problems that developing countries face have substantially decreased their attraction to foreign investors in view of their reduced capacity to transfer profits and other payments on foreign direct investment. This, coupled with the fact that the developed countries account for a growing share of total direct investment--LDCs' share in foreign investment fell from 31 percent in 1970 to 27 percent in 1980--makes it very unlikely that the rates of

growth reached by such investment during the 1970s may be sustained in the coming years. Therefore, it would seem necessary to develop policies that encourage a greater inflow of external direct investment, including the development of regulatory frameworks satisfactory to the foreign investor and the host country.

It seems clear that meeting LDCs' financial needs in the medium and long run requires a substantial increase in credit flows to these nations on much longer maturities and at lower spreads.[6] The difficulties seem to be particularly serious for the Latin American countries, given the larger magnitude of their external debt.

Covering the public sector's financial needs could be achieved by greatly enlarging the resources of instituions such as the World Bank and the regional development banks to permit them to recover the relative position they held in the 1960s. Evidently, this solution calls for the cooperation of industrial countries in the form of higher contributions to the capital base of these institutions and of strong leadership to overcome the political difficulties it faces in major countries.

Another approach that has been suggested is the creation of a multilateral government-guaranteed fund that would operate on commercial lines, obtaining long-term credits in domestic and international markets. The fund would grant, say, fifteen-year financing for public investment projects and for the purchase of capital goods, permitting the achievement of higher levels of investment and growth in developing countries, as well as improving their profile and therefore their ability to pay and their creditworthiness. For industrial countries faced with a recession, this could mean higher levels of exports and economic activity, making it easier to overcome political resistance to increased development assistance as well as the protectionist trends apparent in the world today. Such a scheme would also contribute to the growth and stability of international capital markets.

Other schemes, some of which have been in existence on a small scale, might be used as supporting mechanisms to deal with the external financing needs of the public sectors of LDCs over the medium and long terms. It has been suggested that the role of export credit guarantee agencies may be extended, so as to ensure against risk not only the trade flows to the developing world but also the lending required to cover its resulting current account deficits.[7] With this purpose, individual agencies in the creditor nations would insure bank lending for balance-of-payments financing, relying both on their own analysis and on the advice of the IMF. With insured credit available, each debtor country would be in a better position to meet both the trading deficit and the interest payments on existing debt.[8]

It has been suggested that such a mechanism might be further reinforced by public or private companies offering political risk insurance on loans to developing countries. This suggestion may be applicable to some regions. Nevertheless, it does not seem to appeal to the Latin American countries since such guarantees have never been provided, not even by the largest borrowers in the area. Political guarantees could give rise to both political and legal problems in these nations since they are contrary to the Calvo doctrine incorporated in the constitutions of several countries.

The recycling of adequate financial flows to the private sector of LDCs could be considerably eased through the creation of official guarantee programs. Evidently, the authorities of debtor countries should stand ready to assume the risks related with currency convertibility and transferability of external payments, but not those linked to purely commercial risks that by their very nature must be assumed by the private entities involved. This distinction must be clearly made if the private sector is to continue to develop as such.

Likewise, private credit to LDCs' private sectors could be directed toward the financing of specific projects. This would have the advantage of ensuring the productive usage of credits and might allow, by diminishing the risks involved in such operations, a decrease in spreads. At the same time, to the extent that insurance mechanisms in lending to LDCs--such as those already suggested--are established, private banks might be able to keep their asset levels below the limits set by regulatory authorities, while increasing the amount of credit potentially available to LDCs by selling off part of their loans. For instance, a combination of transfer guarantees and private risk insurance could convert a syndicated loan into a marketable security that could be sold to pension funds, regional banks, and so on.

Cofinancing with multilateral development institutions could, if procedures were made more agile, contribute substantially to the expansion of capital flows to the developing countries. Similarly, a new form of cofinancing between governments and commercial banks could be considered as a means of stretching maturities and reducing costs to borrowers while preserving an important role for the financial markets.

The magnitude of the problems related to the provision of adequate financial flows to the developing countries in the medium and long run may be roughly quantified. Let us consider first the demand side. During the last few years, imports of capital by LDCs rose to levels between 4.5 percent and 6 percent of GDP. Although these nations must be considered structural capital importers, such figures seem to be high by historical standards. Assuming that the current account deficit as a percentage of GDP falls to more normal

levels--of, say, 3 percent of GDP--and using the basis of World Bank projections for the future evolution of economic growth in the developing world and world inflation--around 5.5 percent in real terms and 5 percent respectively--one could reasonably expect the current account deficit of the nonoil LDCs to be of about US$125 billion by 1990. To this, one should add a moderate increase in international reserves to reach an equivalent of three months' imports. This would mean an additional reserve accumulation of some US$40 billion in 1990. Thus, total financing requirements of the nonoil developing countries would be of the order of US$165 billion in 1990.

Let us now consider the supply of financial resources. Assume that commercial banks are willing to expand significantly their loans, so that net bank lending to LDCs increases at 3.5 percent per year in real terms between 1982 and 1990. On the basis of the above assumption for inflation, such net flows would amount to about US$40 billion in 1990. This is in fact a very optimistic assumption. It must be recalled that as a result of the debt-restructuring agreements, maturities of about US$80 to US$100 billion have been shifted to the second half of the 1980s in Latin America alone. Therefore, the exercise assumes that a large part of these maturities plus those originally falling due in the second half of the 1980s will be refinanced.

This would imply such very high levels of gross bank lending to the developing countries, particularly those in Latin America, that it is doubtful that they may be attained without the active support or participation of the authorities of industrial countries through some type of official cofinancing arrangements. However, at present there does not appear to be a sufficient awareness of this problem. In fact, some of the bank regulatory agencies of financial centers are moving in the opposite direction, that of tightening supervision and limiting bank exposure to developing countries.

If the rates of growth of private direct investment and official transfers maintain the trend registered during the last ten years, these annual flows to nonoil LDCs would amount to some US$40 billion by the end of this decade. Credit from official sources--namely the World Bank and the regional development banks--may contribute importantly to meet the financial requirements of these countries; nevertheless, the reluctance of the industrial countries to increase substantially the capital base of these institutions might limit--by simply maintaining its trend rate of growth--net new flows of credit to LDCs from these sources to some US$35 billion in 1990.

Therefore, under such optimistic assumptions, there would still remain an external gap of approximately US$50 billion by the end of the 1980s even without taking into account the possibility of capital outflows. More

realistically, on current trends, the gap is likely to be several times larger. If there is a failure of leadership in the major industrial countries and the mechanisms necessary to finance such a gap are not created, the developing countries will be forced to reduce even further their current account deficits and to limit significantly their rates of economic growth.

An alternative method, and perhaps a simpler one, for securing the necessary net flows would involve a major restructuring of amortization payments on external debt owed to commercial banks so as to produce a positive balance on capital account that would supplement domestic savings and permit these economies to attain acceptable rates of growth and effect a positive adjustment. For instance, assume a country faces over the second part of the decade debt-service payments, including amortization, equivalent to 60-70 percent of export revenues, a result of adding the amortization of the recently restructured debt to the existing amortization schedule. Such a situation would be difficult to sustain since it would seriously limit the country's growth possibilities. Suppose on the other hand, that after an initial period of adjustment, a new debt restructuring takes place that extends the grace period through the rest of the decade and distributes amortization payments over ten to fifteen years starting in 1990. Debt-service payment for the rest of the 1980s would be reduced to interest payments alone, the equivalent of, say, 25 to 30 percent of export earnings.

This is clearly a much more manageable prospect, since it will contribute to the restoration of confidence both external and internal and will permit the attainment of satisfactory rates of growth, placing the economy in a better position to face the 1990s. Over the next ten to fifteen years the restructured maturities of the 1980s would represent a signficantly smaller proportion of export revenues, both because of their distribution over a longer period and because the debtor would have a larger export base. Thus, the restructured maturities should prove much easier to refinance through the market.

In a sense, a new and longer-term restructuring could be seen as complementing short-term measures adopted in 1982 and 1983 under the pressure of events, completing the required process for putting major Latin American debtors back on a sustainable growth plan. At the same time and by so doing it would dispel uncertainties and risks that still hang over the international financial system.

CONCLUSIONS

The strains that have recently arisen in the international monetary system, and the prospects for the

coming years, suggest that most of the debtor countries will not receive adequate financial flows unless a new pattern of financing is developed. In the short run, the main objective is to ensure adequate financial flows to the more indebted countries, so as to avoid repeated financial crisis. Although this possibility has been considerably alleviated so far by collective lending agreements, it is still necessary to strengthen the system's ability to cope with the likely recurrence of such crisis. This requires, among other measures, a substantial increase in IMF resources, a modification of its policies on drawings to allow a rapid financial support to those countries in serious liquidity problems, and the cooperation of the private banking community to reschedule important amounts of external debt at longer maturities.

However, even if the short-run problems related with potential liquidity crisis are appropriately dealt with, there still remains the issue of securing sufficient financial flows for development financing purposes. In fact, it may be stated that present problems have resulted to a great extent from the lack of adequate sources of development finance. The difficulties are more serious presently, given the structural nature of the economic problems faced by most LDCs and the possibility that recent debt-rescheduling agreements give rise to new liquidity crisis when the grace periods come to an end. The external indebtedness problem thus is closely linked to the issue of development finance.

The best possible solution to these problems would be one of "growing out of debt." In addition to the adoption of serious adjustment efforts in the developing countries, "growing out of debt" would require a strong and sustained recovery in the world economy, a significant decline in interest rates, and at least the attenuation of protectionist trends in the industrial world. In this context, it is evident that developments outside the control of LDCs are playing and will play a decisive role in the success of the adjustment efforts of debtor countries.

Today, most developing nations are fully aware of the need to adjust their economies in order to find a solution to their current problems. Taking into account the common interest in overcoming the debt crisis and in restoring the growth of the world economy, it seems reasonable to demand that industrial nations support these efforts by adopting measures that contribute to these ends.

Nevertheless, since it is doubtful that the external environment will take a very favorable turn in the near future, adequate financial flows to LDCs must be secured with longer-term maturities, if a solution to the debt difficulties is to be found. These flows would contribute importantly to the expansion of international trade and

the growth of the world economy.

At a time when capital markets will not be able to play the leading role of the past decade, multilateral financial institutions--such as the World Bank and the regional development banks--and government agencies should play a much larger role in the recycling process. These mechanisms could be reinforced by schemes to ensure balance-of-payments lending to LDCs and by stimulating the increase of foreign direct investment. These measures, as well as sustained efforts of adjustment and cooperation, can allow us to find a way out of the present problems.

Alternatively, and perhaps more simply, the required improvement in the capital account could be secured by a major restructuring exercise that would significantly reduce or eliminate amortization payments to the banks over the rest of the decade, distributing them over a period of ten to fifteen years starting in 1990. This would allow Latin American economies to effect a positive adjustment, diversify their exports, and recover reasonable rates of growth, thus placing them in a better position to face the future.

Although the external debt problem will be with us at least for the rest of the decade, it is in the interest of debtor and creditor countries that it not be allowed to sharply reduce the development prospects of LDCs. The social and political consequences of failing to secure acceptable rates of growth in the developing world during a protracted period would be very grave indeed.

NOTES

The ideas expressed in this paper are strictly personal. The author wishes to acknowledge the invaluable assistance of Javier Guzmán C. in the preparation of this paper.

1. According to estimates of the IMF, of the US$67 billion increase in the aggregate current account deficit of the nonoil LDCs from 1978 to 1981, more than 90 percent may be explained by the combined effect of the rise in net interest payments, the deterioration of the group's nonoil terms of trade, and the adverse change in the group's oil trade balance.

2. For instance, the 20 percent debt-service ratio suggested as external indebtedness limit by the World Bank was exceeded by many countries.

3. The rescue packages that have emerged from such agreements have generally included the rescheduling of debt-service payments, the provision of financial assistance both by banks and by official institutions, and the adoption of stabilization programs by the debtor countries.

4. The case of energy is a good instance of a structural adjustment. Adjustment to the higher cost of imported energy will certainly require increasing the price to consumers and reducing somewhat the rate of growth of GDP. However, any attempt of the country to achieve higher rates of growth would result in unsustainable balance-of-payments deficits, unless the structure of the economy is adapted to the new prices through the development of domestic energy sources and a more efficient use of energy.

5. According to some estimates, although the flows of direct investment to LDCs increased from US$2 billion in 1970 to about US$15 billion in 1982, they remained small compared to the volume of borrowing in the international financial markets.

6. Obviously, in the case of many low-income countries, substantial amounts of financial resources on concessional terms are required.

7. This is, with minor modifications, the Lever plan. Lord Lever suggests the creation of a central agency that would advise each agency on the provision of financing to LDCs, relying largely on the recommendations of the IMF.

8. In fact, most of the main countries have set up export credit agencies. Each agency, acting independently, has supported its exporters' trade with insurance facilities, placing limits on the amounts of credit insured.

BIBLIOGRAPHY

Azar, S. A. The Involvement of the Oil Surplus Countries in the International Financial and Trading System. Study on the International Financial and Trading System, Commonwealth Secretariat. London, March 1983.

Buira, Ariel. The Role of the IMF in the 1980's: Report to the Group of Twenty-Four. UNDP/UNCTAD-Project INT/81/046. January 1983.

___. "Prospects for Private International Financing to Developing Countries." Address delivered to the Institute on International Finance at the Southern Methodist University, Dallas, Tex., November 1982.

Cline, W. R. International Debt and the Stability of the World Economy. Washington, D.C., 1983.

Frank, C. R. Future Financing of the Capital Needs of Developing Countries. Study on the International Financial and Trading System, Commonwealth Secretariat. London, March 1983.

International Monetary Fund. World Economic Outlook: A Survey by the Staff of the International Monetary Fund. Washington, D.C., 1983.

Krul, Nicolas. *The Debt Problem: A Search for a New Financial Balance*. Geneva, April 1983.

Morgan Guaranty Trust Company of New York. "Global Debt: Assessment and Long-Term Strategy." *World Financial Market*, June 1983.

O'Brien, Richard. *The Role of Commercial Banks in the International Financial System: A Summary Report*. Study on the International Financial and Trading System, Commonwealth Secretariat. London, April 1983.

Organization for Economic Cooperation and Development. *World Economic Outlook*, July 1983.

Pealtry, Michael G. *The Policies of International Monetary Authorities with Respect to the International Debt Credit*. Geneva, April 1983.

Segré, Claudio. *The External Causes of the Crisis*. Geneva, April 1983.

Sjaastad, Larry A. "The International Debt Quagmire: To Whom Do We Owe It?" Prepared for the Leeds Castle Meeting, July 14-16, 1983.

Soros, George. *The International Debt Problem: Diagnosis and Prognosis*. New York, July 1983.

Streeten, Paul. *Direct Private Foreign Investment, Transnational Corporations and Development*. Study on the International Financial and Trading System, Commonwealth Secretariat. London, March 1983.

Suratgar, David. *Oil Exporters and World Financial Markets*. Study on the International Financial and Trading System, Commonwealth Secretariat. London, April 1983.

World Bank. *World Development Report 1983*. Washington, D.C., 1984.

8
The World Monetary System, the International Business Cycle, and the External Debt Crisis

José Luis Feito

The international financial system can be seen as a set of devices for correcting any eventual malfunctions of the world economy, particularly those rooted in the monetary side. The rationale for international monetary agencies is to ensure that automatic and other built-in mechanisms operating within the financial system will respond adequately to phases of strain. In the presence of pressures and difficulties that threaten the system, international agencies and arrangements are supposed to generate appropriate signals and carry out actions in order to make the system react along desired lines. Over the recent past the international financial system has been put to the test. The aim of this chapter is to analyze the stimulus-response pattern of the international financial system over the recent years in order to shed light on the adequacy of present international monetary arrangements to cope with widespread economic disturbances like the external debt crisis and recession currently plaguing the world economy.

The overwhelming presence of overindebtedness and depression should be seen as a manifestation of business cycle phenomena. The main thesis of this chapter is that the external debt crisis is a result of fundamental changes in the nature of the international monetary mechanism, mainly brought about by the emergence of world financial intermediation and rapid integration of major capital markets in the late 1960s and early 1970s. These changes, together with the cyclic instability of the U.S. economy, expose the world economy to the sort of credit-induced business cycle some national economies experienced during the nineteenth century and the inter-war period. These ideas are developed in the first section, in which the relationships between the international business cycle and the external debt crisis are analyzed and some inferences to be drawn from this analysis are put forward.

One of the conclusions of that section is that international monetary policy should aim not only at

facilitating the smooth transition of the world economy to an equilibrium position but also at ensuring the stability of the world financial system so that the probabilities of another occurrence of worldwide economic depression and overindebtedness are minimized. The armory of international monetary policy is not well equipped to achieve these ends. Ideally, actions should be taken simultaneously in those two fronts. Reforms of the international financial system should be initiated by allowing international financial institutions to play a more active role in the conduct of international monetary policy in current circumstances.

By now it is clear, however, that discussion on reform of the international monetary system is a very slow process going through a kind of stop-and-go cycle. Therefore, it may be convenient to separate the analysis of the scope for short-run actions within the boundary of current international arrangements (covered in the second section), the shortcomings and limitations of present international monetary institutions to cope with the current crisis (the third section), and the needed reforms of the world monetary mechanism from a longer perspective (the fourth section). Finally, the last section provides a summary of the arguments and views expressed in the chapter.

THE INTERNATIONAL BUSINESS CYCLE AND THE EXTERNAL DEBT CRISIS: AN INTERPRETATION

Should there be any doubt, the current world economic recession has officially been certified by the National Bureau of Economic Research as the eighth of the postwar period, more serious than the 1973-1975 recession, second in severity only to the slump of the 1930s. All these postwar worldwide economic depressions have had in common that they have originated in the United States because of the heavy weight this economy has on world trade and, more importantly, on world financial conditions. In some instances, as in 1973-1975, these depressions may have been induced by disturbances outside the United States, but they have been reinforced and made worldwide by the response of the United States and other large industrial countries to these disturbances. By the same token, it is obvious that phases of worldwide growth have been set in motion by the functioning at near full capacity of the U.S. economic machine.

The intensity and pervasiveness of the current world depression are frequently seen as the result of the mix of economic policies implemented in the United States to check the drift toward greater inflation and lower growth that has characterized the performance of this economy over the last decade. Table 8.1 provides some

Table 8.1 The International Business Cycle and Nonoil Developing Countries

	1976	1977	1978	1979	1980	1981	1982
Sources of cyclical disturbances							
Percentage changes in U.S. nominal stock of money (M_1)	6.2	8.2	8.3	7.4	7.3	5.0	8.5
Percentage changes in U.S. real stock of money (M_1)[a]	1.5	2.0	-0.2	-0.7	-2.6	-3.5	3.9
Channels of transmission							
U.S. nominal short-term interest rates	5.0	5.3	7.2	10.1	11.4	14.0	10.6
U.S. real short-term interest rates[a]	-0.2	-0.5	-0.2	1.3	1.9	4.2	4.4
U.S. real GNP rate of growth	5.4	5.5	5.0	2.8	-0.4	1.9	-1.7
Percentage changes in U.S. volume of imports	22.8	13.3	6.6	2.7	-7.5	0.5	-4.4
Impact on nonoil LDCs							
Total flows of external lending in the BIS reporting area (in billions of U.S. dollars)	70	68	90	125	160	165	95
Of which: external lending to nonoil LDSs	21	15	25	40	49	51	25
Debt-service ratio[b]	15.3	15.4	19.0	19.0	17.6	20.4	23.9
Percentage changes in export volumes	11.3	4.9	8.7	9.6	9.0	6.3	0.8
Percentage changes in prices of nonoil primary commodities	13.3	20.7	-4.7	16.5	9.0	-14.8	-12.1
Terms-of-trade changes from preceding year	5.9	5.9	-3.7	-0.3	-6.2	-3.9	-2.7
Real GDP rate of growth[c]	6.0	5.2	5.4	4.6	4.3	2.4	0.9

[a] Nominal rates adjusted by changes in GNP deflator
[b] Interest payments and amortization as percentage of exports of goods and services
[c] Weighted average of nonoil LDCs, excluding China

Source: International Monetary Fund, World Economic Outlook, Annual Report, and Occasional Paper no. 23, (1983).

quantitative indicators of the major domestic effects of these policies as well as the channels through which they have been transmitted to the rest of the world and their impact on nonoil developing countries.

The table is intended to illustrate the following process. The policy of monetary restraint that has been implemented in the United States since 1978, coupled with a growing fiscal imbalance, has led to a marked upsurge of nominal and real interest rates (to which other countries have had to adjust) and gradually declining rates of GNP growth. As can be seen from the data in Table 8.1, the rate of change of M_1 in real terms was negative for four years in a row, considerably shrinking the real stock of money (M_1) and leading to real interest rates that were extremely high by historical standards. The time profile of the shift from negative to positive real interest rates may well have been somewhat different from that suggested by figures in Table 8.1, which depicts real rates simply by subtracting the GDP deflator from nominal rates. Expected rates of inflation tend to be greater than recorded price increases in the initial stages of an inflationary process, whereas the opposite is true for a deflationary process like the one initiated in 1980. In any event, the high real interest rates brought about by such a liquidity squeeze have given rise to a strong differential favorable to assets denominated in U.S. dollars, which have imposed corresponding financial tightening and increases in interest rates in other countries to prevent excessive capital outflows from taking place. Thus, the excess demand for money and corresponding excess supply of goods and services, particularly those whose demand is highly sensitive to changes in interest rates, caused by policies of monetary restraint in the United States have been immediately paralleled in other major industrial countries and ultimately in the rest of the world.

Additionally, the falling rates of real GDP growth in the United States have reduced its volume of imports, thereby channeling deflationary impulses to the rest of the world through a reduced external demand. These effects have been compounded by the cyclic behavior of the U.S. income elasticity to import. Due to speculative inventory cycles and protectionist pressures, import volumes tend to grow faster than output when real GDP is accelerating and to decrease faster when it is decelerating. Moreover, the inflow of capital associated with the differential favorable to assets denominated in U.S. dollars has given rise to a sharp appreciation of the dollar. The beneficial effects for the rest of the world that should spring from the appreciation of the U.S. currency have been offset by the cyclic behavior of imports just mentioned. Indeed, the appreciation of the dollar has been very harmful to countries that have external debt and that import intermediate goods and raw

materials (mostly denominated in U.S. dollars), by sizably raising the local currency value of their foreign liabilities and of their most inelastic items in the import basket.

The impact on nonoil developing countries has been particularly severe, as can be inferred from Table 8.1. The rate of growth of their export proceeds has fallen sharply as a result of lower unit prices and volume of exports. They have undergone a marked deterioration of their terms of trade and have experienced capital outflows that have been attracted by the jump in the rate of return of financial assets denominated in U.S. dollars and a substantial acceleration of the speed with which the debt charges pile up. Those developing countries with a heavy external debt have undergone not only a sizable augmentation of the debt burden but also the effects of decreased international flows of credit stemming from the growing propensity of the banks to reduce their ratio of aggregate external assets to capital in general and their ratio of aggregate external assets to capital in debt-ridden economies in particular.

The main aim of this sketch of recent developments of the evolving world economic scene is to identify the major deflationary forces in the international economy and the channels through which they have been operating. In essence, these forces are the liquidity squeeze and accompanying high real interest rates induced by U.S. financial policies, channeled to the rest of the world through capital markets and the fall in income and demand for foreign goods transmitted through the markets for goods and services. The appreciation of the U.S. dollar, the standard of value of the international monetary system, has transmitted deflationary impulses through both channels.

The preceding account is a rather standard analysis--though placing perhaps too heavy emphasis on the direction of causality running from the monetary forces to the real side of the economy--of the current world economic crisis. One of the limitations of this approach, useful as it is in other respects, is its concentration on explaining the recent downward movement of the international business cycle, implicitly assuming that the world economy was in a stable state of near equilibrium at the beginning of the downswing in, say, 1978. The setting in motion of deflationary forces and their propagation through the world economy is frequently described as an exercise in comparative statics by which the current position of the world economy is seen as the result of changes in certain causal variables, such as the rate of real growth of net private assets in the United States, or any other monetary aggregate starting from a stable equilibrium situation.

This analysis carries with it its own policy recommendations. Since the initial position was one of

acceptable equilibrium, and current conditions point to the existence of excessive underemployment equilibrium and financial strains all over the world, the adequate course of policy is to reverse the causal variables to their original values: to reduce the U.S. federal deficit and increase credit to the private sector, thereby attaining a new equilibrium comparable to the initial one in the United States as well as in the rest of the world. The usefulness and elements of truth in this mode of analysis and policy recommendations should not be denied. Nevertheless, there is a need for supplementary explanations of the weaknesses currently plaguing the world economy and fundamental questions of international monetary policy that cannot be answered by using this analytical frame. The answers to questions relating to the relative stability of the new equilibrium achieved by pursuing the policy actions based on the foregoing analysis and to the conditions that should be met to prevent another phase of world recession and severe financial strains require some knowledge of the dynamic properties of the world economic system. An attempt to furnish some elements out of which tentative answers to these questions could be given is made in the following paragraphs.

A Business Cycle View of Current Strains in the International Financial System

The dynamic properties of the world economy can be ascertained by using the same business cycle analytical apparatus applied to the study of national economies. Specifically, the sort of cyclic oscillations to which the world economy is now subject are best analyzed by reference to the sort of processes studied by the so-called monetary explanations of the business cycle.[1] Before proceeding, there is one question worthy of some detailed consideration regarding the extent of interdependence needed among national economies, for the different countries of the world are following essentially the same cyclic path. It should be pointed out that, for the validity of the views and corollaries drawn from seeing the different economies of the world moving around a common business cycle, it is not a necessary condition that goods and capital markets are fully integrated and ruled by perfect arbitrage relationships. For the validity of those considerations, it is sufficient that the degree and nature of interdependence among national economies be such that disintegrating devices like capital controls, flexible exchange rates, or protectionism either have a very narrow insulating capacity or none at all, their insulation effects being rapidly offset and short lived. A brief account of the main features of this interdependence will suffice to show

that this is certainly the case with the current structure of the world economy.

The Nature and Degree of World Economic Interdependence

The nature and intensity of the international links binding the economic life of each country to that of every other prevent national macroeconomic policies, with the exception of those in the United States, from exerting any systematic influence on the internationally imposed cyclic path. As is well known, until recently international trade in goods and services has been growing faster than national output, thereby increasing the overall exposure of national markets for goods and services to events and policies in other countries. Over that period, convertibility among the main currencies--and through them among the other, hanging, currencies, the gradual lifting of capital controls, and the emergence of a powerful system of world financial intermediation have considerably increased the international mobility of capital as well as the share of tradable financial assets in national stocks of capital. The efficiency of remaining, or newly imposed, capital controls has been eroded considerably in the course of time, making it very difficult to control international movements of capital to any significant degree.

Many of the devices currently in place to control capital movements were conceived and implemented when the stock of capital was rather small relative to normal conditions. On the whole, current capital-control mechanisms were designed during the interwar depression and the period immediately following World War II. It was relatively easier to control capital movements during the 1950s, in a world economy impoverished by the war, than in successive periods where the normal stock-flow ratio between capital and income was restored. The accumulation of capital all over the world resulting from the high rates of growth during the 1960s, together with the integration of major capital markets, has made it increasingly difficult for remaining, or newly established controls, to prevent capital from moving into the financial centers offering better prospects through the many leakages left open by technological advances in communications and transport systems, financial innovations, and more integrated markets for goods and services.

In relation to the nature of this growing international interdependence, the relevant data are the increasing weight of the United States in world production of internationally traded goods and in internationally traded assets. Over the past decade, the propensity of the U.S. economy to import goods and nonfactor services has more than doubled, arising from oscillations around a trend of about 4 percent to about 10 percent, the

export propensity having followed a corresponding behavior. More importantly, the role played by U.S. dollar-denominated financial assets and liabilities in world finance, which had increased continuously since the inception of the Bretton Woods system, has been dramatically strengthened with the recycling processes of oil surpluses and development of international banking and Eurocurrency markets.

The main implication of this is that as a producer of traded goods the United States is comparable in size to other major economies, whereas its position as a price setter in world financial market is, for all practical purposes, that of a monopolist. Thus, for example, the implementation of a policy of monetary restraint in the United States leads to higher interest rates that attract capital inflows from the rest of the world. The size of the U.S. capital market is such that those inflows of foreign savings are not likely to have any significant effect on U.S. domestic interest rates. Consequently, the behavior of interest rates in the United States, and on other assets denominated in U.S. dollars linked to U.S. domestic assets, are the result of essentially U.S. economic policies.[2] This is a major departure from the British-led world economy of the nineteenth century and first decades of the twentieth, when financial conditions in Lombard Street were highly sensitive to external capital flows. It is also a situation that violates crucial conclusions of conventional balance-of-payments theory based on such a world.

Perhaps the major implication is the inability of a system of flexible exchange rates to provide the non-U.S. world with protection against foreign disturbances. A policy of financial restraint in the United States will communicate its effects to the rest of the world through the rapidly clearing capital markets. The impact of monetary contraction and the fall in external demand on the production levels of tradable and nontradable goods in those countries will be immediate, and there is not much that exchange rates can do to improve that situation. They can certainly induce the process pointed out in Note 1, but the importance of these effects is relatively negligible. Flexible exchange rates, however, can have important insulating effects for individual nations if the responses of different countries to U.S. policies differ significantly. It is not probable, however, that there can be more than a few countries that manage to escape from the U.S.-induced deflationary impulses at the expense of others, and in conditions of worldwide recessions, it is doubtful that they can do so at all for any significant period of time.[3]

The Monetary Mechanism of the Expansion and Contraction Processes

The main aim of these paragraphs is to apply the monetary theories of business cycles, phenomena developed by pre-Keynesian economists, to the analysis of the world economy. There is a need to return to this theoretical approach because, contrary to standard static analysis, it links the expansion and ensuing contraction phases of an economy evolving over time, and the relationships between real and monetary disequilibria are not as easily forgotten.

Although there are significant differences among the various theories of business cycles that place heavy emphasis on monetary factors, and it is certainly difficult to put forward a presentation doing justice to them all, it is possible to synthesize some common features and give a simplified account of a business cycle induced by monetary forces.[4] This is done in the following lines trying to single out the main elements behind the upswing and the downturn of a cyclic movement. In what follows, references to a money, capital, or credit market should be understood as an analogue for the set of all deposit-taking and lending banking activities that are made in dollars and other international reserve assets. Additionally, no breakdown of the term structure of interest rates is done. Therefore, references to the long-term rate of interest should be seen as referring to the natural or equilibrium rate. This rate, in turn, would be the one that, under given conditions, keeps the rate of growth of money income in pace with that of real output and noninflationary expectations.

The Expansion Process

A typical monetary cycle is set in motion by a growing discrepancy between flows of voluntary hoarding and rates of credit creation. If unchecked, this discrepancy, whether it is originally caused by over-extension of credit or is the result of maintaining rates of credit while voluntary savings fall, will generate tendencies leading to overinvestment and over-indebtedness situations. Assuming that previous rates of growth of credit and flows of monetary savings were consistent with full employment growth of output and noninflationary expectations, disequilibrium in the money market will cause nominal income to grow faster than output volumes. Money rates of interest will usually fall or, in any event, real rates of interest will decline in relation to the natural long-run rate, creating a premium for borrowers that further increases their demand for credit. During these initial stages of a process of monetary overexpansion, the total supply of

credit by banks is highly elastic and can accommodate the increasing demand of borrowers without significantly eroding the differential between the going real interest rate and the long-term one. This process has also a counterpart on the real side of the economy since the rate of interest not only regulates monetary phenomena but also influences the allocation of productive factors to different branches of economic activity.

As long as monetary disequilibrium persists, sectors where the capital constraint is more binding will tend to expand faster, relative to trends, than others. They will absorb a greater share of the excess supply of bank credits that have no counterpart in voluntary hoarding but rather are backed by artificial savings coming out of the very monetary overexpansion. These sectors, in greater need of capital and more benefited by the lowering of real interest rates and availability of credit, will be prone to achieving faster rates of growth relative to other sectors than would be the case in conditions of monetary equilibrium. Thus, many investment projects are launched, financed out of bank credit creation in excess of voluntary savings, whose viability depends on the persistence of disequilibrium conditions in the money market. Many investments, not viable at equilibrium real rates of interest, are undertaken on the expectations that current relationships between financing conditions and inflation will persist long enough to make them profitable. Overinvestment and malinvestment phenomena, investment projects whose maturity and profitability are not compatible with equilibrium conditions in the money market, are thus emerging.

Standard monetary theory of national economies usually neglects the analysis of the effects on the relative structure of sectors of the distribution of an excessive stream of money creation, by considering them transient effects. According to that theory, although the first impact of monetary disequilibrium may be unevenly distributed, in time it will be proportionately shared by all sectors of the economy; relative prices are thus determined only by real factors, monetary disturbances being able only to produce transient alterations of the price structure. In the case of the world economy, however, excessive international money creation may lead to the structure of relative prices or relative rates of growth of countries, which can be approximated by the simile of sectors in the preceding lines, being distorted for prolonged periods.

It should not be difficult to identify a cumulative process of monetary disequilibrium in the world economy in the late 1960s and early 1970s and, again, in the mid-1970s in broad conformity with that theoretical pattern. The impact of monetary overexpansion in the United States during the late 1960s and early 1970s was largely channeled to developing countries and was

perpetuated by the accelerated development of Eurofinancing. This development was itself accelerated by the persistence of negative real rates of interest. Although Eurocurrency markets offered greater nominal rates of interest than other capital markets, those rates were not keeping pace with inflationary expectations. The degree to which monetary disequilibrium continued to persist during the first oil shock is difficult to assess. With the benefit of hindsight, however, it could be said that credit creation was allowed to finance greater current account deficits of nonoil countries, and greater increases in the price of oil, than would have been desirable from a long-term perspective.

The incentive to overlend to developing countries was reinforced by the tendency of their export prices and export proceeds to incfease faster than the prices of other tradable goods and international trade, respectively. There also was an incentive to overborrow on the part of producers of nontraded goods in some of these countries. In those countries where domestic policies were such that prices of nontradable goods were expected to rise faster than the exchange rate plus the international rate of interest, there was a premium for producers of nontraded goods to resort to external indebtedness--all the more so, if they were facing domestic credit or external resources constraints. These factors had a bearing on enlarging the already high differential between home and international real interest rates and induced commercial bank and public-sector entities in some developing countries to overborrow.

These differential effects of a monetary disequilibrium on different sectors help to explain the distribution of the debt problem among developing countries as well as sectorial aspects within a given country. For a given international nominal rate of interest there will be different real rates of interest for different borrowers, according to the relative pace at which their earnings are expected to rise, whereby domestic factors may influence the degree of world monetary disequilibrium absorbed by the country. As shown by the data in Table 8.2, the resort to indebtedness with the international credit system has been much greater by developing countries in the Western Hemisphere than in Asia. This has been due partly to different structural characteristics and partly to different domestic policy responses between the two regions. For instance, economies in Asia have usually a more developed long-term financial segment in their capital markets. Additionally, their public sectors have achieved a more balanced financial performance, whereby the degree of credit rationing of the private sector was lower than for countries in the Western Hemisphere. Real interest rates, therefore, were generally higher for developing countries in Asia than in the Western Hemisphere during the

Table 8.2 Aspects of the External Debt Cycle in Selected Groups of Developing Countries

	Average Rate of Growth 1968-1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Ratio of external debt to exports of goods and services[a]										
LDCs in Western Hemisphere		163.4	195.8	204.1	194.1	211.5	192.9	178.4	207.4	245.6
LDCs in Asia		81.0	91.6	84.4	83.3	77.7	70.2	68.2	72.5	80.9
Debt-service ratio[b]										
LDCs in Western Hemisphere		27.9	32.2	35.4	31.2	41.7	40.9	35.6	41.7	54.0
LDCs in Asia		7.8	8.5	7.7	7.6	9.6	8.7	8.2	9.2	9.8
Real GDP annual changes[c]										
LDCs in Western Hemisphere	7.6	8.4	6.9	3.1	5.5	5.0	4.5	6.0	-0.1	-1.5
LDCs in Asia (excluding China)	4.2	3.8	4.9	7.5	6.6	7.9	3.3	3.4	5.8	3.7
Changes in consumer prices[d]										
LDCs in Western Hemisphere	18.5	37.5	52.0	66.1	51.2	42.4	49.6	58.2	65.4	76.0
LDCs in Asia (excluding China)	8.3	30.1	13.2	0.5	7.3	5.6	9.8	15.9	14.8	9.9

[a] Ratio of year-end debt to exports for indicated year
[b] Interest and utilization payments as percentages of exports of goods and services
[c] Arithmetic averages of country growth rates weighted by the average U.S. dollar value of GDPs over the previous years
[d] Geometric weighted averages of country indices

Source: International Monetary Fund, World Economic Outlook, 1983.

inflationary expansion process.

Although domestic factors are, of course, important in determining the distributional impact of world monetary disequilibrium, it should not be inferred from this that adequate domestic policies could have avoided, to any significant degree, the current external debt crisis in the Western Hemisphere. For one thing, banks were prone to lend to these countries that were growing very rapidly during the late 1960s and early 1970s and, in fact, during the first half of the decade, although they were accumulating increased inflationary pressures. It is easy to state, with the benefit of hindsight, that those rates of borrowing were excessive. It was much more difficult to anticipate at the time the coming of real positive interest rates and, in fact, nobody did. Once we take account of the fact that the future was unknown by the mid-1970s, it must be recognized that it was neither politically feasible nor economically efficient to abstain from borrowing at real interest rates that, even assuming domestic discipline, were very low by historical standards.

The Contraction Process

Business cycle theorists were particularly eager to show how a process of inflationary expansion brought about by monetary disequilibrium carried with it the seeds of a cumulative process of recession. Over-indebtedness and depression phenomena were seen as having their origins in previous overinvestment and inflationary expansion, the gravity of the recession being related to the magnitude of the causal inflationary disequilibrium.

Several forces are set in motion by the process of growing monetary disequilibrium, which act by arresting the inflationary growth of real output that accompanies the expansionary movement. There is a learning process by which savers anticipate better the effects of credit expansion on the purchasing power of their earnings so that they are less willing to hold their savings on financial assets with very negative rates of interest in successive steps of the expansionary process. When inflationary expectations are very high relative to the nominal rate of interest, not only do savers tend to part with holdings of financial assets but producers also use up idle balances and reserves whose opportunity cost is very high when real interest rates are negative. Thus, as inflationary expectations become embedded in wealth holders, it is increasingly more difficult for banks to extend credit at rates below expected inflation, and the relationship between nominal interest rates and prices tends to approach the long-term trend.

A second force at work in checking the growth of real output accompanying a process of inflationary income

expansion relates to the risk component in the rate of interest. At any moment the market for loanable funds will be clearing by a structure of interest rates reflecting the different risk segments of the market. Successively greater loans to the same borrower are not the same commodity, but different ones each carrying marginally greater risk. Even assuming an infinitely elastic supply of international credit for a certain period, a given borrower will not face a constant interest rate for increased amounts of loans. Regardless of what may happen to the internationally determined interest rates, individual borrowers will generally be faced with a gradually more inelastic supply of loans, depending on the growth of their outstanding debt. The transition from a risk-elastic to a risk-inelastic supply schedule of credit may or may not be a smooth one, but sooner or later heavy borrowers will face substantial increases in average interest rates, as a reflection of an increase in the risk component. On the other hand, banks will not merely attempt to earn greater interest rates for their loans but will also lower credit expansion in order to restore the loanable assets-to-capital ratio that deteriorated during the overlending period. In so doing, they will attempt to reduce to an even greater extent the riskiest assets corresponding to the most heavily indebted borrower.

The structure of production will move so as to conform with the new conditions in the money market. The restoration of natural long-term rates of interest places a heavy burden on those sectors in need of capital whose increased rate of growth was contingent on the continuance of monetary disequilibria and corresponding cheap and abundant credit. Some investment projects must be liquidated and others slowed down. Other sectors and activities that, while not excessively indebted, were dependent upon the overborrowing and growth of the former sectors are also undergoing a serious squeeze on their profitability resulting from the decreased demand for their products. A substantial part of the enlargement in real output built up during the upswing will thereby be destroyed in the course of the ensuing depression. It is not only that many investments are liquidated in an intermediate stage, but that a share of installed capacity is no longer profitable at all since its marginal product does not cover costs inclusive of external debt service.

A secondary depression might take place if the feedback effects of adjustments in the real sector on the monetary side of the economy are of sufficient intensity. Since the expansion in many sectors was financed to a large extent by debt contraction rather than by savings of producers, shares, or long-term loans, there is a risk that debtors might fail to fulfill their obligations, especially if the transition from negative

to positive real interest rates has been too abrupt, and real interest rates have overshot. There is the possibility of an explosive debt cycle. Real debts increase with real interest rates, and their growth tends to induce a further contraction of credit by banks, which in turn will put additional pressures on the debtors to service their obligations.[5]

With the exception of the process of secondary depression, recent developments in the world economy have been in broad accord with the foregoing highly simplified theoretical pattern. However, over the period there were noncyclic events that should be put into the picture to explain more adequately the severity of the external debt crisis. Above all, it must be pointed out that current real interest rates are as far from equilibrium as the negative rates prevailing during the 1970s. As already mentioned, current real interest rates are the result of a distorted policy mix in the United States. The cyclic forces operating to arrest inflationary growth and negative real interest rates have been magnified by the size and expectations on the U.S. public-sector deficit. The U.S. economy, the richest in the world, is importing capital from other countries, many of them developing ones, through sizable current account deficits to finance a large proportion of its public-sector deficit. The United States is receiving considerable capital inflows not only directly from the rest of the world but also indirectly through the crowding-out effect in international and U.S. banking in favor of U.S. assets and securities and against assets in developing countries. This latter effect has been reinforced by financial deregulation and innovation in the U.S. capital market which have tended to reduce the degree of financial international intermediation through Eurocurrency markets. Thus, the process of contraction and the appearance of problems of servicing external debt have been accelerated and aggravated by those developments superimposed on cyclical factors.

The gravity of the situation calls for action on an international basis in order to prevent the onset of a secondary depression and eventual breakdown of the international monetary mechanism. The following section considers the scope for action by international monetary institutions to deal with the strains threatening the cohesiveness of the world economic fabric.

THE SCOPE FOR ACTION BY INTERNATIONAL FINANCIAL INSTITUTIONS

In the short run, there is not much that international financial institutions can do without appropriate policies in the largest industrial countries. A necessary condition for the global recovery of the world economy

and a satisfactory solution to the external debt problem is obviously the sustainability of the recent pickup in the U.S. economy. There seems to be general agreement that for this to happen a change in the current stance of the policy mix, correcting the trend toward greater budgetary disequilibrium, is needed. A vigorous and stable economic recovery will require steadily growing flows of private capital formation, which in turn call for expectations of moderate and reasonably stable prices for the services of capital. A U.S. economy that is growing in the context of potential interest rates closer to long-run values will exert a powerful and beneficial influence on development countries and current external debt strains. A restoration of world monetary equilibrium and long-term normal real interest rates will ease the pressures to serve the volume of outstanding external debt that, for the most part, was contracted at floating interest rates. Even though spreads over the prime rate of international lending would continue to be very high for debt-ridden countries, the impact of declining real interest rates and accompanying developments in the real sector will substantially improve the economic climate and entrepreneurial expectations in such countries.

Whereas the sustained recovery of the U.S. economy is certainly a necessary condition for the stability of the financial system, it is by no means a sufficient one. Even if the recovery consolidates and a strong noninflationary growth can be sustained, it will render its effects on developing countries only after a certain lag. Whatever the length of this lag may be, it should be kept in mind that the capacity to adjust in many developing countries is rapidly reaching unsurpassable limits. Moreover, the deteriorated state of confidence in economic prospects throughout the world is not going to improve overnight, even if definite symptoms that the depression is over become apparent. Therefore, the vital role to be played by the international financial institutions in general, and by the IMF in particular, over the period ahead can hardly be overestimated. The following paragraphs review some possible actions by international financial institutions in relation to the adjustment process and international liquidity creation in the short run. Their limitations and shortcomings in coping with the present world economic crisis are considered in the next section.

Adjustment Processes and Their Financing

One of the critical aspects of the adjustment process is the viability of the economic programs that many debt-burdened countries are currently implementing. The achievement of stable equilibrium conditions in the

world economy may well depend on the success of these programs in attaining sustainable balance of payments structures. As analyzed in the section "The International Business Cycle and the External Debt Crisis," these countries absorbed the largest impact of world monetary disequilibrium and are suffering the gravest consequences of monetary adjustment in the largest industrial countries. They are now forced to transfer a significant proportion of the external resources they received during the expansionary process of the world economy. If, however, they are required to transfer an unbearable amount--the total transfer of financial resources being measured by the difference between nominal rates of interest attached to outstanding debt and the proportion accounted for by new lending over a corresponding period[6]--the world economy could go into the secondary depression phenomenon analyzed in the previous section.

The International Monetary Fund is monitoring and cofinancing many of these adjustment processes. IMF lending to finance adjustment programs is similar to discount policy by central banks in that it provides a certain amount of credit conditional upon the observance of certain ratios related to the financial performance of the borrower. Contrary to what happens in the case of a central bank, however, the amount of lending the IMF can extend is not significant in relation to the dimensions of the balance-of-payments problems of these countries; neither are the functional characteristics of the institution suited to allow it to perform a similar role in conditions of worldwide economic disturbances that are not of a mild, temporary nature. The Fund has not the capacity to act as a lender of last resort to central banks of the world, rapidly facilitating bridge financing until either adjustment or negotiated liquidity provides the needed external resources. This is a role that has been played by the Bank for International Settlements to some extent. The rationale for the Fund in these circumstances depends on its capacity to channel international liquidity from the world banking system to the countries carrying out severe adjustment processes. In this respect, the role of the Fund in cutting the tendency toward self-defeating economic behavior on the part of the banks through the full exercise of its powers of moral suasion and its pivotal position in coordinating central-bank actions has certainly proved to be essential. The Fund has been able to induce much greater flows of international credit toward economies making substantial adjustment efforts than voluntary lending would have allowed. Having said this, there are some questions to be raised in connection with the role of the Fund in the adjustment process.

For instance, it is questionable whether the present mix of adjustment and financing in many of these countries is adequate enough to achieve balance-of-payments

equilibrium without inflicting considerable damage on the growth capacity or the social fabric of the countries concerned. Another fundamental and related question to be addressed is whether the response of the international financial system monitored by the Fund to the first stage of the external debt crisis could be repeated, should the timing of the recovery process in the largest industrial countries fail to make viable the sort of process toward external equilibrium assumed by current adjustment programs. The only degree of freedom left to the Fund in dealing with the problems involved in these questions is, as mentioned, to assist in the adjustment of those countries in need of its resources and of the pyramid of private credit that may be based on them. The room for maneuver of the Fund in this area, in turn, will depend on its capacity to extend adequate amounts of resources to all countries implementing appropriate adjustment policies. Private banks will not easily increase or maintain their exposure in developing countries if the IMF itself does not do the same. The continuous presence of the IMF in those countries could require changes in certain deeply rooted traditions like the revolving nature of Fund resources and the reluctance to resort to external sources of finance other than governments and central banks.

Problem of the IMF Resources

The IMF quota subscriptions, on which its lending capacity has traditionally been based, were increased by 47.5 percent from SDR61 billion to SDR90 billion (from about US$67 billion to US$98.5 billion) when the Eighth General Quota Review came into effect at the beginning of 1984. Most countries represented at the Executive Board of the IMF are concerned that these resources may prove inadequate to deal with the problems posed by current financial strains. These fears have been reinforced by the events associated with the difficulties of some countries in servicing the external debt and by the sizable increase in the demand for the Fund's resources.[7] Additionally, the potential impact of increased quotas on the Fund's contribution to the adjustment process has been somewhat eroded by the conclusions reached by the Interim Committee of the Board of Governors of the International Monetary System at the meeting held on September 25, 1983. At this meeting the decision was made to reduce the multiplier coefficient applied to the quota of members to determine the maximum amount of Fund loans and break the level of access into two tranches.

The extent to which this decision could offset the increased lending powers of the Fund involved in the augmentation of quotas will depend on the interpretation of the two-tier system of access to the resources

established in the decision. Even if the scheme is applied with flexibility, the Fund could experience an excess demand for its resources, since many countries not hitherto involved with it may request financial assistance in the period ahead, as the pulse of the recovery does not seem to be firm enough. It will then be necessary to resort to external sources of finance other than quotas. Borrowing by the Fund from governments and official institutions is a time-consuming process, and apparently it is unable to cover the financial needs of the institution in present circumstances of the world economy. Therefore, the Fund should borrow from private financial markets in amounts and with the maturity dictated by the evolving world economic situation. The Fund's borrowing from private capital markets is liable to cause a crowding out of internal assets that are not now available for developing countries. This is a more desirable development in the present juncture of international capital markets, characterized by a considerable decline in the desired external asset-to-capital ratios. The Fund should make an attempt to seek the widest possible spread of maturities and to cover most segments of the international capital markets. Ideally, it should borrow either in SDRs or in the currencies that compose its basket.

The presence of the Fund in private capital markets is fully justified on the grounds of short-run considerations and longer-term prospects. The uncertainties surrounding the process of transition toward viable external debt structures may give rise to a sudden need for the Fund to have substantial resources at its disposal, should a major unexpected development arise either on the part of the banks or of the heavily indebted borrowing countries. From a longer-term perspective, the widespread presence of the Fund and the SDRs in the markets could contribute to the march of the institution into a central bank along lines considered in the next section.

The SDR Allocations

Another area in which there is scope for further action by the Fund is the issuance of internationally controlled liquidity through SDR allocations. The Fourth Basic Period (each basic period being the time unit during which creation of SDRs is considered) started in 1982 without any provision for allocation. As a result of the voting structure of the Fund, proposals for an SDR allocation have not yet obtained the necessary majority.[8] All the requirements for an SDR allocation considered in the Articles of Agreement of the Fund would appear to indicate continuous allocation of SDRs over time so as to convert this into the centerpiece of the

international monetary system. From the inception of the SDR scheme it was clear that allocation of SDRs should be considered as an instrument that would allow the share of international reserves accounted for by SDRs to grow over time. The development of international banking and the growth of international liquidity over the period led to questions about the viability of the SDR project. Although not officially and openly recognized, the sort of international monetary system centered on the SDR, which commanded support by the majority of Fund members in the past, is no more the longer-term objective into which international monetary arrangements should converge.

Even though it is clear that the overall commitment to promote the SDR as a principal reserve asset of the international monetary system does not command the widespread majority that it once did, it is paradoxical that the scheme has been questioned when it is most needed from the standpoint of its short-run potentialities. As analyzed in the previous section, the mechanism for the generation of international liquidity is subject to erratic fluctuations whereby a period of overexpansion is followed by a phase of excessive contraction. The fall in, or the absence of, importance of the SDR has prevented it from playing any significant role in checking the expansion or contraction of liquidity. As for the contractionary phase currently going on, although the range of allocations contemplated in various meetings of the interim committee would not have corrected the situation of international liquidity in any fundamental sense, given the negligible proportion of international reserves accounted for by SDRs, it would have afforded some relief and strengthened confidence in the existence of a valve through which the IMF could exert the role of lender of last resort to the international financial system. Therefore, allocation of SDRs should be resumed in the short run, although in the longer run the attitude of some national authorities to the relevant sections of the Articles of Agreement of the IMF, in accordance with which the SDR would be made the principal reserve asset in the system, must be clarified.

One of the problems related to the creation of SDRs is that the allocation procedure tends to put more SDRs in the hands of those that need them less. The distribution of unconditional liquidity in the form of SDRs is not related to the relative reserve asset needs of countries, at least not in the first impact, but to their relative quota in the IMF. It would, therefore, be convenient to conceive schemes so as to redirect created reserves through SDR allocations to the countries in relatively greater need of international liquidity, which in any case would receive some relief by the SDRs directly allocated to them. One possibility would be to reach a compromise for a loan to the Fund on the part of those countries that would receive the larger share in

SDR allocations. By this means, SDRs would be transferred to the General Resources Account of the Fund and would be available to increase the financing to countries carrying out adjustment processes.[9]

As can be inferred from the foregoing considerations, the room for maneuver of international monetary institutions in dealing with the current monetary crisis is rather narrow. In the next section, some possible explanations are given of the reasons behind this limited capacity of these institutions that are supposed to be the guardians of the international monetary system in preventing and coping with the external debt crisis.

SHORTCOMINGS AND LIMITATIONS OF INTERNATIONAL FINANCIAL INSTITUTIONS

The fundamental axiom upon which the Bretton Woods system was built was the continuous existence of conditions of approximate equilibrium in the world. The IMF, in particular, was designed to operate within the context of a world moving along an equilibrium path. It was conceived to support a world economic system in equilibrium, the foundations of which were to be established by means and actions beyond the scope of the Fund. The major postwar economies were brought into the equilibrium zone by direct grants and loans from the United States to the European countries that, by then, were the main capital importers in the world. Once these actions outside the Fund were implemented and took effect, that agency was considered responsible for providing the necessary guidance and international liquidity to correct minor deviations arising in the economic performance of a few countries and that of the rest of the world following an equilibrium path. It was believed that the commitment to full employment in the largest industrialized countries along with fine tuning policies would guarantee the achievement of adequate and stable rates of growth for the world economy as a whole. This view was fully embodied in the design of the functional features and general purposes of the IMF.

In a world in which overall depression or inflation was ruled out, instances of disequilibrium were contemplated as disparities between the levels of costs, incomes, and prices between one country and the rest of the world. According to the rules and regulations of the IMF, that country could finance its external disequilibrium by drawing from the institution if the factors leading to the imbalance were of a temporary and self-correcting nature. If the disequilibrium was judged to be "fundamental," the only precise definition for this being to consider it non-self-reversing within a relatively short period of time, the country was asked to devalue and implement a financial package as a prerequisite

to draw from the Fund. A non-self-reversing fundamental equilibrium was thought to be amenable to short-run treatment. The mix of expenditure-cut and expenditure-switching policies of the Fund's programs would bring the country back in line with international equilibrium conditions in a short period of time, allowing the prompt repayment of the temporary credit extended by the Fund. The financial resources of this institution were thus seen as a revolving fund, drawings from which were to be repaid after the relatively short period needed to correct minor disequilibria.

It is important to realize that in the presence of a worldwide cyclic depression of a certain length and a given nature and degree of world economic interdependence, this scheme breaks down completely. In the face of a worldwide recession originating in one or more large industrial countries, simultaneous efforts by other countries to correct external imbalances through domestic deflation and devaluation could lead to further falls in their export proceeds, thereby aggravating the situation and placing the whole burden of adjustment on the income mechanism operating through the import side. More importantly, if worldwide depressions are caused by inflationary overexpansion, what is needed then is to curb excessive monetary growth in the largest industrialized countries. The IMF not only lacks the means to achieve this end, but it also requires a completely different conceptual apparatus. The built-in contradictions of the Bretton Woods system that ultimately led to its breakdown are well known, and there is no need to dwell upon them further. What is less frequently taken into account, however, is the bearing that the assumption of a world economy smoothly evolving around an equilibrium path has on the effective functioning of the international monetary system. From the beginning of the Bretton Woods negotiations there were two distinct views as regards the institutional structure needed to support the international monetary system: the Keynesian view of a world central bank and the U.S. view of a stabilization fund. If the world economy was supposed to move along a path of stable equilibrium, there was obviously no need for a world central bank using whatever assets it might have to prevent major departures from equilibrium. All that was needed was the sort of stabilization fund actually brought into being. However, worldwide cyclic major disequilibria call for an international agency endowed with the powers and means to stabilize the world credit cycle. Only if the IMF were redesigned around the image of a central bank could it be in a position to carry out one job of ensuring a path of stable growth for the world economy.

These shortcomings and limitations of the Bretton Woods institutional net did not pass unnoticed when the system was initiated and, indeed, originated some

proposals for alternative international financial arrangements. For instance, in Jacob Viner[10] there can be found no less than five essays, dated 1945-1947, containing his proposal for a countercyclic international lending agency aimed at stabilizing employment throughout the world. The central theme of this proposal was the need for a set of international agencies that embodied the responsibility of the largest industrialized countries for stable world economic growth, including that in the backward regions of the world. The main long-run operational principle was the apparently simple idea of collecting funds at times of business expansion and lending them at times of economic pressures. For short-run disequilibria stemming from a distorted world distribution of payment imbalances, compulsory arrangements were envisaged by which external credit was to be extended from surplus countries with reserve currencies to those others whose shortages of international reserves and liquidity were related to the formers' surplus. Similar schemes were put forward by two United Nations reports, National and International Measures for Full Employment (1949) and Measures for International Economic Stability (1951). It is interesting to note that the latter report deemed it necessary to carry out far-reaching changes in existing international arrangements along those lines even though the world economy followed an equilibrium path. It was believed by the authors of the report that the cyclic instability of the U.S. economy, even if not departing significantly from the equilibrium path, might give rise to excessively distortive repercussions for developing countries.

It must be accepted that any serious project of international monetary reform must come to terms with the problem of stabilizing the world credit cycle and avoiding major disruptions of an essentially monetary origin. International monetary policy is the task of international monetary agencies. In a way, it would not be an exaggeration to say that the severity of the current crisis of the world economy is partly due to the persistence of the institutional tissue, with broadly the same operational features, of the Bretton Woods system even though the basic assumptions that made that system viable no longer exist. A crucial opportunity to fundamentally correct the system and adopt it to the changed structure and behavioral features of the world economy was missed during the discussions on world monetary reform during the early 1970s. For a number of reasons those attempts were frustrated. First, there was the reluctance of countries to accept constraints on the conduct of their monetary policies in the short run that are implicit in any serious project of a reformed monetary system, and, second, the belief in the insulating properties of a system of flexible exchange rates. The nonreform of the international monetary system has

certainly not been without cost for the world economy. As J. Williamson has put it, "And so the world ended by getting exactly what is implied by those attitudes--a non-system with no coherent mechanism for monetary coordination but relying instead on markets to reconcile the uncoordinated. We are still learning how high a price in terms of economic efficiency has been paid for the triumph of monetary nationalism."[11]

THE WORLD MONETARY SYSTEM AND THE INTERNATIONAL BUSINESS CYCLE: A LONGER VIEW

The view that the profit motive, if working alone, cannot lead to an optimal structure of the money markets has long been shared by most economists. Theoretical considerations as well as historical experiences suggest that if left unchecked competition in these markets will tend to break down any monetary standard. Thus, a role for government in monetary and banking arrangements has been accepted by economists of all schools. Either a commodity standard or a fiduciary standard, if left to private initiative, would be inherently unstable and eventually break down. The maintenance of a commodity standard in a growing economy with price stability requires a considerable amount of real resources to produce the desired accretions to the stock of the monetary commodity. The use of a relatively substantial volume of real resources devoted to this purpose, together with the great difficulty had by producers of the monetary commodity to match the demand for it, establishes strong incentives to find cheaper ways of providing the exchange medium. Fiduciary elements are thus introduced into the monetary system.

If the government does not intervene at this stage, many individual issuers will be encouraged to issue additional amounts of fiduciary currency as long as its cost of production is lower than its purchasing power, whereby there will be a tendency to drive the monetary commodity out of circulation. Additionally, it would be difficult to prevent overissue of the fiduciary commodity by individual producers, and eventually a failure of some producer to fulfill its promises to pay will take place. Because of the pervasive and ethereal nature of money, there is a risk for a chain reaction associated with the failure of individual producers. Even if the consequences of eventual failures on the part of individual producers did not lead to the breakdown of the system, the issuance of the fiduciary medium would be subject to costly erratic oscillations. The government has, therefore, a role to fulfill in the control and expansion of monetary and banking arrangements setting boundaries to the oscillation of fiduciary media induced by the working of the profit motive.[12]

The question arises as to whether this reasoning is also applicable to the argument in favor of a supernational central bank supervising national banking and monetary arrangements. Caution should be exercised in drawing too straightforward a parallel between national and world monetary arrangements. It is difficult, however, not to think that the international monetary system has over time been subject to a dynamic instability of a nature essentially identical to that ruling in purely private monetary systems. The so-called gold standard, which was of course a mixed commodity--fiat money system, broke down because of the inability of governments to control the ratio of gold to internationally accepted fiduciary media despite the calls, on the part of many economists, for a world central bank-like institution to manage that ratio.[13] The gold exchange standard of the Bretton Woods system ceased to exist because of overissue of the international fiduciary money. The fiduciary dollar standard has certainly been subject to episodes of overissue by the main producers of the international medium of exchange, with costly consequences for the world economy. It is true that the existence of central banks at the national level would seem to be sufficient to prevent a widespread failure and eventual breakdown of the world monetary system. In any event, the consequences of overissue could still be very damaging for the world economy and particularly for those countries with a lower share of the wealth of the world. There is no mechanism in the dollar or multiple-reserve international standard to prevent processes of cumulative monetary disequilibrium from happening along with the accompanying phenomena of overindebtedness, overinvestment, and malinvestment and the ensuing overkilling adjustment efforts.

Assuming that the short-term problem of attaining monetary equilibrium in the United States and the world can be solved, the long-run question of what should be done to prevent these experiences from happening again must be addressed. The only efficient corrective to deal with deficiencies in monetary arrangements arising from the tendency of individual entities, be they commercial banks in a national monetary system or reserve currency countries in a world financial system, to overissue from time to time is to ensure the imposition of ceilings and floors on the credit cycle by a superior authority.

Certainly the fact that political interdependence and cooperation have not kept pace with the growth of economic interdependence must be reckoned with. After all, the Bretton Woods institutions we now have were conceived and made possible as a result of World War II. It could then be that there is no scope for effective international monetary schemes, unless some major disruptions of the economic fabric of the world take place. The possibility may arise, therefore, that

optimal monetary arrangements for the world are not politically feasible yet. This, however, is not for the economist to decide. If suboptimal projects are put forward with a view to the political constraints, the final outcome of their discussion would be a more inadequate system than would otherwise be produced. With these considerations in mind, it might not be altogether useless to review some elements of the theory of a world central bank.

One of the most articulated theoretical approaches to a world central bank can be found in the second volume of J. M. Keynes's A Treatise on Money. Writing within the context of the interwar restored gold standard, Keynes proposed a scheme to ensure the viability of the international gold standard and make it compatible with stability of prices and incomes throughout the world. It may be useful to look into these proposals with some detail once again since, although they were formulated with the international gold standard in mind, they are no less valid for an international fiduciary standard.[14]

At the time of writing the Treatise, Keynes placed heavy emphasis on the role of monetary factors behind the trade cycle and the importance and effectiveness of monetary policy in stabilizing it. For the very open British economy it was not possible, however, to control the growth of the domestic stock of money if the external sources of its viability were not likewise controlled. This led Keynes to tackle the issue of needed monetary management at the supernational level. Speculating on the desirable and feasible monetary arrangements for the world economy, Keynes came to the conclusion that the creation of a supernational central bank was needed to carry out an international monetary policy aimed at stabilizing the long-run value of gold and minimizing short-run fluctuations.

> I am disposed to conclude, therefore, that if the various difficulties in the way of an internationally managed gold standard could be overcome within a reasonable period of time, then the best practical objective might be the management of the value of gold by a Supernational Authority, with a number of national monetary system clustering around it, each with a discretion to vary the value of its local money in terms of gold within a range of, say, 2 percent. . . .[15] The ultimate problem before us is, therefore, the evolution of a means of managing the value of gold itself through the agency of some kind of supernational institution.[16]

Having established the need for a "supernational" institution responsible for the management of international

monetary policy, he then set out to analyze the ends and means of international monetary management. In Keynes's view, international monetary policy should be so managed as to stabilize the long-period trend of the value of gold in terms of an index of wholesale products internationally traded, which Keynes called the international tabular standard.[17]

Some of the properties Keynes associated with this standard are particularly relevant for today's international monetary disease. Since prices of commodities and wholesale products are likely to fall relative to the price of services with the pace of technological advance, stability of the value of national moneys in terms of the tabular or wholesale standard will imply a downward tendency of the purchasing power of national moneys in terms of consumption or retail goods. National structures of prices evolving along such a long-term path were considered by Keynes to be most efficient. According to him, such an upward trend in the cost of living induced by the stability of the tabular standard would fit in with the exogenously given tendency of nominal incomes to rise, thereby preventing the short-run disequilibrium stemming from increases in nominal earnings unmatched by corresponding movements in prices of final goods.

In assessing this view, the circumstances that surrounded the appearance of Keynes's _A Treatise on Money_ in 1930 should be taken into consideration. Keynes had in mind a process of deflation that had a particularly damaging impact on those individuals and enterprises that had contracted debt obligations at a fixed interest rate and were facing a growing burden to service the debt. These obligations eventually proved to be unbearable. As he said,

> I think it is desirable that obligations arising out of past borrowing, of which National Debts are the most important, should, as time goes on, gradually command less and less of human effort and of the results of human effort; that progress should loosen _the grip of the dead hand; that the dead hand should not be allowed to grasp the fruits of improvements made long after the live body which once directed it has passed away_.[18]

A second property of this international monetary system would be, in Keynes's opinion, its stabilizing effects on short-term business fluctuations. Business cycles were seen by Keynes as essentially the result of erratic behavior of credit leading to investment disequilibria that reflected rapidly on the wholesale index (note that this was also written before his 1935 _General Theory_). Therefore, the pursuit of a stable tabular

standard, with its need to concentrate on the behavior of wholesale prices and their determinants, involved close attention to investment phenomena by the national and supernational authorities.

As for the methods and control procedures of international monetary policy, Keynes advocated the regulation of the amount of gold put in active circulation in the national systems--depending on the relative scarcity or abundance of the metal--and the management of an international fiduciary asset created through the operations of the supernational central bank with the central banks of the world. The liabilities of this institution would consist of deposits by central banks--supernational bank money (SBM) in Keynes's terminology--fully convertible into gold or national moneys at fixed rates allowing for a difference of 2 percent between the buying and the selling price. Ideally, national moneys should only be cashable in terms of SBM, thereby moving toward a full gold-SBM international standard. The supernational central bank should be allowed to extend loans to national central banks at a managed discount rate, the maximum amount of the loan (the discount quota) being a factor of the bank's deposits in the supernational bank. The supernational central bank should also be endowed so as to effect open-market operations in markets for different national securities. As mentioned earlier, the main aims of this supernational bank would be to stabilize the long-term value of gold or SBM in terms of a tabular standard while avoiding worldwide economic disturbances in the short run. To this end, the bank would be endowed with the powers to implement discount rate, discount quota, and open-market policies.

There are certainly many questionable aspects within this scheme. One instance is the monetary role of gold. Gold is not, however, a vital piece of the Keynes international tabular standard. The presence of gold in the Keynes scheme is due to his effort to advance a proposal of international monetary management to save the gold standard and to prevent the disequilibrating effects of the breakdown of any standard. There is a trade-off, though it may be relatively short-lived, between gold and a world central bank. In the Bretton Woods system gold still had the very positive role of imposing a discipline on the issuance of fiduciary money by the countries whose currencies were used as international reserve assets. Indeed, the Bretton Woods system broke down as soon as excessive creation of fiduciary money, either by monetary policy in the United States or by passive assistance by U.S. monetary policies to monetary demands originated abroad, took place. If there existed an international monetary institution endowed with the powers of a central bank and embodied with a commitment to long-run price stability there would be no need for any monetary commodity to check excessive growth of fiat money. That

could be done by such an institution.

Another questionable point is that a stable tabular standard as advocated by Keynes could have undesirable distributional effects on developing countries or could fail to stabilize national price levels. Once it is accepted that international monetary policy should be concerned with stabilizing an index of tradable goods, there is the possibility of choosing a basket that could have desirable distributional consequences. Additionally, the basket could be subject to minor modifications from time to time to assure its effectiveness.

Another possible shortcoming of the scheme is its reliance on the effectiveness of monetary policy at the international level. In any scheme involving a supernational central bank the monetary liabilities of such an institution will be largely created by monetary developments in the largest industrial countries accounting for the greatest share of international securities markets. It is arguable, therefore, as to whether international monetary policy could do what national monetary policy cannot do, that is to say, a monetary policy aimed at stabilizing the long-run purchasing power of a basket of tradable goods will not necessarily cushion short-run fluctuations around trend. As it happens at the national level, it would not be easy for international monetary authorities to distinguish between temporary developments consistent with and necessary for money market equilibrium and the onset of an inflationary process. As is the case with national economies, it would be difficult to interpret monetary data and follow up the movements of the demand for money. Moreover, any program for international monetary policy would be subject to the same objections as those against national monetary policies that point to the difficulties of choosing the optimal monetary aggregate for intermediate variables whose behavior is linked to that of prices and the control variable through which the intermediate monetary aggregates should be monitored.

In response to these objections it must be recalled that the main objective of an international world central bank is to prevent major disequilibria in the world economy from happening. Short-run fine tuning may certainly not be effective and perhaps should not be sought. As already stated, there is not much disagreement among economists as to the need for a national central bank. There is no agreement at all on the optimal degree of monetary activism. Still it would be possible to design long-run monetary rules that would ensure the prevention of worldwide depression and major inflationary processes.

In spite of the possible drawbacks that stand in the way of an international world bank, it would seem that the advantages are still greater and that profitable action cannot go unexploited for very long. It should be

noted that it took more than two centuries to introduce central banking institutions in national economies. The world economy took a major step in that direction with the inception of the SDR scheme in 1969. The principles embodied in that scheme are still valid and the conversion of the Fund into a central bank along the lines envisaged in it should be accelerated. Perhaps the major shortcoming of the SDR was the belief that the functions of money are separable and that an international money can be created in stages. The SDR was thus created as an international reserve asset without practical scope for its being used as an international means of payment and effectively fulfilling the accompanying function of standard of value. This proved to be incorrect, and the role played by the SDR as an international reserve asset has been negligible if not nil. This has been due partly to the reduced magnitude of allocations. But allocations are, in turn, constrained by the limited use of the SDR. A more effective reform of the Fund in terms of a central bank should turn the SDR into a monetary asset, thus securing its full convertibility into other monetary assets by either public or private agents and encouraging its presence into effective monetary circulation.[19]

SUMMARY AND CONCLUSIONS

One of the main themes of this chapter is that given the nature of world interdependence and existing mechanisms for the generation and world distribution of international liquidity, the international economy is again subject to cyclic oscillations of considerable amplitude and eventually of an explosive character. The evolution of the developing countries will be particularly affected by these erratic fluctuations. As in the past, movements of industrial prices will be accompanied by much wider movements of primary-product prices in the same direction, whereby the terms of trade will work to magnify the business cycle of primary-producing countries. Moreover, the procyclic behavior of protectionist barriers, grants and official aid, flows of concessional finance, and private investment will also contribute to intensify the cyclic swing in developing countries. More importantly, given the behavioral pattern of international capital markets consolidated over the past ten years, excessive international credit will tend to be moved into developing countries in times of expansionary monetary policies in the largest industrial countries and out of them in phases of monetary contraction. Monetary disequilibria will induce maladjustments in the real sector and set in motion self-reversing forces whereby a period of world monetary overexpansion and overindebtedness will be followed by world monetary contraction and will impose

a highly exacting transfer effort on developing countries. Given the nature and degree of world economic interdependence, external debt crisis and worldwide depression may well prove to be a recurrent event following phases of excessive monetary growth.

The current external debt crisis and world depression, therefore, must be seen as a result of the process of excessive world monetary expansion that took place during different intervals of the 1970s. Those who blame some developing countries for their overindebtedness and encourage too strong adjustment efforts for these countries as a sort of purgative process, neglect the fact that this problem was caused by monetary overexpansion in the U.S. economy and other financial centers of the world.

The world economy is still in a trial period as it makes its way toward the attainment of sustainable and stable growth. Even if this situation is achieved without further setbacks, the adjustment costs of this process for the world have already been very high. The productive capacity of most countries has been heavily damaged and, in the best of scenarios, it will take time to cure the ills of the world economic organism. There is no safeguard at all in present international monetary arrangements to prevent that from happening again. Present international monetary institutions were conceived for a world economy not departing significantly from conditions of equilibrium. They are not equipped for preventing the onset of a cumulative inflationary process or recession and secondary depression phenomena like those experienced by the world during the nineteenth century and the interwar period. Business cycles of a certain amplitude are inherent and needed for the effective working of markets. Fluctuations that run the risk of setting in motion a process of cumulative disequilibrium are neither necessary nor unavoidable. Economists have devoted special attention to these matters for a long time and developed theoretical and practical principles to deal with cyclic phenomena. The appropriate mechanism to cope with these aspects for improving the functioning of the economic system over time is a central bank. This is as applicable to national economic systems as to the world economy. Discussions on the reform of the international monetary system are again being launched. Any scheme for international monetary arrangements must come to terms with the need to stabilize the world business cycle. It is difficult to see how this could be done without a central bank-like international institution.

NOTES

1. Business cycle literature went out of fashion with the Keynesian revolution and further development of

Keynesian economics and is now coming back with the rational-expectations approach to macroeconomics, though in a rather narrow form. As it happened with Keynesian economics, a distinction should be made between the assumptions used and the policy implications drawn by authors of the rational-expectations school and the useful insights into cyclic phenomena some of these theoretical constructs may provide. This distinction is made explicit in Lucas (1977). Perhaps the main message of this literature is the need to recover the use of a business cycle, a complete oscillation, as the reference unit of macroeconomic analysis. For bibliographical sources of monetary theories of the business cycle, see Note 4.

2. There would be some repercussive effects of the U.S. monetary restraint that, operating through the market for tradable goods, could affect somewhat the initial upsurge in U.S. interest rates. The interest-rate impact of the U.S. liquidity squeeze would decrease world income and U.S. exports, whereby U.S. income would be affected by an order of magnitude given by the relevant Keynesian multiplier. Additionally, if higher interest rates in the United States are accompanied by an appreciation of the real exchange rate of the dollar, these effects could be reinforced by a reduction of tradable goods shares in output. The fall in income, in turn, would induce a lower demand for real balances and corresponding downward pressures on interest rates.

3. There are other factors, deriving from the pervasive presence of the U.S. dollar in the world monetary scene, that help to nullify the insulating properties of exchange rates. For instance, the fact that a large share of the external debt of countries is denominated in U.S. dollars and is not forward covered means that an appreciation of the U.S. dollar vis-à-vis the currency of the country concerned will generate wealth effects of a depressive impact on domestic producers. Similar effects stem from the increase in the local currency value of oil and other U.S. dollar-denominated and highly inelastic imports associated with an appreciation of the U.S. currency. On these questions, see Dornbusch (1983).

4. The standard reference to these and other theories of the business cycle is still Haberler (1939). The main works from which the views put forward in this section are drawn are Keynes (1930); Hawtrey (1928, 1932); Hayek (1933); and Fisher (1933).

5. A debt-deflation theory of great depressions is put forward by Fisher (1933). Fisher attributed a central role to overindebtedness in inducing secondary recessions and deflation, which ultimately led to a great depression: "The very effort of individuals to lessen their burden of debts increases it, because of the mass effect of the stampede to liquidate in swelling each

dollar owed. . . . [This] is the secret of most, if not all, great depressions: the more debtors pay, the more they owe. The more the economic boat tips, the more it tends to tip. It is not tending to right itself, but is capsizing." Fisher (1933, 344).

6. This is the relationship embodied in Domar's formula (Domar, 1950). In this respect, it should be noted that the rate of growth of new lending to nonoil LDCs was of the order of 7 percent in 1982, whereas the average annual interest rate was of about 14.1 percent (LIBOR plus 1 percent) for that year. For 1983, net new lending was estimated to be of the order of 5 percent, whereas average interest rates were not expected to fall significantly. The order of magnitude of the transfer of resources implied by those figures may well prove to be unsustainable, especially if account is taken that the transfer effort is not uniformly distributed among LDCs.

7. On the same date that the increase in quotas corresponding to the Eighth General Review was agreed (January 18, 1983), the Group of Ten (G-10) leading countries and Switzerland agreed to increase their commitments to supply lines of credit through the General Agreement to Borrow from SDR6.4 billion to SDR17 billion (from about US$6.7 billion to US$16.2 billion). GAB resources would potentially be available for the IMF to lend to all its members (not only--as hitherto--to the G-10 countries) if certain conditions were met. These commitments, like the quota increase to augment resources available for the Fund, had to obtain parliamentary approval before being made available at the beginning of 1984.

8. According to current regulations governing the issuance of SDRs, a decision to allocate SDRs cannot be taken without the positive vote of the United States.

9. The potential role of the other financial institutions in the short run has been somewhat downplayed by events in relation to that of the Fund. From a medium-term perspective, there is no question that a large and effective world bank is essential if the needs of developing countries for long-term capital are to be met. An area of expansion for the institution would be its lending lines on terms that cover the cost of its financial resources raised in private markets. In the near future it will be convenient to raise larger amounts of funds in these markets in order to expand the lending flows to developing countries. There is a multiplier effect associated with this increased lending through the policy of inducing private banks to provide cofinancing of World Bank projects. This increased lending activity of the World Bank would have a stabilizing effect on the supply of long-term capital to developing countries. From the standpoint of the poorer region in the international community, an issue that deserves serious and urgent consideration is the replenishment of the

International Development Association, the soft long-term window of the World Bank. The importance of this agency in financing projects aimed at creating the potential to cover the basic needs of poorer countries cannot be emphasized enough.

10. Viner (1951).

11. Williamson (1982).

12. This is the classic argument for a government-controlled central bank as developed in Friedman (1959).

13. See, in this respect, Cassel (1936) and Keynes (1930).

14. Indeed, Keynes's plan to the Bretton Woods Conference was fully based on the theoretical underpinnings elaborated in the treatise.

15. Keynes (1930, 338).

16. Keynes (1930, 388).

17. Characteristically, Keynes chose to include those goods for which adequate statistical information was available. Thus, Keynes's tabular standard comprised the sixty-two commodities included in the production index calculated by the Economic and Financial Section of the League of Nations. See Keynes (1930, 391).

18. Keynes (1930, 393).

19. Initial steps to reform the Fund along these lines have been advocated by, among others, Polak (1974).

BIBLIOGRAPHY

Brunner, K., and Meltzer, A., eds. _Stabilization of the Domestic and International Economy_, vol. 5 of Carnegie-Rochester Series on Public Policy. North-Holland, 1977.

Cassel, Gustav. _The Downfall of the Gold Standard_. London, 1936.

Domar, Evsey D. "Foreign Investments and the Balance of Payments." _American Economic Review_. December 1950.

Dornbusch, R. "Flexible Exchange Rates and Interdependence." _IMF Staff Papers_, vol. 30, no. 1 (1983).

Fisher, Irving. _Booms and Depressions_. London, 1933.

___. "The Debt-Deflation Theory of Great Depressions." _Econometrica_, vol. 1, no. 4 (1933).

Friedman, Milton. _A Program for Monetary Stability_. New York, 1959.

Haberler, Gottfried. _Prosperity and Depression_. Cambridge, Mass., 1939.

Hawtrey, R. G. _Currency and Credit_. London, 1928.

___. _The Art of Central Banking_. London, 1932.

Hayek, F. A. von. _Monetary Theory and the Trade Cycle_. London, 1933.

Keynes, J. M. _A Treatise on Money_, vol. 2. London, 1930.

Lucas, R. "Understanding Business Cycles." In Stabilization of the Domestic and International Economy, edited by K. Brunner and A. Meltzer. North-Holland, 1977.

Polak, J. J. Thoughts on an International Monetary Fund Based Fully on the SDR. Pamphlet Series no. 28, 1974.

United Nations. National and International Measures for Full Employment. 1949.

___. Measures for International Economic Stability. 1954.

Viner, Jacob. International Economics: Studies. Glencoe, Ill., 1951.

Williamson, J. The Lending Policies of the International Monetary Fund. Washington, D.C., 1982.

Taylor & Francis
Taylor & Francis Group
http://taylorandfrancis.com

Part 2

Case Studies

Taylor & Francis
Taylor & Francis Group
http://taylorandfrancis.com

9
Argentina's Foreign Debt: Its Origin and Consequences

Marcelo Diamond
Daniel Naszewski

INTRODUCTION

On February 2, 1981, less than two months prior to General Roberto Viola's takeover from his predecessor, General Jorge Videla, a 10 percent devaluation of the peso occurred that was to initiate a dramatic change in Argentina's economic situation.

The effect of this apparently insignificant devaluation was similar to that of a crack in a retaining wall: In the two months that followed, interest rates rose sharply, reaching unusually high real levels, even for Argentina; financial panic ensued as foreign short-term credit agreements were not renewed and the flight of private capital increased. Owing to this situation, the new economic team, led by Lorenzo Sigaut, was forced to undertake another devaluation of 30 percent with which the retaining wall gave way once and for all.

A minidevaluation policy, which until February 4 of the same year had been undertaken in accordance with a table announcing the monthly rise in the price of the dollar at decreasing rates systematically lower than the monthly real rate of inflation actually registered, gave rise to several consecutive maxidevaluations. Thus, although during the twelve months prior to this the peso had been devalued 22.6 percent, in the course of the following year--when the crisis occurred--the price of the dollar rose 390 percent (4.9 times). Inflation, which in January 1981 had fallen to a rate of 84 percent per annum, rose sharply again reaching 146 percent during the following twelve months.

Interest rates that had already been positive in real terms for a number of years (although not to the extent that they were to register later) rose sharply in nominal as well as real terms. All activity suddenly slowed down, and in a period of a few weeks, one of the deepest recessions of the century occurred. Thus, the gross domestic product along with domestic consumption fell sharply, as can be seen from the data in Table 9.1.

Table 9.1 Argentina: GDP and Consumption (millions of pesos at 1970 market prices)

Quarterly Development	GDP	Consumption
1980		
III	114.376	90.180
IV	115.689	93.086
1981		
I	109.638	98.977
II	109.711	89.229
III	102.215	79.971
IV	100.649	79.070
1982		
I	101.919	85.096
II	98.220	76.297
III	98.491	75.851
IV	99.794	76.605

Source: Banco Central de la República Argentina.

Having slowly recuperated from the loss of earning power of 1976 and 1977, real wages fell sharply, and the basic wage decreased 14 percent in real terms in four months. A slight recovery occurred in the following months but wages fell even farther with the ensuing change in government and the rise of General Leopoldo Galtieri to power at the end of 1981. Thus, by June 1982, the agreed basic wage had fallen 21 percent in real terms in relation to January 1981, which coincides with the fall in consumption shown in Table 9.1. Already weakened by the policy of economic openness introduced in the previous administration and by the size of the debts the private enterprises were obliged to assume together with the high real interest rates they had to pay, businesses suffered another serious setback as a result of the recession and the consequent fall in the demand and profitability margins.

For the educated middle class, the days of "easy money"[1] were over. For example, the airlines that in previous months had transported hundreds of thousands of Argentine tourists abroad and whose aircraft would return loaded to the brim with purchases, were obliged to suspend services on a large scale due to the reduction in the number of passengers.

As far as the situation in the foreign sector was concerned, international reserves dropped considerably, and without previous notice, Argentina slowly lapsed into a partial suspension of payments of its foreign debt. Finally, as time went by, it became known by word of mouth that during the period from 1976 to 1982 the country's foreign debt had risen to US$30 billion, a figure equivalent to five years' exports. Very slowly the

country became aware of the burden that this mortgage, which in interest alone would absorb nearly 50 percent of Argentina's annual revenue from exports, meant for the economic future of the country.

At the same time there was added concern as to the reasons for this indebtedness and its eventual outcome. It was logical to suppose that the growth in the foreign debt, which was incurred basically as from 1978, would have been accompanied by a parallel increase in productive investment and the country's economic activity. This, however, was not the case. Instead of growing, the economy shrank, as can be observed in the figures in Table 9.2 for the gross domestic product, which in 1982 remained at the same level it had reached in 1973 and 1974.

In describing this situation, the Argentine economist Aldo Ferrer pointed out at the end of 1982 that "from 1976 to 1982, the increase in the foreign debt to more than US$30 billion has been accompanied by the destruction of domestic capital by more than US$60 billion. This estimate does not include losses in human resources as a consequence of the brain drain."[2]

Table 9.2 Argentina: Gross Domestic Product (millions of pesos at 1970 market prices)

1970	86.970
1971	91.221
1972	92.882
1973	96.198
1974	102.136
1975	101.287
1976	100.815
1977	107.310
1978	103.610
1979	110.979
1980	112.194
1981	105.553
1982	99.581

Source: Banco Central de la República Argentina.

The purpose of this chapter is to analyze the complex subject of Argentina's foreign debt and to provide an answer to a number of queries concerning it. For example: What were the causes of the indebtedness? Why did it have a destructive effect on national productive capacity? In what way was foreign indebtedness related to worsening inflation, the fall in real wages, and recession? How were the attempts to renegotiate the foreign debt with the IMF and the private international banks conducted as from 1982? Is Argentina faced with a qualitative change in its typically oscillatory cycle characterized by periodic crises in its balance of payments? Or, on the other hand, are we

dealing with a new phase of the same cycle, perhaps drastically accentuated for various reasons, such as the international financial situation that has prevailed since the oil crisis? How should Argentina face its indebtedness? And lastly: What will be the consequences for the economic future of the country?

In order to answer these queries we will first attempt to bring to light the reasons why Argentina (and other countries in a similar position) are faced with a crisis that cannot be classified in our opinion as a momentary lack of liquidity but rather as a case of structural insolvency in its foreign sector. Later, we will analyze the process that fed foreign indebtedness from 1976 onward and accentuated it as from 1978, at the same time provoking the unprecedented destruction of Argentina's economic system. Third, we will examine the comings and goings of the country's economic policies applied since the beginning of 1981, when the present global national economic crisis began to develop. In this context, an explanation will be given of the way in which negotiations to refinance the foreign debt were undertaken as from the latter months of 1982.

Thus, we will show that despite the unprecedented severity of the situation, indebtedness, inflation, the fall in real wages, and recession are typical of a balance-of-payments crisis of the kind periodically suffered by Argentina (and the majority of the countries that export primary products and that are undergoing the process of industrialization) and indeed are an integral part of the oscillatory movement that has affected the country's political and economic life during the last few decades. At the same time, however, we will attempt to show that the unprecedented magnitude of the crisis in the external sector of Argentina's economy invalidates past extrapolations that predicted an automatic recuperation and that the severity of the phenomenon in itself leads one to believe that this time it will be much more difficult to overcome.

ARGENTINA'S STRUCTURAL TENDENCY TOWARD DISEQUILIBRIUM IN THE EXTERNAL SECTOR

Concern due to the magnitude of worldwide foreign indebtedness, and the indebtedness of countries at an intermediate stage of their industrialization process (like Argentina, for example), would tend to make the phenomenon of external debt seem like a new and unheard-of occurrence produced as a result of the international economic crisis that began with the oil crisis or with the recent change in direction of the U.S. economic policy toward a more orthodox monetary one. However, the growth in the foreign debt of these countries has been a continuous process during the last few decades. In fact,

it can be seen from the data in Table 9.3 that, in the case of Argentina, the foreign debt had been undergoing sustained growth (although not at the rate of recent years) since well before the 1970s. The same may be said of the foreign debt of other countries with similar productive structures.

Why did this foreign indebtedness occur in Argentina? The problem has its origins in the peculiar characteristics of its economic system. Argentina belongs to a group of countries that are at an intermediate stage in their industrialization process and that export primary products. All of these countries possess a fundamental characteristic that the textbooks always fail to mention: the presence of two basically distinct sectors. One is the primary sector (in Argentina's case it is farming; in Venezuela, the petroleum industry; in Brazil, coffee; and so on), and the other is the industrial sector. The primary sector is highly productive or "efficient," thanks to bountiful natural resources such as rich mineral deposits, a benevolent climate, or, in Argentina's case, the fertile land of the "pampa." A different situation is present in the industrial sector where productivity does not depend on natural resources but is a direct function of the level of development and maturity of the industrial system.

Countries at the beginning of the industrialization process generally have a highly productive primary sector and an industrial sector whose relative productivity stays behind. Under these conditions the industrial sector cannot compete internationally with the industries of the more developed countries. However, this non-competitiveness is not due to insufficient industrial productivity, measured in absolute terms, but rather to its relatively low productivity in relation to the primary sector.

Industrial prices expressed in dollars will always depend on domestic prices and the country's current exchange rates, which in turn translate the domestic prices into international terms. However, this exchange rate is set precisely on a scale necessary to place the prices of what is produced in the country on an international level. No matter how inefficient a country may be (as were Taiwan and Korea when they started out), they can always be internationally competitive if the appropriate exchange rate is applied. Their low overall efficiency will be the reason behind a low standard of living but will never prevent them from competing on the world market. This adaptation mechanism for the exchange rate ceases to function in primary exporting countries in the process of industrialization, because their exchange rate is not set on the basis of the parity of the industrial sector, but rather on that of the primary sector, which has traditionally been the one to export. Thus, in Argentina the exchange rate is set at a level

Table 9.3 Argentina: Growth of Foreign Debt (millions of current U.S. dollars)

	Foreign Debt	Foreign Debt[a]
1958[b]	1,000	1,848
1963	3,390	6,278
1964	2,916	5,390
1965	2,650	4,801
1966	2,663	4,664
1967	2,644	4,622
1968	2,805	4,787
1969	3,231	5,305
1970	3,876	6,143
1971	4,356	6,681
1972	5,900	8,664
1973	6,400	8,312
1974	8,100	8,852
1975	7,875	7,875
1976	8,900	8,509
1977	9,678	8,719
1978	12,500	10,443
1979	19,034	14,131
1980	27,162	17,684
1981	35,671	21,296
1982	38,736	22,639

Note: Disagreement exists in the data provided by the Banco Central de la República Argentina (BCRA) depending on the period in question, because on some occasions the short-term debt is taken into account, and on others it is not. Therefore, the figures shown in this table should be considered as an approximate estimate only.

[a]Deflated by the U.S. wholesale price index, basis 1975=100

[b]Estimate based on data provided by the BCRA

Source: BCRA, Series estadísticos sobre compromisos financieros externos y balances de pagos de la República Argentina; other reports; and personal research.

that allows wheat and meat to be exported comfortably. In other words, Argentina has a "pampan" dollar that is inadequate for the level of industrial productivity attained.[3]

Therefore, for prices to be competitive on the international market, industry in the developing countries needs a protective tariff barrier. It was behind this protective wall that industrialization began in Argentina and in all the other primary exporting countries mentioned earlier. If we go back to the last century, we can see that industrialization in the United States and Germany and the introduction of these two countries into a world market dominated by Great Britain

also began in this way. It is important to point out that this protective tariff is in no way indicative of industrial "inefficiency." What these tariffs do, in fact, is to create a system of multiple exchange rates at a parity appropriate to the industrial productivity attained by a country at a given stage of development.

Through industrialization, takeoff is achieved, along with a greater utilization of labor. But at the same time, a persistent deficit in the foreign sector arises. The problem stems from the peculiarities of the productive structure that has emerged, characterized by an industrial sector that works at higher than international prices and a primary sector working at international prices. In what is referred to as an imbalanced productive structure, because its prices are higher, industry does not export unless there is an adequate system of compensatory incentives.

Furthermore, as industry grows it will require an ever-increasing amount of foreign exchange for importing raw materials, intermediate products, and capital goods. By not exporting, industry leaves the generation of foreign exchange to the primary sector, whose growth is much slower than that of industry. At the initiation of industrialization, import substitution economizes on foreign exchange. However, the substitution process becomes more and more sluggish, and at some stage the savings made on foreign exchange are insufficient to cope with industry's growing need for the same.

Therefore, a mixed productive structure emerges composed of two sectors. The industrial sector creates jobs and grows rapidly. As it grows it requires more and more foreign exchange to supply its raw materials and capital goods. The other is the primary sector that, because of its slower rate of growth, finds it more and more difficult to supply the foreign currency needed by the industrial sector. Sooner or later the reserves of foreign exchange are exhausted, and the country is unable to pay its foreign debt and to acquire the raw materials and the intermediate and capital goods it needs to continue its economic activity.

To avoid the paralysis of production, the government resorts to foreign capital and credit. Contrary to what is assumed, these funds are sought not to complement national savings but to avoid a crisis in the balance of payments, in the sense that they enter the country as foreign exchange. However, as foreign indebtedness is mainly incurred to finance expenditure in foreign currency, we are dealing with a palliative measure that merely prolongs the problem and at the same time worsens it as the foreign debt and the interest services increase. Thus, the need arises for even larger contributions in order to maintain an equilibrium. The resulting accumulative foreign indebtedness always ends in a new crisis in the balance of payments even more serious than the

one it was hoped to avoid.

This is the fundamental problem of all unbalanced productive structures, not only in Argentina but also in Chile, Colombia, Brazil, and so on: development in a situation where two different sectors exist, a primary sector working with international prices and an industrial sector working with higher than international prices; the impossibility of exporting on the part of the industrial sector; a higher rate of growth in this sector than in the primary one; the consequent disparity between the consumption of foreign exchange and the ability to produce it, and a recurrent tendency to disequilibrium on the part of the external sector. The tendency to palliate this imbalance in Argentina by means of foreign loans has, in the last two decades, led to an accumulative and permanent growth in the foreign debt and periodic crises in the balance of payments. From the time these crises have occurred, there have been many other upsets, such as huge devaluations, increased struggles for higher income, hyperinflation, and oscillating political changes.[4]

Orthodox Stabilization Programs: Phase One

In Argentina, the usual way of confronting crises in the balance of payments, and one that has traditionally been approved of both at the domestic level and internationally, coincides with the stabilization plans recommended by the IMF. The initial measure is always a devaluation of considerable proportions that, it is supposed, will be an incentive to export and to carry out import substitution in domestic production. However, considering that in Argentina the high prices of manufactures prevent the industrial sector from exporting (except in cases where there are special incentives) and that in general imports are indispensable products essential for continued productive activity, the main stimulating effect of a devaluation lies in its ability to motivate farming production and exports. However, as this effect takes some time even in the most favorable cases, it becomes necessary to resort to a balancing mechanism in the external sector. This mechanism is provided by the recession and induced by the devaluation itself.

To begin with, the devaluation raises the prices of exportable farming products and imported products, together with other costs and prices. In this way real wages are depreciated and revenue is transferred from the city to the countryside and from the industrial salaried sector to the rural landowners, thus reducing the buying power of the working class and lowering overall demand.

Furthermore, the government deliberately restricts money issue and the availability of credit, thus creating monetary illiquidity. As a result, there is a rise in

interest rates and once more the demand falls. In this way, recession, which has already been induced by the devaluation, is reinforced even more. Factories come to a standstill, the need for the importation of raw materials and capital goods is reduced, and the external sector tends toward a low-level equilibrium as a result of the overall reduction in the level of economic activity and income.

This recession has also a second objective: to assure continued incentives for farming production. For these incentives to be maintained and to bear fruit, it is necessary that the farming sector retain the relative price advantages obtained as a result of the devaluation. At the same time, for this to occur, real wages must not be allowed to recuperate to their previous level. And to keep real wages low, the recession must necessarily continue.

Finally, the third objective of monetary restraint and the consequent rise in domestic interest rates is the creation of incentives for the massive entry of foreign capital.

In conclusion, the balancing effect of stabilization plans on the external sector occurs in the short run through the reduction in imports and the flow of capital from abroad and in the long run through the stimulation of the farming sector by changes in relative prices in favor of the same. The common denominator of these three factors is that they all depend on the continuing recessive domestic conditions.

The recessive nature of stabilization plans is the cause of the difficulties that these same plans face. Owing to social pressure, on one hand, and the technical difficulties of maintaining the necessary monetary restraint, on the other, the government--either voluntarily or involuntarily--ends up taking a number of reactivating measures. Salaried workers begin to apply pressure in an attempt to restore their level of income. The same occurs in the industrial sector. The spiral of costs and prices initiated by the devaluation is thus complete. The balancing effect of the stabilizing plan for the external sector disappears. To restore it the government is forced to devaluate again, unleashing another inflationary spiral. In this way, highly virulent outbreaks of a special type of inflation occur that are typical of Argentina and other primary exporting countries in the process of industrialization that one of the authors (Diamond) called elsewhere _exchange rate inflation_.[5]

Generally speaking, the inflation in Argentina has been attributable to different causes and, at different stages in its history, has had different driving forces. However, the most virulent outbreaks have been derived precisely from the attempts to solve the problem of the external sector by means of heavy devaluations and the

consequent transfer of income to the farming sector. As resistance is met from the other sectors, this procedure leads to long periods of struggle for higher income, giving rise to rather violent inflationary phenomena that are very difficult to suppress. The most virulent inflation experienced in Argentina took place in 1959, 1962, 1971-72, 1975, and 1981, after very heavy devaluations that had been provoked by crises in the balance of payments. In each case, this was related to the aforementioned exchange-rate inflation.

In order to contain this type of spiral, the government is finally forced to delay the rate of the devaluation in relation to domestic prices, thus allowing a slow recuperation of income in the salaried industrial sector and allowing reactivation to be established. However, as the economy becomes reactivated, there is an increase in imports. Moreover, as the exchange rate is held back once more, the farming sector begins to lose its price advantage obtained through the initial devaluation. The only balancing mechanism that remains in the external sector, in principle, is the entry of capital and loans from abroad. Thus, sooner or later, these stabilization plans move from the first highly recessive stage to a second less recessive--or even extensive--stage, based on foreign indebtedness.

Stabilization Programs: Phase Two

To obtain the foreign loans needed by the country, the government usually resorts to inducing public and private companies to become indebted in foreign currency by means of attractive incentives. In the first phase of the stabilization programs, this maneuver is achieved by increasing the domestic rates of interest, which renders foreign credits more advantageous. However, this procedure is incompatible with the economic reactivation that is hoped to be achieved in the second phase of the plans, for if the interest rates are high in real terms, the recession will continue.

The solution to the dilemma lies in holding back devaluation in relation to domestic costs toward the end of the first stage of the stabilization programs. The consequent delay in the adjustment of the exchange rate has a highly stimulating effect on the entry of foreign capital. Normally it is thought that incentives directed toward foreign indebtedness are achieved by high real interest rates, taken as the difference between nominal rates and inflation. But this is not quite true: What are important are the nominal domestic rates, on one hand, and the interest rate for dollars abroad plus the devaluation rate, on the other. It is sufficient that there be a permanent holding back of devaluation in relation to domestic inflation for foreign borrowing to

increase considerably, even where real interest rates are low or even negative.

It would therefore seem that a continued delay in adjusting the exchange rate would be the ideal remedy for external disequilibrium, that is, the ability to attract credit from abroad with no, or relatively few, recessive consequences. In order to continue benefiting from this effect, once the postponement of the adjustment of the exchange rate has begun during the transition from phase one to phase two, the government often tends to perpetuate it. In other words, a rate of devaluation that is slower than that of inflation is adopted. This technique encourages, in fact, the entry of foreign capital without the need for recession. But at the same time, it initiates a vicious circle of indebtedness that will inevitably lead to the final fall.

First, as time goes by, the initial structural external deficit grows, and with it the indebtedness necessary to compensate it. Then, there is the interest that increases the original deficit, making it necessary to incur even greater loans in order to service the debt. Second, the postponement in the adjustment to the exchange rate inhibits exports even further and encourages imports, thus increasingly deteriorating the trade balance and aggravating the initial external deficit.

Once initiated, this process of accumulative indebtedness is very hard to curb. The longer it goes on the greater the accumulated disequilibrium in the external sector and the need for new loans. The greater the need for these loans the more urgent it is to acquire compensatory capital and therefore to hold back the exchange rate adjustment in order to maintain the incentives that encourage the entry of such capital.

On the other hand, according to the traditional orthodox ideas that inspire these plans, the main cause of the whole problem of the countries like Argentina is their excessive protectionism and the development of presumably inefficient industries. Thus, while being momentarily in possession of an abundant supply of foreign exchange due to the entry of capital, the country is faced with considerable pressure to open up its economy. As a result, the degree of protection is reduced along with the occasional differential incentives for industrial exports. Although these measures are designed to increase industrial efficiency, in fact they have the opposite effect. They increase imports even more and exports decrease, which reinforces the effects achieved by the postponement of the exchange rate adjustments. The degree of industrial integration falls, whole sectors of activity disappear, and the productive apparatus is impaired. In general, the current account balance of payments becomes more and more unstable, and the foreign indebtedness required to compensate this is greater than what would have been needed had the policy of economic

openness not been employed.

Lastly, in the advanced stages of this phase of orthodox stabilization plans, the situation worsens as a result of the growing number of people who begin transferring their savings abroad to protect themselves against an inevitable devaluation. As this flight of capital must also be compensated, the country must become more indebted. Thus, pressure is exerted mainly on the companies in the public sector to obtain foreign currency by becoming indebted. Finally, the whole process explodes, the chain of indebtedness is broken, and the magnitude of the accumulated external deficit becomes apparent, reflected in the total indebtedness, unleashing an even more serious crisis in the balance of payments than the one that initiated the stabilizing policy to begin with.

Occasionally events occur differently. When the recovery of exchange reserves during the first phase coincides with a favorable change in the terms of trade and with the coming into power of a populist party, conditions are created that favor an expansive phase that lasts only as long as the international reserves last.

On the other hand, it must be added that during this whole process, statistics show that there are two factors that are normally classified as decisive in the deterioration process of the external sector in countries like Argentina, but that do not appear to be significantly relevant. First, the well-known secular deterioration in the terms of trade cannot be proved with any certainty (at least in the case of Argentina), although what can in fact be observed is that, on a number of occasions, the terms of trade have been favorable for the country, as in 1979-80, for example. However, due to a lack of awareness of the foreign limitations described, the governments have never taken advantage of these situations to compensate for future deterioration. Second, remittances for royalties, dividends, and technology payments taken out by transnational companies for their head offices are not of a sufficiently significant magnitude to explain the recurrent crisis in the balance of payments faced by Argentina and all in all appear to be a lesser contributing factor.

THE ERA OF MARTINEZ DE HOZ

What has occurred in Argentina since 1976 coincides exactly with the outline described. Although Argentina's current foreign debt would appear to be partly due to the accumulative indebtedness of three decades, the greater part was incurred under Minister of Finance José Martinez de Hoz, who held that post between April 2, 1976, and March 29, 1981. More precisely, 64.4 percent

of the foreign debt by the end of 1980 (three months before Martinez de Hoz left his job) was incurred from 1978 to 1980 (see Table 9.3). Apart from this, the subsequent increase in indebtedness is also attributable to his administration, because Martinez de Hoz's successors had no alternative but to postpone payments and allow the debt to increase even if this was only through the capitalization of interest that was impossible to pay.

Two clearly differentiated stages can be identified within the Martinez de Hoz management of Argentine finances. The first extended until the middle of 1978, which more or less corresponds to the description of phase one of the stabilization plans. The second, completed with his departure from the government in March 1981, evolved according to the indications for the usual second phase of these plans corresponding to the policy of accumulated indebtedness. It was within this period that the rapid growth in the foreign debt occurred.

The first phase of the stabilizing plan arose in response to the grave balance-of-payments crisis of 1975. Its equilibrating effect was very rapid, and by 1976 a marked recovery could already be observed in the balance-of-payments current account. From then on, until 1978, a growing current account surplus was registered. The foreign debt rose to US$4.6 billion during this period, if the whole of 1978 is included in this estimate, and to US$1.8 billion if 1976 and 1977 only are taken into account. This is a small figure if considered in the light of later events. Furthermore, this increase in the debt was compensated by a simultaneous rise in international reserves of nearly US$3.4 billion, to the extent that the Martinez de Hoz administration began 1978 with a surplus in the external sector.

The economic costs of this recovery were considerable. First of all, there was the usual recessionary effect. Therefore, apart from a brief period of economic expansion in the first half of 1977, during the first three years of the period there was virtual stagnation in the gross domestic product. There was also a slow drop in the contribution of industry to the GDP, which fell from 28.2 percent in 1974 to 25.3 percent in 1978 and continued to fall until it reached 22.4 percent in 1982.[6] Another significant occurrence was the growth in the participation of the services sector in the GDP, as a result of the expansion in the finance subsector.

The second adverse consequence was that the elimination of the disequilibrium in the external sector took place at the cost of a dramatic fall in real wages. Thus, the salaried sector's participation in income fell from 45 percent in 1975 to about 35 percent in the following three years. The decrease in real wages in 1976 may be estimated at about 40 percent.[7]

The third adverse consequence of this policy was the continued high rate of inflation that remained at around 170 percent per annum during 1977 and 1978. However, it did not reach the unprecedented 433 percent registered in 1976 as a result of the typically inflationary spiral that occurred after the great devaluations, in which the different sectors struggled to recuperate their share of income.

In order to curb this inflationary process, the government resorted to a number of measures without success. In 1976, during the first phase, wage freezes were imposed. But as the economy became reactivated, wage controls were exceeded in what were euphemistically called wage slides. In 1979, price controls were implemented but were also overrun. Finally, in the second half of 1977, the government applied even heavier monetary restraints, causing a spectacular rise in interest rates on short-term loans, which remained at a positive monthly real rate of about 4 to 6 percent for several months. This produced a fall in the GDP of no less than 11.6 percent from the third quarter of 1977 to the first quarter of 1978.

The 1978 Change in Course

After two years of the Martinez de Hoz administration, the government's economic team was in serious trouble. Its objective to balance the external sector had been achieved, but at the cost of an acute problem characteristic of recessive stabilization programs. Several years of very impoverished real wages ensued, together with overall economic stagnation, marked conflicts between the different economic sectors in the struggle for higher incomes and the consequent inflation of 170 percent per annum. The consecutive restraint measures applied to the distinct sectors to curb the inflationary spiral--wage and price controls and heavy recession--had exhausted their effect.

In the first half of 1978, as a result of this situation and of political pressure to increase real wages and reactivate the economy, the Martinez de Hoz administration underwent a substantial change. A preparatory measure that had been undertaken in phase one, consisting of an overall reduction in import tariffs, had been intended to be a gradual reform but in actual fact turned out to be rather hasty. This was brought about for two reasons. First, the reform consisted of a particularly exaggerated diagnosis of Argentina's ills, contemplated in terms of industrial inefficiency, which could be remedied through international competition. Second, it was intended that this foreign competition be used to fight inflation.

In mid-1978, the government made the crucial decision to hold back devaluation and tax increases in the public sector in relation to domestic costs, and thus began what we have called phase two of the stabilization plans. Toward the end of 1978, the plan was modified with the addition of a schedule, or rather an explicit program, according to which the government promised to undertake future devaluations at predetermined and decreasing rates. This was justified by the need to increasingly support international competition and involved a double balance-of-payments objective from the monetary point of view: to intensify the presumed efficiency measure of tariff reduction, on one hand, and to curb the rise in domestic prices, on the other, thus provoking a slow descent in the rate of inflation until the programmed decreased rate of inflation was reached.

Unfortunately, the plan had been inspired by a particularly simplistic view of the Argentine economy. To begin with, even with the reduction in tariffs, only a small part of the economy was exposed to foreign competition. Neither services, the liberal professions, nor the construction and foodstuffs industries were exposed to commercial and financial intermediation. About half of the industrial sector was left unexposed due to the existence of certain inherently protective privileges: high transport costs, difficulties in packaging, the perishable nature of certain goods, restrictive administrative and health regulations, and the need for supplies in close proximity in order to produce custom orders, to produce parts and spare parts for certain domestic industrial models, and to carry out maintenance. Lastly, traditional farming activities, although in principle exposed to foreign competition, were faced with a marked rise in international prices, which neutralized any curbing effect that the postponement of the exchange-rate adjustment might have had on domestic prices.

All in all, foreign competition affected only the exposed part of industry, whereas the prices in the non-exposed sector continued to rise at a much faster rate than that of the devaluation as there was nothing to curb them. As this sector exerted pressure on the labor market, it also brought about wage increases far greater than the rate of devaluation. Meanwhile, the exposed sector, whose prices were restricted to the rate of devaluation, was under pressure because of the increased costs of inputs bought from the unexposed sector: services and labor.

The result was a rate of inflation several points above that of devaluation. This rate was not uniform because the increases in the unexposed sector were very much higher than the average rate of inflation, and the increases in the exposed sector were very much lower.

The expected convergence did not occur and the adjustment of exchange rate continued to be postponed. The consequences of this accumulated lack of protection were very serious. In 1978, no productive activity worked with profit margins wide enough to resist two years of increases of costs of several points per month that could not be transferred on to prices. Consequently, the profits of activities directly exposed to inflation dropped until they were eventually converted into losses. The final stage of the process was massive decapitalization. Many production lines were abandoned, and manufacturing plants closed down or even went bankrupt. The shutdown process has not extended even more because of the extremely high cost and irreversible nature of closing down a manufacturing plant. This has led many businesses to opt to continue accumulating their losses rather than paying off employees, in the hopes that the situation would improve.

The counterpart of the sectorial deterioration described was to be seen at a more general level in the growing deficit in the balance of payments on current account, due to the continued increase in imports, tourist spending abroad, the massive flight of capital toward the end of the period, and a relatively lower rate of growth in exports.

This deficit was compensated for by short-term loans, the indebtedness of public and private businesses, and the entry of foreign funds for deposit in Argentine currency in the domestic banking system. The incentive was provided by a combination of moderately positive real rates of interest and the unrealistic rates of exchange. Thus, the invisibles in the balance of payments--non-compensatory capital entry--began to grow. In this way the balance of payments maintained its equilibrium from the point of view of the growing national reserves and the large amounts of foreign currency available for imports, trips abroad, and other transactions. The rapid growth of the foreign debt went unnoticed at that time because of the delay in the elaboration and publication of the corresponding statistics and the inefficient method used by the Banco Central to carry out that job.

The study undertaken by Antonio Lopez,[8] based on the official figures supplied by the Banco Central, reflects the course of the balance of payments from 1976 to 1981 through the disaggregation of data. This permits identification of the negative results of the combination of tariff and exchange-rate policies followed after the change of course in 1978. If one follows the path of the foreign debt as it appears in Table 9.4, one can see that in the triennium of 1976-1978, there was an increase in the debt of only US$1.438 billion as opposed to the US$18.594 billion that accumulated during the triennium of 1979-1981.[9] Because during most of the second triennium the international prices for products exported

Table 9.4 Argentina: Balance of Payments for the 1976-1981 Period (in millions of current U.S. dollars)

	Triennium		Total
	1976/1978	1979/1981	1976/1981
1. Trade balance	4,939.2	-1,706.8	3,232.4
2. Tourism: travel and expenses (net)	-314.0	-4,152.7	-4,466.7
3. Royalties	-191.4	-593.4	-784.8
4. Services (net)	992.9	2,548.9	3,541.8
5. Profits and dividends	-511.6	-1,746.5	-2,258.1
6. Interest (net)	-1,240.2	-4,404.6	-5,644.8
7. Unilateral transfers	98.2	35.5	133.7
8. Non-disaggregated capital outflow (net)	-405.9	-9,245.4	-9,651.3
9. Adjustments due to changes in parity of the dollar or other currency	158.9	-444.3	-285.4
10. Statistical errors and omissions	-74.1	-298.4	-372.5
11. Accumulated result for the balance of payments	3,452.0	-20,007.7	-16,555.7
12. Export financing	527.3	-746.9	-219.6
13. Accumulated increase in the foreign debt	1,438.0	18,594.4	20,032.4
14. Accumulated variation in international reserves	5,417.3	-2,160.2	3,257.1

Note: (1) through (13): The positive figures refer to foreign currency inflow, the negative to outflow.
(14): The positive figures refer to increases in reserves; the negative indicate decreases.

Source: Antonio López, based on Banco Central de la República Argentina figures.

by Argentina, mainly meat and grain, remained at high real levels, the deterioration in the trade balance over this period was not worse.

The presence of a negative balance despite the high prices of Argentine exports can be explained by several concurrent developments. First, there was the sharp increase in imports, which tripled from 1978 to 1980 (an increase of 175 percent in current dollars). This was due mainly to the importation of unnecessary or luxury consumptive goods. Thus, for example, consumer goods, almost all of which face a competitive national market in the case of Argentina, went from 2.2 percent of total exports in 1976 to 17.6 percent in 1980. A similar phenomenon occurred in intermediate and capital-goods sectors, where the increase was accounted for by products that had replaced local production. Second, expenditure on tourism abroad was unprecedented, going from US$314 million in the 1976-1978 triennium to US$4.2 billion during 1978-1981. Third, there was a sharp increase in the area of "nonindividual capital outflow," which accounted for the total sum of US$9.2 billion in investments and financial remittances abroad, made possible by the absolutely free exchange that prevailed up until the last few months of 1981.

The increase in exports was much less than the increase in the expenditure of foreign exchange. The positive effect of the high international prices obtained for traditional exports was counteracted by the delays in the adjustment of the rate of exchange. As regards nontraditional exports, owing to this delay and the reduction in a number of incentives for the sake of "efficiency," both industrial and agro-industrial exports slowly came to a standstill.

The flow of short-term credit to private and state businesses, whose foreign indebtedness was encouraged to cover the growing foreign deficit on current account, was responsible for the high increase in interest payments of US$1.2 billion in the first triennium of the political administration to US$4.4 billion in the second.

The figures for the uses of foreign exchange are even more dramatic if one considers that the total foreign debt, considered correct by the Banco Central and based upon its surveys on the final stocks of the debt, is US$7.7 billion higher than the previous figures based on the balance-of-payments registers. This means that the outflow of foreign currency over this period, shown in the accounts of the balance of payments, is also underestimated by US$7.7 billion. If this figure is compared with estimates based on the observation of reality, one may assume that this additional outflow was partly due to increased outflow of capital, partly to increased spending on the part of tourists going abroad, and partly to higher interest rates.

To sum up, Argentina's indebtedness arose as a result of increased imports, increased tourism, the flight of capital, and interest service. In a number of other countries (such as Brazil, for example), most of the indebtedness was produced by the deterioration in the terms of trade resulting from the rise in oil prices. In Argentina, however, a country that imports virtually no oil and enjoyed high prices for its farming products during the Martinez de Hoz period just analyzed, the terms of trade were rather favorable.

For this reason, Argentina's foreign debt is less attributable to the adverse international situation than is that of other countries. This is so only in the sense that the deterioration in the terms of trade in the years following the demise of the Martinez de Hoz administration was felt with the fall in nontraditional exports, which was not attributable to the reduction in domestic incentives, but rather to the closure of markets and increased protectionism on a world scale. Also, the rise in world real interest rates caused an increase in the cost of servicing the debt as from 1980.

Neither can it be argued that Argentina became indebted in order to grow or to increase its productive efficiency. On the contrary, Argentina became indebted to finance with foreign currency a policy of economic openness that resulted in the massive destruction of its productive capacity and the disintegration of its industrial production, a huge technological step backward owing to the closing down of industrial laboratories, design departments, and so on; a massive desubstitution of imports; and the loss of foreign markets for its exports. In short, this policy on the whole led to a general economic crisis and an unprecedented setback in production and the living standards.

The main effect of the international situation on the Argentine crisis was more indirect. On one hand, the almost unlimited availability of credit from international banks made it easier to become indebted and encouraged irresponsible behavior on the part of the local authorities. On the other hand, the worldwide spread of orthodox doctrines in general, particularly the financial approach to the balance-of-payments problems, had a drastic impact on South America. It permitted the international banks to rationalize and justify the massive recycling of funds at their disposal, thus offering international respectability to the promoters of Argentine domestic orthodoxy.

The End of a Dream

By 1980 it began to be obvious that the Martinez de Hoz administration was leading the economy into a

blind alley. If the rate of devaluation were to increase in order to set the Argentine currency at a level that would counteract the deterioration in the balance of payments, it would immediately curb the inflow of short-term foreign capital, provoke its massive exodus, and make the crisis in the external sector even more marked. If the currency were to be devalued sharply, it would provoke the transfer of income to the agro-exporting sector, an effect typical of stabilization plans that, to work, must be accompanied by a policy of monetary restraint and renewed recession. If the exchange-rate adjustment delay were to continue, capital would continue to flow into the country but at the expense of a growing deterioration in the different sectors in the country, due to competition from imported products and the increased difficulty in exporting. This, in turn, would accentuate even more the disequilibrium in the balance of payments on current account.

Furthermore, as the domestic interest rates were linked to the expected future movements in the rate of exchange, the adverse expectations caused by the postponement in the adjustments to the rate of exchange caused the interest rates to remain very high. Thus, the unsustainable financial costs incurred by the country's productive sector were accentuated. In short, the economic policy moved toward a deadend and therefore posed a dilemma in which every alternative would be disastrous.

Toward the middle of 1980, one of the authors wrote,

> from a general point of view, the situation still remains unsolved. The triple dilemma caused by the need to put an end to the postponement of the exchange rate adjustment, to continue to encourage foreign investment and maintain a reasonable level of activity is still evident. Any two of these three objectives may be easily achieved. But to achieve all three at the same time would be extremely difficult, particularly within the framework of the self-restraint measures imposed by the present government.
>
> A chain is only as strong as its weakest link. The postponement of the adjustment in the exchange rate will have to be stopped eventually, the incentives for foreign investment must be maintained, and therefore the only adjustable variable that remains is the level of activity. Sooner or later the process will lead inevitably to renewed recession, the severity of which will depend on the flexibility of the economic measures to be employed from now on.[10]

Unfortunately, the flexible use of economic measures did not occur. The only defense mechanism available in the face of the balance-of-payments problem was the monetary policy to be applied to the situation in the external sector. So, in the light of the ever-increasing skepticism as to the continuing of the current process, the demand for funds (necessary to settle foreign debts) in the local financial market grew more and more, causing the real interest rates paid and collected by the finance system to increase continually. In December 1980, three months prior to the change in the Ministry of Finance administration, the current interest was at a monthly rate of 7 percent. Taking into account a monthly rate of inflation of nearly 4 percent, that rate was equivalent in real terms to 3 percent per month accumulative, or 42 percent per annum. Given the low rate of devaluation at that time, this interest rate meant about 5 percent interest per month for the dollar--in other words, about 80 percent profit for investments made in dollars.

In February 1981, the monthly current interest rate rose to a nominal 9 percent. In a desperate attempt to find a way out, Martinez de Hoz devalued the peso 10 percent just two months prior to the end of his term. This turned out to be a disastrous measure, for although the magnitude of the devaluation was insufficient to calm apprehension, the mere fact that there had been a devaluation that had violated the commitments assumed with the devaluations schedule published earlier implied a death blow to the house of cards on which the Martinez de Hoz policy was built. During the last two months of his financial administration, the tension in the money market grew more and more, and current rates of interest rose to around 16 percent per month for the leading companies.

THE NEW CRISIS IN THE BALANCE OF PAYMENTS

The rise to power of Lorenzo Sigaut occurred in the midst of a violent slide in the exchange rate. This apparently conjunctural movement reflected a serious crisis in the balance of payments, a disintegrated financial system, and a stagnant, partly destroyed system of production. Added to this critical domestic inheritance there was the aggravation of the international situation: the worldwide rise in real interest rates, the worsening international recession, and the fall in the prices for Argentine exports. Lastly, the ease with which international credit had been made available (since the oil crisis) also began to diminish as the international banking system began to realize that the debts of the developing countries were far greater than their capacity to pay. In other words, the increased difficulty

in obtaining credit when it was most needed was added to the other problems the new minister of finance had to face.

The first measure undertaken by the Ministry of Finance under the new head was a devaluation of 30 percent. After this inevitable devaluation, there were two possible courses to follow. The first was to introduce once more an orthodox stabilization program, this time even more severe than the one in 1976 and assuming the consequences of the recession as well as the drop in real wages that it implied. The other alternative was to attempt to solve the external-sector deficit by avoiding, or at least attenuating as much as possible, these recessive and regressive effects. However, the election of this second course of action implied renouncing the balancing effect of the recession on the external sector and made it essential to substitute for this other equivalent measures capable of stimulating in a more direct way the generation and saving of foreign exchange. In actual fact, as we will see, it became necessary to become highly selective in import substitution, and the ministry, in giving its active support, had to provide definite incentives to encourage the exportation of industrial goods, establish marginal incentives to increase farming production, and, finally, establish some sort of control over the exchange-rate system or at least a dual rate of exchange, one for financial transactions and one for trade.

The new financial administration took a very incoherent course. While following the orthodox policy, not only did it avoid taking any direct action in the external sector, but at the height of the crisis and following the steps of the Martinez de Hoz administration, it also proceeded to implement efficiency measures. Thus, the devaluation was accompanied by a reduction in import tariffs and tax refunds for exports, which partly counteracted the effect of the measure. This, along with the tremendous inertia that existed in traditional exports and imports (in the latter case because of the large number of binding contracts taken out by importers through irrevocable letters of credit), prevented exports from increasing with any celerity and failed to inhibit imports, thus maintaining the disequilibrium in the balance of trade. However, in contrast to the government's orthodox treatment of the exchange and taxation measures, it adopted a lenient attitude toward wage increases and liquidity, which counteracted the redistributive and recessive effects of the devaluation. Consequently, a galloping "exchange-rate inflation" such as that described earlier was unleashed at a rate almost double that of the inflation that had existed prior to March 1981.

The rapid rise in domestic costs and prices in response to the devaluations foretold the need for

further devaluations. Pessimistic expectations regarding future exchange-rate stability sustained the heavy demand for foreign currency for settling loans, thus contributing to the flight of capital. In response to the continued foreign-exchange disequilibirum, in May 1981 the current interest rates remained at 12 percent per month (approximately 4 percent in real terms).

At the beginning of June, another devaluation of 30 percent was inevitable and provided new impetus to exchange-rate-induced inflation. At the end of June, the demand coming from the financial sector made another devaluation of 30 percent necessary. All in all, in the first six months of the crisis, the accumulated devaluation of the peso against the commercial dollar reached 125 percent, and the devaluation in the case of the financial dollar was about 228 percent. During that same half of the year, inflation reached 60 percent compared to the rate of 35 percent for the previous six-month period.

Inflation was not as high as it might have been, because with the third devaluation the government finally authorized a double parity of the exchange market and established a financial dollar that fluctuated freely and a commercial dollar set at a lower rate that required periodic adjustment depending on the rate of inflation. The aim of this measure, which would have helped to control the crisis if it had been applied from the start, was to dissociate as far as possible domestic costs and prices and the devaluations produced by the financial imbalance.

It is important to keep in mind that the great demand in the financial exchange market was due to the fact that only part of the accumulated short-term foreign debt was payable on demand. In fact, one of the most important measures adopted was that of heavily subsidized exchange insurance for those with debts in dollars, on the condition that loans be renewed for a period of no less than a year. As a result of this measure, the government managed to postpone a short-term debt of about US$5 billion until the second half of 1982.

When Sigaut was replaced by Roberto Alemann with General Galtieri's takeover from President Viola, a change took place: A much more coherent orthodox and recessive stabilization plan was adopted. Thus, the exchange market was united once more, which implied a devaluation of 30 percent in the commercial rate of exchange. At the same time, a new "efficiency" reduction in the nontraditional export incentives, in keeping with this orthodox approach, was undertaken. There was an increase in value-added taxes; the nontaxable income floor was frozen; and the money circulation (M_1) was reduced by 20.8 percent in nominal terms from January to March 1982. Wages were frozen in the public sector, along with retirement funds and pensions, and wage increases in the

private sector were discouraged. The recession worsened and domestic consumption fell 10.6 percent between the first and second quarter of 1982. The real wages of the private sector, which in December 1981 were 20 percent below the average for 1970-1975, were reduced a further 15 percent in the first quarter of 1982, while the remunerations in the public sector fell about 22 percent in real terms.[11]

Despite the fact that exports decreased as a result of the fall in international prices for farm products, the situation in the external sector improved as a result of a considerable decrease in imports. The recession caused these to drop during the first quarter of the year to almost half that of the same period of 1981. The entry of new capital also contributed to this situation, reaching a positive balance of US$450 million in the first quarter of 1982.[12] However, the improvement gained at the expense of the recession by no means implied that it would be possible to pay the foreign public debt that, with amortizations and interest to be paid that year, reached the sum of US$12 to 15 billion. With this it was clear that it was absolutely essential for talks to be commenced regarding the refinancing of the debt.

However, on April 2, 1982, the armed conflict with Great Britain arose and had serious repercussions on the crisis in the external sector. To begin with, it led to the suspension of payments to British banks. This measure, taken in reprisal for the blocking of Argentine funds in the United Kingdom, also reduced the short-term inflow of foreign capital to zero. In the face of the emergency, control of the rate of exchange was introduced. Considerable delays in the settlement of Argentina's debts that had arisen from imports were produced. Unpaid letters of credit began to accumulate. Importers began to have more and more difficulty in obtaining foreign credit.

During this period the information available concerning Argentina's position on its foreign debt was very confused and sometimes even contradictory. According to foreign newspapers at that time, the country failed to pay part of its foreign obligations in order to cover the interests alone, which it also paid late. Nevertheless, the syndicated debts due to British banks continued to be paid, although perhaps with some delay and only partially. The policy was that the amounts to be paid to these banks be deposited in the New York branch of the Banco de la Nación Argentina, the non-British banks being paid according to the percentage of their participation in these syndicated credits. Apparently the aim was to show the international banks that it was Argentina's intention to pay its debts at all cost and that it did in fact have the money to pay the British banks. The blocking of payments to Great Britain caused an initial conflict between Argentina and foreign banks because the

latter, through an agreement to share losses and gains with the British banks, also shared the payments by Argentina, and it was their intention that these funds be refunded.

On May 18, 1982, an article in the New York Times published declarations made by new Minister of Finance Roberto Alemann to the effect that Argentina intended to substitute a medium-term debt for its short-term maturity debts of US$3.5 billion. The article gave the impression that these debts were in fact refinanced. During the same period, Alemann made public the assurances made by the U.S. bankers that they would continue to refinance Argentina with short-term credit until the end of the war in the South Atlantic. Lastly, in Wall Street Journal, on June 21, 1982, the opinion was that "technically Argentina has suspended payments."

The political crisis that arose as a result of the military defeat that culminated in the fall of Galtieri put an end to the management of the Ministry of Finance by Alemann. At that moment, in the second quarter of 1982, the country's GDP stood as low as that of 1973, and the GDP per capita was 12 percent lower than that in 1973. The situation was characterized by very low wages, high unemployment, the largest foreign debt in the country's history, a negative balance on current account despite the heavy recession, and huge private business indebtedness.

An Attempt to Change Course

During the first few days of July 1982, José María Dagnino Pastore became the new minister of finance, and the young economist Domingo Cavallo took control of the Banco Central. In the following months, the latter was to wield almost as much power as the minister himself. On the initiative of Cavallo, the first attempt to undertake a drastic change in the course of the economic policy was made. The priorities were to reactivate the productive capacity and to refinance and settle the high business liabilities that were impossible to pay and that accumulated during the progressive indebtedness incurred by the private sector during the crisis.

To achieve the reactivation of the economy and the settlement of debts, a financial reform was introduced that included a considerable reduction in the interest rates paid on short-term deposits by the banks (to negative real levels). It also included granting a certain amount of preferential credit to the private sector at these lowered interest rates. At the same time, the refinancing of business liabilities was undertaken also at these preferential rates, in pesos as well as in foreign currency.

These measures were accompanied by a number of steps designed to alleviate the situation in the external sector and allow the intended economic expansion. The measures introduced included another change in the dual exchange rate: a devaluation of nearly 30 percent in the commercial exchange rate, tempered by some retentions of foreign exchange entering for traditional exports, together with the establishing of a floating financial and services exchange-rate market. At the same time, to relieve the burden of the heavy demand on the financial market, the Banco Central reestablished exchange insurance for credit that was to be renewed for more than one year and also authorized "swaps." The settlement of overdue foreign debts through governmental foreign-exchange bonds provided for this purpose by the Banco Central at a subsidized exchange rate was also authorized. Lastly, the disposal on the financial market of part of the foreign currency obtained as payment for industrial exports was approved.

As regards the domestic market, the reduction in the rates of interest was responsible for some savings being used in the acquisition of goods. This effectively reactivated the economy. Unfortunately, it also channeled a considerable part of the funds into the exchange market, either directly or indirectly.

The immediate impact was manifested by the rapidly broadening gap between the financial dollar and the commercial dollar, to the extent that in a very short time the difference between the two was 75 percent. Meanwhile, the devaluation of the commercial dollar, along with the rise in the financial and services dollar (due to its impact on transport, interest payments, and so on), produced severe inflation that rose to around 15 percent per month. Owing to the progressive reduction in liquidity due to inflation and to the progressive shrinkage in the preferential credit, the initial reactivating effect was slowly lost.

As far as the other objective is concerned--the settlement of the private-sector debt--this was achieved by a heavy transfer of revenue to the indebted sector at negative real interest rates. Without going into an analysis of the costs and benefits of this transfer to the economy as a whole, it undoubtedly made possible the survival of a great number of enterprises that, under the previous conditions, had been destined to disappear.

The Dagnino Pastore-Cavallo experiment was cut short by the resignation of Dagnino Pastore and the elimination of both officials just a few days before the annual assembly of the IMF and the World Bank, which took place in Toronto in September 1982.

REFINANCING

Dagnino Pastore was replaced by Jorge Wehbe, who assumed office in the midst of total political debilitation of the armed forces and a strong fight of many civilian sectors for participation in the severely diminished income resulting from the continual recessive policies implemented to stabilize the external sector and curb inflation. Wehbe also faced the task of initiating formal renegotiation of the foreign debt. Up until that moment, the dramatic problem of the debt had never really been confronted. The country's reaction was limited, on one hand, to the encouragement of all possible means of postponing payments or to measures that would attract more short-term capital, almost without heed to its cost. Thus, the Argentine government, which for the sake of presumed increased efficiency scrimped on tax resources for years when in fact moderate state support through the right channels would have been sufficient to obtain foreign exchange at reasonable terms, was forced to incur monstrous expenditure merely to postpone maturities. On the other hand, in many instances Argentina simply suspended payments on its debts without going into any formal renegotiation.

This proverbial attitude of hiding one's head in the sand to avoid facing a problem was due to the politically delicate nature of everything related to the foreign debt. First, the fact that the debt had been acquired to finance destructive efficiency policies, along with the squandering of foreign currency, created strong resistance to any official discussion related to payments, for to admit publicly that debt payments were overdue would have been considered a confirmation of the inadequacy of the policy that had led to the indebtedness.

Second, the inexact account of the foreign debt on the part of the Banco Central, and the fact that the figures taken from surveys did not coincide with the balance-of-payments registers, created doubts as to the real magnitude of the debt and also the legitimacy of the figures supposed to be owed by the private sector.

The third political obstacle took the form of resistance to the intervention of the International Monetary Fund in the renegotiations, a condition that is usually insisted upon by foreign banks. Through Argentina's repeated experience in agreements with the Fund (nine standby agreements have been subscribed to in the course of the country's history), there was ample knowledge of the recessive conditions brought about the the same, which fostered the strong political resistance to any commitments being made with that institution.

The last political obstacle was the armed dispute with the United Kingdom. While the conflict continued it made all open talks regarding the debt impossible.

Even when it was over, it made discussion difficult because the private international banking institutions, as a prerequisite for any negotiation, insisted that there be a formal declaration on the cessation of hostilities and the lifting of economic sanctions against British business--once again a very delicate political issue.

However, the delay in payments continued, and as more debts matured, formal negotiation became inevitable. So Wehbe decided to take advantage of his visit to the Toronto IMF annual meeting to begin the first explicit talks with the international banks and the IMF concerning the renegotiations.

The first step taken by the Argentine government was to fulfill the banking institutions' prerequisite regarding the termination of hostilities with Great Britain. Nevertheless, due to the reasons already mentioned, the political atmosphere as regards the problem of the debt continued to be highly explosive. It is for this reason that all negotiations from September 1982 onward have been undertaken in a highly reserved manner. The terms, amount, and conditions of the renovations; the talks with the IMF; the alternatives; and so on have been surrounded by an aura of mystery. Information has been fragmentary, and in order to reconstruct the whole picture, it is often necessary to resort to information provided by the international press and to work with a number of conjectures. The following is an attempt to explain the outcome of the reconstruction of that stage of negotiations.

The Negotiations

In general, four different courses of action can be differentiated in the talks. The first was the negotiation of a standby credit with the Fund, granted not so much because of the magnitude of the debt but rather because it meant the green light--a kind of good conduct certificate for the country--that opened up the way to refinancing by the private banks. The second aspect concerned relatively small auxiliary credit from private banks, destined to finance interest payments while negotiations regarding the principal of the debt continued. The third aspect was the negotiation of the debt of the companies of the public sector with the international banks. The fourth aspect was the renewed postponement of payments on all short-term revolving credit of the private sector obtained through "swaps" or as a result of successive postponements obtained since 1981 with exchange insurance.

The talks with the Fund were undertaken in accordance with the established norms and with the utmost discretion up to the point at which the Memorandum of Agreement made with the Fund (signed on January 7, 1983)

was published on March 11, 1983, by La Prensa, a daily newspaper in Buenos Aires, along with an article entitled "Objectives and Strategy for Economic Recovery." The conditions set by this agreement were of three kinds. The first referred to the targets of the external sector. Definite limits were established for the deficit in the balance of payments measured in terms of changes in net international reserves, which up until 1984 were not to fall more than US$5 billion. The acceptable delays in foreign payments were defined and the settlements were to be made before June 30, 1983.

The second type of conditions covered the measures introduced to reduce overall demand. In this case, the public-sector deficit and monetary expansion were strictly limited, if annual inflation was not to exceed 160 percent. Based on this assumption and using restrictive criteria, the permitted monetary expansion was calculated.

Lastly, the third kind of conditions referred to the elimination of limiting measures related to the external sector. Thus, Argentina agreed to impose no new restrictions on imports and to progressively do away with the existing ones. Essentially it was agreed to rescind the decision that prevented payments to be made for imports before 180 days. Another agreement involved new steps toward a liberalization and unification of the exchange system, which would reverse the dual parity of the exchange rate and the restrictions established during the Dagnino Pastore-Cavallo term. Also, without assuming any other commitment in this case, Argentina agreed to review its system of export incentives. A final rather decorative ingredient, related to the substantive measures proposed, was the manifested intention to attain a 5 percent growth in the gross domestic product during 1983.

The first fruit of the negotiation with the Fund was an agreement by which a standby loan of US$2.15 billion, to be spread over a given period, was granted as compensation for diminished exports. The loan was to be delivered in full by March 1984, the latest date set for the newly elected government to assume power.

From partial information that exists concerning these loans, it can be deduced that by September 1983 US$560 million in IMF loans for diminished exports and two standby tranches of approximately US$318 million each entered the country. Apart from this, the progress made in the negotiations with the Fund opened the doors to auxiliary credit from the international banks, which was to be used for the payment of interest and to service the outstanding debt that had been pending since April 1982.

For this purpose a bridge loan of US$1.1 billion, signed on December 30, 1982, was obtained, and the first two installments were made with no problem. According to the newspaper Clarín of September 13, 1983,

"originally the loan was not to be refinanced or postponed, and its gradual amortization was directly tied to the payment of funds from the above-mentioned IMF standby credit." At the same time, it was agreed that, in principle, a medium-term loan of US$1.5 billion would be granted in three installments, the objective being also to aid the payment of interest and outstanding amortizations.

However, trouble arose with the payment of the last installment of the bridge credit and the whole of the medium-term credit. To begin with, after March 1982 Argentina had fallen behind in the payment of some interest. The lending banks demanded that these payments be brought up to date before they would disburse the last installment of the bridge credit, thus creating a vicious circle: Argentina had insufficient funds to pay the interest, and the new funds were withheld until these interests were paid. Finally, according to the July 1, 1983, edition of the New York Times, it was to have been agreed that Argentina would not receive US$300 million of the last bridge credit installment, diverting it directly to the payment of the interest owed in May. It was added that the operation was part of a new agreement concerning the medium-term credit of US$1.5 billion that had been agreed upon beforehand but had not been disbursed. In fact, by September this loan had still not been handed over. This time the problem arose because the lending banks insisted on a modification to Argentine law that placed foreign lenders on an equal standing with the local lenders. This modification in the legislation finally came through. But even this was not enough to overcome all the obstacles, for the banks insisted that renegotiation be completed previously with Aerolineas Argentinas and other state enterprises.

As was said before, one of the largest portions of Argentina's foreign debt is that of state enterprises, whose maturities in 1982 and 1983 totaled approximately US$7 billion. It would therefore seem reasonable that the lending banks should demand the renegotiation of the capital debt before disbursing further credit. However, it is sufficient to take into account the conditions set by the lending banks for renegotiation for this impression of their reasonableness to be erased. These conditions included such abusive demands as interest rates set2.125 points above LIBOR; a commission at over 1.125 percent; very high additional moratory interest in the case of default; the global guarantee that the term default apply to all state enterprises, or the state itself, when any one of them falls behind in its payments; an explicit renunciation of all efforts on the part of the state or its enterprises to defend itself from any embargo whatsoever; the obligation to provide detailed information to the lenders regarding the economic performance of the state and its enterprises; and other

similar conditions applied to a country manifesting a genuine intention to pay its debts. The cut of the remainder of the credit already agreed upon to a lesser amount, credit which was vital to a country on the verge of a suspension of payments, and the taking advantage of the needs of that country in order to obtain a signed contract reinforce the impression of abuse.

Lastly, this impression is confirmed when the restrictions imposed on the country through the agreement are examined: To fail to provide the information agreed upon implied the suspension of payments; to question or argue about any of the clauses of the agreement in the future implied the suspension of payments; the withdrawal of IMF support also implied suspension of payments. In other words, to adopt an economic policy approved by the IMF implied that the repayment of the debt might be demanded immediately, along with the payment of moratory interest.

Despite the strong opposition from the state enterprises, reluctant to sign such an agreement, the government backed down and approved a general agreement for state enterprises in accordance with the lenders' demands. The first concrete agreement was signed with Aerolineas Argentinas.

However, the troubles were still not over. The publication of this agreement caused a strong generalized public reaction that called for the intervention of federal judge Pinto Kramer. Kramer's basic objection was to the submission to the jurisdiction of the New York courts, as convened in the signed agreement (which paradoxically was probably the least serious of the conditions). First he ordered the government not to proceed with the renewal of other pending contracts; later he nullified the agreement already signed with Aerolineas Argentinas; finally he detained the president of the Banco Central, Jorge Gonzalez del Solar, on charges of having apparently failed to fulfill his official obligations in this respect.

On hearing this news the lending banks not only decided to suspend the first installment of the medium-term credit once more but also to suspend the whole credit operation with Argentina. The International Monetary Fund, which had suspended the payment of the third installment because of its inconformity with the fulfillment of the clauses of the standby credit, maintained the suspension. While the government appealed the orders of the judge, the Banco Central suspended the delivery of new import permits and the delivery of foreign currency to travelers. Financial panic ensued. This was the situation at the beginning of October 1983 at the time of this writing.

Furthermore, even though this conflict were to be solved, there is another problem that must not be ignored, about which there is very little information. This is

the exchange insurance and "swap" operations, which totaled US$7 billion. These debts were assumed by the state and postponed unilaterally until 1985 or 1986, the corresponding promissory notes being handed over to the foreign lenders. However, rumor has it that there is disagreement as to the conditions of the rollover established by the Argentine government.

An attempt to estimate Argentina's overall commitments shows about US$2.8 billion that must be paid in interest and amortizations on loans that matured in 1982; US$7 billion in outstanding private debts or debts due to be paid in 1982 for exchange insurance and "swaps"; nearly US$7 billion in capital debts by public enterprises due in 1983; and interest that must be paid on debts maturing after 1983, on debts that were refinanced in 1983, and on outstanding debts. All in all, according to different national and foreign publications, this amounts to a total of about US$21 billion.

This commitment made it necessary to obtain refinancing with foreign resources to the sum of US$17.65 billion, to be divided into the US$3.65 billion that Wehbe hoped to obtain from the IMF and the private international banking institutions, on one hand, and US$14 billion to refinance "swaps," exchange insurance, and the debts of public enterprises. Lastly, it was hoped that approximately US$3.35 billion more would be obtained to pay the remainder, most of which was interest on debts that were either due, outstanding, or refinanced. With this, the above-mentioned US$21 billion would be covered. The US$3.35 billion would be obtained from the expected trade balance surplus and possibly through an additional loan for a much lesser amount, as the agreement with the Fund included restrictions regarding the taking out of further foreign loans. As funds were also needed almost immediately to cover needs until the arrival of the US$3.65 billion, it became necessary to resort to the aforementioned bridge loan of US$1.1 billion and to funds from the BIS estimated at US$650 million.

However, as has been shown, the refinancing plan for the debts was only partially fulfilled due to the increasing difficulties that arose. In Table 9.5, the very small contribution registered so far during Wehbe's term can be seen as regards the obtaining of US$5.4 billion of the aforementioned foreign funds.

To sum up, after two and a half years of crisis, the situation in the fall of 1983 continued unstable. Maturities were not being paid on time, and the problem was being handled on the basis of last-minute decisions made under pressure, amid an atmosphere of conflict and considerable uncertainty and anxiety.

Table 9.5 Argentina: Estimate of Loans Applied for and Received During 1983 (millions of U.S. dollars)

Item	Amount Requested	Entry[a]
Bridge loan from private banks for 1 year	1,100	1,100 in July 1983
IMF: Compensation for diminished exports	560	560 beginning of 1983
IMF: Standby credit, 5 tranches	1,590	636 end of September 1983
BIS: Short-term	650	
Medium-term loan from private banks	1,500	
Total credit granted for outstanding payments and settlement of debts of 1983	5,400	2,946

[a]The loans were agreed upon although in some cases the sums were not delivered to the country but were sent directly to settle accumulated outstanding debts.

Source: Estimates based on information released by Coyuntura y Desarrollo, no. 57; Informe Industrial, no. 67, Clarín newspaper, several different dates; La Nación newspaper, several different dates (all of these published in Buenos Aires); Wall Street Journal, Financial Times, and other foreign publications issued between September 1982 and June 1983.

The Term of Finance Minister Wehbe

As far as Wehbe's influence on internal order is concerned, his economic team began its term with a renewed and progressive unification of the exchange rate, which was completed by November 1982 with the usual recessive and inflationary consequences. As regards the rate of inflation, the proposed 160 percent was overtaken by a considerable amount. The desperate struggle on the part of the wage earners to recuperate their share of income, generalized strikes, the prevailing preelectoral atmosphere, and the progressive loss of authority on the part of the government gave way to massive wage increases that in turn caused an acceleration in the progressive devaluation of the official market rate. At the same time, the sharp rise of the "parallel" dollar market originated by the uncertainty of the situation also had a considerable inflationary effect. As a result, in September 1983 the rate of inflation reached 550 percent per annum.

The guidelines related to the fiscal deficit were breached for several reasons. First, there was unforeseen state expenditure due to floods in the northeastern part of the country to an extent never before experienced in the history of Argentina. Second, phenomena commonly found in all stabilization plans appeared: On one hand, the recessive conditions adversely affected the taxpayers' capacity; on the other, the rise in the rate of inflation led to considerable delay in tax collection. Thus, to a great extent the budget deficit arose as a result of the inflation, which was in turn fed by the struggle for higher income that at least seemed to generate a certain recovery in real wages.

Lastly, as regards monetary liquidity, the expansionary limits agreed to with the Fund--based on an assumed 160 percent inflation--were in fact too low in relation to the accelerated growth of the prices and led to drastic illiquidity. The total credit available at the rate regulated by the Banco Central was completely inadequate in the light of the demands of the economic system. Meanwhile, in September, interest rates rose to 35 percent monthly in the parallel open credit market. In short, even for the Argentines accustomed to tremendous distortion and uncertainty in the economic system, the situation in October 1983 bordered on science fiction.

CONDITIONS FOR A WAY OUT

By the process just described, Argentina found itself in an extremely difficult position. As we have seen, the interest alone on the foreign debt accounted for half the country's exports. The inflow of foreign exchange was never sufficient to sustain even moderate economic growth, so by the fall of 1983 Argentina had at its disposal no more than half the foreign currency amount needed to support its productive structure with imports. Under these conditions, not even the severe recession is sufficient to free the necessary foreign funds to pay the interest on the debt. In other words, to achieve the relatively modest aim of freezing the capital debt and paying the interest alone, an even deeper recession will be necessary.

What are the prospects for a way out? Traditional financial sectors with orthodox tendencies are awaiting a solution in the form of international recovery and a greater demand for Argentine exportable products. However, the basic disequilibrium in the international payments system that led to the present situation still prevails. So, permanent worldwide recovery seems very unlikely. Moreover, even if this reactivation were achieved, this situation might improve but could never solve the problem, because of the magnitude of the foreign debt.

As opposed to the orthodox point of view, political parties place emphasis on the need to renegotiate and to postpone interest payments and payments on the debt principal. The experience of Argentina and other countries has shown that although renegotiation is not difficult, problems arise from the conditions the lenders attempt to impose. Those causing most concern are the typical recessive conditions set by the International Monetary Fund, whose intervention is always insisted upon by the foreign banking institutions. If these are accepted, they render expansion and growth virtually impossible. The question here is whether these recessive conditions are inalterable or whether it is possible to postpone debt service without accepting them.

Let us first consider the reason why the Fund establishes these recessive demands. The main concern of the IMF in approving renegotiation is to ensure that the indebted country takes advantage of the respite granted to it to generate the capacity to service the debt. However, as regards practical free-exchange measures of restraint on which the Fund has imposed its own philosophy, the only effective method remaining that would enable a country like Argentina to attain the surplus in its current balance-of-payments account needed to pay its debts is an overall drop in the level of activity. Thus, the insistence on recessive measures.

Although recession is by no means desirable, the external balancing effect that is sought is essential, even from the point of view of the indebted country. If the necessary funds for the payment of the debt are not generated, the only thing the country would achieve by postponing the maturities would be a brief respite, but it would find itself faced with the same problem two or three years later, aggravated in the interim by the burden of additional accumulated interest and an even greater basic external disequilibrium due to the disparity between imports and exports, which tends to restrict both recovery and growth.

The correct approach to the problem is to reject the recessive orthodoxy of the Fund and to advocate responsible heterodoxy. That is to say, it is not enough to merely reject orthodox procedures; they must be replaced by other measures that will make the repayment of the debt feasible. Specifically, while demanding a nonrecessive renegotiation, the country must design and establish an alternative foreign economic policy capable of providing the surplus of foreign exchange necessary to pay its debts, without the need for recession.

A lasting solution to the present situation in Argentina therefore requires a policy compatible with domestic expansion and equilibrium in the external sector. We are convinced that a policy of this kind is feasible in Argentina, which has a particularly high exporting and substitutive capacity untapped owing to the lack of

the appropriate economic tools.

The Basic Concepts Behind a Compatible Policy

In view of limitations of space, we will simply mention the main conceptual changes that are implied when compared with customary policies.

First, there is the problem of diagnosis. For many years Argentina has alternated between two theoretical models derived from conflicting economic policies. The first is neoclassical, based on orthodox policy. As the past experiences largely demonstrated, it leads to recession, stagnation, and accumulative foreign indebtedness. These consequences are a result of the model's complete inadequacy to cope with reality. But in actual fact, this model is based on the presumed optimum utilization of productive capacity, and the conclusions and priorities derived from it are being applied to a country whose main problem is precisely the subutilization of this capacity.

The alternative model that provides the inspiration for the more acceptable policies and alternates with the orthodox model in the pre-Alfonsín government policies is of Keynesian origin. It would appear that this model is appropriate for Argentina as it is based specifically on assumed reduction in the productive capacity. However, this is an erroneous conclusion: The Keynesian model is applicable to cases in which unemployment is due to spontaneous insufficiency in domestic demand, that is, a fall in demand that occurs where acute contraction of the external sector does not exist; yet the recession in Argentina and countries in a similar position is derived precisely from such a deterioration. The insufficiency in demand that can be observed is not spontaneous, but is deliberately provoked by the Banco Central in order to bring balance to the external sector. It can be overcome with expansionist Keynesian policies once the foreign restraint motivating the insufficiency is overcome.

Therefore, the first step toward a change in economic policy is to adopt a different theory as distinct from the classical and Keynesian theories as these two are from each other, taking as its point of departure the existence of external constraint and the priority of overcoming it.[13]

The second conceptual change concerns the need to accept unbalanced productive structure as part of reality. Argentina has systematically confused the need for protectionist barriers for its industry with industrial inefficiency, attributing the latter to the incompetence or indolence of its entrepreneurs. This ideological prejudice is behind the numerous destructive episodes of "efficiency" and has impeded the design not only of a

stable coherent import-substitution policy but also of a policy for industrial exports. Therefore, it is of prime importance to understand that the gap between international and Argentine industrial prices is not the result of industrial inefficiency, measured in absolute terms, but rather results from the relative disadvantage of industry as opposed to the primary sector, which is characteristic of the initial and intermediate stages of development. For this reason, in the case of unbalanced productive structures based on the coexistence of a highly productive primary sector and a less productive industrial sector, protectionist tariffs on imported goods are not a sign of inefficiency. Rather they constitute an indirect way of generating multiple rates of exchange on imports suited to the industrial parity.

A clear understanding of this concept will pave the way for intense import substitution, which is at present impeded by the notion that relates any increase in industrial prices over and above the international level to inefficiency. Of course, this does not imply substitution at any cost. A rational attitude toward industrialization in Argentina requires that there be a higher rate for the industrial dollar than for the farming dollar, but within reason. An appropriate analytic frame of reference of the kind just mentioned would allow the wealth-generating power of each additional dollar in an economy that has been strangled by an inefficient foreign-exchange system to be compared with the eventual sacrifice in efficiency that goes hand in hand with the assignation of funds for import substitution at a higher than international cost. On the basis of this comparison, the maximum cost of substitution allowable in each different stage of development may be calculated, and incentives for import substitution established within these limits.

The mobilization of industrial exports, which is the third concept to be examined here, is also facilitated by the clarification of the problem of efficiency. We have seen that the main reason for Argentine balance-of-payments problems has been the disparity between exports and imports, due to the impossibility (or at best the difficulty) of exporting industrial products. This difficulty in turn is attributable to the gap between Argentine industrial prices and those of the international market. We stated that the cause of this gap was a relatively lower industrial activity in relation to that of farming activities, as well as the fact that the rate of exchange was based on the productivity of the latter.

As far as import substitution is concerned, this inadequacy in the rate of exchange, when applied to industrial productivity, was gradually overcome through import tariffs applied from the time the industrialization process commenced. But when dealing with exports,

for decades the same rate of exchange was maintained for industry as for traditional farming. It is here that the basic incoherence in Argentina's industrial process lies. On one hand, it was accepted that there was a need for differential rates of exchange when industry worked for the domestic market, but when it was a question of exporting industrial goods, this criterion was not applied.

In order to eliminate constraints in the foreign sector and remove the obstacles to Argentina's growth, this incoherence must be rectified once and for all. To do this it is necessary to modify the underlying philosophy. Instead of insisting on greater industrial efficiency as a condition for exporting, it must be realized that achievement of greater efficiency is one of the goals of the process of industrial development and cannot be considered a prerequisite for the same. Therefore, the degree of industrial productivity attained at any given moment must be accepted as a fact, at least in the medium run. From this can be derived the need to eliminate constraints in the foreign sector. One of the main ways of achieving this is to develop a system of differential incentives for industrial exports.

There are a number of techniques available that could achieve this objective. One is the utilization of a system of tax refunds similar to that used for tariffs. Another is to set the nominal rate of exchange closer to the industrial parity and to readjust the traditional farming industry's rate of exchange through adequate export taxes. The truth is that both procedures have been followed in the last twenty years and are still being utilized in Argentina today. But their application has been so indecisive and inconsistent that they have been quite ineffective. The aim would be to convert these measures, which up until now have merely been used as conjunctural palliatives or as a reluctant concession to industrial inefficiency, into key elements of sector policy and the country's development.

The fourth option involves the encouragement of exportable farming products. The problem here is that a rise in production implies either the cultivation of new land that at present is lying fallow or more intense farming of cultivated land using more technology and investing more capital. Both procedures imply a relatively higher cost for the additional production required (for example, the second tonne of wheat per hectare would cost more than the first). Orthodox policies attempt to encourage increased farming production by means of heavy devaluations and consequent price increase that would compensate for this increased cost. However, these higher prices, apart from being applied to the new production, are also applied to the previous one, the costs of which remain the same. Thus, massive transfers of income are made in favor of the

farming sector. These transfers are unsustainable for the rest of the society and constitute the main provocation of the struggle for increased income and the severe inflationary phenomena in Argentina.

The answer to the problem is to design and establish incentives that would have a marginal effect and be applicable specifically to increases in production without provoking unnecessary transfers of income in favor of production already undertaken. This can be achieved through an appropriate combination of moderate increases in farming prices along with appropriate fixed land tax. Another means is to use state subsidies or to lower taxes on technological input or strategic capital goods necessary to increse the productivity of the land.

The fifth and last technique involves the exchange regime and domestic financial system. In this respect, policies in Argentina move between two extremes. The orthodox policies are always characterized by free exchange and a domestic financial system designed to attract short-term foreign capital. This means either high domestic positive real interest rates or not so positive real rates, combined with postponement of adjustments to the exchange rate. The first variable is heavily recessive. The second, even though it may be expansive, leads to a much more accelerated accumulative foreign indebtedness that in a very short time would lead to a renewed balance-of-payments crisis.

At the other extreme there are the more populist policies that are characterized by interest rates heavily negative in real terms, combined with exchange controls aimed at isolating the domestic financial circuit from the foreign. However, the moment the difference between foreign interest rates and real domestic rates becomes pronounced, the control of the exchange rate is overridden, and there is a heavy flight of capital via the "parallel" foreign-currency market. There is no perfect solution here. The most that can be achieved is a reasonable compromise between the conflicting external and domestic objectives. Such a compromise can only be achieved by:

1. maintaining the exchange control with a basic rate of exchange that retains its real level, that is, that evolves in real terms according to domestic inflation less international inflation
2. establishing the short-term passive bank interest rates at levels that are only slightly negative and the active rates at neutral levels
3. maintaining sufficient monetary efficiency to allow short-term active nonbank rates to establish themselves at a slightly higher positive level than that of the international market
4. providing measures to encourage long-term domestic saving at rates similar to those of the

international market.

If the economic policy is restructured according to these outlines, Argentina may effectively reconcile its economic expansion with the creation of the surplus necessary to service its debt. It is true that from a more traditional point of view, some of the proposed measures may seem costly in terms of the efficient allocation of resources or fiscal expenditure. But, if seen from the point of view of a theoretical model worked out on the basis of the dominant characteristic, that is, constraints in the external sector, these costs become less important in the light of the economic benefits obtained through the recovery and growth that the proposed measures would allow.[14]

Renegotiation of the Debt

Any measure designed to modify the productive structure will take time to bear fruit, even assuming that the external economic policy adopted were very effective, since it would be impossible to eliminate constraints in the external sector immediately. Therefore, the renegotiation of capital debts and part of the interest would have to continue. Nevertheless, the need for recessive conditions would be avoided, because in adopting a nonrecessive program for achieving equilibrium in the external sector--a program based on differential rates of exchange for importers and exporters, greater marginal incentives for farming, and a flexible exchange and finance policy--it would again be possible to show the creditors that Argentina was capable of generating the capacity necessary to settle its debts and to achieve economic expansion.

The problem that arises in this case is that this nonrecessive program would clash with the second condition usually demanded by the International Monetary Fund as regards the withdrawal of protectionist measures, the unification of the rate of exchange, the elimination of differential incentives for nontraditional exports, and other "efficiency" measures. The Fund usually insists on the removal of the measures that Argentina and other countries in a similar position need in order to reconcile economic expansion with equilibrium in the external sector. This paradox is due to the Fund's double objective. Apart from assuming the task of making sure that the economic policies of the indebted countries are compatible with their capacity to settle their debts, because of its traditional ideology the Fund feel that its second task is to safeguard free international trade.

No one with any common sense could fail to see the obvious contradiction between these objectives. The more that differential protectionist measures and those

designed to stimulate exports are eliminated in countries like Argentina, the greater will be the tendency for imports to grow and for industrial exports to diminish. The tendency toward disequilibrium in the external sector will increase, the recession needed to counteract it will have to be greater, and it will be more difficult to implement the IMF program.

From the point of view of doctrine, this contradiction is always denied by the Fund on the basis of neo-classical rationale advocating automatic equilibrium in the foreign sector through free-market activity. Market freedom is insisted upon as an automatic cure for all ills. Nevertheless, in the light of their practical experience, the Fund's officials realize that the procedures proposed by this institution for countries like Argentina for external adjustment do not work according to theory. For this reason although the Fund never proposes heterodox plans for adjustment in the external sector on its own initiative, it may accept them when proposed by the indebted country. The main condition is that the program be theoretically sound. In other words, the International Monetary Fund will ultimately tolerate heterodoxy if and when it is technically reliable.

In Argentina the problem has always been that with the usual oscillation in economic policies, reliable heterodoxy has never occurred. The local orthodox trend has usually tended to be even more rigidly free-exchange-oriented than the Fund itself. In fact, in order to overcome domestic objections to the policies being imposed, the Fund's point of view has often been used as an argument, thus making it appear even more villainous and its negotiable suggestions are presented as categoric impositions impossible to be resisted.

Moreover, up until now the popular opinion has usually repudiated orthodox policies without tackling the basic problem, that is, without proposing coherent concrete alternatives for adjustments in the external sector that would be compatible with expansion. The country's greatest challenge is to get out of this oscillatory movement.

There is still one more aspect of the negotiation to be considered, and that is cost. When payment is postponed the IMF usually applies heavy risk surcharges to the rollover credit, plus rollover commissions and additional surcharges for delayed payment or default. These lack any reasonable justification. In private commercial activity, when a mistake is made and credit is granted to a company that later appears before a creditors' meeting, it is considered satisfactory if the amount lent is recuperated along with the normal accrued interest and without punitive measures. It is highly unlikely that additional gains from the postponement would even be considered.

In the renegotiations between the international banking institutions and indebted countries, the opposite occurs. Here, the postponement of payments has become a considerable additional source of profits for the banks. Furthermore, as can be seen in the agreement with Aerolineas Argentinas, the government tends to agree to legal clauses that are extremely difficult to fulfill. These clauses may totally inhibit freedom of action, impose excessive penalties for even the slightest default, and imply the application of penalties. In short, rather than ensuring payment of the debt, these renegotiation contracts reflect the creditor's intention of taking maximum advantage of the situation and gradually securing the dependence of the debtors.

Why does Argentina allow itself to be subject to these conditions? In this case it is not a question of any real disadvantage in the bargaining situation, but rather the inability of the country to determine its own position adequately. Between Argentina and its creditors there clearly exists a situation of mutual dependence. Argentina cannot run the risk of a suspension of payments for it would mean delinkage from the rest of the world. On the other hand, due to the size of Argentina's debt and the legal implications for the banks of an explicit suspension of payments, the creditors cannot take the risk of this occurring either. In view of this, conditions do exist that would allow very equilibratory negotiations.

The attitude of the Argentine government is not derived from any true balance of power but rather from the lack of any local political cohesion, the habit of always resorting to last-minute negotiations when a suspension of payments is imminent, and the strong ideological, social, and cultural pressure exerted on the country's ruling elites by the international banking institutions. Moreover, the representatives of the leading parties tend to ignore the real severity of the financial conditions and to overestimate the country's negotiating capacity. Hard-line tactics insisted on in the talks in practice are very difficult to sustain. Once more the familiar attitude that oscillates between imagined omnipotence and excessive submission becomes apparent. What is needed is a more serious, more realistic, and less improvisational attitude toward the negotiating process.

THE FUTURE

Is Argentina capable of emerging from the present crisis by adopting a rational attitude and establishing coherent economic policies? Or will the habitual cycle of expansion and recession continue? Certain objective circumstances would appear to indicate that, for better

or for worse, we are on the verge of a great qualitative change.

After many years of military government, elections will be held in Argentina shortly to choose a constitutional government. Drawing a rather loose parallel with the United States, the military government in Argentina could be compared to the Republican administration with its recessive orthodox and economic "recovery" policies. The constitutional government could be compared to the Democrats' expansive Keynesian policies. However, up until now, either as an effect of a recent recession or as a result of a favorable situation in the world market, the representative governments have always been in power in situations where abundant international reserves have made domestic economic expansion possible. On each occasion, this expansion has lasted only as long as the international reserves. This will be the first time that a constitutional government assumes power in the absence of reserves, with the country on the verge of a suspension of payments and with a foreign debt on which the interest alone accounts for half the revenue from exports. Therefore, the government will lack its usual margin of maneuverability in the external sector needed to achieve the reactivation of the domestic market.

On the other hand, the prospects for an eventual swing toward orthodoxy would not be advantageous either. With these turnabouts, after the accustomed "atonement for sins" of the first recessive phase, there was always the prospect of a "reward," typical of phase two and provided by economic expansion on the basis of foreign credit. Such a reward always lasted only as long as the country's debt-servicing capacity. But today the international financial crisis makes further indebtedness on the part of Argentina impossible and will continue to do so for a long time, so that this door to a solution is closed.

Therefore the usual oscillation between expansion and recession would appear to have ended. In the light of the present situation, there are two possible courses to take. If the economic policies followed up until now are not modified, the only alternative will be a prolonged recession, intense enough to allow the payment of interest on the foreign debt. With the present debt magnitude an even deeper recession than the present one is necessary. But with the social, political, and economic tension and national frustration that has accumulated, this alternative is unsustainable and would have unforeseen political consequences.

The second alternative is the adoption of a rational economic policy adapted to the needs of the country. There are two points in favor of this proposal. The first is the growing awareness on the political scene that the days of improvisation are over and that drastic solutions are necessary. The second is the maturing

technical knowledge of the two major democratic parties, one of which will shortly assume power. Today these parties are much more qualified than before to free themselves from the yoke of deep-rooted ideas and to adopt a creative approach in keeping with reality.

The Overall Nature of the Problem

The analysis of Argentina's indebtedness that has been done up until now is incomplete. The present disequilibrium in the balance of payments of the different Latin American countries is not due solely to individual structural problems or to errors in the individual economic policies of each country. Independently of these, the disequilibrium stems also from an overall disequilibrium in the worldwide payments system that arose in part as a result of the oil crisis.

In fact, the major consequence of this crisis was that for almost ten years the oil-importing countries accumulated an overall balance-of-payments deficit on current account in relation to the oil-exporting countries. A number of oil-importing countries were forced to maintain this deficit because, while the worldwide disequilibrium continued, it was not mathematically possible for all countries to maintain an equilibrium in their balance of payments. Finally, mainly as a result of world recession, the overall oil deficit tended to recede. But the surpluses that the oil-exporting countries had accumulated in the interim, which had been recycled via the world banking institutions to the importing countries, continued to generate interest. Thus, the overall deficit in the current account persisted--not, strictly speaking, as a result of the oil crisis but rather of the disequilibrium generated through the servicing of debts that had accumulated as a result. These services have become particularly heavy with the rise in real world interest rates over the last few years.

In this situation, it continues to be impossible for all countries to achieve an equilibrium in their balance of payments on current account, and it is even less likely that they can accumulate the surpluses necessary to settle their debts.[15] It is possible that this objective might be reached by Argentina alone, but if this were the case, it would mean the aggravation of the deficit of some other country or group of countries. Presumably, that country would try to defend itself by restricting imports or encouraging exports, which would then make Argentina's aim to achieve equilibrium even more difficult to attain. The hoped-for recovery of the industrial countries will not solve the problem either, because its immediate effect might be to increase oil prices, which would then aggravate the overall imbalance even more.

A definitive solution applicable to all countries simultaneously can only be found by the combination of policies adapted to the needs of each individual country and by an overall solution for the payments problem. This would imply a heavy reduction in world interest rates and, until the overall disequilibrium has receded, an adequate recycling system established with the intervention of some kind of intergovernmental security network. Above all, it would imply the need for governments and banking institutions to realize that they are not merely facing a simple aggregate of problems arising from countries unable to balance their foreign accounts, but rather the consequences of an overall disequilibrium in the system that must be treated as such. This subject, however, goes beyond the scope of this chapter.

NOTES

1. This is the title of an Argentine film reflecting that particular situation.
2. Aldo Ferrer, "La Deuda Externa Argentina: Problemas y Perspectivas," paper presented at conference held at the University of New York (published in _Informe Ganadero_, Buenos Aires, 1982).
3. An analysis of this exchange effect can be found in Marcelo Diamond, _Doctrinas Económicas, Desarrollo e Independencia_, Buenos Aires, 1973. Also in Marcelo Diamond, "La Estructura Productiva Desequilibrada y el Tipo de Cambio," _Desarrollo Económico_ (Buenos Aires), April-June 1972.
4. A detailed description of the economic model of imbalanced productive structures and their characteristics can be found in Diamond, _Doctrinas Económicas_.
5. This type of inflation is analyzed in ibid.; Marcelo Diamond, "Towards a Change in the Economic Paradigm Through the Experience of Developing Countries," _Journal of Development Economics_ 5:19-53; and Marcelo Diamond, "Los Cuatro Tipos de Inflación Argentina," _Competencia_ (Buenos Aires), April 1971.
6. Calculated on the basis of data from the Banco Central.
7. Guido Di Tella, _Perón-Perón 1973-76_, Buenos Aires, 1983.
8. Antonio Lopez, "La Deuda Externa en Cifras," unpublished (synthesis in the newspaper _Clarín_, Buenos Aires, July 1983).
9. As shown later, the figures for the foreign debt obtained from the Banco Central survey differ from those obtained from the analysis of the balance of payments for 1976 to 1981. Thus, according to the survey, the foreign debt increased during this period by US$27.79 billion, whereas the balance of payments indicates an increase of US$20.0344 billion. This means

a difference of US$7.764 billion.

10. Diamond, *Doctrinas Económicas*.

11. Calculated according to data from IFED, *Coyuntura y Desarrollo*, several issues and statistical appendices, Buenos Aires, 1982.

12. IFED, *Coyuntura y Desarrollo*, no. 50, Buenos Aires, April 1982.

13. Diamond, *Doctrinas Económicas*.

14. Marcelo Diamond, "Hacia una Política del Sector Externo," paper presented at the seminar La Construcción de la Democracia en Argentina, Buenos Aires, August 1983.

15. Diamond, "Towards a Change in the Economic Paradigm."

10
Rescheduling Brazil's Foreign Debt: Recent Developments and Prospects

Paulo Nogueira Batista, Jr.

INTRODUCTION

Since the final months of 1982, Brazil has been involved in the laborious process of rescheduling its external debt.[1] Renegotiating a debt as large as Brazil's is of course a most difficult task. According to official data, in March 1983 Brazil's foreign debt (including short-term obligations) was in the range of US$86 billion[2] of which US$57 billion had been provided by foreign private banks operating within the Bank for International Settlements' reporting area.[3] Given the structure of the debt, two-thirds of which is owed to foreign commercial banks, and the fact that several hundred individual credit institutions from the United States, Europe, Japan, and other countries are involved, the problem of coordinating and keeping in balance all these interests transforms the whole renegotiation process into a veritable administrative nightmare.

In this context, it is difficult to evaluate adequately the recent restructuring and refinancing of Brazil's debt service as implemented by the Brazilian economic authorities with the support of the International Monetary Fund and a group of large U.S. commercial banks. Nevertheless, because of the importance of this issue for the short- and long-term prospects of both Brazil and international financial markets, it is essential to examine how negotiations between Brazil and its foreign creditors are being conducted.

This essay attempts to describe how Brazil's external financial relations have evolved recently, highlighting the major drawbacks in present rescheduling procedures. The first section comments briefly on the origins of the current balance-of-payments crisis and the impact it has had on Brazil's international reserves. The second section discusses the reasons for the early failure of the first phase of debt renegotiations from December 1982 to mid-1983. The third section deals with the general outline of the financing and rescheduling

agreement for 1984, now under negotiation. In the final section, the main problems involved in the present approach to Brazil's debt-servicing difficulties are underlined and an attempt is made to sketch some aspects of a new debt-restructuring strategy. My view is that, unless Brazil's policymakers radically change their attitude toward the foreign debt problem, they will find it difficult to avoid a further deterioration of the country's already serious economic situation.

THE BRAZILIAN FOREIGN-EXCHANGE CRISIS

The immediate cause of the recent foreign-exchange crisis was the sudden, unexpected interruption in the flow of foreign bank credit. This interruption came about in the third quarter of 1982 in the wake of the confidence crisis generated by the Mexican moratorium. However, Brazil's balance-of-payments problems evidently started much earlier, and the drastic reduction in the inflow of external credit has only brought into the open the latent liquidity crisis that had existed since 1980, as can be seen from figures for foreign-exchange reserves presented later in this section.

In fact, Brazil's balance-of-payments situation, already precarious since the first oil crisis of 1973-74,[4] became considerably more serious after 1979 as a result of the second oil shock, the dramatic increase in international interest rates, the world recession of 1980-1982, the contraction in international trade, and the fall in the prices of several of Brazil's major exports. The impact of these external shocks was magnified by the Brazilian economic authorities' failure to evaluate correctly the evolution of the international situation. In fact, economic policy during this period was extremely erratic and totally lacking in a clear definition of main objectives.[5]

Consequently, Brazil's foreign-exchange position at the start of 1982 was already quite unfavorable. After the Mexican payments suspension and its effect on international bank credit, it became increasingly difficult to admit that Brazil's foreign liabilities could continue to be refinanced or "recycled" through normal market mechanisms. In 1982, a series of unfavorable circumstances (a fall in exports, an unexpected increase in interest payments, a reduced inflow of medium- and long-term foreign funds, and the problems involved in refinancing the short-term commercial debt and the liabilities of foreign branches and subsidiaries of Brazilian banks) wore down Brazil's resistance (see Table 10.1).

In November 1982, the Brazilian government made public its intention to seek maximum access to IMF funds. In December, after being assured direct support from the

Table 10.1 Brazil: Balance of Payments (main items), 1968-1982 (in billions of U.S. dollars)

Item	1968-73[a]	1974-78[a]	1979	1980	1981	1982[b]
(A) Trade balance	0.0	-2.3	-2.8	-2.8	1.2	0.8
Exports (FOB)	3.3	10.3	15.2	20.1	23.3	20.2
Imports (FOB)	3.3	12.6	18.1	23.0	22.1	19.4
(B) Services	-1.0	-3.7	-7.2	-9.6	-12.2	-15.5
Interest (net)	-0.3	-1.8	-4.2	-6.3	-9.2	-11.4
Other services[c]	-0.7	-1.9	-3.0	-3.3	-3.0	-4.1
(C) Current transactions (A+B)	-1.0	-6.0	-10.0	-12.4	-11.0	-14.8
(D) Capital	1.9	7.1	6.9	9.3	12.0	6.3
Direct Investments[d] (net)	0.3	0.9	1.5	1.1	1.6	1.0
Currency Loans & Financing (medium- and long-term)	2.3	8.6	11.2	10.6	15.6	12.5
Amortizations (medium- & long-term)	-0.9	-3.3	-6.4	-5.0	-6.2	-7.0
Other	0.2	0.9	0.6	2.6	1.1	-0.3
(E) Errors & omissions	0.2	-0.3	-0.1	-0.3	-0.4	-0.4
(F) Surplus or deficit (C+D+E)	1.0	0.9	-3.2	-3.5	0.6	-8.9

Note: In some cases numbers may not add because of rounding.

[a] Annual average

[b] Preliminary data

[c] Excludes reinvested profits and includes unilateral transfers

[d] Excludes reinvestment

Source: Banco Central do Brasil.

Fund, Brazil presented its major private creditors with a global financial scheme for 1983 and decided to partially suspend amortization payments. In spite of the bridge loans provided by a group of large private international banks, the U.S. Treasury, the Bank for International Settlements, and the first tranche of the compensatory financing facility from the IMF, Brazil's international reserves were considerably lower at the end of 1982, falling from US$7.5 billion in December 1981 to only US$4 billion by December 1982.

Furthermore, it must be noted that these official figures, which refer to the "international liquidity of the monetary authorities," provide only a partial indication of the real situation. In fact, these figures should not be considered as correct indicators of the effective international liquidity of the monetary authorities. First, because there is some uncertainty as to the real convertibility of the assets registered as international reserves by the central bank. Although the exact composition of the reserves is unknown, there are indications that foreign-exchange crises in several of Brazil's trading partners, such as Poland and Mexico, to which substantial amounts of export finance credit had been extended, have led to a reduction in the value and effective liquidity of some assets included in Brazil's official reserves statistics. Second, since these figures correspond to gross assets (see Table 10.2), the monetary authorities (and other government agencies) can artificially maintain official liquidity levels by taking out short-term credits or through accounting operations with branches of Brazilian banks abroad. This is exactly what seems to have been happening in Brazil over the past three years. As can be seen from the data in Table 10.3, the monetary authorities' short-term liabilities increased significantly during 1980 and were consistently above US$3 billion in 1981. In the early months of 1982, they increased considerably again. The reduction in net reserves was much greater than the reduction in gross reserves in this period, and the former have almost always stood at less than the value of two months' imports since mid-1980.

More recent data for September 1982 were included in the Technical Memorandum annexed to the Letter of Intent sent to the IMF on January 6, 1983 (see Table 10.4). On September 30, 1982, the gross reserves of the monetary authorities came to a total of US$4.3521 billion and short-term liabilities to US$3.3037 billion. Thus, net international reserves amounted to only US$1.0484 billion, equivalent to less than twenty days' imports.

By the end of 1982, net international reserves of the Brazilian monetary authorities, as defined in the Technical Memorandum of Understanding, were already *negative* by several billion dollars. In December 1982 the total of short-term foreign liabilities of both the

Table 10.2 Brazil: Gross International Reserves of the Monetary Authorities (Banco Central and Banco do Brasil), 1976-1982 (in millions of U.S. dollars)

Period	Special Drawing Rights (A)	Reserve Position in IMF[a] (B)	Foreign Exchange[b] (C)	Gold[c] (D)	Gross Reserves of Monetary Authorities (E=A+B+C+D)
1976: December	199	188	6,101	56	6,544
1977: December	210	195	6,787	64	7,256
1978: December	239	181	11,406	68	11,894
1979: December	383	241	8,342	722	9,688
1980					
March	468	262	6,185	1,036	7,951
June	508	288	4,825	953	6,574
September	504	271	4,534	1,179	6,488
December	384	344	5,042	1,143	6,913
1981					
March	456	301	4,749	971	6,477
June	447	258	4,496	948	6,149
September	444	255	4,759	887	6,345
December	452	264	5,888	905	7,509
1982					
March	439	260	5,594	789	7,082
June	425	274	5,428	814	6,941
September	189	282	4,714	871	5,056
December	0	287	3,641	65	3,993

[a]Unconditional IMF related reserve assets

[b]Claims against foreigners in the form of bank deposits, treasury bills, and other documents that may be used to cover balance-of-payments deficits, including nonnegotiable credit bills obtained through agreements between central banks or governments

[c]Since October 1979 gold has been assessed on the basis of the daily average closing quotations in London during the preceding two months.

Source: International Monetary Fund.

Banco Central and the Banco do Brasil, plus the liabilities incurred by making use of IMF funds, exceeded the value of their foreign assets by approximately US$3.0 billion.[6]

DEBT RENEGOTIATION: THE FIRST ROUND

On December 20, 1982, the Brazilian economic authorities presented the country's major bank creditors with a comprehensive financial program for 1983, subdivided into the following four projects:

Table 10.3 Brazil: Net International Reserves of the Monetary Authorities, 1976-1982 (in millions of U.S. dollars)

Period	Gross Reserves of Monetary Authorities (1)	Short-Term Liabilities of Monetary Authorities (2)	Net Reserves of Monetary Authorities (3=1-2)	Imports[a] (FOB) (4)	Reserves/ Imports Ratio (%) (5=3/4)
1976: December	6,544	887	5,657	13,196	42.9
1977: December	7,256	1,040	6,216	11,934	52.1
1978: December	11,894	1,613	10,281	14,465	71.1
1979: December	9,688	1,763	7,925	21,950	36.1
1980					
March	7,951	2,883	5,068	21,931	23.1
June	6,574	3,147	3,427	22,999	14.9
September	6,488	3,329	3,159	24,174	13.1
December	6,913	3,413	3,500	22,717	15.4
1981					
March	6,477	3,578	2,899	22,423	12.9
June	6,149	3,403	2,746	22,261	12.3
September	6,345	3,258	3,087	22,441	13.8
December	7,509	3,237	4,272	21,238	20.1
1982					
January	7,284	3,808	3,476	21,036	16.5
February	7,080	4,769	2,311	19,738	11.7
March	7,082	4,577	2,505	19,216	13.0

[a] Imports of preceding three months at annual rate

<u>Source</u>: Banco Central do Brasil and International Monetary Fund.

Table 10.4 Brazil: Net International Reserves of the Monetary Authorities (Banco Central and Banco do Brazil), September 30, 1982 (in millions of U.S. dollars)

(A) Assets	4,352.1
Spot Assets	1,386.1
Short-Term Assets	2,617.4
Medium- and Long-Term Assets	348.6
(B) Liabilities	3,303.7
Spot Liabilities	--
Short-Term Liabilities	3,303.7
Medium-Term Liabilities (IMF)[a]	--
(C) Net International Reserves (A-B)	1,048.4

[a]Includes all repurchase obligations arising from the use of Fund resources in the first credit tranche, under the extended agreement, the compensatory financing facility, and the buffer stock financing facility

Source: Technical Memorandum of Understanding (annexed to Letter of Intent of January 6, 1983).

1. a "jumbo loan" of US$4.4 billion to be provided by foreign commercial banks in proportion to their outstanding credits to Brazil
2. the rescheduling of amortizations due to foreign banks in 1983 (total value estimated to exceed US$4.0 billion)
3. the renewal of short-term commercial credit lines
4. the restoration of total interbank lines for foreign branches and subsidiaries of Brazilian banks to the level observed in mid-1982.[7]

The volume of funds requested depended of course on the forecasts for the current and capital accounts of the balance of payments, including the estimates concerning short-term foreign debt and interbank debts of the subsidiaries and foreign branches of Brazilian banks. The central aspect of the projections was Brazil's commitment to generate an unprecedented surplus of US$6.0 billion in its trade balance and to ensure an also unprecedented reduction of over 50 percent in its current account deficit in 1983. It was hoped that the resources provided by these four projects along with loans from official credit sources, suppliers' credits, and direct investment would create a capital account surplus sufficient to cover the deficit on current account and to finance an increase of approximately US$1.0 billion in gross international reserves.

It must be stressed first of all that even if the financial program for 1983 had been successful in all its basic points, it would not have been able to assure a

smooth administration of Brazil's foreign accounts. When one considers that Brazil started 1983 with negative net reserves, and gross reserves totaling less than three months' imports, it is obvious that an increase of barely US$1.0 billion in reserves would not have brought about any significant change in the country's foreign-exchange situation. Despite the adjustment effort implicit in a reduction of over 50 percent in the current account deficit, Brazil's external vulnerability would still have been extremely high by the end of 1983.

In fact, most of the new resources provided by the foreign commercial banks and the IMF in 1983 were already committed to the settlement of bridge loans disbursed during the final quarter of the previous year. More than 60 percent of the resources to be provided by the IMF in 1983 were to be primarily destined to settle short-term debts owed to the U.S. Treasury and to the BIS; more than 50 percent of the US$4.4 billion jumbo loan was to be used in the settlement of bridge loans advanced by commercial banks. More important, however, is the fact that the program proposed to the foreign banks was based on a series of rather controversial hypotheses regarding the behavior of Brazil's foreign accounts in the short term. In fact, the four-project package proposed in December 1982 did not contain enough medium- and long-term financial resources and therefore became excessively dependent on short-term credit lines.

After a few months, it became apparent that the plan for adjustment and foreign financing designed by the Brazilian government for 1983 could not be fulfilled as initially formulated. Brazil was then obliged, even before the end of the first semester of 1983, to seek a way of broadening the scope of the financing program presented to the private international banks in December 1982. It had become absolutely clear that one of the basic assumptions of the program was unrealistic, namely, the assumption that foreign banks would voluntarily maintain or even increase their short-term exposure with Brazil or foreign branches of Brazilian banks. The partial failure of the third project (short-term commercial liabilities) and, in particular, of the fourth project (reestablishment of interbank lines for foreign branches of Brazilian banks) seems to have largely contributed to the deterioration of the situation. The obstinate resistance of a substantial part of the international banking community prevented Brazil from reaching the expected levels of short-term financing. This resistance can be attributed to a number of factors, the most obvious being a general dissatisfaction with the way in which negotiations were carried out, the incompatibility of the fourth project with the normal functioning of the interbank market, a general lack of confidence in Latin American borrowers, growing doubts concerning Brazil's trustworthiness, and, finally,

discontentment among various banking sectors in face of the preeminence of New York banks during the negotiations on the four Brazilian projects.[8]

Furthermore, as has already been stated, the four-project program was based on a series of controversial hypotheses regarding the behavior of Brazil's foreign accounts in 1983. From monthly data issued by the government, one could see that the balance-of-trade surplus would probably equal, or even exceed, the target of US$6.0 billion. Nevertheless, on the whole the foreign accounts did not adjust to the government's forecasts for 1983, and there was a considerable deterioration in the global balance-of-payments position. The discrepancies between targets and actual results seem to have been partly due to a larger than expected deficit in the interest and other services accounts. More important, however, were the deviations observed in capital account of the balance of payments. As a result of the failure of the fourth project, of a substantial fall in foreign direct investment, and of delays in the disbursement of loans, net reserves became increasing negative while the volume of payment arrears expanded. Under these circumstances, Brazil was unable to respect the quarterly ceilings for the global balance-of-payments deficit agreed upon with the IMF.

In fact, the inevitable redefinition of the debt-renegotiation process suffered considerably from the premature failure of the first and second versions of the internal adjustment program negotiated between Brazil and the Fund. The four-project program was merely a financial compensation for a severe adjustment program approved by the IMF Executive Board in February 1983. The disbursement of resources for the first project was linked contractually with the release of IMF funds, which in turn depended on the quarterly monitoring of the adjustment program and the previously established performance criteria.

In mid-April 1983, the president of the Banco Central announced the IMF's decision to suspend the disbursement of the second tranche of its loan to Brazil until the reasons for the nonfulfillment of some of the performance criteria were clarified. Brazil had greatly exceeded the targets fixed for the public sectors' borrowing requirements as well as for the net domestic assets of the monetary authorities and for the global balance-of-payments deficit.[9] Thus, in less than two months it had become public that the agreement signed in January and revised in February had become obsolete. The targets were so unrealistic that the quantitative criteria stipulated in the Letter of Intent prepared at the end of February proved impossible to achieve only one month later.

In fact, the shortcomings of the adjustment program, as well as the speed with which this first phase of

negotiations between the Brazilian authorities and the IMF had been concluded, did show, on one hand, a negligent attitude on the part of Brazil and, on the other, a lack of understanding of the peculiarities of the Brazilian economy by the IMF technical staff. As a result, the disbursement of credits that had already been agreed upon was called to a halt, and there was a growing erosion of the domestic and foreign credibility of Brazilian policymakers.[10]

The combination of these problems exerted unprecedented pressure on Brazil's foreign accounts. Since its international reserves were exhausted and it was impossible to continue raising short-term compensatory loans, Brazil had no alternative but to allow arrears to accumulate. Brazil's net international reserves, already negative by several billion dollars at the end of 1982, were even further reduced in the first semester of 1983. At the end of June, the short-term and medium-term (IMF) liabilities of the monetary authorities exceeded the value of their foreign assets by some US$4.5 billion (see Table 10.5). The total sum of payment arrears amounted to almost US$1.0 billion at the end of March[11] and exceeded US$2.5 billion at the end of August.[12]

DEBT RENEGOTIATION: THE SECOND ROUND

Given the failure of the first financing and adjustment program negotiated with the foreign commercial banks and the IMF, the Brazilian government was forced to initiate a second round of negotiations halfway through 1983. However, the delay in arriving at a new agreement with the IMF resulted in the slowing down of negotiations with foreign commercial banks and other sources of credit. Although negotiations had not been concluded at the time of this writing, the new version for the program had already been outlined, permitting a preliminary evaluation.

The new foreign financing program has been designed to meet the credit requirements for 1984 and to cover the shortfalls of the 1983 program. The most important change is perhaps the decision to apply to the Paris Club, that is, to reschedule the amortizations and interest due on loans from foreign governments or guaranteed by foreign governments. During the previous round of negotiations, only medium- and long-term amortizations due to foreign banks (and Brazilian banks abroad) were rescheduled. There has also been a slight reduction in the spread (and other costs) and an extension of the grace period and the final maturity applied in the first project (US$6.5 billion in "new money") and the second project (rescheduling of amortizations due to banks in 1984). Finally, there are signs that the governments of industrialized countries will be willing to step up,

Table 10.5 Brazil: Net International Reserves of the Monetary Authorities (Banco Central and Banco do Brasil), June 30, 1983 (in millions of U.S. dollars)

(A) Assets	2,940.8
Spot Assets	677.8
Short-Term Assets	1,739.7
Medium- and Long-Term Assets	523.3
(B) Liabilities	7,434.8
Spot Liabilities	--
Short-Term Liabilities	5,978.3
Medium-Term Liabilities (IMF)[a]	1,456.5
(C) Net International Reserves (A-B)	-4,494.0

[a]Includes all repurchase obligations arising from the use of Fund resources in the first credit tranche, under the extended arrangement, the compensatory financing, and the buffer stock financing facility

Source: Technical Memorandum of Understanding (annexed to Letter of Intent of September 15, 1983).

although only marginally, their level of involvement in financing the country's imports.

Despite these improvements it cannot be said that there has been a basic change in the manner of approaching the issue of debt renegotiation. Given that the debt owed to foreign governments (or guaranteed by government agencies) amounts to a relatively small fraction of total debt, applying to the Paris Club does not imply any significant increase in the liabilities subject to rescheduling. As far as the cost of bank credit is concerned, the new program will not improve conditions significantly: The .125 percent reduction in spread should lead to a reduction of only about US$15.0 million in interest payments in 1984 and the extension of the final maturity (from 8 to 9 years) will have no significant effect on the debt's time structure. However, the increase of the grace period from 2½ to 5 years will help avoid a major concentration of payments in the mid-1980s.

It ought to be emphasized, however, that all these changes and amendments are part of a program that at present is still under negotiation. It must also be stressed that these changes are clearly only of secondary importance. In fact, the program resulting from this second round of negotiations retains all the major characteristics of the first one. The adjustment program outlined in the third version of the Letter of Intent is as harsh as or even harsher in its approach than the previous documents.[13] The new agreement with the IMF continues to demand a substantial reduction in the current account deficit and in the public-sector's borrowing requirements without providing adequate foreign financing in compensation. In fact, this new program will probably

not allow an appreciable increase of international reserves in 1984. The main problem appears to be that Brazil is supposed to continue paying nearly all interest payments. To highlight the inadequacy of the present program, one only has to compare the volume of new loans put at Brazil's disposal for 1984 with estimates referring to the interest account. Approximately US$4.0 billion of the new US$6.5 billion jumbo loan was in fact to be used to cover additional credit requirements in 1983, meaning that liquid funds available from this loan in 1984 will cover less than one-third of the estimated US$9.0 billion of interest payments due to foreign commercial banks in the same year. Excessively ambitious targets for the trade balance and the consequent adoption of policies that increase inflationary pressures and/or reduce the level of economic activity are thus made inevitable.

In these circumstances one cannot exclude the possibility of a third round of negotiations in the not too distant future. In all probability, new talks would involve a redefinition not only of the foreign financing program but also of the terms of adjustment imposed by the IMF. Nonetheless, one should not forget that this never-ending process of negotiation and renegotiation aggravates domestic instability and makes the task of finding a suitable solution to the problems posed by Brazil's foreign debt even more difficult. Alternative debt-restructuring strategies, which by now appear to be essential, will be dealt with in the following section.

MAIN PROBLEMS INVOLVED IN THE PRESENT APPROACH AND AN OUTLINE FOR AN ALTERNATIVE DEBT-RESTRUCTURING STRATEGY

The attitude adopted by the Brazilian government since the opening of formal debt renegotiations in late 1982 has been far too cautious and hesitant. The initial attempt (by now totally discredited) was to differentiate Brazil from the rest of Latin America. Brazil even went so far as to try to project an image of itself as the victim of the effects of a confidence crisis generated by events in Mexico and Argentina. Instead of presenting an explicit policy program and a coherent debt-renegotiation scheme, Brazil engaged in a series of dubious delaying maneuvers that have primarily resulted in a continuous decline in the possibility of serious negotiations with the IMF and bank creditors.

But the basic problem with the economic policies supported by the IMF and the international banks is that the degree of adjustment demanded from Brazil is clearly excessive, threatening to surpass the limits deemed tolerable from both political and social points of view. From 1983 on, Brazil will be obliged to effect a *premature* transfer of real resources abroad. For the first time in many years, aggregate expenditure on investment

and consumption will be considerably lower than the gross domestic product. The difference will be transferred abroad in the form of a positive balance in the trade and nonfactor services accounts. In 1983 this outward transfer was to amount to about US$3.0 billion.

From the new Letter of Intent sent to the IMF on September 15, 1983, it can be deduced that this trend would continue during 1984. If official targets are fulfilled, there will be a negative "resource gap" of about US$6 billion in 1984, that is, an outward transfer twice as large as the one observed in 1983. In fact, if the balance between adjustment and financing is not changed, this premature transfer of resources will be a great burden to Brazil throughout the 1980s and could substantially reduce its capacity for economic growth.[14]

The increase in the next external debt reflects essentially the difference between the current account deficit and the net inflow of direct investment. Ignoring other factor services, unilateral transfers, and net lending to other countries, the rate of growth of the net stock of debt is determined by the resource gap, the average international interest rate, and the net foreign-exchange contribution of equity capital:

$$\frac{\Delta ED}{ED_{t-1}} = \frac{RG}{ED_{t-1}} + \frac{I}{ED_{t-1}} + \frac{DI-PD}{ED_{t-1}}$$

where ED = net external debt, RG = resource gap, I = interest payments (net), DI = direct investment (net), and PD = profits and dividends (net).

Assuming that the remittance of profits and dividends is more or less compensated for by the inflow of direct investment, the resource gap can be seen as reflecting the difference between the rate of growth of the debt and the average international interest rate:

$$\frac{RG}{ED_{t-1}} = \frac{\Delta ED}{ED_{t-1}} - \frac{I}{ED_{t-1}}$$

Under present circumstances, international banks, the major source of credit for Brazil, are apparently refusing to agree to an increase of their exposure above 7 or 8 percent annually.[15] Unless there is an increase in official and multilateral credits, and if the average annual interest rate remains at the present level of about 13 percent, Brazil will have to generate during the next few years net exports of goods and nonfactor services equivalent to 6 or 7 percent of outstanding debt. We therefore face a hitherto unknown situation in which a low-income country such as Brazil is having to transform itself overnight into an exporter of real resources, as a result of a large and unexpected reduction

in foreign loans.[16]

Instead of accepting commitments of this nature and programs that require a substantial transfer of real resources abroad, Brazil should make it clear that it is not prepared to bear the full burden of a balance-of-payments crisis that was partially caused by external factors, such as the rise in the price of oil, unresolved contradictions in U.S. economic policy, a dramatic increase in international interest rates, and world recession, coupled with an abrupt and unexpected contraction in the inflow of foreign bank loans since mid-1982. A sharing of the adjustment burden is unavoidable given the critical situation in which Brazil finds itself as a result of policy mistakes and also of a protracted international crisis.

International banks, which in the past have benefited substantially from making loans to Brazil, will have to prepare themselves to accept emergency solutions and to absorb losses. They must now recognize that Brazil is not in a position to cover interest payments with an increasing trade surplus and a continuously growing transfer of real resources abroad. On the other hand, it must also be recognized that the banks themselves are facing serious restrictions and going through a crisis on a scale unknown since the 1930s. The simultaneous nonfulfillment of obligations on the part of major debtors such as Brazil, Mexico, Argentina, Poland, and Venezuela will probably have a lasting negative effect on the growth rate of international bank credit. Recent estimates show that Brazil's total interest payments will reach approximately US$35.0 billion in 1984-1986.[17] Since these payments will not be financed with additional credit flows, it seems inevitable that the interest on the debt be rescheduled. If not, Brazil and other debtor countries will be forced to generate massive outward transfers of real resources.

There are clear advantages in capitalization of interest payments as compared with the present system for partial financing of interest by jumbo loans organized in a semicompulsory manner and based on a combination of political pressure on the banks and very high spreads. First, rescheduling interest payments could lead to a change in the balance between adjustment and financing, avoiding (or at the very least minimizing) the outward transfer of resources. Second, automatic protection would be provided against an unexpected rise in international interest rates. Third, it would allow Brazil to negotiate a significant reduction in spreads and also extend maturities, since it would no longer be necessary to attract the banks' participation in jumbo loans by enticing them with extortionate financial conditions. In fact, given support from bank supervisory authorities and changes in bank regulations in certain countries, rescheduling interest repayments could be a more favorable

solution even for the banks themselves. Contrary to the financing of interest payments via new loans, the capitalization of interest would automatically guarantee the balanced and equitable involvement of the several hundred individual creditors in financing the additional requirements of Brazil. In these circumstances, the exposure of each bank in Brazil would increase proportionately to loans outstanding.

A realistic debt restructuring adjusted to Brazil's effective repayments possibilities should include the following basic points: (1) rescheduling of all, or almost all, medium- and long-term amortizations; (2) rescheduling or capitalization of interest payments; (3) conversion of short-term financial debt into medium- or long-term debt; (4) lengthening of maturities and considerable reduction in spreads and other charges and commissions imposed by the banks in recent deals; and (5) extension of the consolidation period (the period in which payments to be rescheduled fall due) from one to three or five years. A realistic restructuring of the debt service due over the next few years would avoid (or at least reduce) outward resource transfers and enable Brazil to defend the level of domestic employment, rebuild international reserves, and bring under control inflationary pressures caused by external constraints. If Brazil fails to win the understanding and support of its creditors, it will probably be obliged to adopt a very inflexible approach in the future and impose conditions on a unilateral basis. In Brazil, it is becoming increasingly clear that a radical change of attitude is essential if the country is to restore a minimum level of economic growth and bring inflation under control over the next few years.

NOTES

1. This chapter was written on the basis of information available in October 1983. Part of this study was carried out with financial support from the Instituto de Planejamento Econômico e Social Aplicado (IPEA).

2. Banco Central do Brasil, Informativo Mensal, September 1983, p. 11.

3. Data reported by banks in the Group of Ten countries; by Luxembourg, Switzerland, Austria, Denmark, Ireland, and by branches of U.S. banks in the Bahamas, the Cayman Islands, Panama, Hong Kong, and Singapore. Bank for International Settlements, International Banking Developments--Second Quarter 1983, Monetary and Economic Department, Basle, October 1983, p. 1 and table 5.

4. For an analysis of the effects of external shocks and Brazil's economic policy response in the years 1974-1978, see Antonio Carlos Lemgruber, Paulo Nogueira

Batista, Jr., and Roberto Fendt, Jr., Choques Externos e Respostas de Política Econômica no Brasil: O Primeiro Choque do Petróleo, Estudos Especiais IBRE, no. 3, Rio de Janeiro, 1981.

5. For a recent evaluation of the Brazilian economy and its place in the world economy, see Edmar L. Bacha and Pedro S. Malan, "Brazil's Debt: From the Miracle to the Fund," paper presented at the conference on Democratizing Brazil? Yale University, March 1983; and Pedro S. Malan and Regis Bonelli, "Crescimento Economico, Industrializacão e Balanco de Pagamentos: O Brasil dos Anos 70 aos Anos 80" (IPEA/INPES, Texto para Discussao Interna no. 60, October 1983, mimeo).

6. According to preliminary information included in a report prepared by the technical staff of the IMF, the net reserves of the monetary authorities were negative by US$1.5 billion on December 31, 1982 (see the appendix to the speech given by the finance minister, Ernane Galveas, "A Crise Mundial e a Estratégia Brasileira de Ajustamento do Balanço de Pagamentos," in the federal Senate on March 23, 1983). Since the estimated balance-of-payments deficit for 1983 was later increased by US$1.4 billion, net international reserves must have been negative by almost US$3.0 billion at the end of 1982.

7. Carlos Geraldo Langoni, "A Estratégia do Brasil na Crise Financeira Atual," speech given in New York on December 20, 1982, at a meeting of Brazil's major bank creditors (published by the Brazilian press on December 24, 1982).

8. For a good journalistic description of some of the problems of this first round of debt negotiations, see "The War Among Brazil's Bankers," Fortune, July 11, 1983, pp. 50-55.

9. According to a document prepared by the Western Hemisphere Department of the IMF, released unofficially by the Brazilian press on July 8 and 9, and also in accordance with the Letter of Intent sent to the Fund on September 15.

10. For an account of recent negotiations between Brazil and the IMF, see Maria Silvia Bastos Marques and Paulo Nogueira Batista, Jr., "A Terceira Versão do Acordo Brasil-FMI" (Fundação Getulio Vargas, IBRE/CEMEI, October 1983, mimeo.), pp. 3-7. For an analysis and critical observations on the theoretical model used by the IMF, see, for example, Edmar L. Bacha, "The IMF Threat: The Prospects for Maladjustment in Brazil" (Pontifícia Universidade Catolica de Rio de Janeiro, May 1983, mimeo.); Maria Silvia Bastos Marques, "O Conceito de Ativos Domésticos Líquidos e Sua Aplicação ao Brasil" (Fundação Getulio Vargas, June 1983, mimeo.); Paulo Nogueira Batista, Jr., "Em Defesa de Critérios de Desempenho Indexados" (Fundação Getulio Vargas, IBRE/CEMEI, June 1983, mimeo.); Edmar L. Bacha, "Do Brasil para o FMI: Prólogo para a Terceira Carta" (Pontifícia

Universidade Catolica de Rio de Janeiro, June 1983, mimeo.); Rogério L. F. Werneck, "A Armadilha Financeira do Setor Público e as Empresas Estatais" (Pontifícia Universidade Catolica de Rio de Janeiro, June 1983, mimeo.).

11. Preliminary data released by the Bano Central in April 1983 to the foreign banks participating in the liaison committee. Later these figures were also made available to the Brazilian press, indicating that at the end of March the central bank's cash position was negative by US$999 million.

12. See para. 8 of the Technical Memorandum annexed to the Letter of Intent of September 15, 1983.

13. For a recent analysis of the third version of the agreement between Brazil and the IMF, see Bastos Marques and Batista, "A Terceira Versão," pp. 8-34.

14. Since Brazil's net exports of goods and "nonfactor" services only cover a part of factor payments to nonresidents, total domestic expenditure is greater than the GNP. Despite the fact that domestic expenditure is now lower than GDP, there is still a fairly large deficit on current account that basically corresponds to the difference between net factor payments and the surplus in the trade and "nonfactor" services accounts. The excess of GDP over aggregate domestic expenditure "finances" part of the income transferred in the form of interest payments, profits and dividends, and so on.

15. The US$4.4 billion "jumbo loan" of 1983 represents a 7.5 percent increase in bank exposure to Brazil, as estimated by Banco Central, _Informativo Mensal_, January 1983, p. 8.

16. Paulo H. Pereira Lira, "A Crise Internacional da Dívida Externa--Um Tratamento Orientado para o Crescimento," paper presented at conference on the International Debt Crisis held in London, sponsored by the International Banking and Finance Centre, The City University, October 5, 1983.

17. Pedro Sampaio Malan and Paulo Nogueira Batista, Jr., "Estimativa das Necessidades de Financiamento Externo do Brasil até 1986" (July 1983, mimeo.), table 1.

11
The Mexican External Debt: The Last Decade

Ernesto Zedillo Ponce de León

Until a decade ago the history of Mexico's foreign debt had comprised four clearly distinguishable periods. First, the period from 1824 to 1888. These two dates mark the year that the country obtained its first significant foreign loan and the year the original English debt of 1824 and 1825 was finally settled after many bitter incidents involving defaults, moratoriums, and the like. The second period was from 1888 to 1911, which essentially corresponds to the Porfiriato era. During the period, thanks to the image of political stability and improved management of public finances, Mexico enjoyed ready access to foreign financing. As a consequence, the country's foreign debt grew more than eightfold. Third was the period ranging from the start of the Mexican Revolution to the signing of the Suárez-Lamont Agreement in 1942. During these difficult years, the Mexican government was repeatedly unable to fulfill its foreign-debt obligations or to reach a rescheduling agreement with its creditors. The episode was finally closed with the signing of a rather advantageous agreement for Mexico, as had happened in 1888. The fourth period was from World War II until the early 1970s. During those years, in which the country regained its access to international capital markets, foreign financing was mostly obtained from official sources and was kept in a modest proportion with respect to most macroeconomics aggregates. If not quite unimportant, the role of foreign financing was strictly limited to supplementing other policy instruments.[1]

1973 was a real turning point. Between 1954 and 1972, the net flow of the foreign public debt averaged US$218.7 million a year. It increased to something more than US$1.6 billion in 1973 alone and kept growing in subsequent years. As a consequence, the stock of the foreign public debt, which amounted to US$6.8 billion at the end of 1972, increased to almost US$21 billion by the time the Echeverría administration was over (1976) and to US$58.1 billion when President López Portillo left

office (1982). Considering the foreign debt of commercial banks and of private-sector firms, the country's total external debt had reached US$27.5 billion in late 1976 and US$84.1 billion six years later. Not surprisingly, the last two financial crises experienced by Mexico (1976 and 1982) have been closely linked to the external-debt problem.

It is the purpose of this chapter to review--albeit briefly and rather informally--the evolution of Mexico's foreign debt since 1973. For reasons of relevance and opportunity, emphasis will be given to the latest events.

THE ECHEVERRÍA EPOCH (1971-1976)

As far as the growth of the external debt is concerned, the first two years of President Echeverría's term were not different from the Stabilizing Development period,[2] yet the active pursuit of financial stability that still commanded a great deal of importance in 1971 started to taper off in 1972. For one thing, GDP growth in 1971 had been the smallest in eighteen years. On the other hand, there was a mounting current of opinion at the highest government level that felt the economic policy model in effect since the mid-1950s had been "exhausted," and therefore a change in priorities and in courses of action was long overdue. Consequently, public expenditure began to expand.

Notwithstanding that the new strategy had an immediate negative impact on the public sector's deficit and on monetary expansion, it seemed to work properly in many other important respects: GDP growth surged to 8.5 percent, inflation was a bit more than 5 percent, and the current account deficit was not very different from the levels registered in the two previous years--around US$1 billion (see Table 11.1). These results reaffirmed the stance of those advocating a more active government involvement in the solution of social and economic problems through the expansion of public expenditure.

The "new medicine" was applied vigorously in 1973: Public expenditure as a proportion of GDP, which had averaged 21 percent during 1966-1970, reached 27 percent, whereas the overall public sector's deficit relative to GDP (historically less than 2.5 percent) soared to 6.9 percent. This time, however, the "magic of 1972" worked rather imperfectly. Inflation climbed to a double-digit figure for the first time in almost two decades, and the current account deficit jumped to US$1.5 billion. Yet GDP growth was sustained at the highly respectable rate of 8.4 percent, and furthermore, financing of the enlarged external disequilibrium did not pose an important problem. As stated before, the net flow of the foreign public debt was easily increased many times over its

Table 11.1 Mexico: Some Basic Indicators of the Echeverría Term

Year	Real GDP Growth[a] (%)	Inflation[b] (%)	Public-Sector Deficit[c] (%)	Public Expenditure[d] (%)	Public Income[d] (%)	Current Account Deficit (millions of U.S. dollars)
1966-1970[e]	6.9	3.5	2.5	21.1	19.0	750.5
1971	4.2	5.3	2.5	20.9	18.2	928.9
1972	8.5	5.0	4.9	23.6	18.5	1,005.7
1973	8.4	12.0	6.9	27.0	19.8	1,528.8
1974	6.1	23.7	7.2	28.3	20.9	3,226.0
1975	5.6	15.1	10.0	33.2	23.0	4,442.6
1976	4.2	15.8	9.9	33.6	23.5	3,683.3

[a] Mexico's National Accounts were revised in 1980; as a consequence, GDP growth figures from 1970 onward have been adjusted upward.

[b] For 1966-1970 the average annual percentage increase in the workers' cost of living was used. For 1971 onward the average annual percentage increase in the consumer price index was taken.

[c] The overall financial deficit as a percentage of GDP

[d] As a percentage of GDP

[e] Average for the period

Source: Nacional Financiera, La Economía Mexicana en Cifras (México, D.F., 1981); Banco de México, Indicadores Económicos, Subdirección de Investigación Económica, several issues; Banco de México, Indices de Precios, Subdirección de Investigación Económica, several issues; Secretaría de Hacienda y Crédito Público, Estadísticas Hacendarias del Sector Público, Dirección General de Evaluación Hacendaria, 1983.

trend value.

In spite of the significant acceleration of inflation and the financial and current account disequilibria of 1973 and of the following year, economic policy was kept on the same track until the end of the administration. The early warning signals did little to induce a change of course. Undoubtedly, there was a marked change in the priorities of policymakers during those years, partly provoked by the past accumulation of social and political demands and partly the result of the very peculiar way in which President Echeverría exercised his governmental authority. Yet the main justification for the economic policy that prevailed at the time came from conditions abroad. Thus, inflation was explained not as a phenomenon caused by internal factors, but rather as a consequence of the worldwide rise in inflation. This was a most powerful argument for neglecting the urgency of pursuing an antiinflationary policy. In turn, the recession in the industrial countries served as an argument for increasing domestic expenditure to compensate for the fall in external demand. The latter, because of its impact on Mexican exports, was also blamed for worsening the current account disequilibrium.

If the above external factors were used to justify the economic policy, it was quite another external phenomenon that made such a policy sustainable over several years; the ample availability of foreign financing. Table 11.2 shows the evolution of the stock and flows of the foreign public debt during the period 1970-1976.[3] The fast growth in the nominal value of the stock of the foreign public debt starting in 1973 has already been mentioned. The sheer size of the debt says little, if not measured in real terms or--preferably--against other economic variables, especially against a measure of the national wealth. Unfortunately, such a measure does not exist for Mexico, and one has to settle for the use of some proxies. This is done in Table 11.2, where the net flow of the debt is assessed against several macroeconomic aggregates. Of course, comparing debt figures--which are measured in dollars--with variables that are calculated in domestic currency has to be done with some care. The usual procedure is to convert peso-denominated figures into dollars by means of the observed exchange rate. This method yields a very distorted picture when the period of analysis has been characterized by high inflation rates and an insufficiently adjusted exchange rate. A major distortion in such comparisons may also arise for periods following a significant devaluation in the exchange rate. In order to smooth out--if not avoid altogether--these difficulties, all ratios of Table 11.2 involving a peso-denominated variable have been calculated with an "equilibrium" exchange rate, derived from a purchasing power parity method, as explained in the Appendix to

Table 11.2 Mexico: Evolution of the Foreign Public Debt During the Echeverría Term

				Net Flow as Percentage of					
Year	Stock[a]	Net Flow[a]	Interest Payments[a]	GDP	Fixed Investment	Current Account Income	Total Public Expenditure	Public Sector's Deficit	Interest Payments/ Current Account Income
1970	6,255.5	443.4	290.3	1.4	7.2	13.6	6.3	37.8	8.9
1971	6,666.7	411.2	306.2	1.2	6.7	11.6	5.8	48.8	8.7
1972	6,820.9	154.2	321.4	0.4	2.0	3.6	1.6	7.7	7.5
1973	8,448.8	1,627.9	442.1	3.2	16.8	30.1	12.0	47.3	8.2
1974	11,373.8	2,925.0	707.1	4.6	23.1	42.8	16.2	63.5	10.3
1975	15,705.1	4,331.3	1,031.5	5.5	25.8	60.7	16.7	55.2	14.5
1976	20,846.4	5,141.3	1,318.7	6.1	29.2	62.1	18.2	62.0	15.9

Note: All comparisons between a dollar and a peso variable were made by means of an "equilibrium" exchange rate calculated as described in the Appendix to Chapter 11.

[a] Millions of U.S. dollars

Source: Secretaría de Hacienda y Crédito Público, Estadísticas Hacendarias del Sector Público, Dirección General de Informática y Evolución Hacendarias, 1983; Ernesto Zedillo, "External Public Indebtedness in Mexico: Recent History and Future Oil Bounded Optimal Growth," Ph.D. dissertation, Yale University, 1981.

this chapter.

What is suggested by the nominal figures is amply confirmed by all the relative measures. During 1970-1972, the net flow of the foreign public debt averaged only 1 percent of GDP. That proportion more than tripled in 1973 and averaged 5.4 percent in 1974-1976. Equally dramatic was the increase in the ratio of net flow to current account income--a proxy closer to depicting the growth of the debt with respect to the economy's capacity to serve it. That ratio--11.6 percent in the first year of the administration--rose to more than 60 percent in the final year of the period. It can also be seen that the increase in the foreign public debt went far beyond the increase in public expenditure and fiscal deficits during those years. Thus, the ratio of the net flow to public expenditure, which was normally around 6 percent--look at the figures for 1970-1971 in Table 11.2--doubled in 1973 and tripled in 1976. As a proportion of the public sector's deficit, the aggregate averaged 60 percent in the second half of the administration; it had averaged less than 40 percent during the first half. In short, the relative measures in Table 11.2 confirm that, starting in 1973, public external borrowing took on increasing importance for the Mexican economy. This importance was not reversed during the rest of the Echeverría administration.

The impressive growth of the foreign debt from 1973 onward was accompanied by significant changes in several debt-management aspects that seem worth mentioning.[4] Let us look at the sources of credit. During the 1950s and early 1960s, credits granted by official entities--bilateral or multilateral organizations--were the main source of foreign public borrowing. This predominance of official lending started to decline rather rapidly in the mid-1960s, so much so that by 1967 private financial flows were the main source of public external financing. This trend accelerated with the expansion of Mexican borrowing. Thus, by 1973, 55 percent of the total stock of foreign public debt was owed to private financial institutions; three years later the proportion had increased to 75 percent. Also during the same period, loans raised through syndicates in the Eurocurrency market became the most popular instrument to tap financial markets. Previously, direct bank loans had constituted the usual instrument. In turn, the greater reliance on syndicated Eurocredits allowed Mexico's foreign public debt to become much more diversified with respect to the number and nationalities of lending institutions. It also permitted a modest degree of diversification in the currencies in which the debt was denominated.

Relying on external financing was doubtless further encouraged by the relatively low cost of foreign savings. The nominal implicit interest rate paid on the foreign

public debt averaged somewhat less than 9 percent during 1973-1976. However, when international inflation is accounted for, the real rate proves to be negative (around -2.0 percent) for the same period. This helps to explain why, in spite of the manyfold increases in borrowing, the ratio of interest payments to total current account income did not rise very much until 1975-1976, as shown in the last column of Table 11.2. Of course, as the debt mushroomed, lending conditions began to harden. Thus, whereas the typical Mexican Eurocurrency credit carried a total maturity of over ten years and a spread above LIBOR of only .625 in 1973, such terms became five years and 1.5, respectively, by 1976.

The seemingly smooth workings of the "new" model did not last very long. In 1974, the rate of inflation--12 percent in 1973--almost doubled, whereas GDP growth--though still high--fell by more than two percentage points with respect to the rate registered the previous year. Economic growth further decreased in 1975 and 1976. At the same time, public finances continued to deteriorate and other economic policy instruments, such as the exchange rate and domestic interest rates, continued to be handled inflexibly. A process of financial disintermediation resulted that, together with the effective crowding out induced by public expenditure and other factors, produced stagnation in private investment. The explosive combination of phenomena--mounting fiscal deficits, high rates of inflation, a fixed exchange rate, negative real rates of interest, and bitter exchanges between the public and the private sectors about each other's role in the economic and political life of the country--was bound to provoke capital flight.

The situation became openly worrisome by late 1975, yet only minor adjustments were made. After all, 1976 was an election year, and foreign financing, if more expensive, was still available. However, during July and August capital outflows became unbearable and on the eve of the last presidential address--on August 31--the crash occurred. The twenty-two-year-long era of fixed parity was terminated, and the peso was allowed to float against the dollar. By then, foreign sources of credit had shrunk, and it became only a matter of days before a standby agreement had to be signed with the IMF as a precondition to avoid a complete exhaustion of external financing. In short, another chapter of Mexico's history as foreign debtor had been closed--albeit temporarily--by the final months of 1976. Perhaps the epitaph for the period was provided by *The Economist* in 1977 when it stated rather cynically, "Mexico used to be the darling of international bankers. Not any more."

Why the debt cycle had become so pronounced, short, and explosive--not only for Mexico but also for many other developing countries--became a focal point of

conferences and articles. The early attempts at probing into the general causes of the higher indebtedness unanimously pointed to the 1973-1974 oil shock and the subsequent world depression as the main causes of the spectacular increase in the LDCs' foreign public debt. In other words, external shocks were to be blamed for what happened. This point of view also prevailed among Mexican officials and was taken as an excuse to avoid, or at least delay, significant changes in the conduct of economic policy. This view as applied to Mexico, however, was wrong.

If the external-shocks hypothesis was correct for countries such as Brazil, it had only a minor content of truth with respect to Mexico. In previous works guided by Balassa's 1979 pioneer study, "Policy Responses to External Shocks in Developing Countries," I analyzed the influence of external disturbances on the growth of the foreign public debt during the period of concern.[5] The methodology used consisted of decomposing increases in the debt over and above its trend value during several years. Some were strictly identifiable as caused by external shocks; the rest were attributable to policy responses to external shocks and/or to internal shocks themselves.

Within this framework, two types of external shocks were carefully defined and accounted for: the balance-of-payments effects of reduced world demand for Mexican exports and the balance-of-payments effects of adverse terms-of-trade changes. The results of this research could not be more striking: During the period 1973-1976, the foreign public debt grew US$10.1 billion beyond what was warranted for past trends. Yet, of this additional growth, only 22 percent can be accounted for by external shocks. Actually, external conditions proved to have a favorable impact on the country's balance of payments in 1973, regarding the expansion in foreign demand as well as the improvement in the terms of trade. During the 1974-1976 period, these external phenomena were truly debt inducing--especially the worsening of terms of trade, but their overall impact falls very short of explaining the tremendous growth in Mexico's debt.

Consequently, one has to look at internal factors in order to explain the growth of the debt. Results of the study showed that increased import demand was the most important factor underlying the surge in the debt level during the 1973-1975 period, whereas private capital flight--by a wide margin--became the main debt-inducing phenomenon in 1976.

Put in a nutshell, the greater external disequilibrium of the Mexican economy during the Echeverría administration was provoked not by external shocks but rather by internal ones. The adoption of a broader range of economic and social objectives on the part of the government was not accompanied by more and better policy

instruments.[6] A sharply increased aggregate demand implied not only more demand for imports but also a reduced availability of surpluses to be exported. Such effects were further reinforced by the acceleration of domestic inflation vis-à-vis external rates. The latter phenomenon, interacting with a rather inflexible interest-rates policy, implied a significant reduction in real yields of liabilities offered by domestic financial intermediaries. As a consequence, the rate of real growth of financial savings started to decline very rapidly, becoming only one-sixth of what it had been during the period 1965-1970. As inflation continued--thus over-valuing the real exchange rate--and the external dis-equilibrium persisted, expectations about a peso devaluation sharply increased. This led to an avalanche of capital flight that was resisted only by means of contracting more foreign loans and draining off foreign-exchange reserves.

In short, the Echeverría government, sincerely or not, tried to achieve more political and economic objectives than the administrations that preceded it in the previous forty years. Such efforts, however, demanded much more than an unbridled expansion of public expenditure and external borrowing. The final result could be nothing less than a financial crisis, in the midst of which the López Portillo administration took over in December 1976.

FROM BOOM TO BUST: THE LÓPEZ PORTILLO ADMINISTRATION (1977-1982)

Mexico's economic outlook was extremely gloomy in early 1977. The country's postwar record of fast economic growth had begun to look like a phenomenon of the past with little chance it could be repeated in the near future. Very few observers doubted that the stabilization program signed with the IMF in November 1976 marked the start of a long period in which slow economic growth would be the price to pay if the country's precarious financial situation was to be improved. In spite of the IMF standby agreement and the firmness with which it began to be applied in early 1977, there were widespread fears about the country's ability to continue borrowing in international capital markets.

In many--but not all--respects, the country's economic performance lived up to those expectations during 1977 (see Table 11.3). Adjustment, if not dramatic, was truly drastic. Total real investment decreased almost 7 percent in 1977. The public sector's deficit as a percentage of GDP fell by more than three percentage points. The average exchange rate for 1977 was 80 percent higher than the rate that was kept fixed during more than two decades. The current account deficit fell by almost 60

Table 11.3 Mexico: Basic Economic Indicators During the López Portillo Term

	GDP Real Growth	Inflation		Public Investment		Private Investment		Total Investment		Current Account Deficit (millions of U.S. dollars)	Exchange Rate		Oil	
		Average	December to December	(1)	(2)	(1)	(2)	(1)	(2)		Nominal[a] (pesos per U.S. dollar)	Real (Index)[b]	Reserves[c]	Production[d]
1977	3.4	27.2	27.4	-6.0	8.9	-7.3	10.7	-6.7	19.6	1,596.4	22.7	102.5	16,001.6	981.1
1978	8.2	17.5	16.2	20.9	10.0	10.5	11.1	15.2	21.1	2,693.0	22.7	99.1	40,194.0	1,212.6
1979	9.2	18.2	20.0	17.8	11.0	22.4	12.4	20.2	23.4	4,870.5	22.8	93.9	45,803.6	1,471.0
1980	8.3	26.3	29.8	12.4	11.0	17.1	13.2	14.9	24.2	7,223.3	23.3	83.9	60,126.3	1,936.0
1981	7.9	28.0	28.7	--	--	--	--	14.7	25.7	12,544.3	26.2	77.4	72,008.4	2,313.0
1982	-.5	58.9	98.9	--	--	--	--	-15.9	22.7	2,684.5	122.5	146.9	72,008.4[e]	2,748.2

(1) Percentage change in real investment
(2) Investment as percentage of GDP

[a] Nominal exchange rate at the closing of December of each year (for 1982 it is the average of the free and controlled rates)

[b] Real exchange rate index calculated as described in the Appendix to Chapter 11 (value at the closing of December of each year)

[c] In millions of barrels (includes oil and natural gas)

[d] Daily production in thousands of barrels

[e] According to the source, the 1982 figures are the same as 1981 because the major oil fields are currently being studied for a better evaluation of total reserves.

Source: Banco de México, Indicadores Económicos, Subdirección de Investigación Económica, several issues; Banco de México, Indices de Precios, Subdirección de Investigación Económica, several issues; Secretaría de Programación y Presupuesto, Sistema de Cuentas Nacionales de Mexico, several issues; Petróleos Mexicanos, El Sector Petrolero Mexicano, 1979-1982. Estadístices Seleccionadas, Gerencia de Análisis y Evaluación del Mercado Internacional, Coordinación de Comercio International, 1983.

percent, and GDP growth registered its lowest rate in more than two decades.

Contrary to what had been expected earlier about the availability of external financing, the public sector was able to raise the targeted amounts in international capital markets. _Ex post_, this achievement was not surprising. A deus ex machina had begun to appear. Shortly after taking office, the new government changed the policy of handling almost secretly the figures on the country's oil reserves and revealed that figures were much higher than previously thought. Thus, proven hydrocarbon reserves of 6.4 billion barrels by the end of 1975 increased to 11.2 billion by the end of 1976 and to 16 billion by late 1977. These figures, as well as the decisiveness shown by the new government in taking advantage of the country's oil potential, made international bankers once again enthusiastic about Mexico.

The "nightmare of 1976" was over soon. By late 1977, expectations about Mexico's economic prospects were very different from what they had been only a year before. Although other factors--such as the conciliatory tone of the new administration and the early successes of its economic adjustment program--played an important role, there should be no doubt that the announcements about oil reserves and the plans to exploit them were the main factor behind the renewed vigor in aggregate expenditure that led to the "earlier-than-expected" recovery of the economy in 1978.

Actually, the public-expenditure-led growth model was revived with as much vigor as it had been during the peak Echeverría years. In 1978, public investment grew more than 20 percent, and overall public expenditure started to increase again as a proportion of GDP (see Table 11.3). In spite of the fact that the traumatic events of the mid-1970s were too recent to be forgotten, nobody seemed to panic, for it was claimed that the revival of the failed model was being implemented on bases quite different from the ones observed before. First, it was said, the resources to finance the development of Mexico in a noninflationary fashion were going to be provided by the new oil wealth. Furthermore, taking advantage of such wealth required the expansion of public investment at any event.

Second, it was also affirmed that the government was going to more actively use other policy instruments left practically untouched before. In this respect, there were some encouraging symptoms at the beginning. A financial reform was undertaken by which the banking system was restructured and the instruments of monetary control were modernized. Interest-rate policy became much more flexible and attentive to real yields and to developments in foreign financial markets, and Treasury Certificates (CETES) were introduced as a more rational way to finance the public sector's deficit. On the

fiscal side, an in-depth reform was announced with the introduction of the value-added tax. With respect to industrial and commercial policy, there were some early attempts to rationalize the whole structure of relative prices through the elimination of quantitative restrictions on imports and the simplification of fiscal incentives for industrial activities. Third, this time the public sector was not going to be alone in enhancing the country's stock of capital. Private investment was to be encouraged so that a more balanced pattern of growth evolved.

The model, as supported by this rationality, seemed to perform satisfactorily--some would say, terrifically--for a few years. It led to the highest GDP growth--a rate of 8.4 percent on average during the 1978-1981 period--ever experienced by the Mexican economy. As predicted, not only public investment soared but also private investment. Consequently, total fixed investment, which had been less than 20 percent of GDP in 1977, reached a proportion of 25 percent in 1981. Although Mexican labor statistics are rather unreliable, it is indisputable that employment grew significantly, so much so that legal minimum wages stopped having much of a significance. The labor market became, indeed, a suppliers' market.

The bet on oil was a winning one, at least for a while. Proven reserves continued growing every year, and their exploitation evolved rapidly. Oil exports, which had been only .2 million barrels a day in 1977, surpassed the one-million-barrel-a-day mark by late 1980. The timing to tap the new oil wealth seemed even more striking: Crude prices increased two and a half times between the date the first optimistic news on oil reserves was known (late 1976) and 1980.

On the external-debt front, some developments were also very positive up to 1980. The stock of foreign public debt grew rather conservatively during the period 1977-1980. The net flow of the aggregate averaged only US$3.2 billion during that period--far less than the average flow of more than US$4 billion registered in the last three years of the Echeverría term. Other components of the country's external debt grew more dynamically. Thus, the private sector's foreign debt--of firms and banks--that had amounted to US$6.8 billion at the end of 1977 reached almost US$17 billion by late 1980. Yet, the total external debt, when measured against the size of economy, consistently decreased through 1980. As shown by the figures of Table 11.4, the ratio of total debt to GDP fell from 35.8 percent in 1977 to 31.3 percent in 1980.[7] However, when the net flow of the total external debt is assessed against total fixed investment and current account income, its importance started to climb right after 1978, as shown in Table 11.5.

Table 11.4 Mexico: The Evolution of the Total External Debt During the López Portillo Term

	Stock of Foreign Debt (millions of U.S. dollars)				Stock of Foreign Public Debt[a]	Stock of Total Foreign Debt[a]
	Public	Private	Commercial Banks	Total		
1977	23,834	5,000	1,800	30,634	27.8	35.8
1978	26,422	5,200	2,000	33,622	25.7	32.7
1979	29,757	7,900	2,600	40,257	23.2	31.4
1980	33,873	11,800	5,100	50,773	20.9	31.3
1981	52,156	14,900	7,000	74,056	27.6	39.1
1982	58,146	18,000	8,000	84,146	29.8	43.1

Note: All comparisons between a dollar and a peso variable were made by means of an "equilibrium" exchange rate calculated as described in the Appendix to Chapter 11.

[a] As percentage of GDP

Source: Banco de México, *Indicadores Económicos*, Subdirección de Investigación Económica, several issues; Secretaría de Hacienda y Crédito Público, *México: Economic and Financial Statistics*, December 1983.

Table 11.5 Mexico: The Flows of the External Debt During the López Portillo Term

	Net Flow (millions of U.S. dollars)		Interest Payments (millions of U.S. dollars)		Net Flow of Total External Debt as Percentage of		Net Flow of Foreign Debt as a Percentage of			Interest Payments of External Debt as a Total Percentage of
	of Total External Debt	of Foreign Public Debt	Total External Debt	Foreign Public Debt	Total Fixed Investment	Current Account Income	GDP	Public Expenditure	Public Sector Deficit	Current Account Income
1977	3,287.3	2,987.3	1,973.9	1,542.3	19.5	35.8	3.5	11.3	51.8	21.5
1978	2,988.8	2,588.8	2,571.6	2,023.1	13.8	25.6	2.5	7.8	37.8	22.1
1979	6,634.7	3,334.7	3,709.3	2,888.4	22.1	40.8	2.6	7.8	35.3	22.8
1980	10,515.5	4,115.5	5,476.7	3,957.6	26.9	42.2	2.5	7.1	32.3	22.0
1981	23,283.3	18,283.3	8,383.2	5,476.0	48.0	75.6	9.7	22.8	66.0	27.2
1982	10,089.6	5,989.6	10,879.4	7,791.3	23.2	32.8	3.1	6.4	17.4	35.4

Note: All comparisons between a dollar and a peso variable were made by means of an "equilibrium" exchange rate calculated as described in the Appendix to Chapter 11.

Source: Banco de México, *Indicadores Económicos*, Subdirección de Investigación Económica, several issues; Secretaría de Programación y Presupuesto, *Sistema de Cuentas Nacionales de México*, several issues.

In any case, the public foreign debt, which had been the bankers' headache in 1976, evolved very reasonably through 1980. Its net flow, with respect to several relevant macroeconomic aggregates after the initial adjustment of 1977, was kept in rather modest proportions during two-thirds of the López Portillo administration. Thus--with respect to GDP, public expenditure, and the public-sector deficit--the net flow averaged 2.5 percent, 7.5 percent, and 35.1 percent, respectively, during 1978-1980.

The relative adjustment in the size of the foreign public debt during that period, together with the expectations created by the new oil wealth, should help to explain the tremendous upgrading Mexico's credit experienced in international capital markets. Fierce competition among foreign lenders to grant new loans to the Mexican government and to public enterprises was an everyday event during the booming years. In a matter of hours and days, important credit lines could be arranged. Putting together Eurocredit syndicates was not a difficult task by any means; there was always an excess demand to subscribe them. It is interesting to notice that 35 percent of the gross borrowings undertaken by public agencies in 1979 was made through close syndicates; the participation in such deals had been nil in 1977. Undoubtedly, the frustration of many foreign lenders in placing new loans in the public sector was not unrelated to the ease with which the Mexican private sector was able to finance itself abroad during the same period.

Needless to say, Mexican negotiators took full advantage of the bullishness of the market to improve on the maturity profile and cost of the country's debt.[8] Whereas the maturity of credits obtained by Mexican public agencies in the Eurocurrency market was, on average, a bit less than five years during 1975 and 1976, such average maturity became longer than eight years by 1978 and 1979. Equally important was the improvement in the spreads over LIBOR charged in Eurocurrency credits. The typical Mexican long-term credit carried an average spread of around 1.625 percentage points during the 1975-1977 period. For the same customers the spread fluctuated between .625 and .875 percentage points in 1978 and 1979. In fact, what had been a very expensive debt, with maturities heavily concentrated in the medium term in 1976, two years later had become a nicely scheduled one carrying very low spreads only comparable to those paid by prime customers in Western industrialized countries. Needless to say, the national oil company Petróleos Mexicanos was of paramount importance in improving on the cost and profile of the debt. Its "financial glamor" was fully utilized for such purposes. The state oil monopoly's participation in gross borrowing by the Mexican public sector increased from 14.5 percent in 1977 to almost 40 percent by 1979.

Table 11.6 Mexico: Current Account During the López Portillo Term (in billions of U.S. dollars)

	1977	Percentage Change (1976-1977)	1978	Percentage Change (1977-1978)	1979	Percentage Change (1978-1979)	1980	Percentage Change (1979-1980)	1981	Percentage Change (1980-1981)	1982	Percentage Change (1981-1982)
Expenses	10.8	-9.9	11.7	8.2	21.1	81.4	32.2	52.2	43.4	34.8	33.4	-23.0
Imports (CIF)	6.0	-9.8	8.3	38.4	12.6	51.0	19.8	57.1	25.2	27.2	15.0	-40.2
Interest & Profits	2.2	4.5	2.8	28.8	4.1	45.9	5.9	45.6	8.9	50.9	11.4	27.7
Services & Others	2.5	-20.6	3.2	26.5	4.5	38.9	6.5	44.4	9.3	43.3	7.0	-24.9
Income	9.2	10.9	11.7	27.0	16.3	39.6	24.9	53-4	30.8	23.5	30.7	-0.3
Oil exports[a]	1.0	19.3	1.9	80.7	3.9	107.6	9.9	154.5	14.6	47.5	16.5	13.1
Nonoil exports	3.6	12.7	4.2	16.0	4.9	17.7	5.3	6.4	4.8	-7.8	4.5	-6.5
Interests abroad	0.2	32.0	0.4	75.1	0.7	72.4	1.0	47.2	1.4	35.6	1.2	-10.0
Services & others	4.3	-3.4	5.2	20.7	6.8	30.2	8.8	30.2	10.0	13.8	8.5	-15.4
Current Account Deficit	1.6	-56.7	2.7	68.7	4.9	80.1	7.2	48.3	12.5	73.7	2.7	-78.6

Note: The percentage changes were calculated with figures in millions of U.S. dollars.

[a] Includes oil, gas, derivatives, and petrochemicals

Source: Banco de México, *Indicadores Económicos*, Subdirección de Investigación Económica, several issues.

Unfortunately, booms are not forever. While the idyll between international bankers and Mexico was reaching its most intense stages (1980-1981), some fundamental disequilibria in the domestic economy had taken on renewed force and reached tremendous proportions. At the same time, the outside world had also changed.

Table 11.6 shows in gross terms what happened in the external sector. The early adjustment in the current account deficit of 1977-1978 had frankly subsided by 1979, when the deficit reached US$4.9 billion in spite of the fact that the value of oil exports had increased almost four times in just a couple of years and nonoil exports had also been growing very dynamically. By 1979, the Mexican economy was importing US$12.6 billion (CIF) worth of merchandise--a pretty high figure if assessed against any macroeconomic variable. Yet, imports further increased to almost US$20.0 billion the next year. As a consequence, and notwithstanding the fact that oil exports had almost reached the US$10.0 billion level, the current account deficit exceeded US$7.2 billion. This seemed inconceivable for an oil-endowed developing country. Even if due account is taken of international inflation and its impact on import prices and interest rates, the fact that the current account deficit could reach such a level in a year in which oil revenues increased two and one-half times should have caused observers of the Mexican economy to raise their eyebrows. To the international bankers' comfort, Mexico became the "champion of absorption"--not only of its own oil revenues, but of others as well.

The external disequilibrium was just the tip of the iceberg. It was purely a consequence of many other disarrays in the Mexican economy--most notably, the unchecked expansion in aggregate demand led by the growth in public expenditure. Table 11.7 tells the story of the public finances during the López Portillo years. As was shown in Table 11.7, public expenditure as a proportion of GDP had peaked at 33.6 percent during the previous administration. In spite of the early rhetoric, this proportion was reached again in 1979 and was surpassed by two percentage points in 1980. It was not caused only by the need for increasing PEMEX investment; non-PEMEX public expenditure as a share of GDP was consistently augmented from 1977 on. Of course, within the context of short-run macroeconomic policy, a mushrooming public expenditure is not so much of a problem in itself. It becomes so, however, when politicians of any ideological stance forget about the financing side of it. Although the public income derived from the oil sector almost doubled as a proportion of GDP between 1977 and 1980, the overall deficit could never be reduced to the levels contemplated at the beginning of the administration. What happened was just the opposite, worsening after 1978. The macroeconomic impact of the

Table 11.7 Mexico: Public Finance During the López Portillo Term (as percentage of GDP)

	Total Public Expenditure	Public Expenditure Without PEMEX	PEMEX Expenditure	Public Expenditure Without Interest Payments[a]	Total Public Income	Income Oil Sector	Income Nonoil Sector	Financial Deficit	Financial Deficit	
									Internal	External
1977	30.9	27.2	3.7	29.0	24.2	4.3	19.8	6.7	3.1	3.7
1978	32.2	27.5	4.7	30.2	25.5	5.0	20.4	6.7	4.0	2.7
1979	33.6	28.3	5.3	31.4	26.2	6.1	20.1	7.4	4.5	2.9
1980	35.6	30.4	5.2	33.5	27.8	8.0	19.7	7.9	4.9	2.9
1981	42.4	35.0	7.5	40.0	27.7	8.0	19.7	14.7	6.2	8.5
1982	48.9	41.3	7.6	40.8	31.0	12.4	18.6	17.9	14.1	3.8

[a]Paid by the public sector on its internal and foreign debts

Source: Secretaría de Hacienda y Crédito Público, *Estadísticas Hacendarias del Sector Público*, Dirección General de Informática y Evaluación Hacendaria, 1983.

public sector's financial disequilibrium is better assessed by looking at a concept that in Mexican public finances is called the internal deficit.[9] As shown in Table 11.7, the deterioration of this factor was more acute than that registered by the overall financial deficit. The government's retreat from early intentions of increasing the relative size of fiscal and public-enterprise revenues explains this disequilibrium as much as the overflow of all categories of public expenditure.

The impact of the fiscal deficit on the domestic market's disequilibrium was reinforced by the rapid expansion of private demand, both in consumption and investment. In spite of the rather precipitate and unplanned opening of the economy to foreign imports, the strong demand pull was bound to have a significant effect on domestic inflation. As shown by the figures of Table 11.3, inflation could not be lowered even to the levels of 1975-1976, and it started to accelerate again in 1979. Yet, during more than four years and well into 1981, the exchange rate was kept practically fixed. Obviously, this situation had to lead to a consistent overvaluation of the Mexican peso, as proven by the index of the real exchange rate of Table 11.3. Considering the overheating of the economy and the exchange-rate policy followed at the time, it is not surprising at all that the external-sector disequilibrium worsened to the degree it did despite increased oil revenues.

The economic balance of 1980 should have sufficed to alert policymakers of the risks ahead. At that point, far less than an overall adjustment was needed. A clean-up of public finances to stop the worsening trend of the fiscal deficit, plus some adjustments--especially in exchange-rate policy with possibly a more active crawl--would have done the trick. Admittedly, the budget approved for fiscal year 1981 explicitly incorporated the objective of not allowing the overall deficit to become further increased in nominal terms. Unfortunately, this was just a formality. In practice, even a timid gradualistic approach on fiscal matters and exchange-rate policy sounded like heresy--even an insult--to the rationale of the time. The most popular members of the cabinet were those who produced the grandest projects and programs, overriding the budget approved by the congress. (In contrast, the head of the central bank was no longer summoned to the economic cabinet meetings by early 1980.) Just as had happened in the Echeverría years, the president himself authorized the _ampliaciones presupuestales_ (out-of-budget items) that were needed.

The inertia of the public-expenditure-led growth model proved to be overwhelming. The warning voices of the more prudent members of the cabinet were completely ineffective to provoke a change of course. It is not an exaggeration to say that the majority of the pessimistic economic forecasts made then found their way, not to the

cabinet meetings, but to the wastebasket. This explains why the 1981 budget overlooked not only internal bottlenecks but also conditions abroad. Perhaps the most dramatic example of this miscalculation is provided by the projections on the value of crude exports for 1981. The budget makers assumed that Mexico could export a volume 75 percent higher at a price 10 percent above what was registered in 1980, when oil prices were already above thirty U.S. dollars a barrel and the world economy had started to enter into a deep recession.

The official scenario still had some credibility during the first half of 1981. The beginning of the debacle took place in June when it became clear that PEMEX had to lower sale prices in order to continue placing orders of crude abroad. This was too hard to swallow. Instead of facing the signals of the market--as naturally as had been done two years before, when oil prices started their upward swing--the Ministry of National Properties and Industrial Development (SEPAFIN) designed a "new" marketing strategy by which those buyers unwilling to pay the Mexican prices would be erased from PEMEX's customer list.[10] Forgetting about the "small country" assumption--perhaps for being too neoclassical?--a good percentage of Mexican oil exports was left out of the international crude market over the space of several weeks. Although holders of wealth had started to read the basic economic statistics in a less complacent way, the possibility of an exchange-rate devaluation still looked somewhat academic just before the "oil price affair." Such a possibility became an open threat by mid-June, however, leading to a tremendous capital flight and to "dollarization" of deposits in the Mexican banking system.

The seriousness of the situation demanded bold actions that again were not taken or were postponed. Even though there was official admission that the peso was under heavy attack, little was done beyond rhetoric to face what had started to be a financial crisis. The exchange rate continued to be depreciated daily at an annual rate of only 9 percent. An across-the-board cut of 4 percent in public expenditure was decreed, but with respect to the already higher than budgeted level. And, as it turned out, not even this timid adjustment was made. By late July, the targeted overall deficit had been revised upward to 540 billion pesos (from less than 415 billion pesos in the original budget). Yet, when the year was over, the deficit reached 865 billion pesos. This outcome was not caused by a relative fall in public income, since the same proportion of GDP was kept. Actually, the underlying factor was the tremendous increase in public expenditure. The latter aggregate evolved from 35.6 percent of GDP in 1980 to 42.4 percent in 1981 (Table 11.7). As a consequence, the overall deficit reached almost 15 percent of GDP (it had been 10

percent in the "worst" Echeverría year). One does not have to be a monetarist to realize that such an imbalance has to produce a profound disequilibrium in the money market that sooner or later has to be settled either via prices, the balance of payments, or a combination of both.

The balance-of-payments effect was the dominant one in the Mexican economy during 1981. The current account deficit soared to US$12.5 billion. It can be said that an impressive imports bill (US$25.1 billion) and a sharp worsening in the traditionally favorable services account was what led to such a result. Although oil exports did not reach the level officially forecast, they did reach a value of US$14.6 billion--47.5 percent more than during the previous year. Equally impressive was the drain via capital account. There is no foolproof way of estimating capital flight. An idea can be gained, however, from the fact that the official balance-of-payments statistics of 1981 reported an increase of Mexican financial assets abroad of US$2.5 billion, as well as a negative errors and omissions item for US$8.4 billion. Most probably, the latter figure contains other phenomena such as smuggling, but at any rate a total estimate for capital flight between US$8 and 9 billion does not seem unreasonable.[11]

The question is why right after the oil problem the Mexican economy, far from sinking into a financial crisis that would have forced an immediate adjustment, was able to continue growing at the expense of enlarging its fundamental disequilibria. The answer to this riddle can be found in the availability of foreign financing. As shown in Table 11.4, Mexico's total external debt grew more than US$23 billion in 1981 alone. Of course, most of the new debt was contracted by the public sector. The net flow of the foreign public debt was US$18.3 billion. Yet, all of the increase in the commercial banks' external debt of that year (around US$2.0 billion) was also relent to the public sector. Undoubtedly, in 1981 foreign financing became the slack variable that served to avoid the adjustment that otherwise would have been warranted.

Needless to say, resorting to external borrowing in such a way had to bring about profound and adverse consequences. Immediately, there was a sharp deterioration in lending conditions to Mexico. At the close of 1980, the short-term foreign public debt was only US$1.5 billion. A year later, the same aggregate jumped to US$10.8 billion, not counting the amounts obtained through Mexican commercial banks. The enviable spreads of a few months earlier had also started to vanish and were replaced by new ones that were considerably higher.[12]

It will take the talent of a top specialist on highly competitive but imperfect markets to understand why international bankers did not stop lending to Mexico before they did. One possible yet unexplored explanation is that they did not individually realize what they

were doing as a whole. Some of them might have believed the official story that Mexico was just experiencing a temporary cash-flow problem and had fallen into the temptation of recycling (short-term and profitably) the then abundant petrodollars. Others, traditionally involved in Mexico, just followed the inertia of past years. What seems to be clear, however, is that very few knew that Mexico's debt was growing so fast during the second half of 1981. It is highly suggestive that the balance-of-payments statistics released in February 1982 still reported a net increase in the foreign public debt of US$14.5 billion for 1981--almost US$4 billion less than the actual figure.[13]

Despite some final resistance, it was announced that the peso was being devalued on the night of February 17--initially by 40 percent; some days later an overall stabilization package of rather orthodox making was announced. For a few days, it seemed possible that the Mexican economy could pass from a booming situation to an orderly adjustment. This was far from true; the initial adjustment program was soon overridden by measures that were clearly inconsistent with it. Although the program was never officially repudiated--and was even formalized as a presidential decree--it was not put into real practice either. Thus, for example, the program called for a maximum emergency wage increase of 10 percent. Instead, and just a few weeks after the devaluation, wage raises of up to 30 percent were decreed by the government. The program also called for immediate increases in the prices charged for services and goods produced by public enterprises; several months had to pass, however, before the first significant raise was announced. Rather, an "emergency" plan to support productive firms was implemented. By providing fiscal relief and granting outright subsidies, this plan constituted another clear signal that it would take a while before public finances could indeed be improved. Pressures to finish projects already started made it very difficult to control the nominal expansion in public expenditure.

Meanwhile, the clashes between the government and the private-sector spokesmen--quite reminiscent of the ones that had occurred six years previously--became more frequent and fiery. Not surprisingly, as soon as mid-March 1982 there were signs that capital flight had started again. Another major devaluation was avoided for several months, but only at the expense of exhausting foreign-exchange reserves and using the last "voluntary" foreign credit available to Mexico. Renewing short-term credits that had been obtained during 1981 became increasingly difficult. Renewal periods became shorter and shorter while spreads climbed higher and higher.

In order to alleviate an impressive piling up of short-term credits inherited from 1981, three important

medium-term syndicates were arranged during the first semester of 1982. The first, placed by PEMEX in February, raised US$2.0 billion. A state development bank (Nacional Financiera--NAFINSA) was the borrowing agency in the second, which took place in March. It provided US$1.2 billion. The last syndication consisted of a "jumbo" of US$2.5 billion with the Mexican federal government as debtor and was arranged during May and June. In many ways, this credit was a turning point. As the facility was being put together, it became clear that market perception concerning Mexico's creditworthiness was completely deteriorating. Even though the pricing of the loan to lenders was very attractive compared to previous deals, it took an enormous effort on the part of Mexican negotiators to gather the necessary commitments.[14] To their dismay, only 75 banks out of 650 accepted the invitation to subscribe the facility. Considering the enormous difficulties that had to be faced before signing the loan on June 30, it became clear that the only debt-management expedient left was to continue rolling over short-term credits--at any price and at any maturity. This, of course, could not last.

The peso continued to be under heavy speculation during July 1982. Too late, it was decided to implement some of the measures included in the Economic Adjustment Program that had not been put into effect. Accordingly, at the beginning of August, it was announced that the prices of some basic products were being raised. After this announcement was made, pressure on the central bank's reserves became unbearable. On August 6, 1982, a new two-tier foreign-exchange system was set up. Still speculation continued, and just one week later, dollar-denominated deposits in the Mexican banking system were made payable only in domestic currency. Banks were also ordered to temporarily suspend foreign-exchange transactions. In the face of those events, it became evident that foreign creditors had been totally scared away and that the resumption of any kind of normal credit conditions could not be expected for a long time.

At that moment, the financial authorities could either wait for foreign creditors to make public the country's insolvency or confront the facts and declare unilaterally that the country was not able to keep up with payments of principal. Wisely, the second approach was followed. On August 20, the secretary of finance, Jesús Silva-Herzog, met with representatives of a large number of creditor banks and requested a three-month moratorium on payments of principal as well as the formation of an advisory group of creditors to negotiate the restructuring of the foreign public debt. A few days earlier, the Mexican government had obtained important financial backing from its U.S. counterpart in the form of credits from the Commodity Credit Corporation and the Treasury Department. Negotiations with the Bank for

International Settlements to obtain a US$1.5 billion credit from several of its members were initiated in the last days of August. Early that month, formal talks about a standby agreement had been started with an IMF mission.

The realism of August comforted Mexico's creditors for only a few days. On September 1, President López Portillo announced that private banks were being nationalized and that overall foreign-exchange controls were being instituted. The international banking community must have panicked at the idea that such a radical stance could also spread to the management of the foreign-debt problem--a possibility that, indeed, was very feasible for a few weeks. To everybody's luck, it did not happen.

EPILOGUE, OR HOW TO ATTEMPT MENDING A COUNTRY'S INTERNATIONAL CREDIT

When President López Portillo left office on December 1, 1982, the Mexican economy was experiencing a crisis even more profound than the one registered six years earlier--something inconceivable for a country that had earned US$47 billion in oil revenues and had gone through a rapid process of capital formation during the previous five years. Thus, by the end of 1982, real GDP had fallen by .5 percent; inflation had reached almost 100 percent (consumer price index growth, December to December); the monetary authorities had completely lost control of the foreign-exchange market, so much so that the black-market rate was more than double the average official rates;[15] capital flight continued practically unchecked, in spite of the supposedly overall foreign-exchange controls; the public sector's financial deficit had reached 17.9 percent of GDP during the year; the domestic financial system was shrinking; and, for practical purposes, the country was in a moratorium with respect of its foreign-debt obligations.

In fact, during the last four months of 1982, the country complied only with payments of interest and a minor percentage of payments on principal of the foreign public debt. All payments corresponding to the private foreign debt had been suspended. The country's overall external debt picture was dismal. The public sector had arrears of US$8.1 billion in payments of principal already; furthermore, US$14.3 billion would have come due in 1984 and 1985. Relatively speaking, the private sector's situation was worse. It owed US$18.0 billion to foreign financial institutions, two-thirds of which had repayment periods that went no farther than 1984. It also declared US$4.0 billion in liabilities outstanding with foreign suppliers when a registry at the Secretariat of Commerce was opened.

On general economic policy, the new administration opted for a drastic adjustment--it actually had no other alternative. Not surprisingly, the core of the Economic Adjustment Program was to correct the public finance disequilibrium. The target was to reduce the deficit to 8.5 percent of GDP in 1983. As a consequence, in addition to important across-the-board real cuts in public expenditure, stiff actions on the income side were taken at once. They included significant increases both in the value-added tax and in income-tax rates for upper brackets, as well as major revisions in the prices charged by public enterprises (gasoline, electricity, and so on). At the same time, important rectifications were made on the exchange-rate and financial policies. The overall system of exchange controls was replaced by a rather standard dual system consisting of a controlled market (including all merchandise exports, the majority of merchandise imports, and all foreign-debt-related flows) and a free market (for the rest of transactions). The initial level in the exchange rate for the free market was placed close to the rate prevailing on the black market, thus leading to a significant reduction in the latter's volume of transactions. In the controlled market, an opening rate that overshot the value considered to be equilibrium from a PPP criterion was dictated. A daily "crawl" in this rate also followed. In the financial sphere, domestic interest rates were increased, and a strict monetary targeting consistent with the pursued adjustment in public finances was implemented.

A number of the above measures were contained in the letter of intention submitted to the IMF Board of Directors in November 1982 and were ratified as soon as the new administration took over. The agreement reached with the technical mission of the IMF called for a net flow of foreign lending to the public sector provided by private banks of US$5.0 billion in 1983. To the creditors' surprise, the IMF managing director let everybody know that he would "not recommend the approval of the IMF Agreement to the Executive Board of the IMF without assurances from both official sources and commercial banks that adequate external financing was in place for the success of the Mexican Adjustment Program and the IMF Agreement, and the principles of a realistic restructuring scheme of the Mexican debt would be favorably considered by the community."[16] The telex from which the foregoing quote was taken contained the principles of the strategy followed by the Mexican government to deal with both the borrowing of net resources and the restructuring of the foreign public debt in 1983.

The essence of the approach to obtain the additional financing required for 1983 was to organize an unprecedented number of banks to subscribe a "mammoth" loan (US$5.0 billion). Each creditor's relative participation in the deal was defined on the basis of the exposure of

each in the country as of August 1982. It implied that every bank with assets in Mexico was requested--and somehow subtly forced--to underwrite the facility. This element of "fairness" explains, to a great extent, the enthusiastic support received from the largest banks to raise the needed resources. The attractive pricing also helped to close the deal. Creditors were offered, at their own option, a spread of 2.5 over LIBOR or 2.125 over prime. The maturity requested did not punish lenders either; it consisted of only six years, including a three-year grace period. Attractive commitment and facility fees were offered as well. With the assistance of the advisory group and of top officials from the IMF and several central banks, including the Federal Reserve, the credit was granted practically on time, an impressive total of 526 banks having participated in this syndication.

Regarding the restructuring of the foreign public debt, the target was to reschedule all payments to fall due between August 23, 1982, and December 31, 1984, with the exception of payments to be due on "excluded" debt. The latter comprised, besides other minor categories, credits granted or guaranteed by official entities--either government or multilateral. Consequently, the rescheduling was basically applied to the debt owed to private financial institutions. Mexican negotiators asked for a principal repayment period of eight years, including a four-year grace period. In exchange, creditors were to be paid at their own election a rate of LIBOR plus 1.875 or prime plus 1.75. They were also offered a 1 percent restructure fee. The reschedule undertaking was also quite successful. Only a year after the original request was made, the first set of restructuring contracts was signed. By the end of 1983, twenty-seven, restructure agreements between Mexican public-sector entities and their foreign creditors had been concluded, representing liabilities of US$23 billion.

The problem of the private sector's foreign debt proved to be as challenging as the public sector's. Arrears in interest that had accrued during the last four months of 1982 and early 1983 (almost US$.9 billion) were the first problem to solve. Debtor firms were asked to constitute, through a peso payment and at the controlled rate of exchange, dollar-denominated deposits in favor of their foreign creditors. These deposits earned a commercial rate (typically LIBOR plus 1.0) and were transferred by the central bank through several installments for complete liquidation by the end of 1983.

It was clear, however, that the simultaneous occurrence of the halt in the automatic rolling over of the debt, the balance-of-payments crisis, and the abrupt deterioration of domestic business conditions inevitably had to lead to an overall renegotiation of the private sector's debt. From the start, two important decisions were taken by the Mexican financial authorities: First,

the government was not going to assume the private sector's debt--that is, foreign lenders would have to retain the commercial risk involved in their credits, with debt renegotiation having to take place individually between lenders and borrowers; second, debtors would receive no subsidy to settle their foreign obligations.[17]

In order to encourage the restructuring process, it was decided to offer exchange risk coverage of principal and interest for debts that could be rescheduled according to the guidelines issued by the financial authorities. Plainly speaking, firms were able to substitute their peso-denominated liabilities for their dollar obligations, as long as the latter could be restructured at long term. Accordingly, firms were able to transfer the foreign-exchange risk of their liabilities to the public sector. This mechanism was also successful, and by the time the deadline rolled around (late October 1983), private liabilities for almost US$12 billion had been covered by the facility. Almost 100 percent of that amount corresponded to obligations renegotiated to mature at eight or more years, including a four-year grace period. Nearly three hundred different financial institutions agreed to the mechanism in addition to two hundred foreign suppliers.

As this chapter was being written, the private foreign debt that did not enter under the program was being settled or restructured through other mechanisms. Debt owed to foreign suppliers was repaid through two other programs, which were made public by the central bank on February 28 and August 3, 1983. Basically, these programs allowed firms--through a peso payment--to constitute dollar-denominated deposits whose ownership could be transferred in payment to foreign suppliers. In addition, up to 100 percent of income from exports of debtor firms was permitted to be used to pay off the same type of debt. Another segment of private foreign debt--involving some US$2 billion--was already long-term and covered for exchange risks by virtue of another system of foreign-currency swaps offered by Banco de México since 1977. Loans guaranteed by agencies of foreign governments are to be settled through bilateral agreements that are in the process of negotiation. The remainder was largely that of firms in excellent financial condition whose liabilities had been restructured and whose prospects were good for exporting, thus automatically granting them coverage against fluctuations in the exchange rate.

The process of restructuring the country's foreign debt was greatly favored by the way in which the economy adjusted itself during 1983. To the astonishment of many people, the target was achieved of reducing the public sector's overall financial deficit to 8.5 percent of GDP. But even more striking was the adjustment in the balance of payments: The trade surplus amounted to US$13.7 billion, and that of the current account was US$5.6 billion.

In spite of the pronounced devaluation and the short-run impact of increased prices on many products produced by the public sector, inflation (December to December) was reduced by one-fifth with respect to the rate registered during 1982.

The economic adjustment paid off in terms of improved creditworthiness. In December 1983, a general agreement was reached with the advisory group, defining the conditions for the new money to be lent to the Mexican government during 1984. According to the agreement, the package would comprise US$3.8 billion. Lending banks were again asked to participate on the basis of their pro rata exposure to Mexico in August 1982. This time, however, conditions were softened significantly, with creditors being offered 1.5 percent over LIBOR or 1.125 over prime, at their own election. Instead of the six-year maturity obtained in the previous deal, the new credit would carry a ten-year term, including a five-year grace period. Commitment and facility fees were also reduced, and even though the amount requested was not fully committed as of early February 1984, it was expected that eventually the deal would come through as expected.

In short, one could say that the debt crisis of 1982 was overcome. Fears that Mexico would provoke an international financial hecatomb began to fade as problems of other debtor countries came into focus. It is too soon to say whether at any moment in the near or not-so-near future this respite will give way to another disastrous episode in the country's history as foreign debtor. Much will depend on whether the Economic Adjustment Program proves to be successful--not only for correcting the basic macroeconomic disequilibria but for leading to a new stage of fast economic growth.

Growth of the same quality as in recent decades could only be sustainable for a few years at most. In order to avoid a new crisis, much more than controlling inflation or resuming growth will be needed. It is not an exaggeration to say that it will require deep structural changes in Mexico's economic and political life--changes that have yet to be conceived and undertaken and whose analysis goes beyond the scope of this chapter. A critical factor also would be that the international environment--both economic and institutional--not be any worse than the one now prevailing.

APPENDIX

As studied by Artus[18] and many other authors, all procedures to calculate an "equilibrium" exchange rate have several shortcomings. More for simplicity in its calculation and interpretation than for its theoretical appeal, a purchasing power parity (PPP) method was chosen here to estimate such an equilibrium rate. Using the

formulation suggested by Lipschitz,[19] an index of the real exchange rate was computed with the following formula:

$$IRR = \prod_{i=1}^{n} (e_i P_i/P)^{w_i}$$

where e_i is an index of the domestic currency price of foreign currency; P_i, an index of the price level in country i; P, an index of the domestic price level; and w_i, the weight of country i in the index

$$(\sum_{i=1}^{n} w_i = 1.0).$$

The wholesale price index of each country was used; n=21; w_i was determined according to each country's participation in Mexico's total merchandise trade; the base year is 1978 and was chosen for several--albeit arbitrary--reasons. First, it was a year of high economic growth. Second, merchandise imports--excluding those by the oil sector--grew 15 percent in real terms, not a very high income elasticity. Third, nonoil merchandise exports grew 8 percent in real terms; other exports such as tourism also grew very dynamically. And fourth, the errors and omissions item of the balance of payments was negligible, a fact that suggests that capital flight and smuggling were insignificant. In short, even though 1978 was a year of rapid growth, the external sector was very much in equilibrium. The fact that it is a rather recent year is convenient, too.[20] All relevant data were obtained from the International Financial Statistics of the IMF.

According to the above methodology, during the period 1972-1982 the equilibrium exchange rate (pesos per U.S. dollar; average value for the year) was as follows:

Year		Rate
1972	-	13.845
1973	-	13.788
1974	-	14.152
1975	-	14.049
1976	-	16.356
1977	-	21.592
1978	-	22.753
1979	-	23.963
1980	-	26.383
1981	-	32.758
1982	-	50.566

NOTES

The opinions in this chapter are mine and should not be attributed to my employer. I thank Norman Glass for his helpful suggestions in regard to my use of English.

1. Good sources on the history of Mexico's foreign debt are Turlington (1930); Bazant (1968); and Green (1976).

2. Term used by a former minister of finance to describe the economic policies followed during the second half of the 1950s and the 1960s; this was a period of rapid growth and price stability.

3. Data on the external private debt are rather unreliable for this period; therefore, the analysis of this section focuses on the foreign public debt.

4. These facts on debt management are more extensively studied in Zedillo (1981a), pp. 58-89.

5. Zedillo (1980) and Zedillo (1981a, chap. 4).

6. For an interesting analysis of the period see Solís (1981).

7. These comparisons are also made by means of an "equilibrium" exchange rate.

8. See Zedillo (1981a) pp. 58-89.

9. Equals total financial deficit minus the "external deficit." The latter is defined as the difference between public sector's income in foreign exchange (e.g., oil revenues) minus expenditures abroad (e.g., imports and payments of interests).

10. New York Times (1981).

11. Foreign-exchange reserves still had a modest gain during the year.

12. See Castro (1983).

13. See Banco de México (1982).

14. See Castro (1983).

15. At the time there were two official rates (50 and 70 pesos per dollar); the black-market rate fluctuated around 140 pesos.

16. Quoted from p. 4 of a telex sent by the minister of finance of Mexico to the international banking community on December 8, 1982.

17. A description of this mechanism is given in Zedillo (1983).

18. Artus (1978).

19. Lipschitz (1979).

20. Further justification of this index can be found in Zedillo (1981b). I thank Miguel Durán of Banco de México for gathering the data and computing the index.

BIBLIOGRAPHY

Artus, J. R. 1978. "Methods of Assessing the Long-run Equilibrium Value of an Exchange Rate." Journal of International Economics 8:277-299.

Balassa, Beli. 1979. "Policy Responses to External Shocks in Developing Countries: Implications for International Trade and Long-Time Growth." Washington, D.C. Mimeo.

Banco de México. 1982. Informe Anual 1981. México, D.F.
Bazant, Jan. 1968. Historia de la Deuda Exterior de México (1823-1946). México, D.F.
Castro, E. 1983. "Algunas Consideraciones Sobre el Financiamiento Externo de México en los Años de 1980-1982." México, D.F. Mimeo.
Green, Roserio. 1976. El Endeudamiento Público Externo de México 1940-1973. México, D.F.
Lipschitz, L. 1979. "Exchange Rate Policy for a Small Developing Country, and the Selection of an Appropriate Standard." IMF Staff Papers 26: 423-449.
"Mexico, in Switch, Will Lift Oil Price." 1981. New York Times (June 17).
Solís, Leopoldo. 1981. Economic Policy Reform in Mexico: A Case Study for Developing Countries. New York.
"Mexican Headache for International Banks." 1977. The Economist (January 22):99.
Turlington, Edgar. 1930. Mexico and Her Foreign Debtors. New York.
Zedillo, Ernesto. 1980. "The Balance of Payments Effects of External Shocks in Non-OPEC Developing Countries. The Case of Mexico." Paris.
___. 1981a. "External Public Indebtedness in Mexico. Recent History and Future Oil Bounded Optimal Growth." Ph.D. dissertation, Yale University.
___. 1981b. "Algunas Consideraciones Sobre el Tipo de Cambio del Peso." Subdirección de Investigación Económica, Banco de México. Mimeo.
___. 1983. "The Program for Coverage of Exchange Risks. A General Description and Financial Aspects." México, D.F. Mimeo.

12 The Renegotiation of Venezuela's Foreign Debt During 1982 and 1983

Eduardo Mayobre

PROBLEMS IN RENEGOTIATING

By the end of 1982, Venezuela's foreign debt had reached approximately US$33 billion. Although this is a high figure, it is low when compared to that of other Latin American countries. In terms of foreign earnings, the Venezuelan debt is equal to 151 percent of the country's exports of goods and services. By way of contrast, the corresponding figure for Argentina's debt is 388 percent, for Brazil 354 percent, Chile 287 percent, and for Mexico, Peru, and Equador 264 percent, 260 percent, and 230 percent, respectively.

However, in the renegotiation processes that became general practice throughout the continent during 1982 and 1983, it has been Venezuela that has found it most difficult to reach an agreement with its creditors. Since March 1983, when the need for renegotiation was officially recognized, the Venezuelan government has had to recur on two occasions (in April and July) to a ninety-day deferments of payments on its debt, and at the end of the second of these periods it barely managed to obtain a third deferment of thirty days. In addition, there was very little probability that an agreement would be reached before the end of the year as regards a rescheduling of the debt, and it was thought that it would only be possible for meaningful negotiations to be initiated when the new government came to power in February 1984.

This development is surprising, for until recently Venezuela enjoyed a privileged place in the international finance markets; due to the characteristics of its debt and the size of its reserves, the rescheduling of maturities seemed, at first glance, an easy objective to attain. However, what seemed an easily manageable situation has become more and more complex, with serious repercussions on the country's domestic economy as well as its international position. On first examination, several facts appear that explain the changes mentioned.

1. The structure of the debt is very vulnerable, as 45 percent of Venezuela's foreign indebtedness is short-term. This means that although the total debt is not excessive, the maturities due in 1983 and 1984 exceeded the country's repayment capacity during this period. The portion subject to renegotiation, which includes long-term debt amortization due during the same two years, is US$18 billion without taking account of the private-sector debt whose share of short-term maturities is higher than that of the public sector. If one makes comparisons with other countries in Latin America, one finds that their short-term debt accounts for 19 percent of the total debt in Brazil, Argentina, and Chile and 20 percent, 29 percent, and 30 percent in Ecuador, Peru, and Mexico, respectively.

2. The drop in earnings from oil sales that began in 1982 should be pointed out. These earnings, which account for more than 90 percent of Venezuela's exports, fell by 20 percent in 1982, and a similar decline was expected in 1983. This fall in foreign revenue is due to a reduction in crude export prices and to a considerable contraction in export volume as a result of the production quotas agreed upon by OPEC in response to the depressing conditions in the international oil market. Initially, since the Venezuelan authorities thought that this would be a minor temporary reduction, no appropriate preventive action was considered.

3. The emergence of difficulties in serving the debt in other countries in Latin America, and the Mexican crisis of 1982 in particular, led the international banks to act with more caution with regard to their Latin American debtors and to reexamine the risks they had assumed in the region. This general attitude proved detrimental to Venezuela when it became obvious that the country was experiencing difficulties in meeting its foreign commitments as well. Although the need to refinance the short-term debt had already been recognized, to the extent that in August 1981 the Venezuelan Congress had passed a law authorizing the undertaking of appropriate commitments, the executive branch refrained from taking action for administrative reasons and because it misunderstood what was occurring in the market. Thus, when the Latin American situation began to be viewed as a world crisis, only small amounts of credit had been renegotiated by Venezuela.

4. The fact that Venezuela had ample international reserves at the beginning of 1982 made the authorities believe that they would receive special treatment from the international banks. At the beginning of 1982, its official international reserves totaled US$8.6 billion. Added to these were the financial reserves of the oil industry and Venezuela's Investment Fund, giving a total of approximately US$19 billion. There was also the possibility of revaluing the gold reserves still valued

at the official price of US$42 per ounce. When problems in the foreign-trade sector and difficulties in the renegotiating process started to become apparent, the authorities decided that centralizing the international reserves in the Central Bank and revaluing the gold reserves would demonstrate the country's financial strength and thus facilitate the negotiations. This, however, turned out to be self-defeating, since it gave the impression that this was the government's last recourse and one that could adversely affect the oil industry.

5. The domestic economic situation and the monetary policies that were adopted brought about a flight of capital that began in 1981 and became more acute throughout 1982. From 1979 onward, policies were adopted that were designed to restrict economic activity. These led to a 50 percent reduction in real terms in private investment between 1978 and 1981. A great deal of the surplus capital that had previously been invested internally was withdrawn from the country. In addition, in mid-1981, domestic interest rates fell while foreign rates remained at a much higher level and had a tendency to rise. This meant a differential of more than four points in favor of foreign interest rates within the framework of a free-exchange system, which encouraged the flight of capital.

This flight of capital was condoned by the monetary authorities as part of a very strange policy termed "deliberate leaks," which was designed to reduce the cash flow in the domestic economy. Toward the end of the year, when domestic interest rates were allowed to float and tended to rise to international levels, the outflow of capital continued due to a growing lack of confidence in the future of the domestic economy. Later, the drop in earnings from oil sales, the centralization of the oil industry's financial reserves, the executive's intervention in the largest bank in the country--Banco de los Trabajadores de Venezuela, and the growing conviction that a devaluation was imminent undermined confidence even further and accelerated the flight of capital.
In the months preceding the introduction by decree of exchange controls and differential exchange rates in February 1983, there was a net weekly capital outflow of US$400 million. This meant that while in a normal year, such as 1978, the short-term capital outflow was US$1.3 billion, this figure reached US$5.5 billion in 1981, US$7 billion in 1982, and over US$2 billion in the first two months of 1983.

6. The fact that the currency had remained stable for twenty years, with the exception of two minor readjustments at the beginning of the 1970s and only one devaluation since 1941, meant that a change in the exchange rate would prove economically and politically traumatic. This led the authorities to delay and attempt to avoid the devaluation of the bolivar. When the devaluation became inevitable in February 1983, it

was disguised under an extremely complex system of exchange rates.

The Venezuelan currency has usually been overvalued since its par value is determined relative to the oil sector and not to the rest of the economy. But, even without taking this fact into account, it is easy to see that from 1978 onward the bolivar underwent considerable real appreciation in value, as a consequence of inflation rates in Venezuela higher than those of its trading partners and of the strengthening of the dollar against the European currencies (the bolivar maintained a fixed par value in relation to the dollar).

Calculations show that in the four years preceding the exchange measures of February 1983, the currency became overvalued by approximately 35 percent in relation to that of the industrial countries. The exaggerated value of the bolivar led to an increase in imports and foreign travel and made it practically impossible to increment nontraditional exports. Subsequently, when it became obvious that the exchange rate could not be sustained, capital flight increased. The government's reluctance to implement exchange measures allowed these effects to reach an extreme.

7. The difficulties in arranging the refinancing of the debt can be explained by the fact that after having maintained an average annual growth rate of 5.5 percent over the twenty years from 1958 to 1978, the country's economy underwent four consecutive years of stagnation. During this last period the authorities were unwilling to take the measures necessary to deal with the situation that they faced for fear of the social and political repercussions these could have. On the contrary, although there were some reductions in central government spending, state enterprises and public financial institutions became more heavily indebted. Both groups resorted to foreign credit in order to compensate for their operating deficits, the reduction in funds assigned by the central government, and the lack of liquidity in the internal market.

8. The political situation tended to make the government postpone any measure that might have proved unpopular, and consequently it became evasive in its negotiations with its creditors. Almost from the outset, the government's popularity was damaged by the stagnation in the economy, unemployment, and rising inflation that far outstripped levels customary in Venezuela. When the financial and fiscal crisis became evident in mid-1982, the selection of the presidential candidates to stand in the December 1983 elections had just begun. During the period of negotiations with the foreign creditors, the electoral campaign was in full swing, and polls were showing a clear disadvantage for the government party candidate. In these circumstances the authorities avoided taking any action or making any

commitment that would undermine their popularity. For example, as will be seen later, attempts were made to avoid reaching an agreement with the International Monetary Fund and strong objections were even made to the measures recommended by that institution. As a result, no serious negotiations with the Fund came about. In addition, there was an absence of unified criteria on the part of the fiscal and monetary authorities, which reached the extreme of a public dispute between the minister of the Treasury and the director of the Central Bank.

9. The central government's lack of control over the indebtedness of both the state enterprises and other decentralized government bodies made it virtually impossible to arrive at a clear idea of the total of the public-sector debt. The absence of hard data in turn hindered the negotiations, as it created a discrepancy between the parties involved as to the amount that was to be negotiated. There were also delays in the interest payments of the state institutions, and difficulties arose over the recognition of loans contracted without attention to the pertinent legal procedures. Moreover, there was the problem of private foreign debt, for which there were neither records nor control, making it impossible to determine the nature or the total of the same with any precision. Since the exchange control law stipulates that foreign currency will only be provided for certain types of private debts, for which refinancing has already been arranged, the foreign debt of the private sector is considered together with that of the public sector in the negotiations with the creditors.

10. As a result of several of the aforementioned points, not only was there no reduction in public spending during the period in which the crisis was developing, but it actually expanded considerably between 1980 and 1981 as a result of increases in oil earnings, and remained virtually stable over the following two years.

These facts can be more clearly understood once the reader is acquainted with the negotiating process that took place during 1982 and 1983.

THE RENEGOTIATION PROCESS

In August 1981, the National Congress passed a Refinancing Law for a sum of 61 billion bolivars. This law, which authorized the executive to assume, consolidate, and restructure the short-term debt of the public sector, was discussed in the Sixth National Plan. The plan's investment program entailed public borrowing for several projects and contained a number of legal initiatives designed to facilitate their financing. A plan for the refinancing of short-term debts contracted prior to June 1982 was also included in the national plan,

so that total public borrowing could be taken into account. A significant proportion of this borrowing had been undertaken by state enterprises without the authorization of the executive and in some cases without complying with all the relevant legal requirements. In order to prevent these practices from continuing, the Refinancing Law was passed, and modifications were made to the Public Credit Law that introduced controls and sanctions to be applied to whoever assumed obligations for the state without authorization. One of the requirements established for refinancing was the approval by the Finance Commission of the legislative chamber of a detailed list of the debts involved.

Despite the authorization that had been given by Congress, the executive delayed in starting refinancing negotiations and in approaching the international finance markets. First it attended to administrative problems in gathering the information required by Congress, and then it decided that the market conditions were not suitable. Negotiations initiated with the international banks on several occasions in 1982 in most cases did not lead to any agreement, as the Venezuelan authorities considered that the terms they were offered were not in keeping with the country's financial position.

The decline of the oil markets and the application of production quotas agreed upon by OPEC during the summer of that year made the government believe that Venezuela would create a false impression before the international banks of being weak, for they thought that the oil demand would increase during the second half of the year and the estimates of foreign earnings would therefore be much more favorable. On the basis of these assumptions, the Venezuelan government considered that it would not be wise to accept the interest rates it was being offered, which were approximately an eighth of a percent higher than those it had obtained previously, since this could create a precedent and undermine the country's position in the international finance markets.

For these reasons, the Venezuelan government decided to postpone the refinancing negotiations until midyear and to renew short-term loans as they matured. As part of this strategy, credit for the vast sum of US$2 billion was being arranged and was to be ready by June or July. Meanwhile, the Falklands crisis occurred in which Venezuela supported the Argentine position actively and with determination. The resulting rumors and opinions adversely affected relations with the British financial community. Some of the funds from the Venezuelan oil industry were withdrawn from British banks when it was rumored that they might be frozen, and a number of the United Kingdom's banks abandoned the talks regarding the giant credit.

At the same time, Mexico was already involved in negotiations for credit for an amount similar to that

requested by Venezuela and had decided to accept higher interest rates in order to obtain resources. This influenced the terms offered to Venezuela, which were rejected. The government objected to the combined use of the U.S. preferential rate and the London interbanking rate, which had been used on previous occasions, and considered that, in its view of the market, the money was overpriced. Events that followed were to show that to reject the terms that had been offered was a great mistake.

Later, the Mexican crisis and the difficulties faced by other countries in the region led the international banks to adopt a more inflexible position toward Latin America. This, coupled with the deterioration in the internal situation in Venezuela and the fact that several state enterprises were behind in their payments, resulted in some short-term credit not being renewed. In the face of this situation, which was also compounded by the reduction in reserves due to the flight of capital, the authorities decided to centralize the reserves of the state enterprises and to set a new par value for gold in order to show that "dollar for dollar" the country's foreign liabilities were matched by its international reserves. This measure particularly affected the nationalized oil industry, which until then had maintained a position of absolute financial independence, thus allowing it to finance its own current account operations and maintain enough foreign currency to finance its expansion program. By the end of 1981, the net short-term international assets of Petróleos de Venezuela (the Venezuelan oil company) totaled US$7.66 billion. The new gold par value, which rose from US$42.22 to US$300 per ounce, meant a US$3 billion dollar increase in international reserves. These measures did not overly impress the international banks, which had long been aware of the different types of reserves held by Venezuela.

In the light of these new market circumstances, toward the end of September a new refinancing plan was presented by the government that was designed to reschedule US$8.7 billion of the current account debt. Under this new plan the government was willing to pay much higher interest rates (of between 1 percent and 1.625 percent above LIBOR) than those it had rejected a few months previously and abandoned the idea of obtaining giant loans. Under these conditions, it managed to refinance approximately US$1 billion by the end of 1982.

The aggravation of the crisis in Mexico, Brazil, and Argentina, fear of a reduction in oil prices, and the collapse of the domestic economy (involving intervention in the Banco de los Trabajadores de Venezuela) impaired the success of the above-mentioned plan. A report by the _Financial Times_ at the beginning of January 1983 commented in this regard that the "Euromarket responded

enthusiastically to the announcement in October of the refinancing plan, particularly as conditions were offered that were considered exceptionally generous by the banks which had been used to bargaining with Venezuela over the price of its foreign credit." It added that the "enthusiasm due to these refinancing plans is beginning to wane." By this time, the imminent reduction in oil prices and the flight of capital had seriously eroded confidence in the Venezuelan economy. It was not difficult to foresee that a currency crisis was probable.

During 1982, efforts had been made to deal with the problem of the short-term debt. These were unsuccessful, as the Venezuelan authorities had failed to perceive the deterioration of conditions in the international finance markets. They considered that the extent of their international reserves gave them a financial stability that deserved preferential treatment, and they remained under the illusion that an upturn in the oil markets would increase their foreign earnings. None of these hopes came to fruition, and the domestic economic situation meanwhile continued to worsen.

THE SITUATION IN 1983

By 1983 the situation had become even more difficult. There was the need not only to renew short-term credit but also to pay the amortizations on the medium- and long-term loans contracted in previous years that were heavily concentrated in 1983 and 1984. The unsuccessful negotiations undertaken in 1982 had undermined the country's international credibility, and the foreign drain on reserves had become more acute, as a result of a loss of confidence within the nation and of rumors of a devaluation.

Furthermore, during the first four months of 1983 the oil market had deteriorated even further, and there was fear that a price war could begin between the exporting countries. The production quotas agreed upon by OPEC in the summer of 1982 were no longer applicable in the second half of the year, and the production increases by countries like Nigeria, Venezuela, Iran, and Indonesia were causing friction within the organization. Furthermore, the OPEC countries were accusing one another of granting discounts that violated the price schemes agreed upon. The OPEC countries' loss of a considerable share of the market to new exporters was making the situation even more difficult. Under these circumstances, the free convertibility of the bolivar was suspended on February 18, 1983, and after several days of discussion and disagreement between members of the government a new exchange scheme was established.

This consisted of the introduction of three exchange rates. The exchange rate of 4.30 bolivars to the dollar

was maintained for public-sector transactions, including debt servicing and the importation of essential goods. A rate of 6 bolivars per dollar was set for the remainder of trade transactions, which would be subject to a system of exchange control. Lastly, a free floating rate was established for financial operations, traveling expenses, and other international transactions.

It was established that for the payment of the private-sector foreign debt, dollars would be made available at the preferential rate of 4.30 bolivars for the total debt amount, provided that the latter had been refinanced by the creditors allowing at least a one-year grace period and a three-year period of maturity. This was one of the points that caused most controversy among members of the government and that still has not been completely worked out, owing to the difficulty of defining the total debt amount and the fact that one of the conditions, that of refinancing, is beyond the control of the debtors.

In order to administer this exchange plan the Office for the System of Differential Exchange Rates (RECADI) was set up under the control of the Treasury, as a result of the differences in opinion between it and the Central Bank of Venezuela. The establishment of RECADI led to administrative difficulties that caused a permanent delay in furnishing foreign currency at the preferential rates of 4.30 and 6 bolivars per dollar. This office was practically created from nothing, and it spent the greater part of its time establishing the legitimacy of requests for preferential rates of currency. Later, the Central Bank of Venezuela refused to recognize some of the authorizations given by RECADI, particularly those relating to the private foreign debt, thus prolonging an atmosphere of uncertainty that still continues to be felt.

As a complement to the exchange measures, a decree was passed freezing prices for two months. This was later replaced by an "administrated prices system" that stipulated that any price increases must be authorized by the Ministry for Development. Under this system the authorities had three months in which to consider proposed price rise. In actual fact prices were frozen for nearly six months.

Under the exchange system that had been adopted, the government decided not to intervene in the free market. Initially, the bolivar sold at around 8 to the dollar, but then rapidly started to rise due to a shortage of foreign currency. A peculiarity of the Venezuelan economy is that 90 percent of its foreign-currency earnings are generated by the public sector; thus the action the monetary authorities either do or do not take determines the market. Faced with this rise in the price of the dollar, the Central Bank decided to intervene in the Stock Exchange, but its intervention

gave rise to exceedingly easy speculative practices and destabilized the market. In the light of these circumstances, the Central Bank withdrew from the market and started to provide the commercial banks with foreign currency at a fixed rate of 9.95 bolivars per dollar, while the Stock Exchange withdrew from the foreign-currency market. The amount sold by the Central Bank (US$120 million per month) was greatly inferior to the demand and led to the emergence of alternative markets. One of these operates through the money-exchange offices, providing limited quantities to purchasers; the other, with higher rates, has no restrictions as regards quantity, its transactions being carried out directly between vendor and purchaser.

Having remained stable at between 8 and 9 bolivars for a few weeks, the free dollar rose continuously to reach 12 bolivars, when the Central Bank withdrew. By mid-July it reached 17 bolivars, only to fall to a rate of between 13 and 14 bolivars per dollar during August and September. As a result of all these factors, in October 1983 there were five different exchange rates: two preferential rates of 4.30 and 6 bolivars, the bank rate of 9.95, the money-exchange-office rate of 13 bolivars, and the free rate of 14. To these can be added several special intermediate rates. As can be observed, there is more than a 300 percent variation among the different exchange rates, which not only makes for complete uncertainty (since access to the different rates is not clearly defined) but also encourages irregular transactions to be made.

It is easy to imagine that as a result of this exchange disorder, the consequent uncertainty, and the administrative difficulties in obtaining foreign currency at preferential rates, there has been a tendency for production to fall dramatically on one hand and for unemployment to rise steeply on the other. This can be clearly observed in the monetary indicators: Despite a notable increase in domestic liquidity as a result of exchange control, the demand for credit has remained stagnant.

In addition, the lack of foreign currency at preferential rates has led to a fall in input supplies to the production centers. Faced with difficulties in obtaining foreign currency at such rates, manufacturers have only used the free market in extreme cases, leading to a reduction in imports and a shortage of raw materials and making it necessary for manufacturers to reduce production levels. There have been no serious shortages, since it was customary for the country to maintain high levels of inventories, and with an impending devaluation, extra supplies were in many cases purchased in advance. Thus the shortage of foreign currency has resulted in lower levels of inventories rather than chronic shortages. In any case, reliable estimates show that imports have

fallen by more than 40 percent so far in 1983, a decrease that can only be explained by a marked reduction in inventories.

RELATIONS WITH THE IMF

The renegotiation process has been accompanied by the paralysis of the economy and the retention of an unsustainable exchange-rate system. When the exchange control was introduced in February 1983, the authorities made a final attempt to refinance the short-term debt following the outlines it had been proposing since October 1982. These negotiations failed and, by the second half of March, gave way to negotiations to obtain a three-month moratorium on capital payments, the idea being that during this period conditions could arise that would ensure the country's medium-term payment capacity. The moratorium was obtained without major difficulties, and the same interest rates were maintained for the debts outstanding. However, the total sum to be refinanced rose from US$8.7 billion, which was the originally suggested figure, to US$18 billion, accounted for by the loans due to mature in 1983 and 1984.

For the purpose of these new negotiations, the Venezuelan authorities adopted the attitude that Venezuela's case was different from that of other Latin American countries in that its total debt was relatively smaller; the country still had about US$9 billion in reserves and did not require new credit to satisfy its foreign requirements. For these reasons the government hoped to reach an agreement that would not involve the International Monetary Fund or, at least, that would not imply the kind of conditions a credit agreement with that institution normally implies.

In the meantime, in mid-March 1983 OPEC decided to considerably reduce its official oil prices and to reintroduce production quotas for its members. Although this decision meant an additional reduction in Venezuela's foreign earnings, it introduced an element of stability into the oil market that allowed better planning of the action to be taken in the home sphere and dissipated a series of fears concerning the oil market that had become widespread during the previous months.

Under these circumstances, an advisory committee of creditor banks was set up, headed by the Chase Manhattan Bank, to serve as the counterpart to the Venezuelan authorities in the negotiations. The committee demanded first that the total of Venezuela's debt be made clear. This requirement turned out to be more of a problem than was at first thought, because the debts of the state enterprises and institutes were often neither controlled nor registered. The committee also demanded that some

of these institutions that had not been included in previous refinancing schemes (in particular the Banco Industrial de Venezuela) bring their delayed payments up to date. This requirement was not carried out to the full because of a lack of organization and for domestic legal reasons. The delay in outstanding interest payments was to become a permanent source of irritation throughout the whole negotiating process between the Venezuelan government and its creditors, particularly because promises to solve the problem were made several times without these commitments being honored. The third condition stipulated by the creditors was that talks should be initiated with the International Monetary Fund. At first the nature of these talks was not clear, since it was not propounded that Venezuela needed to reach a credit agreement with the Fund.

The initial talks with the International Monetary Fund were consultative. However, the government hinted that it might request a credit agreement and even went so far as to ask to be informed of the basic conditions demanded by the Fund. As part of the Fund's routine procedures in the supervision of exchange systems, a consultation had been proposed for 1983 to examine the case of Venezuela. The government requested that this meeting be brought forward, this being the official reason for the exchange of missions. At the time of their second visit to the country, the Fund representatives, who were expecting to commence negotiations for a credit agreement, found that the Venezuelan authorities were not prepared to discuss their exchange system. The talks were limited to establishing the veracity of the official figure for the fiscal deficit.

Meanwhile the Venezuelan authorities had been discussing how they could solve the problem of obtaining the Fund's approval for their policies without having to constrain themselves to the conditions of the standby credit agreements of that institution. The government expected the Fund to be sympathetic toward its concerns, since Venezuela had made significant contributions to the Fund during the years of its oil bonanza. As a result of these contributions, the country had a net credit with the Fund of US$1.2 billion. This amount, considered part of its international reserves, could be used automatically but was not an endorsement for the world monetary authority of the way the Venezuelan government would manage the economy.

The apparently obvious solution to the problem of obtaining the support of the International Monetary Fund without having to meet its conditions lay in the compensatory credit facility. This service is provided for countries that have suffered a temporary setback in export earnings, provided that the cause of their shortfall in income be beyond the control of the authorities. Usually, this reduction in earnings is due to fluctuations

in the raw-material markets in countries whose exports depend on these products. This was the case in Venezuela, where oil exports had fallen by almost 20 percent in two consecutive years.

However, the compensatory credit facility had never been applied to an oil-exporting country for the simple reason that none of these had ever needed it. Given the important role that the OPEC countries had played in the financial upheavals that occurred following the increases in oil prices between 1974 and 1979, it was a politically delicate matter to consider allowing the oil exporters to use the IMF compensatory facility.

In order to oppose the oil countries' access to the compensatory credit facility, it was argued that the price of crude oil was not outside the control of the authorities in the OPEC countries, since it is fixed by a cartel of producers. A more technical argument held that there was no certainty that this shortage of resources was reversible and therefore temporary, since oil prices are not subject to the cycles affecting other raw materials.

On the basis of these facts, the managing director of the IMF addressed himself to the general problem of whether the oil-exporting countries could have access to the compensatory credit facility. During consideration of the matter, it was concluded that no impediment existed in this respect, but that requests by the oil-exporting countries should be studied on a case-by-case basis. The main argument in support of this conclusion was that OPEC does not act as a cartel, since the fixed prices established by it do not determine market conditions but rather respond to them. This line of thought is important in the light of propaganda that circulated in previous years, which held that price fixing by OPEC had been the cause of most international economic ills. However, the Fund, whose arguments tend to suit its own convenience, could not admit discrimination against a group of countries without contradicting its principle of equal treatment for all members.

The Venezuelan authorities considered the IMF Executive Board's decision a victory. They thought that it would make an agreement possible, which in turn would facilitate a refinancing arrangement. They forgot, however, that a further requirement for access to be had to the compensatory facility is that "the authorities cooperate with the Fund in solving their balance of payments problems." Since they had not taken any measures that could be interpreted as doing so, access to the facility proved practically impossible.

Meanwhile, the Venezuelan government made the grave mistake of announcing to its creditors that in principle it had reached an agreement with the IMF, although such an agreement did not exist. Denial of this by the Fund authorities damaged the credibility of the Venezuelan

authorities, as was to be expected.

In the consultation on Venezuela that took place in the Executive Board of the Fund, the general impression regarding the measures taken by the government and its intentions for future action was negative. The report by the IMF authorities declared, for example, that "the recent action by the Venezuelan authorities is insufficient to deal with the country's economic difficulties and the measures they have taken are not the appropriate ones." It explained that the measures "ran the risk of rapidly depleting international reserves, seriously increasing inflation and distorting the allocation of resources." By way of conclusion, it said that "the country's serious problems can only be solved through adjustment measures" in the most diverse areas of the economy.

In the talks with the Venezuelan authorities, the Fund missions had recommended the following measures:

1. modification of the exchange system, preferably by means of a devaluation aimed at unifying the exchange rates
2. raising the domestic price of crude oil to international levels
3. reduction in public spending
4. increase in the prices of public services and of goods produced by state enterprises
5. increased income tax and the introduction of a sales tax
6. reduction of net internal credit and allowing interest rates to continue to float
7. lifting the recently decreed restrictions on imports
8. freeing prices and freezing wages

These recommendations were never seriously discussed, since at no time did the talks on a possible credit agreement between Venezuela and the Fund go beyond the preliminary stages. In their report, the authorities of the Fund recorded that although the Venezuelan authorities expressed agreement with some of the recommendations, they considered "that it was not possible to contemplate immediate action in these areas, due mainly to the impending December 1983 elections."

In these circumstances the Venezuelan government publicly rejected the Fund's recommendations, alleging that they were impossible to accept because of their high social cost. This practically closed the doors to an agreement. It should be noted that the aforementioned measures were recommendations made during the consultation process and not conditions for a credit agreement, since there exists, in principle, a limit to the conditions that can be set in such agreements. As the possibility of a contingency credit was never seriously considered, the Fund did not modify its initial

recommendations.

The consultation in the Executive Board of the IMF took place at the beginning of July 1983, and it was supposed that it would form the basis for the negotiations. By that date the Venezuelan government had requested and obtained a second moratorium for its amortization payments. As a condition for granting it, the creditors had insisted that talks with the Fund continue with the object of reaching an agreement within the three-month period of payments deferred. They had also insisted that the outstanding interest payments be met and that a solution be found to the problem of the private debt.

At the end of July a new mission from the Fund visited Venezuela. This proved to be fruitless, for in a televised message to the nation the minister of treasury stated that there would be no changes in the policies adopted up until then--in the exchange system in particular--and that any settlement with the Fund would have to be made following the December 1983 elections. Shortly after, at the beginning of September, the foreign banks' advisory committee agreed that it would make no formal proposal to the government of Venezuela for the rescheduling of its debt, since it considered it essential that Venezuela reach a parallel agreement with the International Monetary Fund and meet its outstanding payments. This reference to a "parallel" agreement can easily be interpreted as a demand for a contingent credit agreement, since this arrangement is the only one that could be carried out simultaneously, as it is subject to a quarterly review.

An additional problem was the public dispute between the minister of treasury and the president of the Central Bank concerning the handling of the private foreign debt. The Central Bank invoked legal reasons for refusing to provide currency already approved by RECADI for the debt payments of a number of private companies. The matter was important since one of the creditor banks had threatened legal action if the outstanding payments were not made. The Venezuelan company concerned was willing to meet its obligations but could not obtain the foreign currency it had been authorized. After several days of public discussion, a bill was passed on September 27 by which dollars could be granted at the preferential rate up until December 31 for the payment of the private sector's debt, provided that the difference between the preferential and the bank rate for the dollar was put up as surety and that the debt was recognized by a commission created especially for this purpose. Although this bill dispelled the uncertainty of the moment, it did not solve the question of the private trade debt and the treatment that the private sector would receive from January 1984 onward.

Subsequently, on the day on which the second moratorium ended, the creditor banks granted a third deferment of payments of only one month and at a higher rate of interest. This limit was designed to observe Venezuela's behavior in relation to meeting its outstanding interest payments. If this situation was rectified, the moratorium would be extended for another three months until January 31, 1984, four days before the takeover of the new government. It can therefore be concluded that the refinancing process initiated in 1981 and the renegotiation of the debt attempted during 1983 were unsuccessful and that the rescheduling of Venezuela's foreign commitments could not be achieved before mid-1984 at the earliest.

ACHIEVING ECONOMIC STABILIZATION

All the facts related so far explain why the 1983 negotiations to reschedule the debt have failed and why Venezuela, in spite of being in a more favorable position than other countries in the region, has become one of the most difficult cases. It would, however, seem pertinent to make a few additional comments.

Venezuela is not only in the position of having to solve a delicate foreign-debt problem, but is also faced with the dilemma of having to adopt a program of economic stabilization after four years of economic stagnation. Normally, a disequilibrium in the balance of payments is caused by the excessive utilization of resources in the domestic economy, producing rates of growth that are unsustainable in the medium term. Thus, the International Monetary Fund's customary prescription consists of reducing the level of internal economic activity, which then leads to a fall in the demand for imports and generates exportable surpluses. In the case of Venezuela, however, four years of recession came between the period of accelerated growth and the time when balance-of-payments problems arose. This peculiar situation is due to the recession coinciding with a marked increase in foreign-currency resources.

The 1979 increases in oil prices meant that between 1978 and 1981 export earnings went up from US$9.2 billion to US$20.2 billion. Despite this, the gross national product dropped during these years at an average annual rate of .2 percent. In 1982 it rose by .6 percent, and estimates suggested that it would drop again in 1983 by at least 3 percent. Thus, at the time of the balance-of-payments problems, unemployment had reached an all-time high, and the utilization of installed capacity was particularly low.

Under these circumstances, it would be counterproductive to follow traditional remedies. Greater deflation could lead to the destruction of the production

capacity, increase the already existing distrust, inhibit investment, raise unemployment to socially unacceptable levels, and discourage the return of capital previously taken out of the country. The social tension that would be caused by higher unemployment deserves special attention as good labor relations have been one of the most positive features of the Venezuelan economy in the last twenty-five years, despite the existence of strong trade unions. It should also be underlined that the financial situation of the manufacturing companies could prove impossible to sustain if there were a further drop in demand. In short, in Venezuela at the present moment there is not the social tolerance to a deflationary policy that might possibly exist in countries whose balance-of-payments problems emerged immediately following periods of accelerated growth.

Furthermore, the existence of considerable idle capacity leads one to believe that it would be possible to adopt policies to reactivate the economy without unnecessarily aggravating the balance-of-payments and inflation problems. The overvaluation of the currency has meant that the Venezuelan economy is extraordinarily open and that there are, therefore, ample opportunities for import substitution, even of finished consumer goods. The reactivation of the economy, moreover, would serve to encourage the return of capital from abroad that has not yet been invested in other economies, since it would create new investment opportunities in the domestic sector.

The devaluation could have become an incentive to reactivate the economy since, in itself, it implied increased protection. But the adoption of an essentially unstable exchange system inhibited investment, creating uncertainty as regards the financial situation of enterprises. Moreover, the repeated announcement of a refinancing agreement that never actually materialized maintained the suspense as to the future of the economy, which brought production to a standstill.

In order for production to return to normal, therefore, it is essential that an exchange policy be defined. But this is just one aspect of a wider stabilization program whose aim should be to achieve a return to reasonable rates of growth. The designing of such a program would facilitate negotiations with the creditors. But, by the same token, no program of any kind will be accomplished if the negotiations are unsuccessful.

Now, the course the 1983 negotiations have taken leads one to conclude that, if the debt is to be rescheduled, it is practically inevitable that an agreement be made with the International Monetary Fund. However, an agreement with the Fund can only be made if the need to reactivate the economy is recognized. The Venezuelan government should, therefore, be clever

enough to formulate a reactivation program that would reestablish a basic equilibrium in the balance of payments and in the fiscal situation. As far as the Fund is concerned, it needs to be flexible and realistic enough to recognize that this equilibrium will only be achieved if a climate of confidence can be created and a domestic demand capable of setting the production apparatus in motion can be maintained. If this does not occur, the only remaining alternative will be a settlement with the creditors that would not involve the Fund or a moratorium that would have negative effects for both Venezuela and the international financial community.

A stabilization and reactivation program will require as much discipline as that demanded by traditional Fund strategy, except that the discipline would be of a different kind. Whatever the approach adopted it is essential that public finances be put in order, which could serve as common ground between the orthodox recommendations and a strategy more in keeping with the needs of the country. Theoretically, such ordering is easy to achieve, since there is a wide margin of wastage and disorderly utilization of resources for public spending. Furthermore, since taxes are excessively low in Venezuela, their increase is feasible. Thus one sees that the Fund's recommendations concerning fiscal austerity, increases in the domestic price of oil, and the introduction of new taxes form an acceptable and even necessary part of any stabilization program.

The differences mentioned might arise in other areas, such as the role to be played by the public sector. In Venezuela the state has for many years been the driving force behind the economy. The fact that it generates more than 40 percent of the gross national product makes this practically inevitable. Therefore, although one might accept that the weight of reactivation should lie with the private sector and that it is essential that resources be freed to allow private industry to recover, it is also true that the private sector will only increase its level of activity if the public sector maintains an adequate level of demand. In this sense, the adoption of doctrinaire points of view concerning the relative importance of one or other sector is totally misplaced. In the Venezuelan economy the public sector plays a role that cannot be modified in the short term, and if this sector is paralyzed, the rest of the economy will also come to a standstill.

The second area in which differences should be reduced is trade policy. While in the medium and long term Venezuela needs to increase its nontraditional exports, the short-term possibilities for diversifying exports are quite slim, even taking into account the incentives created by the devaluation. In the field of imports, on the other hand, there is a wide margin for reducing foreign-currency needs, since income levels in

previous years and the overvaluation of the bolivar created consumer patterns that encouraged imports. This resulted, for example, in imports representing more than 27 percent of the gross national product in 1982. There is therefore a wide margin for import substitution. As previously mentioned, the production capacity standing idle could achieve this goal in the short term. This would constitute one of the key elements for reactivation and cannot, therefore, be subordinated to theoretical positions regarding trade liberalization.

A third area in which an understanding of the Venezuelan situation is required in order to design an economics program is prices and wages policy. For many years, Venezuela has been a country in which prices have been stable. Between 1958 and 1978 the average annual increase in the cost of living was 4 percent. In the past four years this average has risen to 15 percent. However, wage increases have not kept pace with inflation. Wage negotiations are still carried out on the basis of nominal consumer prices and, with only two exceptions in the last ten years, no general wage increases have been granted. This situation has prevailed despite the fact that the country has strong trade union organizations and enjoys freedom of contract and civil rights.

In the past, real increases in income generated by economic activity and the low rate of inflation allowed an income-price spiral to be avoided. But after three years of real decreases in income, any increase in prices that is not at least partially compensated by wage increases is quite likely to produce changes in the attitudes of the workers. The risk of a wage increase causing a conflict cannot be taken, as it would destroy the peaceful labor relations that have formed one of the most positive features of Venezuela's economy and democracy and could cause an inflationary spiral that would undermine the equilibrium of the economic and social fabric.

For this reason, any economic stabilization program in Venezuela should remain flexible in the treatment of wages and prices. The possibility should not be precluded of adopting wage policies that would incorporate control mechanisms applicable to both wages and prices. This is particularly pertinent in the present situation, since the effect of the devaluation and the checking of inflationary pressures brought about as a result of the price freeze (which lasted more than six months) could create an unmanageable situation in the absence of suitable control mechanisms.

The problems concerning price increases and their effects on incomes must be taken into account in determining the exchange rate. It is clear that the present exchange system cannot be maintained. It is necessary for it to be simplified and for the number of differential exchange rates and the difference between the official

and the free rates to be reduced. Here the reactivation policy can be reconciled with orthodox policy without any major problem. But the extreme must not be reached where determining an equilibrium exchange rate could provoke uncontrollable instability in wages and prices. For this reason it is necessary to either limit the extent of the devaluation or make available suitable tools for adjustment and control.

It would seem possible to design a reactivation and stabilization program that would ensure Venezuela's medium-term payment capacity and that could consequently lead to an agreement with its creditors concerning the rescheduling of the debt. The International Monetary Fund's support for a program of this kind is important in that it would facilitate the negotiations and maintain the ritual of international financial relations. But it would be lamentable if maintaining this ritual prevented reaching a solution to the problem of Venzuela's debt--one of the easiest to solve, since it is the most artificial in what has come to be termed the international foreign-debt crisis.

APPENDIX

For many years Venezuela has been a country with a small foreign debt. Following the blockade imposed in 1902 by Great Britain, Germany, and Italy in retaliation for the delay in paying outstanding debts, the governments of Venezuela have avoided becoming indebted to foreign countries, and public opinion has remained particularly sensitive and averse to international finance commitments. The dictatorship of General Vicente Gómez, who ruled the country between 1908 and 1936, set itself the task of eliminating the foreign debt. In 1930, on the occasion of the centenary of the death of Simón Bolívar, the general gave the following address to the country: "I believe that the best, most pleasing and enduring gift we can offer to his memory is to totally eliminate the foreign debt, for by this uncommon action the nation will achieve new glory and respect." Funds were mobilized for this purpose, and from then until 1957 officially Venezuela had no foreign debt. This was made possible by the discovery and exploitation of the country's oil wealth and the resultant increase in its foreign reserves.

However, during the 1950s the decentralized public-sector enterprises had begun to acquire debts without registering them. As a result, by January 1958 this debt had reached the figure of 3 billion bolivars, twice that of the nation's official debt.

During the year in which the present period of Venezuelan democracy began, the debts were consolidated. But at the same time the flight of capital brought about by political instability and a fall in oil prices led to a decrease in international reserves. In the light of these circumstances a loan for US$2 billion was agreed upon in 1960 with a consortium of foreign banks. This operation signified Venezuela's return to the international finance markets. Following that date, "the country began a policy of complementing its public savings with foreign resources to cover both its day-to-day and development needs, a process which was encouraged by Venezuela's permanent solvency resulting from its balance of payments situation."[1] This process meant a moderate increase in indebtedness up until 1973. In 1957 Venezuela's total foreign public debt was US$236 million. In 1960 it was US$294 million; in 1963, 161 million; in 1968, 437 million; and in 1973, US$1.212 billion (these data are from the Banco Central de Venezuela).

After 1974 and the increase in oil prices, the situation changed radically. The new foreign earnings were too large to be absorbed by the economy, and mechanisms such as the Venezuelan Investment Fund were created to take money out of circulation in order to assign it at a later date to profitable investment. The

increase in aggregate demand made it necessary, however, to increase imports. The economy had acquired new dimensions and very rigorous investment projects were drawn up to absorb additional resources. What held most sway at this time was the conviction, confirmed by the forecasts of the international organizations, that the real price of oil was to increase steadily. From 1975 onward investment grew in real terms at an interannual rate of more than 20 percent. By 1978, total investment represented 40 percent of the gross national product.

From 1974 onward, however, oil earnings fell, and the government thought it wise to maintain high levels of reserves, particularly following the nationalization of the oil industry in 1976. Thus, it turned to foreign credit in order to finance its large investment projects, many of which implied undividable expenditures. By this time, the multilateral finance agencies, such as the World Bank, had suspended credit to the oil-exporting countries; therefore the latter turned almost exclusively to the private international banks. The tendency to use the private banks rather than the international organizations had existed for several years. Thus, while three-quarters of the debt contracted in 1965 was granted by public finance institutions, in 1973 this percentage had dropped to 30 percent.

The attraction of the oil countries for the international banks also meant that Venezuela was offered the most advantageous credit conditions for almost any purpose. The central government's difficulties in controlling the debts of the state enterprises and agencies, which had been growing in previous years, increased to the extent that by 1978 approximately 30 percent of the debt consisted of short-term loans taken out by these institutions. These were not registered as part of the public debt, so total public debt figures for the period 1974-1982 (as well as those already cited for 1957-1973) are underestimated. The 1974-1982 figures on Venezuela's total foreign public debt (also from the Banco Central de Venezuela) are: 1974, US$1.095 billion; 1976, 3.290 billion; 1978, 7.253 billion; 1980, 9.655 billion; and 1982, 12.101 billion.

The increase in the debt between 1974 and 1978 can be traced to the Law for the Nationalization of the Oil Industry by which bonds for the public debt were issued to the value of US$918 million; the Law for Investment in the Basic Sectors of Production, which represented a debt of approximately US$5.4 billion; and the Refinancing Law designed to improve the short-term position of the state institutions.

Fifty-two percent of the registered debt for 1974-1982 matured in the five years between 1979 and 1983. To this should be added the short-term debt for which reliable figures are not available and whose total has been the subject of controversy. Estimates reveal its

total to be at least 23 billion bolivars but do not give a breakdown for the foreign and the internal debt. If the same percentage is used for the foreign debt as for the registered debt, this gives a short-term foreign debt of US$3.7 billion, to which can be added a similar sum for liabilities outside the public-finance sector.

By the close of 1982, according to Venezuelan calculations made for the renegotiation talks, the total foreign debt was running at US$26.690 billion. This total, which included debt of state enterprises and finance bodies, was made up of US$13.992 billion in registered medium- and long-term debt and US$12.698 billion in short-term debt and foreign liabilities of the public-finance sector. This is in marked contrast to the previous figure of US$12.101 billion in registered debt for 1982. The unusual increase in the indebtedness of the public sector's finance institutions was due to the use of short-term foreign credit to bridge operating deficits and to finance long-term investment. To the short-term debt of state agencies should be added the private sector's foreign debt. According to RECADI, that total lies somewhere between US$8 and 9 billion and mainly consists of short-term debt.

NOTES

1. Venezuelan Investment Fund, Evolution of the Public Debt in Venezuela, Caracas, 1979.

13 The External Debt, Financial Liberalization, and Crisis in Chile

Ricardo Ffrench-Davis

Most Latin American countries are facing a dramatic problem of external indebtedness. The sharp deterioration in international markets registered since 1981 has affected the developing nations with unusual severity; the drop in export prices and difficulties of access to the markets of industrialized countries, the rise in interest rates, and the sharp reduction in the new inflow of capital have all joined together to give rise to the biggest external shock in the last half century.

Although generalized, the effects of the external shock on the economies of the debtor nations display considerable variety, which is due to the diverse bargaining powers of the countries, the different speeds and magnitudes of each country's indebtedness process, and the development and indebtedness strategies adopted by them. The latter was also a determining factor in the level of development that each country had reached when it was hit by the external crisis. In other words, there are nations whose economies stagnated or even contracted during the last decade, yet there are others that grew vigorously by using for this purpose the abundant external credit available to them on international markets.

During the last decade the Chilean economy has undergone changes of overwhelming importance. After the 1973 coup d'état, an orthodox monetarist economic model was imposed that progressively liberated various markets, transferred public enterprises to private hands, and systematically did away with the capacity of the state to regulate economic activity. In the area of international economic relations, an import liberalization process was carried out that suppressed selectivity in trade policy, eliminated paratariff restrictions, and established a uniform tariff of 10 percent for almost all imports. This opening-up process in trade was accompanied by a similarly unrestricted opening-up process vis-à-vis foreign investment and by the reduction of restrictions on the purchase and sale of foreign currency and capital

movements.

Within the context of the innumerable changes that have taken place in recent years, it is difficult to single out the effects of a particular area of economic policy. This study concentrates, however, on the external debt of Chile. Because of the intimate relation this had with the operation of the domestic capital market and the balance-of-payments policy, the main features and results registered in these two areas will be set forth here, too.

As has been shown in other studies, the Chilean economy registered a very unsatisfactory performance during the period 1973-1982.[1] At the same time, a spectacular process of concentration of income and wealth took place.[2] The total failure of the experiment carried out in these years is associated to a significant extent, albeit not exclusively, with the trade and financing policies imposed in the period in question. The way these policies were applied made it possible for the external debt to grow very rapidly in the most recent years. At the same time, instead of supporting domestic capital formation, this increase in debt discouraged it. This resulted from five important causes: the rapid and indiscriminate liberalization of imports (especially of consumer goods), the lag in adjustment of the nominal exchange rate, the persistence of high real interest rates on the domestic market, the absolute freedom given to the market forces to decide on the use made of funds of both domestic and external origin, and the difficulty in identifying the market comparative advantages or finding attractive opportunities for productive investment in the context of the market conditions determined by the application of an orthodox monetarist model.

Finally, a high level of vulnerability of the national economy was generated. Thus, in view of the passive and neutral domestic policies pursued, the economy had no weapons to deal with changes originating in the exterior. Furthermore, the rapid indebtedness and the magnitude of the deficit on current account could obviously not be maintained in the medium term, even if the international financial crisis had not occurred. Consequently, the external sector was placed on a course that would inevitably call for a traumatic adjustment process. The seriousness of this situation was accentuated, of course, by the fact that during this ten-year period the national production base and capacity for adjustment were actually weakened rather than developed. Thus, for example, the value added by Chilean manufacturing in 1982 was 16 percent less than in 1973: a flagrant contrast with the developing countries as a whole, which raised their production over the same period by 50 percent.

The first section of this chapter sets forth the main features of the financial opening-up process and gives brief details of the official conceptual framework,

the policies adopted, and the evolution of capital movements and the external debt; special attention is given to bank loans and the behavior of the capital flows received by private debtors. In the second section, the macroeconomic impact of the external indebtedness is examined (especially the way in which it affected monetary and exchange-rate policies), the global adjustment processes to which it gave rise are analyzed, and the evolution of interest rates--especially the persistent gap between domestic and external interest rates--is studied. An examination is made in the third section of the various sources of external vulnerability to which Chile has been exposed as a result of the financial openness. I argue in contradiction to the orthodox monetarist approach that the problems that arose were concentrated in the private-sector segment of the debt, and I attempt to explain why the massive inflow of financial capital, as well as being accompanied by a reduction in national saving, was associated with a decline in the rate of capital formation. The section ends with a brief description of the main features of the external financial situation and the renegotiation process faced by Chile in 1983. Finally, the last section contains a brief recapitulation of the lessons provided by the orthodox monetarist experiment in the field of financial relations and foreign debt.

FINANCIAL OPENNESS AND EXTERNAL INDEBTEDNESS

The official policy postulated an unrestricted opening up to capital movements and the indiscriminate liberalization of the domestic financial market. In this section I set forth the conceptual framework on which the financial opening up was based, then examine the way in which the principles in question were applied and finally analyze the quantitative details of the volume and composition of capital movements and external indebtedness.

The Conceptual Framework of the Experiment

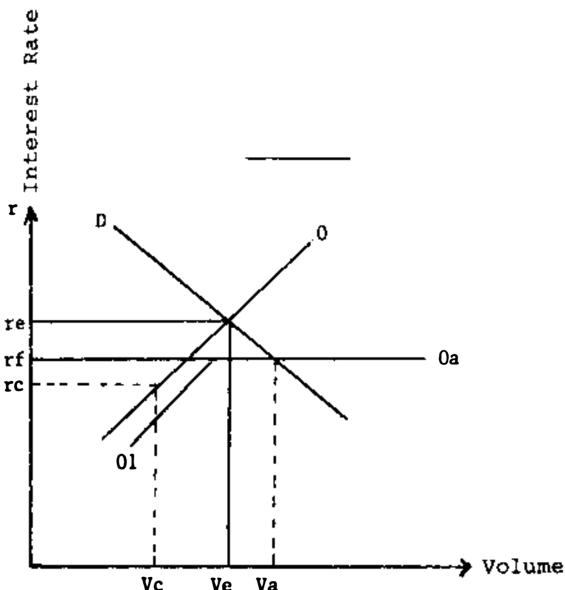
There are of course some very sophisticated orthodox monetarist versions of how the liberalization of capital markets should work and of its effects as compared with those of the so-called financial represssion. The essential aspects of the official version can be conveyed by a very simple scheme, however.

The liberalization of the domestic financial market and the opening up to capital movements sought to increase saving from both domestic and external sources and to improve the allocation of credit resources. In response, it was expected that there would be an increase

in the volume of investment and in its efficiency that would provide the basis for vigorous economic growth.

In simple terms, the conceptual framework may be described with the aid of Figure 13.1. Curves O and D show the supply of and demand for lendable funds prevailing in the market, identified with saving and investment, respectively. To begin with, there had prevailed what is called in the jargon of monetarism a situation of financial repression, in the sense that there were restrictions regarding the organization of new banks and the operations they could carry out. Against this background, the authorities fixed an interest rate (rc) lower than the equilibrium rate for a closed economy (re) and also less than that of an open economy (rf<re). This gives a volume of savings Vc, and demand is rationed to the same level (for the sake of simplicity it is assumed that initially there was no net inflow of foreign capital). The volume of saving and investment (Vc) is less than that in a closed market situation with a free rate, which would be Ve; at the same time, some unprofitable investments are made, since the rationing means that not all of the most efficient investments are made. Thus, some investments would be made that even had returns equal to rc, whereas others with a higher yield would remain without financing (inevitably, in some the return would be greater than re, since the total investment would not exceed Vc).

Figure 13.1 Conventional Conceptual Framework of the Liberalization of Capital Markets



The domestic financial reform would permit r to rise to its equilibrium level and would give savers more alternatives for investing their funds. Thanks to the greater variety of alternative options, there would be a greater supply ($O1$, located to the right of O), which would displace in particular "investment" in "non-productive" assets. At the same time, the opening up of finance to the exterior would permit the entry of foreign capital to supplement the funds available for investment. With the free movement of capital, a volume of investment $Va > Ve$ would be reached, and the domestic interest rate would become equal to rf.

The exchange-rate policy adopted is a determining factor in the results obtained. In order for interest rates to be equal, there must be no expectations of variation in the real rate of exchange (deflated by net inflation). First of all, this was sought through a policy of minidevaluations. Subsequently, an attempt was made with a fixed exchange rate. Official policy assumed that, in a free trade regime such as was already in operation in 1979, with a fiscal budget that registered a surplus and an exchange rate close to the "equilibrium level," freezing of the nominal exchange rate would rapidly prevent domestic inflation from exceeding external inflation. Thus, the exchange rate would become the main instrument for stabilizing the level of domestic prices.[3] The authorities thus formally adopted the most extreme type of monetarism: that is to say, the monetary approach to the balance of payments, with its corollary of a fixed exchange rate and neutral monetary policy.

The discrepancies between official thinking and reality were very marked. The volumes of national saving and capital formation were less than Vc: That is to say, instead of growing, they went down markedly. The domestic interest rate stood at unexpectedly high levels and was spectacularly higher than the external rate. Fixing of the nominal exchange rate led to a significant loss of purchasing power. Private indebtedness grew out of all proportion, encouraged by borrowers' assumption that its real cost would remain low and that there would continue to be easy access to credit in the future. Finally, the excessive indebtedness, with the correspondingly higher service costs, weakened the system of production and the payments capacity instead of proportionately strengthening them. The intensity of these discrepancies contributed to the general failure of the model imposed during the 1970s in Chile.

The New Institutional Framework

In the period under consideration,[4] three subperiods may be distinguished as regards the application

of these financial policies. The first ran from 1973 to 1975. During that period there were no substantial changes in the domestic financial system. Various measures taken to encourage foreign investment and external credits had little effect, in the sense that the net flows were not significant. The second period began in 1975, with the drastic reform of the domestic financial system and the transfer of most of the commercial banks to private ownership. The application of the principles in question as regards external financing was gradual, however. The evolution that took place in this aspect was in contrast to the speedy opening up to the exterior as regards trade, an opening that was still expanding. In the following years, however, there was a heavy inflow of capital, which grew rapidly between 1976 and 1981. The determining factors of this flow were the abundance of funds available on the international market, the low initial bank debt, the "image of creditworthiness" that Chile managed to project, and the absence of domestic and external restrictions regarding the use of the funds. In the last part of the period, from the end of 1981 onward, even though the liberalization of capital inflows was intensified still further, the net flows shrank drastically, both as a result of the emergence of the international financial crisis and of the tardy recognition by the international banking system of the overindebtedness incurred by Chile.

The main reason for the limitations on the size and periods of the capital movements is to be found in the aim of ensuring control over the money supply, which for several years played the principal role in the anti-inflation policy. It was considered that, in view of the big differences that had existed between the domestic and external interest rates, "a drastic liberalization of the capital account would attract credit in such volume that this would hold up the stabilization program. For this reason, a gradual liberalization process was preferred."[5] The official declarations always insisted on the temporary nature of the restrictions imposed, however. Indeed, with the passage of time, the movement of capital was liberalized through increases in the maximum amounts of indebtedness and the elimination of restrictions or their replacement with more flexible controls.

In 1981, the year in which the net use of foreign capital came to 21 percent of the GDP, the entry of financial credits (under Article 14 of the law on international exchange operations) was subject to a minimum stay in the country of twenty-four months and the compulsory deposit of a percentage of the credit (10 or 15 percent, depending on the term) in the case of operations for less than sixty-six months. There were no special restrictions on the volume of credit that the banks could procure abroad and grant in the form of

foreign-currency loans in Chile, but there was still a limit on the security that could be provided. During 1982, in the midst of the internal crisis of the Chilean economy, the minimum term of twenty-four months for credits was eliminated and the compulsory deposit was set at 5 percent of the external loan, which was a rate similar to the reserves demanded in respect of domestic bank deposits.

The capital movements have been influenced by the conditions in which the financial institutions have operated. At the end of 1973, the commercial banks were mostly in the hands of the state, as a result of the process of nationalization of the banking system promoted by the previous government. During 1975, most of the banks were offered for sale and returned to the private sector. Together with the freeing of interest rates in April of that year, wide facilities were also given for the setting of readjustment conditions (monetary corrections) in respect of operations for more than ninety days and for the payment of interest on short-term deposits. Furthermore, the regulations regarding control of the amount of credit in national currency, which had mainly been aimed at channeling credit to production rather than consumption, were eliminated, and both the authorized operations and their conditions were made the same for the different types of financial institutions.

Changes in the regulation of foreign banks were also included within this trend toward uniform treatment. The activities of foreign banks had been restricted during the governments of Presidents Frei and Allende, and they did not begin to return to the market until December 1974, when the restrictions prohibiting their operation in the country were lifted.

Financial Capital Movements and Indebtedness, Volume, Origin, and Destination

Capital movements grew rapidly from 1977 onward. Even though after that date the Chilean external sector registered a large and growing current account deficit, the net inflow of capital was sufficient to permit significant accumulation of international reserves until 1981. The larger flow took place against the background of big expansion of the external sector, especially of imports of nonessential consumer goods. The capital movements were overwhelmingly concentrated in credits to the private sector without any state guarantee, less than 20 percent of the inflow being accounted for by direct foreign investment and loans to the public sector.

Table 13.1 shows the evolution of various indicators of annual capital movements. The flows, expressed in money of constant purchasing power, increased very markedly in the second half of the 1970s (columns 1 and 2). They

Table 13.1 Chile: Annual Deficit on Current Account and Capital Movements (millions of 1977 U.S. dollars)

Year	Balance on Current Account (1)	Cross Inflow of Credits (2)	External Financing of Investments (%) (3)	External Financing of Domestic Expenditure (%) (4)	Export Deficit (%) (5)	Debt-Servicing Coefficient (%) (6)
1970	-166	941	6.8	1.4	6.5	27.0
1971	-367	772	15.5	2.8	16.9	38.4
1972	-690	1,302	36.4	5.4	40.0	27.9
1973	-441	1,106	24.7	3.6	20.7	25.4
1974	-256	1,064	12.0	2.1	8.9	35.1
1975	-534	1,109	32.5	5.0	29.3	55.6
1976	160	1,086	-11.4	-1.4	-6.5	52.7
1977	-551	1,390	34.1	4.6	22.5	52.8
1978	-965	2,559	50.9	7.4	38.5	58.3
1979	-933	2,691	42.2	6.6	27.3	50.8
1980	-1,382	3,270	51.2	9.0	36.8	47.7
1981	-3,348	4,640	108.1	20.7	103.2	70.8
1982	-1,693	2,238	87.2	12.2	53.4	88.5

Note: All the nominal figures in U.S. dollars were deflated by the External Price Index (R. Ffrench-Davis, "Indice de Precios Externos para Calcular el Valor Real del Comercio Internacional de Chile, 1952-80," *Notas Técnicas no. 32* [Santiago: CIEPLAN, 1981]) in order to convert them into figures at 1977 prices. Column (3) measures the percentage relationship between the deficit on current account and gross fixed capital formation; column (4) indicates the relationship between the deficit on current account and the gross domestic product; column (5) is the relation between the deficit on current account and exports of nonfinancial goods and services; column (6) is the quotient of the gross outflow plus net interest payments and total exports of nonfinancial goods and services. For the conversion into U.S. dollars of the figures for GDP and investment, which were originally given in 1977 pesos, the average real exchange rate for the three-year period 1976-1978 was used, expressed in 1977 pesos per U.S. dollar of the same year.

Source: Calculated on the basis of Banco Central de Chile, *Balanza de Pagos*, *Deuda Externa de Chile*, and *Cuentas Nacionales Nuevas*.

also grew as a proportion of various domestic variables. Thus columns 3 and 4 show that the capital movements markedly increased as a proportion of gross domestic investment and of the GDP. This was partly a result of the relative stagnation of the latter two variables during the 1970s. External savings (deficit on current account) and the servicing of capital also grew, with some ups and downs, in relation to exports (columns 5 and 6), in spite of the dynamic growth of the latter in the early years of the orthodox monetarist experiment. The total debt servicing amounted in 1981 to 71 percent of exports of goods and services, and in 1982 it rose to 88 percent: that is to say, three times the servicing coefficient of the years 1970-1974. In short, various quantitative data show that from 1977 onward, capital movements assumed a rapidly growing relative weight in the Chilean economy. The coefficients reflecting their incidence show a debt-servicing burden substantially greater than for Latin America as a whole in the 1970s.[6]

Debt-related transactions (as reflected by the volume of gross transactions and amortization payments) increased faster than the net capital flows, since the terms of the external credits grew shorter. This was a direct consequence of the increased share accounted for by debts with private creditor banks (see Table 13.2), which operate with shorter maturities. The magnitude reached by capital movements is reflected by the fact that in the two-year period 1980-1981, the gross inflow of credits was equivalent to 25 percent of the GDP.

During the period under analysis, significant changes took place as regards the agents (creditors and debtors) participating in movements of capital. In regard to creditors, in 1981 over 80 percent of the external debt was with banks and financial institutions, which had accounted for only 19 percent of it at the end of 1974 (Table 13.2). This increased participation by private lenders in the origin of funds was reflected in a decline in the _nominal amount_ of the debt with official bodies. This reassignment of borrowing was partly the result of greater use of an external supply of bank funds, which had previously been relatively little used by Chile as compared with other semiindustrialized countries. Before 1977, Chile had had less recourse than the rest of the Latin American countries to the international banking system. From then on, however, it rapidly caught up and (according to the Bank for International Settlements data) became one of the principal debtors with the private international capital market among the non-oil-exporting developing countries, moving up from eleventh place in 1976 to fifth place in 1981. Within the Latin American context, Chile's per capita bank debt in 1982 came to over US$1,000, compared with a regional average of US$600 and only about US$500 in the case of Brazil.[7]

Table 13.2 Chile: Total External Debt and Debt with Private Financial Institutions

Year	Total Debt (millions of US$)	Financial Institutions (millions of US$)	Financial Institutions Share in total (%)
1974	4,776	923	19.3
1975	5,453	1,352	24.8
1976	5,392	1,506	27.9
1977	5,763	2,144	37.2
1978	7,153	3,723	52.0
1979	8,790	5,885	67.0
1980	11,331	8,579	75.7
1981	15,706	13,169	83.8
1982	17,263	14,986	86.8

Source: Banco Central, Deuda Externa de Chile, 1982, tables 1, 3, and 11; R. Ffrench-Davis and J. P. Arellano, "Apertura Financiera Externa: La Experiencia Chilena en 1973-80," Colección Estudios CIEPLAN 5, 1981, table 7. The total debt refers to the current disbursed balance. In addition to the traditional debt, it includes national currency liabilities, liabilities with the IMF, and short-term international liabilities of the monetary system. From 1975 onward, it includes short-term debts contracted by sectors other than the monetary system, with the exception of direct foreign-trade operations.

Furthermore, Chile's bank debt grew at the rate of 57 percent per year between 1977 and 1981, compared with an average of 28 percent for the developing countries as a whole.

As regards debtors, the inflow of credits for the private sector showed marked growth; in the public sector debt-amortization payments predominated. Thus, after 1975 the growing net inflow of capital was received mostly by the private sector. This situation was in line with a deliberate policy of the government, as part of its program of reducing state participation. This was facilitated by the change that took place in international markets: the loss of weight on the part of official finance institutions, which operated mostly with government bodies, and the vigorous emergence of the private international capital markets, which offer access to both public and private debtors.

This evolution, described so far in terms of annual flows of resources, is also reflected in the external debt balances. Table 13.3 shows the composition of the gross and net debt (gross debt less reserves), by primary borrowers. It will be seen that the private sector (including the commercial banking system) increased its share as gross debtor from 19 percent in 1973 to 73 percent in 1982.

In addition, the level of the international reserves rose steadily up to 1981. This has implications for the

Table 13.3 Chile: External Debt, by Borrowers (millions of U.S. dollars)

	Gross Debt		Net Debt		Private-Sector Share in Net Debt (%)
Year	Public Sector (1)	Private Sector (2)	Public Sector (3)	Private Sector (4)	(5)
1973	3,276	786	3,063	716	18.9
1974	3,897	879	3,709	773	17.2
1975	4,426	1,027	4,252	931	18.0
1976	4,252	1,140	3,718	1,016	21.5
1977	4,319	1,444	3,763	1,339	26.2
1978	4,858	2,295	3,648	2,147	37.0
1979	5,018	3,772	2,882	3,053	54.9
1980	4,905	6,426	1,569	5,986	79.2
1981	5,145	10,561	1,878	9,761	83.9
1982	5,892	11,371	3,866	10,586	73.2

Note: Column (1) excludes state-guaranteed private debt and external debt contracted by the Banco del Estado de Chile; column (2) includes state-guaranteed private debt and debt contracted by the Banco del Estado de Chile; columns (3) and (4) represent the gross debt less the international reserves of the Banco Central and of the financial system, respectively. For the purpose of measuring reserves, holdings of gold were valued at the constant real price of US$42.222 per ounce of fine gold, base 1977.

Source: International Monetary Fund, International Financial Statistics Yearbook, 1982, and May 1983; Banco Central, Boletín Mensual (May 1983), Deuda Externa de Chile (1979 and 1982), and Indicadores Económicos y Sociales (1960-1982); DIPRES, Exposición Sobre el Estado de la Hacienda Pública, October 1982.

effects caused by the external indebtedness of domestic purchasing power. When foreign credit has as its counterpart a bigger current account deficit (corresponding, for example, to a similar increase in imports), the recipient of the credit increases purchasing power without a direct impact on the rest of the economy. When the external credit ultimately involves an increase in the reserves, however, the debtor's purchasing power is increased at the expense of the Central Bank emission corresponding to the excess foreign currency on the exchange market that the Central Bank is obliged to acquire. The final incidence on the purchasing power of the public and private sector will therefore depend on the reaction of the government to the accumulation of reserves, which may be expressed through such measures as raising the exchange rate, further liberalizing imports, reducing domestic credit, or reducing public expenditure.

An estimate of the impact or initial effect of the movement of capital is shown in columns 3 and 4 of Table 13.3, which show the total debt less the reserves of the respective sectors. As the accumulation of assets

was concentrated in the public sector (Central Bank), up to 1981 this was reflected in a substantial reduction in its net liabilities (accumulated balance of current loans less reserves of the sector). In the case of the private sector, in contrast, the net indebtedness grew very rapidly, increasing by a factor of fifteen between 1973 and 1983. These data show clearly that the inflow of external capital helped to accentuate the process of greater private participation in expenditure in the Chilean economy.

It should be noted that the majority of the private debt was contracted without state guarantee. Thus, in 1981 almost two-thirds of Chile's total debt lacked official guarantee, and the figure was still over 60 percent toward the end of 1982. The presence of a nonguaranteed debt of over US$10.5 billion undoubtedly constitutes a decisive factor in the process of renegotiation of the external debt.

In regard to the intermediaries dealing with the external capital, up to 1977 the private sector obtained a significant part of the credits directly, because of the quantitative restrictions faced by the banks in these operations. This statement calls for two qualifications, however. On the one hand, the section of the nonfinancial private sector with most access to external credit was that with the closest connections with national and foreign banking institutions. On the other hand, a substantial proportion of these loans had bank guarantees. From 1978 onward, the domestic financial sector assumed greater importance in the direct intermediation of external private financing. Table 13.4 gives details of the credits that entered the country under the terms of Article 14. This table shows that between 1978 and 1981, the public sector virtually disappeared as a user of this source of external funds while the banking institutions achieved marked predominance as intermediaries, operating with them directly or indirectly (i.e., as guarantors).

During the first years of the process, in spite of the expansion of external indebtedness and the increase in the deficit on current account, the government did not show much concern in this respect. On the contrary, it maintained that what was important was the way in which the real net debt evolved, the rate of interest paid, and the sectors contracting indebtedness.

The official figures for the real net debt showed a reduction over the five-year period 1976-1980: According to them, it went down from US$5.3 billion in 1975 to US$4.3 billion in 1980 (in 1977 dollars). Two external factors explained this reduction in contrast with the high annual rate of indebtedness. The first factor in terms of its importance was the rate of international inflation, which eroded the real value of the debt balance; the second factor was that the debt also went

Table 13.4 Chile: Article 14--Gross Annual Flows of Credit, by Debtors

Year	Total Flow of Credit (millions of US$) (1)	Percentage Breakdown: Public Sector (2)	Private Nonfinancial Sector (3) and (4)		Financial Institutions (5)
1976	262.6	13.3	86.3		0.4
1977	336.4	13.2	80.1		6.7
			Nonguaranteed (3)	Guaranteed (4)	
1978	780.2	4.2	31.0	26.0	38.8
1979	1,245.2	1.8	34.7	21.6	41.9
1980	2,503.7	3.1	14.5	17.6	64.8
1981	4,516.7	1.9	20.6	4.6	72.9
1982	1,770.8	24.4	24.7	6.1	44.8

Note: Column (1) shows the gross annual flow of disbursed credits, less compulsory deposits. The breakdown over columns (2) to (5) was estimated on the basis of that for Santiago.

Source: Prepared on the basis of Banco Central, "Créditos Liquidados Artículo 14" (December 1980), and *Boletín Mensual*, no. 662 (April 1983).

down in response to the rise in the value of that portion of the reserves maintained in gold. Between them, these two factors explained a reduction of US$2.7 billion in real net indebtedness in the five-year period in question.[8] Thus, instead of having gone down in real terms by 18 percent, the debt would have grown by one-third if it had not been for these two factors and would have shown a sharp acceleration toward the end of the period in question. It was therefore clear that the rapid growth of external indebtedness permitted was dangerous, and also prejudicial to national development, as is shown later. Nevertheless, the government insisted right up to the end that entering into debt was good business because the real interest rate was very low or actually negative; furthermore, the debtors were in the private sector, which was subject to "free" market laws so that, in official opinion, there could be no doubt that it was efficient.

INDEBTEDNESS AND MACROECONOMIC ADJUSTMENT

A massive process of external indebtedness such as the one that took place between 1977 and 1981 has significant effects in many areas of the national economy. This was demonstrated with great intensity in Chile. The process profoundly affected total demand and its composition, contributed to the spectacular concentration

of wealth, considerably altered the functioning of the process of saving and investment, and conditioned to a decisive extent the handling of monetary and foreign-exchange policies.

The initial impact of the external indebtedness involved an increase in the availability of foreign exchange. This increase gives rise to two possibilities that are its counterpart. One is an increase in the international reserves, usually accompanied by an increase in monetary issue; the other consists of the expansion of the current account deficit. In practice, up to 1981, the growing indebtedness manifested itself in both ways simultaneously, since the net inflow of capital was greater than the capacity of the national economy to absorb the resources provided by external credits. The current account deficit steadily increased by considerable amounts (see Table 13.1, columns 1 and 4): In 1980, net use of foreign capital was close to the equivalent of 9 percent of the gross domestic product, in contrast with 5 percent for Latin America as a whole. In spite of this, the inflow of capital through private debtors grew still more quickly. The corresponding surplus (the difference between the volume of funds received and those used) gave rise to the increase in international reserves registered up to 1980; in that year the total Central Bank reserves represented 68 percent of annual imports of goods.

The rapid accumulation of reserves had substantial effects on the handling of monetary and foreign-exchange policies. Furthermore, the big capital movements--both those used to finance greater spending on imports and those that went to swell the international reserves--meant that a very high proportion of the total credit available in the national economy originated from foreign funds, and its cost was associated with the evolution of the exchange rate. This section is devoted to these three topics, ending with a summary of the principal distortions--with their effects as regards assignment and distribution--caused by the greater financial openness to the exterior.

Monetary Policy and the Crowding Out of Domestic Credit

From 1975 onward, exchange operations (net purchases of foreign exchange by the Central Bank) constituted the main source of expansion of money issue.[9] As time went on this phenomenon was further intensified, and in the three-year period 1978-1980 these operations represented over 100 percent of the total money issue. As already noted, the overwhelming proportion of net purchases of foreign exchange by the Central Bank came from the private sector. Indeed, in some years exchange operations with the public sector even had a contractive effect. As

regards the credit operations of the Central Bank, those carried out with the public sector showed a negative balance from the year 1975 onward, whereas those with the private sector showed modest expansion throughout the period. This situation continued until 1981, when the serious macroeconomic disadjustments that had been build-up in the Chilean economy began to emerge into the open, and the loss of international reserves began. Correspondingly, the monetary effect of exchange operations became markedly restrictive.

As indicated in the first section, during certain periods direct restrictions were used with regard to the inflow of capital, as an instrument of monetary programming. One of these restrictions was particularly directed toward controlling the monetary effect of the inflow of capital, by limiting the amount of resources that could be changed in the Central Bank each month. This limitation was enforced--with successive modifications in the maximum amounts of exchange operations authorized--from September 1977 to April 1980. These restrictions were not sufficient to keep the inflow of loans to the private sector down to a volume compatible with the monetary expansion desired by the economic authorities, however. Consequently, the latter took action regarding the other sources of money issue and regarding the exchange rate. In both cases, there was a crowding out of the domestic economy by the economy associated with the exterior. Domestic credit was restricted in the face of the increase in money issue through net foreign-exchange purchase operations. The exchange rate, for its part, was revalued or lagged behind the actual situation (see the next section) in response to the accumulation of reserves, thus crowding domestic producers of tradable goods out of the market.

The goals in regard to the expansion of liquidity remained in force as long as the closed-economy monetary approach predominated. Subsequently, in 1979, the open-economy monetary approach was adopted. Under this, the nominal exchange rate was frozen, a "neutral" monetary policy was explicitly adopted, and it was hoped that a process of automatic adjustment of the money supply would enter into force. Thus, the variations in the international reserves were to be the determining factors of the degree of liquidity of the national economy, against the background of a balanced fiscal budget and stable bank reserve rates.

This monetary approach to the balance of payments prevailed to the full for three years, from mid-1979 to mid-1982, with a "neutral" monetary policy based on the dollar standard. During the last year in which it was in force, a contractive "automatic adjustment" began to operate, with disastrous effects on employment and national production.[10]

Exchange Policy: Instability and Lag

Exchange policy assumed varied forms during the period under analysis. Up to June 1976, the exchange rate was changed between one and four times per month. From then on, after a sudden revaluation at that date and another in March 1977, it was devalued daily according to a scale fixed every month in advance. This arrangement was kept up until February 1978, when a table of daily exchange-rate adjustments was fixed for the rest of the year. The same scheme was announced for 1979, but in June of that year it was interrupted when the exchange rate was devalued to the nominal level that it had been programmed to reach at the end of the year (thirty-nine Chilean pesos per U.S. dollar). It was kept at this level until 1982, when there was an 18 percent devaluation. This was followed by the announcement of a table of minidevaluations, soon replaced by a free rate; this lasted only a short time and was then replaced by various forms of minidevaluations according to domestic or net inflation. The effect of these minidevaluations on the real exchange rate is shown in Table 13.5.

I have analyzed the exchange policies applied in Chile in detail in other studies.[11] Here, I shall limit myself to stressing a very important feature of exchange policy that consists of the notable discrepancies between the real situation and the monetary approach to the balance of payments. It has been demonstrated in practice that through their policies the authorities can bring about notable variations in the level of the real exchange rate. In other words, the single-exchange-rate law, even in an economy whose external trade is as liberalized as in the case of Chile since 1979, has very limited validity. In particular, the exchange rate lags can be so large that they involve adjustments diverging from equilibrium for the space of several years, thus generating erroneous signals, faulty assignment of resources, and a low rate of utilization of production capacity.

These tendencies were manifested very forcibly in Chile, especially during the period when the fixed nominal exchange rate was thirty-nine pesos per dollar. During the three-year period when the exchange rate was frozen, its real level deteriorated by close to one-third. Domestic inflation went down significantly, from over 30 percent per year to less than 10 percent, but during the transition between these two levels an imbalance of the size mentioned was accumulated between domestic and external prices. Consequently, in order to return to the initial level of the real exchange rate, which was apparently considered by the government and its advisers as being close to equilibrium,[12] it would be necessary for inflation in Chile to be over thirty percentage points lower than the international level.

Table 13.5 Chile: Real Exchange Rate and Wages
(Chilean pesos per 1977 U.S. dollars)

Year	Real Exchange Rate	
	Deflated by Corrected Consumer Price Index	Deflated by Index of Wages and Salaries of National Statistical Institute
1974	23.40	27.90
1975	32.14	39.44
1976	25.89	29.89
1977	21.54	21.54
1978	23.81	21.48
1979	23.16	19.31
1980	20.09	15.41
1981	16.93	11.92
1982	19.63	13.86

Note: The annual average nominal exchange rate was inflated by the external price index.

Source: Central Bank, Boletín Mensual, various issues; National Statistical Institute, Indice de Sueldos y Salarios; R. Cortazar and J. Marshall, "Indice de Precios al Consumidor en Chile: 1970-78," Colección Estudias CIEPLAN 4, 1980; and R. Ffrench-Davis, "Indice de Precios Externos para Calcular el Valor Real del Comercio Internacional de Chile, 1952-80," Notas Técnicas no. 32 (Santiago: CIEPLAN, 1981).

During the last months of 1981 and the first half of 1982 there was a slight adjustment of relative prices in this direction.[13] At the same time, however, there was a violent increase in open unemployment and a rapid drop in manufacturing production.[14] It may be noted that the segment of the economy with debts expressed in pesos (nonreadjustable) would have had to suffer an increase in its real liabilities if there had indeed been an intensive deflationary process. As domestic indebtedness was generalized, the perturbing effects on the debtor enterprises would have been substantial.

The plain truth is that, after some months of automatic adjustment, with a slight movement in the direction of the required readjustment of relative prices, the economic results were disastrous. The economic team did not succeed in achieving the imposition of the suggested plan to accelerate the adjustment through a reduction by decree of nominal wages. Instead, the abrupt devaluation of June 1982 took place.

Throughout the ten-year period, the effect of exchange-rate variations on capital flows practically did not figure among the objectives taken into account in determining exchange policy. The inflow of external financial resources, however, was crucial in order to permit the handling of the exchange rate in the light of objectives other than those of the efficient assignment

of resources without (up to 1981) bringing about a deterioration in the overall balance of payments. The use of the exchange rate to guide expectations (in 1976-1979) and/or to set a limit on domestic price rises (1979-1982) did indeed result in smaller inflation. The net inflation persistently went down more slowly than the exchange rate, however: The latter acted as a variable tending to repress inflation, but devalued itself during the process. This, together with the liberalization of imports and the recovery in economic activity registered between 1977 and 1981, led to a significant current account deficit that amounted in 1981 to 21 percent of the GDP.[15] At the same time, the gradual deterioration in the real exchange rate reduced the cost of external indebtedness, so that in 1979 and 1980 this cost was negative. Consequently, the flows were affected by the variations in the real exchange rate, accentuating the problem of the composition of the balance of payments:[16] the growing deterioration in the current account deficit and a likewise growing surplus on the capital account.

Interest-Rate Differentials

The official approach expected both a sharp tendency toward a reduction in financial intermediation spreads and the leveling of domestic and foreign interest rates, in response to the overall liberalization of the financial system. However, throughout the period large differentials persisted between the rates of interest for loans and deposits on the domestic financial market, while the level of both rates was notably high. Furthermore, in spite of the big inflows of capital registered, especially from 1979 onward, domestic rates were considerably higher than international rates, as shown by Table 13.6. The domestic rate refers to the predominant segment of the market, covering transactions for terms of thirty to eighty-nine days, and the international interest rate is that paid for bank credits obtained under Article 14, plus the cost in respect of compulsory deposits and the financial intermediation margin, all converted into their peso equivalents.

It may be noted that the *ex post* gap between the domestic and external rates for loans never dropped below an annual rate of eighteen percentage points. In this respect, the traditional explanations that the differential is due to expectations of a bigger devaluation than the effective evolution of the official exchange rate do not seem to be valid. For example, between 1977 and 1982 the parallel or black-market rate was very similar to the official rate.[17] The easy access to the exchange market that existed at that time and the cash nature of the parallel rate do not make

Table 13.6 Chile: Domestic and External Real Interest Rates Reflecting Their Level with the Conversion of External Transactions into Pesos (annual percentages)

	Domestic (1)	External (2)	Differential (3)
1975 (second half)	121.0	--	--
1976	51.2	-21.1	72.3
1977	39.4	0.2	39.2
1978	35.1	3.8	31.3
1979	16.9	-0.9	17.8
1980	12.2	-8.0	20.2
1981	38.8	12.4	26.4
1982	35.2	45.0	-9.8

Source: Prepared on the basis of data from the Banco Central; Instituto Nacional de Estadisticos; J. P. Arellano, "De la Liberalización a la Intervención: El Mercado de Capitales en Chile, 1974-83," Colección CIEPLAN 11, December 1983; R. Cortazar and J. Marshall, "Indice de Precios al Consumidor en Chile: 1970-78," Colección Estudios CIEPLAN 4, 1980; and R. Ffrench-Davis and J. P. Arellano, "Apertura Financiera Externa: La Experiencia Chilena en 1973-80," Colección Estudios CIEPLAN 5, 1981. In 1982, the "preferential" exchange rate fixed by the government for existing debtors was used in calculating the external interest rate.

it a precise indicator as regards expectations of devaluation over twenty-four months, which is the minimum term for the entry of capital under Article 14, but they do reflect the prevailing atmosphere of a quiet market in which there was continual sale of foreign exchange by the public over bank counters.

It is possible, however, that despite the quietness displayed by the market, debtors with the exterior did not foresee the lag repeatedly suffered by the real exchange rate. Likewise, it seems quite possible that the market was not very aware of the need to make an adjustment for external inflation when measuring the real exchange rate. It is therefore probable that the expected "external interest rate," comparable on the "market" with the real domestic rate, would be closer to its nominal level in dollars than to the *ex post* rate given in column 2 of Table 13.6. This nominal rate fluctuated between 14 percent and 23 percent between 1976 and 1982. Consequently, even using this hypothesis, there would still be a substantial gap with the rate for domestic credit.

In addition to the domestic/external gap, there were substantial differentials between the domestic rates for deposits and for loans. There were various reasons for these high spreads, and their significance was changing over the course of the period. This topic has been dealt with elsewhere.[18] I shall therefore limit myself here to mentioning some of the aspects that have the

greatest implications for the central analysis, that is to say, the subject of the external debt and capital movements.

Traditional explanations put forward are as follows: (1) the requirement to maintain bank reserves is adduced as a determining factor in the gap between domestic interest rates on deposits and loans (the financial intermediation spread), (2) the fiscal deficit and the inelastic demand for credit by public enterprises are indicated as being responsible for the high interest rates on loans, and (3) the restrictions on movements of capital are said to be responsible for the differential between rf and re (Figure 13.1). None of these possible causes was of significant importance during the whole period, however. The first of them was of some importance only in 1975-1976, because of the high requirements for non-interest-bearing bank reserves and high inflation (over 300 percent per year). Nevertheless, very high levels of financial intermediation spread, net of the costs of maintaining these reserves, persisted during most of the period from 1975 to 1982. Moreover, the fiscal deficit went down rapidly and substantially (to less than 3 percent of the GDP in 1975) and became a surplus in 1979. Finally, in spite of the persistence of restrictions on movements of capital, such movements reached very high levels, as was shown in the first section. Consequently, the orthodox analysis is not capable of explaining why, with net capital inflows equivalent to an average of 7.7 percent of the GDP in 1978-1980, the gap between domestic and external interest rates stood at an average of twenty-three percentage points per year (see Table 13.6). In this period, as noted, it was clear that there were as yet no expectations of a massive devaluation.

It must therefore have been other factors that carried greater weight in explaining the behavior of interest rates and of the financial intermediation spread. Various items of information suggest that the banking system has been inefficient and that its operating costs rose after the reform.

1. One of the reasons for this up to 1977 was the under-utilization of the installed capacity. Furthermore, the fact that the system has operated with such short terms for both deposits and loans has constituted another cause of increased costs. This would seem to explain why in 1978 the cost level of the system was of the order of 8 percent of total loans, a very high figure by comparative international standards. Nevertheless, even after discounting the operating costs, the financial intermediation spread still remains very high. The persistence of these high costs and projects has been associated with the structure of the financial market and the degree and form of competition among the institutions in the sector.

2. The short term of the operations facilitated the prevalence of high rates.[19] Applicants who had no access to external credit had to face a severe recession in domestic demand simultaneously with the freeing of interest rates. Against a background of heavy propaganda to the effect that the recession would only be brief, many business people resorted to expensive short-term credit instead of closing down their operations, expecting a rapid reactivation of demand. In these circumstances, debtors did not view themselves as taking out a loan at a real interest rate of 40 percent per year, but rather as borrowing for thirty days at 3 percent, with the probability of renewing the loan for a few months.

Effective demand, however, remained generally depressed (and lagging behind aggregate demand), and interest rates continued to be high and unstable. In the face of the continuing delay in the hoped-for reactivation, business people engaged in successive renewals of their bank debts, with the increased risk that this involved. This phenomenon was further strengthened by the demand for credit by activities that were adversely affected by the tariff liberalization. In spite of business expectations that it would be abandoned, this liberalization process was maintained and even--unexpectedly, on a number of occasions--further intensified until it culminated in a uniform tariff of 10 percent in 1979.

3. Certain opportunities for highly profitable "investments" arose. Numerous public enterprises were disposed of at prices significantly below normal market levels. Similar opportunities were offered by "investments" in real estate and movable assets, whose prices rose notably in real terms: The securities index increased fivefold in constant values between 1975 and 1979. The elimination of regulations on the use of credit made possible its rapid redistribution toward these uses, which were good investments from the private point of view, although not from that of the country as a whole.

4. In recent years there has been a noteworthy increase in consumer credit, especially for imported consumer durables. Here, too, the suppression of the previous restrictions on bank credit for consumers facilitated the change in the composition of expenditure. Furthermore, the liberalization of imports also promoted the expansion of demand for credit to be used in the marketing or purchase of imported consumer goods. Thus, the savings of some nationals filtered through, by way of the financial system, to the consumption of imported goods. This is one explanation for the drop observed in the rate of national saving. In the three-year period 1978-1980, which was the period of alleged great success of the economic model, the rate of national saving, measured as the gross fixed-capital formation rate less the rate of utilization of foreign capital, came to

barely 8 percent.

5. The gradual recovery in domestic economic activity and wages from the very depressed levels reached in 1975, together with the massive official publicity within the prevailing authoritarian framework, helped to create an image of a dynamic and rapidly growing economy. And as the recovery on the basis of the utilization of existing installed capacity began to come to an end, the aggregate demand was fed with the very big external credits that propped up the semblance of a boom period until far into 1981. The atmosphere of success created, together with the consequent expectations of growing income, induced consumers and businesses to continue increasing their indebtedness while it prompted the banks to renew and rapidly expand their lines of credit. Within this context, the banking institutions competed with each other, partly by reducing the cost of their services (the financial intermediation spread) but also by reducing the security demanded from their borrowers.

6. A significant proportion of the funds involved were assigned by the banks to businesses linked to them as regards their ownership. Thus, for example, in 1982 the main bank of the biggest economic group in the country had 44 percent of its portfolio loaned to firms that were openly and directly related to that same group. Consequently, financial transactions became mere internal group operations, weakening appraisal criteria and procedures for recovering debts.

7. In the context already described the high cost of loans on the domestic capital market helped to increase the demand for them rather than to reduce it. Thus, the factors described in paragraphs 2 through 6 tended to make the demand for credit more inelastic, while at the same time the high financial costs caused an increase in the demand for funds in order to pay interest commitments, with this effect predominating over the pure price effect. The fact that credit, viewed as just another product, was traded and used in the same unit as products proper, in contrast with transactions of nonfinancial goods and services in a monetary economy, gave rise to this different behavior of demand referred to. The magnitude of the financial cost effect is illustrated by the fact that between 1976 and 1982 an average debtor paid excess interest, over and above a real "normal" rate of 8 percent per year, amounting to the equivalent of 300 percent of the initial loan. In other words, a borrower who effectively paid the 8 percent to the creditor each year, renewed the principal, and capitalized the interest commitments in excess of 8 percent would be liable by the end of 1982 for a debt over four times the original amount, in money of constant purchasing power.[20] It should be noted, in contrast, that a debtor with the exterior on similar terms would be liable in 1982, just before the devaluation, for a

real debt 44 percent below that contracted in 1976. Consequently, even after a massive real devaluation of 80 percent the debtor would have ended up with a debt equal only to the original amount (and equivalent to only a *quarter* of the liabilities of a person having a debt expressed in pesos). This calculation is, of course, sensitive to the period taken for the starting time. Thus, for example, "tardy" debtors who took out credits in foreign currency only in 1981 or in the first half of 1982 suffered a serious loss, taking into account the real devaluations registered in the remainder of 1982. This is in sharp contrast with the case of "early" debtors.

8. Credit of external origin played a different role from the one that it had traditionally assumed. It is usually supposed that such funds entered an integrated market characterized by great substitutability between resources of domestic and external origin, so that both types of interest rates would therefore tend to equalize. It is probably true that the external credit did help to relieve the demand for funds on the domestic market. Nevertheless, the effects of the factors mentioned earlier were stronger, and they therefore pushed up the domestic rate of interest on loans. This was because of the persistent segmentation displayed by the market. In effect, only some of the debtors could enter into indebtedness directly with the exterior or gain access to credit through the intermediation of local banking institutions. As a result, the difference between the domestic and external interest rates reached notably high levels, fluctuating in the period 1977-1981 between eighteen and forty percentage points per year (see Table 13.6). As already noted, the explanation for this does not lie in the expectations of devaluation, since until far into 1981 these were of no significance, but it is to be found rather in the marked segmentation that prevailed in the financial market. Of course this segmentation was not absolute. In a considerable part of the market there were borrowers who had simultaneous access to both domestic and external sources of funds, in proportions that varied according to their banking connections.[21]

Credit of external origin was available on a very large scale, representing as much as some 40 percent of the total loanable funds of the financial system. The differentials in interest rates therefore had substantial effects, from the point of view of both assignment and distribution. Small- and medium-sized producers were mostly relegated to the segment where high interest rates prevailed. In contrast, entities having links with the management of the financial institutions and the main economic groups had easy access to external credit, either directly or through the intermediation of national banks. This noteworthy and prolonged segmentation of the market helps to explain the spectacular concentration of income and wealth in these years.

EXTERNAL VULNERABILITY AND THE DYNAMICS OF INDEBTEDNESS

The conditions prevailing in the world economy and on the domestic market promoted a process of growing indebtedness that gave rise to great vulnerability of the Chilean external sector. Moreover, the form assumed by the transfer of external resources and the incentives given by the economic model caused the external indebtedness to be accompanied by a decline in domestic investment and saving (see Table 13.1, column 3) and the crowding out of national production.

As shown in the second section, for several years the real external debt did not appear to be growing strongly, in spite of the growing deficit on current account. The behavior of real net indebtedness, the ease with which new credits could be obtained, and the low real rates of interest on international markets led many countries to take a complacent attitude during the 1970s and the early 1980s. This was backed up by the opinion prevailing in domestic official circles that, since the indebtedness was predominantly of a private nature, the use made of it would naturally be efficient.[22]

The growing indebtedness made possible a gradual appreciation in the exchange rate. This, in turn, made it still more attractive to resort to external loans; thanks to this appreciation, the real cost of foreign-currency credit was negative during almost the whole period of financial liberalization. The process was thus self-encouraging, accelerating the inflow of capital, which increased aggregate demand and permitted the continuation and intensification of the process of exchange-rate appreciation. This led to growing accommodation of the national economy to a massive inflow of financial capital.

In the production system, however, what was taking place was the opposite to what was maintained by the official version. Both components of the saving investment process showed unsatisfactory behavior, with rates of savings investment manifestly below the levels reached in the 1960s. An increasing proportion of the resources was directed toward the consumption of imported goods, crowding out spending on national products and domestic saving. There was discouragement of investment, especially in the production of tradable goods. The clearest "comparative advantages" were in the purchase of assets on the domestic market from deeply indebted business people at depreciated prices. Except for some sectors making intensive use of natural resources, such as fruit production and fisheries (which did indeed expand) and luxury construction, investment ran into the difficulty of identifying comparative advantages: The lag or instability of the exchange rate, the behavior of interest rates, the deliberate running down of public production-support activities, the reduction of public

investment, the indiscriminate liberalization of imports, the noteworthy deterioration in income distribution--all combined to provide a discouraging environment for productive investment. Paradoxically, in spite of the prevailing climate of euphoric success and the close communication between the government and the economic groups, the accumulation process languished. This was because of the intrinsic nature of the model, the financial bias given to the national economy, and the difficulty of identifying opportunities for productive investment in a context subject to such drastic changes and with no provision for the state to play an active role in its function of guiding national development.

Quite apart from the unsatisfactory performance of the system of production, it was obvious that the impetus imparted to the external sector could not be kept for long, even if there were no change in the external situation. Nevertheless the official view was that the process would regulate itself automatically. It was maintained that since there was no fiscal deficit, since money issue was less than the value of the international reserves,[23] and since the monetary policy was "neutral," it was impossible for an exchange crisis to arise. It was confidently believed that imports of consumer goods would rapidly reach saturation level and that the adjustment capacity of the economy had been strengthened by the policy imposed since 1973. In contrast with these beliefs, however, when the international financial problems emerged in 1981, the trade deficit amounted to 11 percent of the GDP, and the current account deficit stood at 21 percent. The deterioration in the financial and foreign-trade situation thus coincided with the inescapable need to reduce the size of the external-sector imbalance and the exchange-rate lag.

The difficulties experienced by Chile in procuring external credits coincided with a domestic situation in which there was a pressing need for fresh resources and in which the government had done away with economic regulation mechanisms and relied on the automatic corrections implicit in the dollar standard. At the same time the system of production was weakened and deep in debt. Thus, the external shock was multiplied at the level of the domestic economy and was reflected in a decline of 14 percent in the GDP in 1982, concentrated in the manufacturing and construction sectors (which declined together by 23 percent).

In short, the external shock found Chile in a highly vulnerable position, and this multiplied its negative effects on the national economy. At the same time, Chile's production base was seriously weakened. As already demonstrated,[24] if the value added in financial activities and in the trading of imported goods is deducted, the per capita national product in 1981, _before_ the effects of the shock, stood only at a level similar

to 1974. This is an unmistakable sign of stagnation compared with the growth of the rest of the world. Consequently, the violent deterioration observed in 1982 came on top of a situation in which the economy was already functioning badly.

Chile's access to financial markets was becoming increasingly difficult, while its international reserves, although still high, were going down rapidly. After repeated announcements that it was not necessary to renegotiate the country's external debt, the Chilean government initiated a long process, the final stage of which--the signing of contracts between debtors and creditors--has still not been completed.

The renegotiation was carried out by the government of Chile, in spite of the fact that most of the debt corresponded to the private sector and did not enjoy state guarantees. This is not in the least surprising, of course, but it is in sharp contradiction with the arguments put forward by the economic authorities right up to 1982 regarding the "efficiency" of private indebtedness. The renegotiation covered the amortization payments due between February 1983 and the end of 1984 on the bank debt of public and private entities domiciled in Chile. It covered about two-thirds of the total liabilities falling due in the period in respect of medium- and long-term debt.

As in the case of most of the renegotiation operations carried out in the last two years, this was preceded by an agreement with the IMF. The terms regarding payment schedules and interest rates agreed upon with the committee representing the hundreds of creditor banks were similar to those reached in other cases, such as those of Argentina, Brazil, and Mexico. At first sight, there would not appear to be any substantial differences in result obtained by Chile. Without wishing to enter here into an examination of the rules established regarding the principle of immunity from jurisdiction and execution and the undertakings entered into on domestic economic policy, however, I would like to emphasize two decisive differences observed in the case of Chile. These concern the agreement with the IMF and the absence of any prior public guarantee in respect of most of the debt with the banks.

The agreement with the IMF is particularly restrictive, the provision with the most serious consequences being that connected with the fiscal deficit. This was fixed at 1.7 percent for 1983, but after only a short time it was necessary to raise it to 2.3 percent. This level meant that, despite the 14 percent drop in the GDP in the preceding year, the decline in production continued in 1983. This drop in the GDP was the determining factor in the 1983 trade surplus of close to 5 percent. The cost in terms of the loss of production, employment, and economic potential has been extremely

high. There has been an "adjustment," it is true, but it seems to be clearly inefficient.[25]

As regards the terms agreed upon with the committee of banks, the similarity between the financing terms obtained in the different national cases does not take due account of the fact that in Chile the debt was predominantly without state guarantee. This feature should have represented a factor of great weight in any renegotiation process, especially when the private sector in debt to the exterior is not in a position to pay off its liabilities in the period covered by the renegotiation. The fact is that the Chilean government gave its guarantee in respect of the debt of national financial entities that had previously not enjoyed such backing, but did not, in spite of this, manage to obtain noticeably more favorable conditions than other countries.

The level of overindebtedness of the Chilean economy is so serious that in spite of the renegotiation process, payments of interest and capital in 1983 were equivalent to almost 12 percent of the 1983 product. There is also a tendency for the problem to get worse, since the scheduled amortization payments are due to increase enormously in 1985. In the two-year period 1985-1986 they are due to exceed the amortization payments prior to the 1983-1984 renegotiation process by 50 percent. This increase is due mainly to the maturity of liabilities in respect of the credits used between 1979 and 1981. Clearly, the mid-1983 renegotiation only tackled part of the problem generated by the present economic policy. Together with the deterioration that has taken place in international financial markets, this leaves outstanding a volume of debt-servicing liabilities that will keep the national economy, year after year, sunk in uncertainty and obliged to give priority to financial aspects at the expense of the urgent and serious social and production problems the country is suffering.

SOME LESSONS OF THIS EXPERIENCE

In this recapitulation I want to emphasize four lessons deriving from the financial opening-up process. They refer to the distortions caused by indiscriminate opening up in regard to concentration and inefficiency in the allocation of resources; the alternative ways in which the domestic and external financial markets could be interrelated; criteria regarding the regulation of volumes of capital movements; and the channeling of funds to investment.

The financial opening-up process is not neutral concerning the allocation of resources, especially during the transition from a closed economy to an open economy, because of the pressures it generates on aspects such as the composition of money issue, the level of the exchange

rate or tariff protection, and public investment. During the transition it is necessary to adapt the structure of aggregate supply and demand, as well as to establish a bigger gap between expenditure and domestic production. The key questions in this respect concern the optimum path to be followed by the adjustment and the question of whether the access to external funds and their cost will be stable in the future. The financial market operates with very narrow horizons and does not take due account of the repercussions on national productive activity. Consequently, it is essential that the opening-up process should be regulated in a programmed manner.

As regards the repercussions in the financial sphere itself, access to external credit is not homogeneous, not only because of domestic regulations but also because of the nature of the international financial markets. In practice, this type of credit has been available mainly to certain segments of the national economy such as big import and export enterprises and firms associated with foreign financial institutions. In the case of credit for importers, for example, the differences in cost already analyzed meant that the opening-up process constituted yet another form of removal of protection from those engaged in import substitution. The differences observed between different applicants regarding access to and cost of external credit affect not only the efficiency of resource allocation but also the distribution of income and wealth. In particular, the opening up of the capital account in Chile provided substantial profits for those who were able to obtain external credits. There can be no doubt, however, that the effects and their distribution will depend on the forms of regulation and channels of intermediation used. Thus, for example, the effects on income distribution and the level of investment can be varied depending on whether the intermediation is carried out by enterprises, by commercial banks, or through the Central Bank or a public body responsible for promoting productive investment (such as the Development Corporation--CORFO).

From another point of view, the change from public to private entities as the destination of flows of funds and the concentration observed in the access to those funds have had very noteworthy consequences in the political sphere. First, they contributed to the spectacular concentration of economic power observed in recent years. Second, they generated powerful antidevaluation forces that, together with the prevailing economic ideology, helped to keep the exchange rate frozen for three years (from mid-1979 to mid-1982), while its real value displayed a pronounced deterioration; in this connection the antidevaluation pressures of the importers were reinforced by those of the economic groups that had taken out debts in foreign currency.

A second lesson that emerges very clearly from the experience of Chile and other countries in the Southern Cone is that indiscriminate liberalization is not a suitable condition for bringing about the integration into a single market of funds of domestic and external origin. Indeed, in reality the opposite took place. If an objective is to promote an alternative option leading to an integrated market, functionally beneficial for national development, important conditions are seen to be: (1) channeling external funds, except for external trade and compensatory credit, into a common pool with domestic resources; (2) eliminating the exchange risk borne by debtors with the exterior by expressing in national currency the external resources transferred to the domestic market; (3) explicitly pushing the market toward a maturity structure compatible with productive investment, which calls for long maturities; and (4) regulating real interest rates with the objective of avoiding both negative rates and excessively high rates, since both extremes are prejudicial to the efficiency of investment.

A third lesson is connected with the destabilizing nature of capital movements. In small countries and those where the domestic markets are not fluid and integrated, this instability can be very disturbing to economic activity. It is not just a question of the conditions that the free movement of capital imposes on monetary, fiscal, and/or exchange policies. Another feature of great practical significance is that the international financial markets suffer from fluctuations that are promptly transmitted to the domestic markets unless there is some form of regulation. In addition to this overall feature of markets, the supply of new funds available to each country in particular is subject to abrupt changes in response to variations in the lenders' perception of those countries' creditworthiness or in connection with the using up of the amounts of credit lenders are willing to make available to each country--amounts that are related more to the total amount of the debt than to the volume of the net flows in each period. For the debtor countries, however, it is the net flow and the corresponding current account financing that is the most pertinent variable for their short-term policy.

In the macroeconomic literature, emphasis is usually placed on regulations on capital movements that operate exclusively on relative prices; among these is a tax on interest designed to compensate for certain "externalities." It is quite true that this mechanism may make it possible to tackle the particular problem of a country that has a stable supply of loans with a positive trend. Likewise, certain kinds of taxes can reduce short-term speculative movements by making them more expensive compared with longer-term movements. The existence of external instability in the supply of funds,

however, must be tackled with mechanisms acting directly on the volumes of credits. In other words, it is necessary to establish machinery to regulate the total volume of indebtedness registered in each period. Within this context, there may be room, in a complementary capacity, for instruments acting on _prices_, such as taxes and compulsory deposits. It must be understood, however, that these will carry out a fundamentally distributive function, taxing the differentials between interest rates. When, some day in the future, an abundant but probably unstable supply of financial credit again becomes available, we should not forget the lesson provided by recent years regarding the evils of excessive and disturbing external indebtedness.

A fourth lesson is that, except in the case of flows of a compensatory nature, the regulation of capital movements should provide for their channeling toward the process of savings/investment. Insofar as these funds are directed toward the domestic financial market without any clear guidelines as regards their destination, they can easily filter through to consumption. The experience of various developing countries suggests that the final use of funds is determined to a significant extent by the way in which the inflow of capital is regulated and channeled.[26]

NOTES

This chapter presents a study that is part of the CIEPLAN (Corporation for Economic Research for Latin America) research program on Economics and International Relations, which is receiving the support of the Ford Foundation. A study of the financial opening-up process in the period 1973-1980 is made in R. Ffrench-Davis and J. P. Arellano, "Apertura Financiera Externa," 1981. Grateful acknowledgment is made to J. P. Arellano for his authorization to use in the present study part of the material contained in that publication. I wish to express my gratitude for the comments by CIEPLAN researchers J. Estévez and C. Massad and the collaboration of J. A. Ruiz.

1. See A. Foxley and R. Ffrench-Davis, "Latin American Experiments in Neo-Conservative Economics," _Colección Estudios CIEPLAN 7_, March 1982, special issue, and University of California Press, 1982.

2. R. Cortazar, "Chile: Resultados Distributivos, 1973-82," _Notas Técnicas No. 57_, CIEPLAN, Santiago, 1983.

3. R. McKinnon, "Foreign Exchange Policy and Economic Liberalization in LDCs," in _Alternativas de Políticas Financieras en Economías Pequeñas y Abiertas al Exterior_, Estudios Monetarios 7, Santiago, 1981.

4. More detailed information on the regulations that have governed the movement of capital is given in an

annex published in Colección Estudios CIEPLAN 5, July 1981, and in J. A. Ruiz, "Regulaciones del Movimiento de Capital Financiero: Chile, 1974-82" (CIEPLAN, 1983, mimeo.).

5. S. De la Cuadra, paper presented at the seminar organized by the Fundación de la Facultad de Ciencias Económicas de la Universidad Católica, in Banco Central de Chile, Boletín Mensual, no. 627, May 1980.

6. Inter-American Development Bank (IDB), Progreso Económico y Social en América Latina: El Sector Externo, Informe 1982, Washington, D.C., 1982. E. Bacha and C. Díaz-Alejandro, "Mercados Financieros: Una Visión Desde la Semiperiferia," and A. Fishlow, "La Deuda Externa Latinoamericana: Problema o Solución," both in R. Ffrench-Davis, ed., Relaciones Financieras Externas y Desarrollo Nacional en América Latina, Mexico City, 1983c.

7. R. Ffrench-Davis, ed., "Una Estrategia de Apertura Externa Selectiva," Reconstrucción Económica para la Democracia, Santiago, 1983a.

8. R. Ffrench-Davis, "Indice de Precios Externos para Calcular el Valor Real del Comercio Internacional de Chile, 1952-80," Notas Técnicas no. 32, CIEPLAN, Santiago, June 1981.

9. R. Ffrench-Davis and J. P. Arellano, "Apertura Financiera Externa: La Experiencia Chilena en 1973-80," Colección Estudios CIEPLAN 5, Santiago, July 1981, table 13.

10. J. P. Arellano and R. Cortazar, "Del Milagro a la Crisis," Colección Estudios CIEPLAN 8, Santiago, July 1982.

11. A brief summary is given in Ffrench-Davis and Arellano, "Apertura Financiera Externa," pp. 333-336; and a detailed analysis is made in R. Ffrench-Davis, "Exchange Rate Policies in Chile: The Experience with Crawling Peg," Colección Estudios CIEPLAN 2, December 1979 (and in J. Williamson, Exchange Rate Rules, London, 1981).

12. R. Ffrench-Davis, "Exchange Rate Policies in Chile."

13. The wholesale price index actually went down by 8 percent, mainly as regards agricultural goods, between May 1981 and May 1982, whereas the consumer price index went down by 1 percent between February and May 1982. By May 1982 the external price index had gone down by 2 percent in twelve months.

14. Open unemployment in Santiago rose from 11 percent to 23 percent between September 1981 and June 1982. Manufacturing production went down by 22 percent in 1982.

15. The increase in the deficit was associated with the increase in imports and in the volume of indebtedness, the decline in nontraditional exports, the rise in interest rates, and the deterioration in the price of copper. With regard to this latter item, it may be noted that the smaller fiscal income in 1981 from this

source compared with the average for 1960-1970 was equivalent to US$109 million (US$266 million if only the period 1965-1970 is considered) at 1977 prices, that is to say, .7 percent (1.6 percent) of the 1981 GDP. The figures (at current values) for the contribution made to fiscal income by the large-scale copper-mining industry were provided by the Comisión Chilena del Cobre; here they have been deflated by the external price index. The deterioration in the price of copper was offset by the improvement in the price of molybdenum and the procurement for Chile of the economic rent of the copper deposits through the process of nationalization of these activities.

16. Some of the quantitative restrictions used to control the inflow of capital helped to make movements of private capital independent of short-term fluctuations in the exchange rate. Mention should be made in particular of the minimum limit of two years for indebtedness and the compulsory deposits, which went down in proportion to the term of the loan.

17. P. Meller and A. Solimano, "Inestabilidad Financiera, Burbujas Espectaculativas y Tasa de Interés Real: Chile, 1975-83" (CIEPLAN, Santiago, 1983, mimeo.).

18. J. P. Arellano, "De la Liberalización a la Intervención: El Mercado de Capitales en Chile, 1974-83," Colección Estudios CIEPLAN 11, Santiago, December 1983. Ffrench-Davis and Arellano, "Apertura Financiera Externa."

19. A more traditional factor, which was of some importance on several occasions, was the downward trend in the rate of inflation and the lag in the adjustment of nominal interest rates.

20. These calculations were made using the corrected consumer price index. If the official consumer price index had been used, then the total amount of the "real" debt would be 5.3 times greater. The accumulated "error" in the calculation of the official consumer price index in the three-year period 1976-1978 was close to 30 percent. See R. Cortazar and J. Marshall, "Indice de Precios al Consumidor en Chile: 1970-78," Colección Estudios CIEPLAN 4, Santiago, November 1980.

21. There was also significant dispersion within the domestic market itself. For example, the average publicly offered nominal interest rates for loans exceeded the weighted average rate calculated by the Central Bank by five and ten percentage points in 1979 and 1980 respectively.

22. W. Robichek, "Some Reflections About External Public Debt Management," in Alternativas de Políticas Financieras en Economías Pequeñas y Abiertas al Exterior, Estudios Monetarios 7, Santiago, 1981, pp. 171-172.

23. At the end of 1980, the Central Bank reserves amounted to US$4.072 billion. The bank had liabilities not taken into account in the definition of "reserves"

for a total of US$945 million, however, while the banking system had net liabilities equivalent to US$3.260 billion.

24. R. Ffrench-Davis, "The Monetarist Experiment in Chile: A Survey," Colección Estudios CIEPLAN 9, Santiago, December 1982 (and in World Development, Oxford, November 1983).

25. For an alternative approach, see my article "Una Estrategia de Apertura Externa Selectiva."

26. Ibid.

BIBLIOGRAPHY

Arellano, J. P. "Macroeconomic Stability and the Optimal Degree of Capital Mobility." Journal of Development Economics, June 1982.

___. "De la Liberalización a la Intervención: El Mercado de Capitales en Chile, 1974-83." Colección Estudios CIEPLAN 11. Santiago, December 1983.

Arellano, J. P., and R. Cortazar. "Del Milagro a la Crisis." Colección Estudios CIEPLAN 8. Santiago, July 1982.

Bacha, E., and C. Diaz-Alejandro. "Mercados Financieros: Una Visión Desde la Semiperiferia." Relaciones Financieras Externas y Desarrollo Nacional en América Latina, edited by R. Ffrench-Davis. Mexico City, 1983.

Bank for International Settlements (BIS). Annual Report. Basle, various years.

Banco Central De Chile. Balanza de Pagos. Santiago, annual publication.

___. Deuda Externa. Santiago, annual publication.

___. Estudios Monetarios, nos. 4-7.

Center for Planning Research and Studies (CIEPLAN). Reconstrucción Económica para la Democracia. Santiago, 1983.

Cortazar, R. "Chile: Resultados Distributivos, 1973-82." Notas Técnicas No. 57. Santiago, June 1983.

Cortazar, R., and J. Marshall. "Indice de Precios al Consumidor en Chile: 1970-78." Colección Estudios CIEPLAN 4. Santiago, November 1980.

De la Cuadra, S. Paper presented at the seminar organized by the Fundación de la Facultad de Ciencias Económicas de la Universidad Católica. In Banco Central de Chile, Boletín Mensual, no. 627, May 1980.

Devlin, R. "Renegotiation of Latin America's Debt: An Analysis of the Monopoly Power of Private Banks." CEPAL Review, no. 20 (Santiago, August 1983).

DIPRES. Somos Realmente Independientes Gracias al Esfuerzo de Todos los Chilenos. Santiago, 1978.

Ffrench-Davis, R. Economía Internacional: Teorías y Politicas para el Desarrollo. Mexico City, 1979a.

___. "Exchange Rate Policies in Chile: The Experience with Crawling Peg." Colección Estudios CIEPLAN 2, Santiago, December 1979b (and in J. Williamson. Exchange Rate Rules. London, 1981.

___. "Indice de Precios Externos para Calcular el Valor Real del Comercio Internacional de Chile, 1952-80." Notas Técnicas no. 32, Santiago: CIEPLAN, June 1981.

___. "The Monetarist Experiment in Chile: A Survey." Colección Estudios CIEPLAN 9, Santiago, December 1982 (and in World Development [Oxford], November 1983).

Ffrench-Davis, R. (ed.). "Una Estrategia de Apertura Externa Selectiva." Reconstrucción Económica para la Democracia. Santiago, 1983a.

___. "El Problema de la Deuda Externa en América Latina: Tendencias y Perspectivas en 1983." Integración Latinoamericana. Buenos Aires, 1983b (and in Inter-American Development Bank [IDB]. Progreso Económico y Social en América Latina: El Sector Externo, Informe 1982. Washington, D.C., 1982).

___. Relaciones Financieras Externas y Desarrollo Nacional en América Latina. Mexico City, 1983c.

Ffrench-Davis, R., and J. P. Arellano. "Apertura Financiera Externa: La Experiencia Chilena en 1973-80." Colección Estudios CIEPLAN 5, Santiago, July 1981 (and in Relaciones Financieras Externas y Desarrollo Nacional en América Latina, edited by R. Ffrench-Davis. Mexico City, 1983.

Fishlow, A. "La Deuda Externa Latinoamericana: Problema o Solución." In Relaciones Financieras Externas y Desarrollo Nacional en América Latina, edited by R. Ffrench-Davis. Mexico City, 1983.

Foxley, A., and R. Ffrench-Davis. "Latin American Experiments in Neo-Conservative Economics." Colección Estudios CIEPLAN 7, Santiago, March 1982, special issue (and University of California Press, 1982).

Griffith-Jones, S. "The Evolution of External Finance, Economic Policy and Development in Chile, 1973-78." Institute of Development Studies (IDS), Sussex University, England. Mimeo. 1980.

Guardia, A., J. E. Herrera, A. Martinez, C. Ominami, and C. Rojas. "Una Renegociación Global para una Nueva Política de la Deuda Externa Chilena 1974-1982." Informe de Coyuntura Económica. Santiago, March-April 1983.

Gutierrez, M. "Reflexiones Sobre Apertura Financiera: El Caso Chileno." Estudios Económicos No. 14. Santiago, 1982.

Herrera, J. E., and J. Morales. "La Inversión Financiera Externa: El Caso de Chile, 1974-78." Colección Estudios CIEPLAN 1. Santiago, July 1979.
Massad, C. "The External Debt and the Financial Problems of Latin America," CEPAL Review No. 20, Santiago, August 1983.
McKinnon, R. "La Intermediación Financiera y el Control Monetario en Chile." Cuadernos de Economía No. 43 (Santiago), December 1977.
___. "Represión Financiera y el Problema de la Liberalización Dentro de los Países Menos Desarrollados." Cuadernos de Economía No. 47 (Santiago), 1979.
___. "Foreign Exchange Policy and Economic Liberalization in LDCs," in Alternativas de Políticas Financieras en Economías Pequeñas y Abiertas al Exterior. Estudios Monetarios 7. Santiago, 1981.
Meller, P., and A. Solimano. "Inestabilidad Financiera, Burbujas Espectaculativas y Tasa de Interés Real: Chile, 1975-83." CIEPLAN. Santiago, 1983. Mimeo.
Ministerio de Hacienda. Exposición Sobre el Estado de la Hacienda Pública. Annual publication.
Ominami, C. "Del Colapso de la Economía de Endeudamiento Internacional, a la Necesidad de una Estrategia de Independencia Nacional." Academia de Humanismo Cristiano, CERC. Santiago. November 1983. Mimeo.
Robichek, W. "Some Reflections About External Public Debt Management." In Alternativas de Políticas Financieras en Economías Pequeñas y Abiertas al Exterior. Estudios Monetarios 7. Santiago, 1981.
Ruíz, J. A. "Regulaciones del Movimiento de Capital Financiero: Chile, 1974-82." CIEPLAN. Santiago. 1983. Mimeo.
Sanfuentes, A. "Antecedentes Sobre la Deuda Externa Chilena." Estudios Monetarios 4. Santiago, 1978.
Sjaastad, L., and H. Cortéz. "El Enfoque Monetario de la Balanza de Pagos y las Tasas de Interés en Chile." Estudios de Economía No. 11, Universidad de Chile, First semester 1978.
Tapia, D. "Apertura al Mercado Financiero Internacional." Institucionalidad Económica e Integración Financiera con el Exterior. Santiago, 1979.
Zahler, R. "Repercusiones Monetarias y Reales de la Apertura Financiera al Exterior: El Caso Chileno, 1975-78." Revista de la CEPAL, April 1980.

14 Peru and Its Private Bankers: Scenes from an Unhappy Marriage

Robert Devlin
Enrique de la Piedra

INTRODUCTION

In the postwar period, Peru was one of the first countries in Latin America to develop an articulation with private commercial banks that went beyond short-term trade credits. Its relationship with private banks has not always been a happy one, however, and in the last twenty years it has had the distinction of going through three complete borrowing cycles with these institutions, each with its boom period followed by a severe crash. This chapter will attempt to tell, in a synthetic way, the story of Peru's experience with private banks and then to explore what lessons might be drawn from it.

Peru is not unlike other developing economies; its underdeveloped economic and social structure brings forth a chronic shortfall of internal savings vis-à-vis investment possibilities. In other words, there is a valid and real need for capital imports and external savings. Since the mid-1960s, an ever-growing portion of these external savings has had its source in private-bank loans (see Table 14.1). This factor alone was enough to increase the external vulnerability of the country since management of interface with banks is considerably more challenging than that involving more traditional sources of finance: Interest rates are commercial and subject to great variability; amortization periods are relatively short, thereby boosting refinancing requirements; and bankers' private perception of risk induces a sharply procyclic lending behavior on their part.[1]

Whatever the vulnerability associated with a dominant role for private banks in the financing of development, it was exacerbated in the case of Peru by what might be termed "overborrowing." This refers to a situation--characteristic of the 1970s--in which the supply of credit is extremely abundant and demand adjusts itself to available supply rather than to a real savings gap per se. In other words, demand for finance becomes delinked from the savings/investment mechanism; indeed,

Table 14.1 Peru: Distribution of External Public Debt by Source of Finance (percentage)

	Private				Official		
	Suppliers	Banks	Bonds	Others	Multi-lateral	Bi-lateral	Total[a]
1965-1966							
Peru	41	11	5	-	23	21	100
Latin America	20	11	8	1	23	37	100
1975-1976							
Peru	14	42	-	-	9	35	100
Latin America	10	45	4	2	19	21	100
1979-1980							
Peru	14	37	-	-	11	38	100
Latin America	7	56	7	-	17	13	100

Note: The dash indicates an amount that is nil or negligible.

[a]May not sum to 100 because of rounding.

Source: Inter-American Development Bank, External Debt of the Latin American Countries (Washington, D.C., 1982).

any nominal gap in savings becomes inflated, or artificially overstated, as easy finance gives rise to relaxation of the internal discipline needed to minimize the effects of the basic economic disequilibria that a developing country is expected to face in a variable and uncertain external economic environment.

Peru's actual shortfall of internal savings has its origins in two intractable financing gaps: the government budget and the balance of payments. Even if Peru has been most imaginative and aggressive in tackling the gaps when foreign finance was restricted, the advent of abundant credit on easy terms usually caused this discipline to unravel and debt to build up to unsustainable proportions. Because finance came largely from the procyclically inclined private banks, the debt buildup was extremely rapid and the later restriction very severe, with unusually adverse consequences for the country's development.

With regard to the government budget, since the early 1960s Peru has confronted an asymmetry between rapidly growing demands on the state to perform economic, welfare, and defense functions and--not withstanding the real obstacles to expanding the tax base of a developing country--a perennial political reluctance to give it the financial wherewithal to carry out this mandate.[2] Consequently, public current expenditures and investment programs have been oversized, tax pressure has tended to lag, state enterprises have had to operate

on a less than commercial basis, and the defense establishment has become disproportional to the level of development of the country. This situation has been possible, in part, because authorities could all too frequently substitute foreign finance for the hard political decisions needed to give the state the degree of financial autonomy it needed. This arrangement would, of course, be satisfactory if continued and exponentially growing foreign finance could be counted on, but the very policies that gave rise to a need for foreign finance also gradually undermined the creditworthiness of the state that was needed to sustain the credit flows.

As for the external accounts, they have suffered from a long-term stagnation in the export sector, coupled with a high propensity to import. The export sector's volume has been variously handicapped by factors such as uncertain policies regarding the role of foreign investment in Peru's all important mineral subsector, uncompetitive exchange rates, and ecological disasters (such as those affecting fishing). On the other hand, Peru's proclivity to import has been enhanced by overvalued exchange rates and direct subsidies, unrealized expectations regarding exportable petroleum reserves in the Amazon jungle, massive arms purchases, overscaled investment projects with high import content, stagnant local food production, and--more recently--attempts to follow the example of Southern Cone neighbors to open up the economy. Foreign finance, rather than filling the commercial gap, has often encouraged it to grow by underpinning policies that inflated external disequilibria. Once again, if finance were eternally available in exponentially growing amounts, this situation would be perfectly satisfactory. Unfortunately, the rise to dominance of procyclic commercial-bank finance brought an ever more sensitive link between trends on the current account of the balance of payments and the behavior of capital flows, making the economy even more vulnerable to crisis and upheaval.

These themes will recur throughout the paper. As to its organization, the next three sections treat Peru's three modern borrowing cycles with private banks, each with its credit boom and subsequent crash: 1965-1971, 1972-1978, and 1979-1984. The 1972-1978 cycle is of special importance because it gave rise to the impressive external debt that plagues Peru and its creditors until this very day. The last section will provide a more conceptual, or theoretical, explanation of Peru's problems with its bankers, focusing on a flawed bargaining strategy both with regard to the country's contraction of new debt and the rescheduling of old debt.

THE FIRST ROUND OF INDEBTEDNESS: 1965-1971

As has been mentioned, Peru was one of the first countries in Latin America to establish a significant articulation with private banks based on medium-term lending. Although both the magnitude of the indebtedness and the qualitative relations with the creditors were very different from what would follow in the 1970s and 1980s, it is worthwhile to provide a brief overview of events in this period.

Peru's newly elected civilian administration, under the leadership of Fernando Belaúnde Terry, assumed power in mid-1963.[3] It was activist and reformist in spirit, representing a sharp inversion of the passive role traditionally attributed to the state in an economy molded by liberal principles.[4] Public-sector activity expanded relatively fast as reflected by the fact that expenditure (excluding amortization of the debt) more than doubled over the period 1963-1965, and growth--even in real terms--remained substantial at more than 50 percent.[5]

The government encountered almost immediate difficulties in the financial area. While expenditures were pushed upward by an ambitious public program, revenues lagged due to a narrow and relatively inelastic tax base and an extremely recalcitrant congress that refused to support the government's proposed tax reforms. The consequence was a considerable expansion of the fiscal deficit; the accounts went from being roughly in balance in 1962-1963 to a deficit of nearly 5 percent of GDP by 1965. This, of course, contributed to price instability as the rate of inflation reached 16 percent in 1965, compared to the average rate of 7 percent for 1961-1964. On the external side, imports grew rapidly on account of the government investment program and the overvaluation of the sol, while export performance slumped--after the relative boom of the early 1960s--as both volume and unit prices slackened. Consequently, the trade account, which had tended toward equilibrium at the beginning of the decade, registered a deficit equivalent to 12 percent of export earnings in 1965-1966; meanwhile the current account deficit rose from .7 percent of GDP in the 1960-1964 period to nearly 4 percent by 1965-1966.

The government made considerable use of foreign finance. By 1967 the public external debt as a percentage of product had nearly doubled its average of 1960-1964, rising from 6.5 percent to 12.2 percent. Peru took relatively heavy recourse to finance from foreign suppliers as reflected in the fact that the participation of these creditors in the public external debt was 41 percent, compared to a Latin American average of 20 percent (see again Table 14.1). Official government and multilateral lenders held another 44 percent of the public debt. Private banks' participation was relatively small

at 11 percent, but played a very important role at the margin of events.

During the period 1964-1968 private banks provided continuous budgetary support to the government. In the midst of precarious fiscal and balance-of-payments situations, bankers came forth with many short-term bridge loans (the exact amount of which is difficult to determine) and medium-term credits to the tune of roughly US$30 million annually. The terms of lending were relatively stiff: 1.50 to 1.75 percent over the U.S. prime rate for loans with a five-year maturity and grace periods of one or two years. Most of the lending was concentrated in a handful of large, internationally experienced U.S. banks.[6] Although lending by U.S. banks to LDCs was not yet in vogue, these institutions were attracted to Peru by familiarity (there was a long and large presence of U.S. transnational corporations--TNCs--in the country), the government's still relatively liberal economic regime, and the very attractive price the authorities were willing to pay for the loans. At the same time the banks were quite cautious lenders: They usually insisted on the establishment of escrow accounts for loans to semiautonomous government agencies.

The continued buildup of economic difficulties, coupled with the reverse repayment flow stemming from the relatively hard lending terms of foreign suppliers and banks, soon culminated in serious problems in 1967 and open financial crisis in 1968.

The banks, now somewhat committed to Peru because of earlier outstanding loans, continued to provide support to the government during the crisis. Short-term bridge loans were awarded, and bankers restructured their debt via the technique of refinancing. Interestingly, the banks also agreed to provide a new "standby credit": US$65 million from U.S. banks and US$25 million from European institutions. However, the loans (never actually drawn upon), in addition to bearing the stiff terms noted earlier, also carried some rather rugged conditionality. The money was directly linked to the fulfillment of the tough IMF standby agreements signed by the government, and banks imposed restrictions on public-sector foreign borrowing that were similar to the terms laid down by the IMF itself. The IMF put a virtual halt on borrowing for maturities of between 180 days and 10 years and placed strict limits on loans with a maturity of between 10 and 15 years.

An emergency economic law introduced in June 1968 (which included new tax measures) came too late to save the government, which was suffering from an increasing lack of popularity due to its economic problems and to the controversy over the handling of a long-lasting dispute with an Exxon subsidiary. In October, the government fell victim to a military coup headed by General Juan Velasco Alvarado.

The new government had an interesting objective: It sought what it termed to be "a third way" to development that would bridge the gap between capitalism and socialism. There was a declared goal of reducing foreign dependence, reforming agriculture, and industrializing via exports with emphasis on internal savings for investment. The government also showed interest in pursuing the stabilization effort initiated in the last days of the previous government.[7]

Peru's bankers took a cautious, if not hostile, attitude toward the new government. After all, it was very interventionist and was engaged in vigorous disputes with subsidiaries of U.S. enterprises as well as with the Nixon administration, which attempted to defend their interests. Major commercial lenders awarded practically no new loans to Peru in the period 1969-1971, thereby tacitly, if not explicitly, cooperating with the foreign financial blockade organized by the U.S. administration. Bankers did agree to refinance their past loans, if for no other reason than fear that the new, more radical government might default on its debts. However, they did so on very onerous terms: Spreads were 1.75 to 2.25 percent over base interest rates, maturities only 5 years, and grace periods a Spartan-like .5 to 1.5 years.

The private bankers, did, however, alter their view of the need for the protection of the IMF. The new military government refused to renew the IMF standby agreement signed by the Belaúnde administration and set to expire in mid-1969. Fears of default, coupled with signs of successful stabilization, encouraged New York bankers to accede to Peru's wishes. However, they advanced conditionality of their own. Essentially this consisted of extremely strict limits on debt contraction through the first half of the 1970s, thereby hamstringing the financing of the government's ambitious investment program.

The military authorities, facing the Nixon administration's pressure on official lenders (which also adversely affected guarantees for suppliers' credits) and restrictions by private bankers, found themselves in a financial straitjacket. Interestingly, however, its stabilization efforts in this hostile external environment were relatively successful, restoring a degree of balance to the fiscal and external accounts, all while achieving respectable growth rates.[8]

THE SECOND ROUND OF INDEBTEDNESS: 1972-1978

During the period 1972-1978, Peru's total foreign debt increased two and a half times with practically all this growth being attributable to borrowing by the public sector. Total debt as a percentage of product over the period started out at 69 percent, dipped to a low of 54

percent, and ended up at 69 percent once again. There was, however, a dramatic boost of the public sector's share, as its debt as a percentage of product rose from 19 percent in 1971 to 44 percent in 1978 (see Table 14.2).

The heavy borrowing by the state reflected events on both edges of the Marshallian scissors. On the demand side, the government as early as 1971 had initiated an ambitious and now inward-oriented development strategy that implied a strong increase in investment, largely based on public projects, many of which were now targeted in productive sectors.[9] Also to play an important part in the demand for foreign finance was a vigorous military arms purchase program.[10]

On the supply side, there developed a major turnaround in Peru's fortunes with foreign creditors. After 1970, private banks, subject to very liquid balances in the Eurocurrency market and virtually no restrictions on lending from this platform, began to expand their horizons to developing areas. In reality, LDCs--and Latin America in particular--became the last frontier in an extremely hectic international expansion of finance capital that had been under way throughout the postwar period. In this expansion many of the large, traditionally international banks that had controlled lending found their market shares being challenged by other large- and medium-sized institutions that formerly had only been interested in their domestic markets. This global expansion, coupled with severe competition for new markets, worked to Peru's favor.

The Initial Years

In 1972 Peru began to be the center of a competitive struggle among the banks. On the one hand, petroleum deposits had been found in the Amazon region, which gave rise to rumors about Peru becoming one of the largest oil producers in the world. On the other hand, the Velasco regime enjoyed a large measure of political power and had managed to implement successful stabilization efforts.

As noted earlier, prior to 1972 Peru's access to bank credit depended on the disposition of a few large U.S. banks that were not very forthcoming with the new regime. However, some newcomers to international lending--U.S. regional, European, and Japanese institutions--were seeking out markets not cornered by the big established banks and began to lend to Peru. A major actor in this regard was Wells Fargo of California, which interestingly had a former public servant of the Belaúnde government as a high-level executive in the office of international lending.

The initial loans were quite lucrative for the new, more aggressive lenders: 2.25 percent over LIBOR for

Table 14.2 Peru: Total External Debt (millions of U.S. dollars)

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983[a]
Total external debt	3,681	3,692	3,832	4,132	5,237	6,257	7,384	8,567	9,324	9,334	9,594	9,638	11,097	12,418
Medium- and long-term	2,190	2,242	2,370	2,709	3,441	4,352	5,250	6,263	7,226	7,941	8,125	8,172	9,279	10,927
Public[b]	986	1,031	1,188	1,508	2,182	3,066	3,939	4,937	5,886	6,633	6,753	6,665	7,615	9,324
Private	1,204	1,211	1,182	1,201	1,259	1,286	1,311	1,326	1,340	1,308	1,372	1,507	1,664	1,603
Short-term	1,491	1,450	1,462	1,423	1,796	1,905	2,134	2,304	2,098	1,393	1,469	1,466	1,818	1,491
	Memorandum Items (percentages)													
Total debt/GDP	74.2	69.1	63.1	54.5	62.1	64.1	68.9	72.5	69.2	57.4	51.2	51.3	58.6	70.8
Public debt/GDP	19.9	19.3	19.6	19.8	25.9	31.4	36.8	41.8	43.7	40.8	36.1	35.4	40.2	62.4
Total debt service/ Exports	25.1	40.8	35.6	46.0	40.8	51.8	56.5	51.4	54.0	35.1	46.2	72.7	69.7	49.5[c]
Public debt service/ Exports[d]	16.2	24.0	23.2	38.9	30.3	35.6	36.2	36.0	35.6	22.4	33.8	54.0	48.6	26.3[c]
Public debt service[d] (millions of U.S. dollars)	167	213	219	433	456	474	485	622	702	825	1,323	1,756	1,491	1,257

[a] Preliminary data

[b] Includes Banco Central de Reserva del Perú

[c] Excludes renegotiated service payments

[d] Medium- and long-term; excludes Banco Central de Reserva del Perú

Source: Banco Central de Reserva del Perú, El Proceso de Renegociación de la Deuda Externa Peruana: 1978-1983 (Lima, 1984).

maturities between 4½ and 6½ years. These terms were considerably higher than those that could be contracted with more coveted Latin American borrowers where competition was stiff; Brazil, for example, could regularly attract loans at 1.5 percent over LIBOR for 10-year maturities. However, as more lenders became attracted to Peru, terms were enhanced for the country; price cutters such as Wells Fargo and Dresdner Bank were instrumental in driving down the cost of borrowing in the early 1970s (see Table 14.3).

Table 14.3 Peru: Index of the Cost of Bank Borrowing, 1971-1976 (1975=100)

1971	1972	1973	1974	1975	1976
131	99	57	36	100	146

Note: Based on consideration of the margin over LIBOR, the maturity, and commissions using the following formula:

$$\frac{[(C_1/A_1) + M_1]/A_1}{[(C_o/A_o) + M_o]/A_o} - 1$$

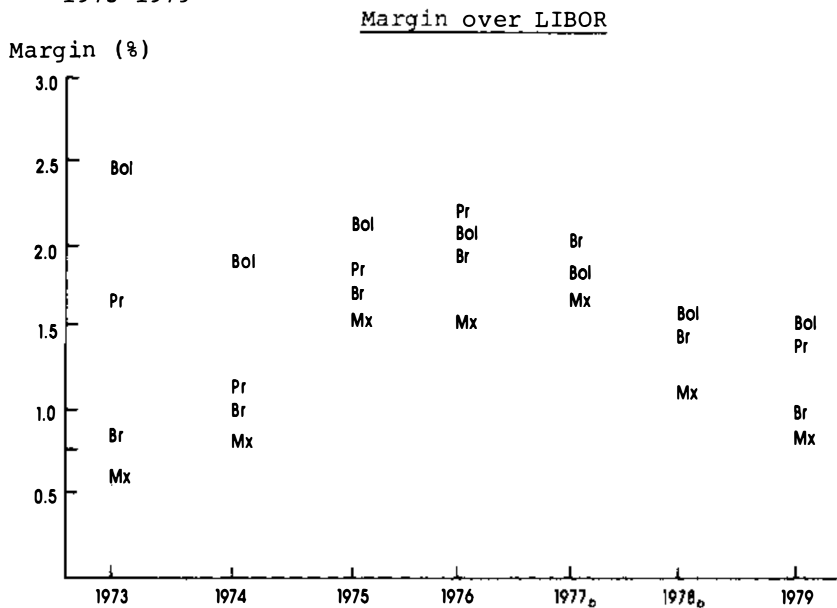
where *C* represents average flat fees, *A* equals the amortization period, and *M* the average margin over LIBOR, all weighted by the face value of the loans.

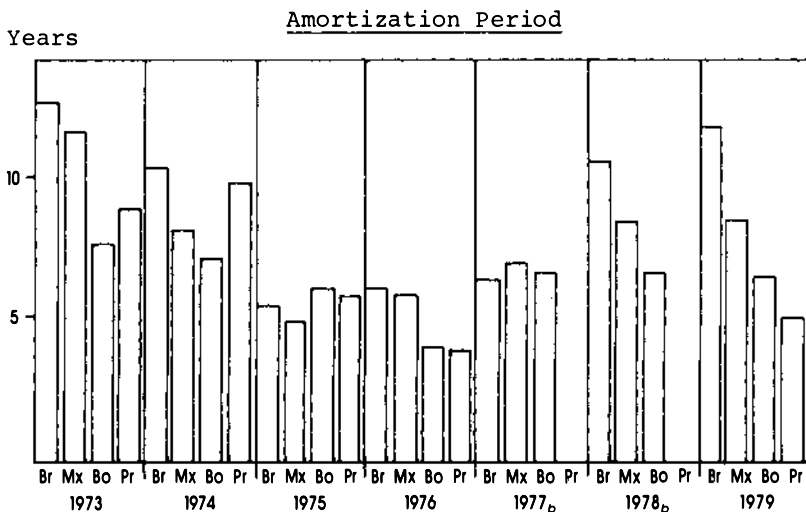
Source: Based on data in Robert Devlin, *Los Bancos Transnacionales y el Financiamiento Externo de América Latina* (Santiago, 1980).

The euphoria in banking circles was such that a former pariah became the darling of international banks, eventually ranking sixth among non-oil-exporting developing-country clients. The number of commercial lenders had risen from just twenty-seven in the late 1960s to nearly two hundred in the first half of the 1970s. Net lending expanded dramatically from slightly negative flows in 1970-71 to an average of US$236 million in 1972-1974. Moreover, terms had shifted strongly in Peru's favor: By 1974 the country could negotiate margins near 1 percent over LIBOR for maturities of ten years, conditions only slightly less favorable than those offered to prime developing-country clients like Brazil and Mexico (see Figure 14.1).

Another advantage of the competitive struggle around Peru was that it broke the grips of the aforementioned financial blockade. With all the new lending coming from the banks, the Nixon administration's effort to financially strangle Peru became increasingly fruitless. The Peruvian government used new loans from the upstart banks to prepay the old loans granted by the big U.S. money center banks that contained conditionality with respect to new indebtedness and hence handicapped the

Figure 14.1 Comparison of Margins and Maturities on Bank Credits for Peru, Brazil, Mexico, and Bolivia, 1973-1979[a]





[a]Average for public-sector borrowing weighted by values.
[b]Peru did not obtain loans in these years.

Key to abbreviations: Bolivia (Bo), Brazil (Br), Mexico (Mx), Peru (Pr)

Source: Mexico and Brazil: World Bank, Borrowing in International Capital Markets, Washington, D.C. (various numbers); Peru and Bolivia: Robert Devlin and Michael Mortimore, Los Bancos Transnacionales, el Estado, y el Endendamiento en Bolivia, Santiago, 1983.

investment program. Moreover, the volume of bank lending became so large as to dilute the effect of any restriction placed on official government and multilateral lenders. Finally, one by one, the big U.S. money center banks, some more rapidly than others, began to renew lending to Peru; they did not like to see an eroding share of the market in a country with a stable military government and with prospects of major oil exports. Also, the U.S. government, now sensing Peru's strategic importance as a potential oil exporter, sought and achieved a settlement--on the whole favorable to Peru--concerning the investment disputes with the Velasco regime.[11]

The relationship with the private banks began to sour in mid-1975. In essence, what happened was that the deterioration of basic economic indicators that had been hidden and in some respects facilitated by abundant finance now became more evident. This, coupled with false expectations with regard to the extent of petroleum reserves, broke the bankers' confidence in Peru, and new lending was stopped.

Not surprisingly, the country was in crisis again. On the fiscal front, the government let tax pressure slide, in part because of exemptions provided to the private sector in attempts to win its confidence and induce investment. The incentives, which could not overcome the ideological contradictions between the interventionist regime and private business, help to explain why tax revenue as a percent of product slipped below the 16 percent of GDP achieved in 1970 as a result of the stabilization effort then in force (see Table 14.4). Meanwhile, central-government expenditure, pushed upward by heavy investment, military expenditure, and subsidies on food and fuels, increased from 17.5 percent of product in 1970 to 21.4 percent in 1975. The consequence of course was a considerably expanded deficit, from 1.4 percent to 5.6 percent of product over the period 1970-1975. (For the consolidated public sector the deficit rose to 9.7 percent.) The relaxed fiscal situation contributed to the acceleration of the average yearly rate of price increases, from the relatively modest pace of 5 percent at the turn of the decade to one of 24 percent by 1975.

The country's external position also eroded during the period of massive indebtedness. On the one hand, the value of imports showed remarkable growth, reaching an equivalent of 23 percent of product in 1975, compared to 16 percent in 1970 (see Table 14.4). This growth was due primarily to an oversized public-investment program:[12] the stagnation of local food production, subsidies on essential consumer items, the fixing of the exchange rate for seven years (1968-1974), tariff rebates on capital imports, and military outlays, which some estimates have put as high as the equivalent of 30 percent of export earnings in the period 1973-1975.[13]

The proclivity to import was contrasted by a remarkably deteriorated export performance. Exports as a percentage of product declined from an average of 20 percent in 1970 to 13 percent by 1975; indeed the coefficient registered in this latter year was two-fifths less than the average recorded in 1960-1964 (see Table 14.4). Several factors were behind this weak performance.

First, the long gestation period of the government's mineral projects, coupled with uncertainty surrounding policies vis-à-vis foreign private investment, was a factor. At the end of the 1950s there were important investments in the mining sector, and their coming on stream in the early 1960s contributed to an export boom. But the impetus was not sustained. During the 1960s all the perspectives for new foreign investment were adversely affected by government commissions examining charges of excess profits in foreign mining firms and by plans to revise the liberal 1950 Mining Code. Consequently, as Thorp and Bertram have put it, an investment strike in the Gran Minería took place.[14] Just when uncertainties were beginning to diminish and investment prospects improved, the 1968 coup took place and brought with it a very nationalistic policy on the subject of foreign participation in the economy, further stifling investment in this vital sector. In spite of the agreement that the Velasco government eventually reached with the U.S.-owned Southern Peru Copper Corporation to develop a major deposit and two projects developed by state-owned mining companies, Peru was left with a "window of vulnerability" in its export sector until the late 1970s because of the very long gestation period of these ventures.

A second major factor in the poor export performance was the already mentioned severely exaggerated expectations about petroleum. The government prematurely implemented a giant US$1 billion trans-Andean oil pipeline only to find out that available petroleum could barely reach one-half of planned throughput. With petroleum failing to materialize in expected volumes, a gaping hole was left in the export structure.

A third feature underlying sluggish exports was a less than vigorous dedication to export promotion. Neither the fixing of the exchange rate nor high tariff walls encouraged exports, and prevailing subsidy schemes were less than adequate to provide a counterbalancing stimulus.

Finally, Peru also suffered from a certain degree of ecological bad luck in the disappearance of the anchovy, a very important foreign-exchange earner. It is to be noted, however, that some measure of overfishing took place in 1970-1971.

Added to the deteriorating trade performance was a buildup of payments for factor services. Peru's heavy recourse to bank debt brought with it the relatively higher interest rates and shorter maturities that

Table 14.4 Peru: Selected Expenditure as a Percentage of GDP

	External Sector					Domestic Sector		Central Government			Public-Sector Deficit
	Exports		Imports		Current Account	Consumption	Fixed Investment	Expenditure	Income	Deficit	
	Current	Real	Current	Real							
1960-1964	22.3	...	20.9	...	-0.7	76.5	14.1	15.7	14.2	-1.5	...
1970	19.7	19.7	15.7	15.7	2.3	83.0	12.4	17.5	16.1	-1.4	-0.8
1973	14.8	14.2	15.3	15.1	-2.1	84.9	12.7	18.7	14.8	-3.9	-4.6
1974	16.1	12.5	21.5	18.7	-7.0	86.5	15.2	18.3	15.2	-3.1	-6.9
1975	12.9	12.1	22.7	20.8	-11.2	90.1	17.4	21.4	15.8	-5.6	-9.7
1976	12.4	11.0	18.1	15.6	-7.8	87.8	16.6	20.7	14.4	-6.3	-10.0
1977	16.7	13.0	20.3	14.5	-6.3	88.5	14.6	22.1	14.6	-7.5	-9.8
1978	22.4	15.6	19.2	11.2	-1.5	82.2	14.0	20.9	15.8	-5.1	-6.2
1979	30.5	19.3	17.9	11.3	6.9	72.9	14.3	18.5	17.9	-0.6	-1.1
1980	27.0	17.4	23.2	16.0	-0.6	78.3	17.2	23.5	20.6	-2.9	-4.7
1981	20.3	16.1	24.3	17.0	-8.3	82.0	20.2	23.0	18.1	-4.9	-8.4
1982	20.6	17.1	24.5	15.6	-8.3	82.6	20.3	22.0	18.1	-3.9	-8.7
1983	...	...	...	...	-5.5[a]	...	...	...	...	-7.5[b]	-10.3[b]

Note: The dots indicate data that are not available or not separately reported.

[a] Unpublished Central Bank data cited in the Andean Report, February 1984

[b] Unpublished Central Bank data cited in the Andean Report, January 1984

Source: Based on data in the Memoria of the Banco Central de Reserva del Perú (various numbers).

accompany commercial indebtedness. This was reflected in the fact that the outflow of debt payments nearly tripled between 1970 and 1974; as a percentage of exports, public debt service rose from 16 percent to 30 percent (see Table 14.2). Given the harsher terms of indebtedness, the new government had to seek an exponentially growing amount of new credit just to facilitate payment of old debt and avoid a net outflow of financial resources.

The asymmetry between import and export trends, coupled with growing debt-service obligations, had its counterpart in a ballooning current account deficit, which went from an average of practically zero between 1968 and 1970 to 11 percent of GDP by 1975. This situation was made possible only by massive lending from the banks during the period, which masked the underlying deterioration in the balance of payments. Moreover, the lending was sufficiently voluminous not only to cover the deficit but to amass nearly US$1 billion of gross international reserves by 1974. This, coupled with the relatively high growth rates of product (see Table 14.5), provided a sense of security and well-being concerning the direction of economic policy. Indeed, in the midst of the oil crisis that rocked most non-oil-exporting LDCs, government authorities in early 1976 expressed satisfaction that the world crisis had not set foot into Peru.

The 1975-1976 Crisis

Had Peru been able to sustain the massive lending from private banks, a policy best described as one of simultaneous pursuit of guns and butter would have been perfectly feasible. However, with the arrival of private commercial banks as the overwhelmingly dominant source of external finance, a new sensitivity developed between events on the current and capital accounts. In other words, private banks are procyclic lenders; once the initial momentum of the euphoric expansion winds down, a country can be left vulnerable to a massive retreat by creditors if economic parameters have moved way out of line and undermined the delicate confidence of private bankers.

What perhaps detonated Peru's latent crisis was the failure of Bank Herstatt of Germany in mid-1974, which set off a semipanic in international banking circles. Even though the bankruptcy was due to poor foreign-exchange management and unrelated to LDC loans, nervous bankers restricted credit, and the terms of lending underwent severe deterioration both with respect to volume and conditions. This in turn made more transparent the financial veil that had been draped over the internal and external structural weaknesses of the Peruvian economy. The world credit crisis, together with the now evident

Table 14.5 Peru: Growth Rates of Selected Economic Indicators (billions of U.S. dollars)

	GDP[a]	Consumption[a]	Investment[a]	Exports[a]	Imports	Inflation[a]	Terms of Trade[b]
1973	6.2	10.4	17.2	-18.3	9.7	9.5	21.9
1974	6.9	9.0	30.4	-5.8	31.9	16.9	42.6
1975	3.3	4.8	10.0	0.4	15.3	23.6	-23.4
1976	3.0	1.6	-11.2	-6.7	-22.8	33.5	4.2
1977	-1.2	-0.3	-22.4	16.7	-7.9	38.0	-6.3
1978	-1.8	-6.7	-12.8	18.1	-24.5	57.8	-15.1
1979	3.8	-1.9	12.1	28.6	5.3	67.7	35.1
1980	3.0	6.8	30.4	-7.0	44.9	59.2	11.5
1981	3.1	1.5	25.2	-4.9	10.0	75.4	-18.4
1982	0.7	0.0	-8.3	6.8	-7.7	64.5	-12.8
1983	-12.0[c]	...	...	...	...	111.1[d]	3.2

Note: Dots indicate data that are not available or not reported separately.

[a] 1970 prices

[b] 1970=100; goods fob/fob

[c] Banco Central data cited in the *Andean Report*, January 1984

[d] Based on Banco Central data cited in the *Andean Report*, February 1984

Source: Banco Central de Reserva del Perú, *Memoria 1982*; Economic Commission for Latin America, Division of Statistics and Quantitative Analysis.

overestimation of the prospects for petroleum in the Amazon and the depressive effects of a world recession, induced the banking system as a whole to perceive that there was a problem in Peru and brought with it special attempts to restrict exposure in the country, serving to deepen the crisis.

Peru had to confront its problems in the context of an extreme dependency on its private banks, an ironic situation given that one of the government's major objectives--and a factor behind the severe investment disputes--was a search for autonomy from "foreign capital." One angle of this dependency is presented in Table 14.6. It can be seen that by 1975 the net transfer of foreign financial resources was equivalent to more than 60 percent of the country's "indigenous" foreign-exchange earning capacity as represented by exports; in other words, a very high percentage of the country's import capacity depended on the tricky business of securing and maintaining net flows from foreign creditors. A second indicator of dependency is seen in Table 14.7: By 1975 the gap between internal savings efforts and investment rose to an amazing twelve points, six times greater than that prevailing in 1973. But more importantly, it should be noticed that the gap was aggravated by a considerable substitution of foreign for domestic savings as indicated by the marked decline in the internal savings coefficient through 1975.

What this implies is that the Peruvian economy was in a poor state to weather the storm once creditors replaced their enthusiasm with caution. It can be seen from the data in Table 14.8 that after 1974 private banks--by now Peru's most important creditor--began a progressive and seriously debilitating reduction of lending to the government. This necessitated an adjustment on Peru's part that, however, was slow in coming and quite disorganized.

In August 1975 the crisis contributed to a political change as General Francisco Morales Bermúdez replaced General Velasco as head of state. With this, the "revolution" began to take on a more conservative tone.[15] Late in the year, a new team consistent with the new orientation took control of the economy and attempted adjustment in face of a massive US$1.5 billion current account deficit and the loss of half of the country's gross international reserves (from US$1 billion at the end of 1974 to less than US$500 million at the end of 1975). One of its first measures was to devalue the sol by 16 percent after seven years at a fixed rate.

The crisis worsened in 1976. At the beginning of the year some additional adjustment measures were introduced. The government toyed with the possibility of an IMF stabilization program, but after informal contacts with Fund officials in Washington, authorities decided that the Fund's requirements were harsh and

Table 14.6 Peru: Net Capital Inflows and Transfer of Financial Resources (millions of U.S. dollars)

	Effective Inflow of Capital[a] (1)	Unregis-tered Transactions (2)	Balance on Capital Account (3)	Net Payment of Profits and Interest (4)			Transfer of Resources		Exports of Goods and Services (7)	Ratio (5)/(7) (8)	Ratio (6)/(7) (9)
				Profit	Interest	Total	I (1)-(4) (5)	II (3)-(4) (6)			
1970	137.0	-35.0	102.0	(73.0)	(60.0)	133.0	4.0	-31.0	1,224.0	0.3	-2.5
1971	3.1	16.0	19.1	(50.1)	(75.2)	125.3	-122.1	-106.2	1,067.2	-11.5	-10.0
1972	160.7	-90.1	70.6	(46.7)	(73.9)	120.6	40.1	-50.0	1,153.0	3.5	-4.3
1973	435.1	-41.7	393.4	(79.9)	(83.5)	163.4	271.7	230.0	1,343.5	20.2	17.1
1974	1,219.5	-72.2	1,147.3	(42.1)	(129.9)	172.0	1,047.5	975.3	1,841.2	56.9	53.0
1975	1,268.8	-190.6	1,078.2	(14.6)	(227.0)	241.6	1,027.2	836.6	1,688.9	60.8	49.5
1976	1,262.6	-326.5	936.1	(43.8)	(326.5)	370.3	892.3	565.8	1,744.2	51.2	32.4
1977	1,155.1	-112.7	1,042.4	(53.7)	(368.4)	422.1	733.0	620.3	2,131.0	34.4	29.1
1978	215.2	52.9	268.1	(84.1)	(494.8)	578.9	-363.7	-310.8	2,400.6	-15.2	-13.0
1979	449.6	-36.0	413.6	(392.5)	(545.1)	937.6	-488.0	-524.0	4,101.1	-11.9	-12.8
1980	911.2	-185.7	725.5	(291.7)	(542.0)	833.7	77.5	-108.2	4,649.7	1.7	-2.3
1981	686.7	451.0	1,137.7	(252.4)	(767.8)	1,020.2	-333.5	117.5	4,054.8	-8.2	2.9
1982	1,901.1	-147.9	1,753.2	(160.1)	(894.2)	1,054.3	846.8	698.9	4,060.5	20.9	17.2
1983	...	...	1,370.0	...	...	1,200.0	...	170.0	3,680.0	...	4.6

Note: Dots indicate data that are not available or are not separately reported.

[a] Equivalent to the capital account before considering the effect of unregistered transactions

[b] Errors and omissions of the balance of payments

Source: Based on data supplied by Economic Commission for Latin America, Division of Statistics and Quantitative Analysis.

Table 14.7 Peru: Savings/Investment Coefficients

	INTERNAL SAVINGS GDP (1)	INVESTMENT GDP (2)	DIFFERENCE (1)-(2)
1970	15.9	12.9	3.0
1973	13.9	16.0	-2.1
1974	12.3	19.5	-7.2
1975	8.5	20.8	-12.3
1976	10.1	17.9	-7.8
1977	8.2	14.1	-5.8
1978	11.2	12.5	-1.3
1979	19.9	13.5	6.4
1980	16.5	17.1	-0.6
1981	12.9	20.7	-7.8
1982	11.5	18.9	-7.4

Source: Banco Central de Reserva del Perú, Memoria 1982.

politically risky for the new and somewhat uncertain regime.[16] Hence, the authorities approached their major U.S. bank creditors in a meeting in New York organized by Manufacturers Hanover Trust and attended by staff members from Bank of America, Citicorp, Wells Fargo, Chase Manhattan, and Morgan Guaranty Trust. In the meeting the Peruvians made a novel proposal: They sought a US$350-400 million refinance credit (termed a balance-of-payments loan) and proposed a stabilization program that would be implemented without the IMF.

The banks at first were reluctant to accede to the request. On the one hand, other LDC borrowers were also confronting difficulties, and extension of financing without the presence of the IMF would establish an uncomfortable precedent. Moreover, there was concern about how the banks might monitor the program. But some institutions such as Citicorp felt that they could handle this monitoring process; there also was concern that unless they supported the new regime, the Velasco forces might regain control of the government and/or authorities would enter into default. Several institutions resisted the proposal, but in the end the Citibank coalition prevailed.

Having won the support of all U.S. banks in July, the government was then in a position to gain the support of European, Canadian, and Japanese institutions. A banking committee was formed with representative institutions from each regional bloc. Total finance was to be US$386 million under the very severe terms of 2.25 percent over LIBOR, for five-year maturities with flat fees of 1.5 percent.

The banks approached the monitoring problem in the following way. The large banks in the committee were largely responsible for evaluating the progress of the

Table 14.8 Peru: Net Flows of Medium- and Long-Term Loan Capital by Type of Creditor (millions of U.S. dollars)

	Private Banks	Suppliers	Western Governments	International Organizations	Socialist Countries	Total
1970	-11	39	26	15	-	69
1971	-4	-8	20	20	-	28
1972	57	-16	48	19	14	122
1973	244	-20	62	7	27	320
1974	407	-8	177	24	97	697
1975	376	22	253	17	125	793
1976	203	31	165	23	92	514
1977	-120	137	206	63	379	665
1978	-36	109	202	36	105	416
1979	266	198	118	73	-12	643
1980	18	87	56	147	69	377
1981	247	78	-50	102	12	389
1982	498	249	48	199	1	995
1983[a]	354	384	259	160	148	1,305

Note: Dash indicates an amount that is nil or negligible.

[a]Preliminary data that do not include adjustment for exchange-rate variations

Source: Banco Central de Reserva del Perú, *El Proceso de Renegociación de la Deuda Externa Peruana: 1978-1983* (Lima, 1984).

government's program. An arrangement was made whereby the government would voluntarily provide the necessary reports and data for the evaluation of the stabilization effort. A sense of conditionality was given to the agreement by providing for a two-tranche disbursement. The first tranche would be disbursed upon signing and the second in January 1977, with the latter being contingent upon approval of 75 percent of the creditors, weighted by the amounts authorized.

For Peru, the agreement--although expensive--allowed it to avoid the IMF. Its stabilization plan[17] had all the trappings of an IMF program--it included a 44 percent devaluation, budget cuts, price adjustments, and so on--and was presented to the banks as being a fair equivalent. But in fact it was a good deal softer than any such program. At least implicitly the bank loans also were conditioned by the requirement that the government settle recent investment disputes with two U.S. firms, but the new government was disposed to a settlement in any event and the bank conditionality merely accelerated the process.[18]

As for the private banks, they did a 360-degree turn. During the credit boom of the early 1970s, conditionality on private-bank loans had all but disappeared. Its appearance in 1976 marked a return to practices of the 1960s. Nor was the decision to extend conditional credit without the IMF a new one: As noted in the section on 1965-1971, from 1969 to 1971 banks provided conditional finance to Peru on their own. What was novel was that bankers took it upon themselves to monitor the whole economy and not just a few parameters like external debt.

Although some large banks had the ability to monitor the economy, and as a group banks objectively enjoyed considerable leverage over government policy, the foray into IMF territory failed. Outside criticism of the venture was strong and arose from concern about having private profit-making institutions monitoring the affairs of a sovereign government. The possibility for conflicts of interest obviously loomed large. Also, given the magnitude of the disequilibrium upheld by the previously abundant finance, as well as the lingering populism in the political structure, authorities were unable to muster the political cohesion necessary to make the hard economic decisions that bankers wanted so that foreign exchange could be made available for the payment of debt.

With the stabilization effort falling short of its targets, and the criticism about the role of the commercial banks in the economy mounting, these institutions withdrew their support for the government. Thus the Morales Bermúdez regime entered into a second phase whereby the banks returned to more familiar terrain and insisted that Peru arrange a standby credit program with the IMF as a condition for the refinancing of the

private debt.

1977-1978: The Crisis Deepens

Once the banks insisted on an IMF "green light," the government passed down a long, circuitous, and often highly conflictive road to an agreement. In 1977 the foreign-exchange crisis deepened; by the second quarter gross international reserves had fallen to only about one month of import cover, and large upcoming payments were due to creditors. Reaching an accord with the IMF proved exceedingly difficult. In mid-1977 new austerity measures were introduced; they met with strong public resistance, however, and this brought the rapid fall of a recently installed finance minister. In late 1977 a new economic team--under severe pressure from bankers, who refused all credit except for last-minute short-term rollovers to avoid a technical default--reached an agreement with the IMF implying adjustments that were extremely ambitious. Following the agreement, banks consented to the extension of new refinance credits.

However, as many expected, the IMF program targets were not met, and in early 1978 both the IMF and the banks withdrew their financial support again. Faced with embarrassment over the IMF fiasco, continuous strikes and demonstrations over austerity measures, and an extreme scarcity of foreign exchange (the country was now taking recourse to part of its gold reserves[19]), there was another change of the economic team in May 1978. With the introduction of new austerity measures, street riots broke out in Lima. In order to stem the drawdown of gold reserves, the new economic minister quickly arranged US$260 million in "swaps" from friendly Latin American central banks.[20] After midyear, broader international support was obtained. A compensatory finance agreement and a more realistic standby accord provided US$311 million of resources from the IMF, and the private banks agreed to roll over for 180 days US$186 million in debt-service payments.[21] Toward the end of the year the economic team, now enjoying a degree of credibility with respect to its economic program, arranged a Paris Club meeting that resulted in the rescheduling of 90 percent of the payments of principal owed to OECD governments for 1979 and 1980 (US$211 million and US$248 million, respectively). Debts of US$154 million due to the socialist countries in 1978-1980 and US$35 million due to Venezuela in 1979 were restructured as well.[22] Finally a refinancing accord was reached with the private banks for maturities falling due in 1979 and 1980, for a total of US$722 million (see Table 14.9).

By the end of 1978 Peru was well on its way to ordering its financial affairs. However, the country had paid a very high price. Moreover, Daly has shown

Table 14.9 Peru: 1978 Restructuring of Commercial Bank Debt

Coverage	Amount (millions of U.S. dollars)	Maturity (years)	Grace Period (years)	Interest Rate (% over LIBOR)	Commissions[a]
90% of maturities falling due in 1979 and 1980	363 (1979)	7	3	1.875	0.5
	359 (1980)	6	3	...[b]	...[b]
50% of US$186 million rolled over in June 1978 and due January 1979	...	1	-	1.75	...

Note: Dots indicate data that are not available or not separately reported. Dash indicates that the amount is nil or negligible.

[a] Flat fee payed on face value of the credit

[b] Were to be negotiated in 1980. Subsequently Peru renegotiated the entire package for 1980 maturities: US$340 million were refinanced over six years (four years' grace) at 1.25 percent over LIBOR and .375 percent in flat commissions.

Source: International Monetary Fund, Recent Multilateral Debt Reschedulings with Official and Bank Creditors (Washington, D.C., 1983); Banco Central de Reserva del Peru, Desarrollo de la Deuda Externa Peruana, 1968-1979 (Lima, 1981) and El Proceso de Renegociación de la Deuda Externa Peruana: 1978-1983 (Lima, 1984).

that the adjustment over 1975-1978 was rather perverse and achieved to a large extent by exogenous factors.[23] Peru's balance-of-payments situation was greatly aided by the fall in aggregate demand brought by falling real wages, cutbacks in investment and imports, and negative growth of product (see Table 14.5). Although there also was an enhancement of export performance, this rested to a large degree on the coming on stream of investment projects in the copper and petroleum sectors initiated well before the adjustment effort. Meanwhile, net negative transfers of financial resources were received from private banks during the heat of the crisis (see Table 14.8), an event that undoubtedly contributed to the forced and disorderly nature of the adjustment process.

It may be noticed from the data in Table 14.8 that the sharp inversion of bank finance in 1977-1978 was to some degree offset by new suppliers' credits and government loans. However, these loans did not provide much relief inasmuch as they were largely for the purchase of arms abroad; indeed in 1977-1978 these purchases were as large as in the previous four-year period. In 1977 they more than doubled with respect to 1976 due to the acquisition of Soviet warplanes. Even though such purchases fell in 1978 along with other imports, they remained approximaely 40 percent above their 1976 level and had increased their participation in imports from 13 percent to 23 percent.

THE THIRD ROUND OF INDEBTEDNESS: 1979-1984

Peru's fortunes turned around dramatically in 1979. Although erratic and negative in character, the economy did achieve an adjustment over the period 1976-1978. Moreover, as mentioned earlier, output from mining investments was now on stream, and petroleum from the Amazon, although well below expectations, was now being produced at a rate of about 135,000 barrels a day, allowing Peru to become a net exporter to the tune of approximately 60,000 barrels a day.[24] When OPEC prices underwent their second major adjustment of the decade in 1979, Peru experienced a large windfall profit. The petroleum bonanza, coupled with better prices for almost all major mineral exports, contributed to a 35 percent rise in the terms of trade in 1979 after a fall of 20 percent in the two preceding years (see Table 14.5). The improvement of the purchasing power of exports (which incorporates the effect of volume as well as prices) rose even more dramatically: 54 percent.

The sudden and unexpected burst of foreign-exchange earnings, coupled with the stemming of dollar outflows via the earlier debt renegotiations, produced an extremely liquid balance of payments: The current account ran its first surplus since 1970 (US$953 million) and the overall

balance of payments had a surplus of US$1.6 billion. The export boom also had a strong positive effect on public savings as nonfinancial public-sector revenues rose by 25 percent in real terms. (As a proportion of GDP they increased from 42 percent in 1978 to 47 percent in 1979.) This occurred simultaneously with the stagnation of private consumption, causing internal savings to swell to 20 percent of GDP (more than double the level of 1977), giving rise to a considerable excess of savings over investment for the first time in several years (see Table 14.7).

With the new influx of liquidity Peru could once again increase imports (their volume rose by 5 percent), and the economy grew by 4 percent (see Table 14.5). Despite what had been an extremely conflictive relationship with private bankers during the 1976-1978 crisis, these institutions, sensing the turnaround, now once again began to actively court Peru as a client. US$463 million of new publicized Eurocurrency credits were organized for the government.[25] Typical conditions were 1.375 percent over LIBOR for maturities of five years.

Peru's liquidity situation was such that authorities took some bold initiatives on the debt. First, they waived the renegotiation of 1980 maturities with the Paris Club. Then they prepaid in January 1980 the US$363 million loan related to the bank refinancing of 1979 maturities; at the same time, practically all short-term foreign Central Bank debt was paid (US$304 million). Furthermore, a new agreement was reached with private bankers to the terms of the refinancing of 1980 maturities (see footnote _b_ of Table 14.9). The strategy was related to two objectives. First, the prepayment of the 1979 loan allowed the government to get rid of a relatively costly credit; the renegotiation of the terms of the 1980 refinancing represented Peru's use of its improved bargaining position to gain better conditions. Second, it was reported in journalistic circles that the authorities wanted to reduce external liquidity at a time when apparently there were pressures from the military to pursue more arms purchases.

In July 1980, after twelve years of military rule, a new civilian government, headed again by Fernando Belaúnde Terry, assumed office. This brought with it an economic policy that built on and intensified the market (and the _apertura_ or liberalization) orientation that began to take hold during the Morales Bermúdez regime. The fundamental short-term objectives were the curbing of inflation (a problem that was never overcome in the Morales Bermúdez period), incentives for renewed dynamism and leadership on the part of the private sector, and liberalization of imports as a way to improve the competitiveness and efficiency of Peruvian industry.

The new government also had another interesting objective: pursuit of a more cautious borrowing strategy,

suggesting that countries do learn from bad experiences. Authorities seemed to recognize the disorderly and counterproductive nature of foreign indebtedness in the 1970s, hence the raising of internal savings, the *ex ante* programming of debt contraction, the seeking out of longer maturities and softer conditions, especially via more active use of official and multilateral sources of debt, and a general reduction of the weight of the debt in the economy were guidelines for policy.[26] In the face of the considerable external liquidity of 1979-1980 (gross reserves were nearly US$2 billion by mid-1980), authorities--in contrast to the 1970s--pursued an anti-cyclic stance and contracted only US$18 million of net bank debt, while short-term obligations showed very modest growth (see Tables 14.2 and 14.8). Moreover, in April 1981, the government--aiming to reduce the cost of external debt, to improve the structure of amortization, and to enhance Peru's financial image--decided to prepay US$359 million corresponding to the refinanced 1980 maturities with the banks and replaced them with credits on better terms from Morgan Guaranty (US$150 million), Wells Fargo (US$120 million), and Manufacturers Hanover (US$120 million). Concomitant with this strategy was an effort to mobilize loans from official and multilateral lenders that culminated in a July 1981 World Bank Consultative Group meeting in Paris for support of the 1981-1985 public investment program comprising US$4.5 billion in external financing.

This behavior was not only consistent with the more prudent borrowing strategy, but it also was concordant with the anti-inflationary struggle that had a high priority in economic policy. There could as well have been the additional motive of discouraging arms purchases. In any event, the strategy backfired somewhat as the buoyant external situation began to fade. On the one hand, prices for major export products slumped (the terms of trade fell by 18 percent in 1981) and the liberalization program, coupled with a sharp deterioration of the real effective exchange rate,[27] provided more pressure to import (value rose by 23 percent and volume by 10 percent). On the other hand, world interest rates began their unprecedented escalation (LIBOR rose to 5 percent in real terms), and net interest payments increased 42 percent, absorbing fully 19 percent of the nation's export earnings.[28] Meanwhile, new loans from international agencies--earmarked for projects--encountered delays, inducing balance-of-payments deficits; by the third quarter of 1981 gross reserves had fallen by half to just US$1 billion, less than three months' import cover.

The advent of less buoyant external conditions exposed the somewhat cosmetic nature of the adjustment program of previous years; exogenous and temporary factors had weighed heavily in the turnaround of the economy, and

when these favorable conditions dissipated, the same old structural problems in the Peruvian economy reappeared.

Just when the government's investment program was gearing up (consolidated public-sector investment rose from 6 percent to 10 percent of GDP between 1979 and 1981), revenues growth became sluggish; the overall public-sector deficit ballooned from 1 percent of GDP in 1979 to more than 8 percent in 1981. Likewise, internal savings slumped, and the savings/investment gap widened to magnitudes not unsimilar to those of the Velasco period.[29] Finally, as mentioned earlier, the real effective exchange rate accelerated its move in an uncompetitive direction, having deteriorated by 24 percent with respect to its level of 1978.[30] These events were accompanied by a major turnaround in the foreign borrowing strategy: In the last quarter of the year the government intensified borrowing and contracted new loans of US$734 million (compared to a total of US$1.154 billion in the previous three quarters), 75 percent of which came from private banks.[31]

The difficult year of 1982 proved to be the beginning of the worst economic crisis in the postwar period. The persistent internal structural disequilibria in the Peruvian economy were aggravated by a deepening of the recession in the OECD area (the terms of trade declined by another 13 percent), the persistence of very high real rates of interest in the Eurocurrency market, and the outbreak of a generalized financial crisis in Latin America that adversely affected access to bank credit.

In 1982 the government's attention shifted from the control of inflation to balancing the external accounts. Early in the year, authorities approached the IMF about the possibility of a standby agreement; it was felt that an IMF program, although politically costly, would facilitate the access to bank credit that was needed to close the now large current account deficit. Also the exchange rate, which had been adjusted cautiously but continuously, began to be devalued at a noticeably accelerated pace.[32] At the same time a very restrictive monetary policy was introduced, causing the sol share of the money supply to fall by 9 percent in real terms.[33] However, there was no success in reducing the current account deficit, in part because imports were resistant to compression on account of public-sector investment (now 11 percent of GDP) and in part because of purchases of military equipment.

With the Mexican financial crisis of August 1982, private banks became reluctant to lend to Latin America generally, detonating unmanageable payments problems in most countries that had any degree of reliance on private credit. Mexico's initiation of a debt rescheduling with its private bankers was followed by a wave of petitions from other Latin American borrowers, overwhelmed as they

were by the combination of record debt-service payments, and by a near halt in new net lending, which destroyed the rollover mechanism that had facilitated payment throughout the 1970s.

Peru tried to isolate itself from the rest of the troubled borrowers in Latin America. It was the second of what was to become sixteen Latin American countries (excluding Jamaica) to agree to submit to an IMF adjustment program,[34] providing bankers with the security of Fund conditionality and a symbol of Peru's seriousness with regard to adjustment. Then, in the midst of all the petitions to reschedule Latin American debt, the Peruvian economic team attempted to distance the country from the phenomena by declaring on numerous occasions that it would honor its obligations punctually and would not follow the example of other countries that were seeking to restructure obligations. Undoubtedly the economic authorities--several of whom had very close ties to Wall Street--also thought that their professional connections in world financial circles might help instill confidence in foreign bankers and permit Peru to distinguish itself from the pack of sinking debtor countries in the region.

Ironically, in the face of its deteriorating external accounts and a widespread state of internal disequilibrium, the only way Peru could, in fact, honor its debts was by contracting new loans from the banks to pay its old debt. This strategy became increasingly fruitless as the country could not avoid the generalized financial depression facing Latin America from mid-1982 onward.[35] However, for 1982 as a whole, a considerable amount of net borrowing was successfully undertaken with the banks (Table 14.8), and a sizable net transfer of foreign financial resources was achieved (Table 14.6). But this was done at the expense of a severe aggravation of Peru's ongoing debt problem, as loans could be secured only on increasingly onerous terms. For instance, in January 1982 Peru was charged LIBOR plus .75 percent for a seven-year US$308 million loan led by Morgan Guaranty Trust. At the end of May 1982 a US$320 million loan organized by Wells Fargo carried an average 1.375 percent spread for six-year maturities. By the end of December, however, Peru was paying 2 to 2.25 percent over LIBOR for five-year maturities. Moreover, medium-term credit was increasingly difficult to secure, necessitating a build-up of short-term debt (see Table 14.2), a lethal event for a country trying to avoid a rescheduling since this accelerates the reverse flow of debt payments.

By early 1983, Peruvian authorities were fully drawn into the Latin American crisis. Small U.S. banks and Japanese institutions were now closing down short-term lines of credit as their confidence in the country waned and they perceived Peru "as just another one of the half-collapsed economies of Latin America."[36] Interestingly, Peruvian economic authorities resisted rescheduling

to the end and it was Citicorp and Chase Manhattan Bank, Peru's two largest commercial creditors, that forced the government's hand. In effect, these institutions worried that the Japanese and smaller banks--with less of a commitment to international lending--would withdraw from Peru and transfer the risks of the country's situation to the big banks in whose portfolio Peruvian obligations carried relatively more weight.

In fact the two banks "counseled" authorities to declare a unilateral moratorium on debt payments so that retreating institutions would be "locked into" the country's fate. The plan called for a forced refinancing of short-term debt: Starting on March 7, 1983, all amortization payments were deferred. Short-term trade-related debt falling due between March 7 and May 31 (around US$500 million) was deferred for 90 days beyond the original date of maturity; public-enterprise working-capital debt (US$1.2 billion) and private-bank short-term debt (US$300 million) falling due between March 7, 1983, and March 7, 1984, were deferred for 360 days. The conditions of the operation were 1.5 percent over LIBOR and flat commissions of .375 percent, plus 1.5 percent for commercial credit lines.

At the same time Peru rescheduled US$408 million of medium-term debt payments falling due between March 7, 1983, and March 6, 1984. Additionally, the banking committee--led by Citicorp and including Chase Manhattan, Manufacturers Hanover Trust, Banco Central (Spain), Bank of Nova Scotia, Bank of Tokyo, Credit Lyonnais, Crocker National Bank, and National Westminster Bank--were to organize new loans of US$450 million. The cost of these operations was 2.25 percent over LIBOR for eight-year maturities (three years' grace) and flat commissions of 1.25 percent (an undisclosed agent's fee was also paid).

The terms of the agreement were extremely stiff: equal to the most onerous borrowing conditions recorded through the three aforementioned borrowing cycles. However, the agreement fell within the general framework of the rescue packages arranged by the banks for other Latin American countries, which were characterized by a marked rise in the cost of debt upon rescheduling obligations. A comparison of the conditions of medium-term syndicated bank credits in 1980-81 with those of the 1983 rescheduling suggests a deterioration of the "negotiated cost" of borrowing of 97 percent for Peru, which, although lower than that experienced by several other borrowers in Latin America, was nevertheless very dramatic (see Table 14.10). Assuming a LIBOR of 5 percent in real terms, the deterioration over the same period with respect to real financial cost was a hefty 19 percent (see footnote d of Table 10).

Notwithstanding the rescue package from the banks, a US$1 billion Paris Club rescheduling later in the year,

Table 14.10 Latin America: Provisional Data on Terms of Debt Rescheduling: 1982-1983

Country	Margin over LIBOR (percentage) 1980-1981 (1)	R (2)	AC (2)	Amortization Period (number of years) 1980-1981 (1)	R (2)	AC (2)	Grace Period (number of years) 1980-1981 (1)	R (2)	AC (2)	Commissions[a] 1980-1981 (1)	R (2)	AC (2)	Deterioration of Terms (percentage) (2):(1)[b]	Cost of Credit in Real Terms (increase)[c]
Argentina	0.67	2.13	2.50	7.5	7.0	5.0	...	3.0	3.0	1.09	...	1.25	...	...
Brazil	1.62	2.50	2.13	8.5	8.0	8.0	...	2.5	2.5	2.01	1.50	1.50	44	9.3
Chile	0.91	2.13	2.25	7.6	8.0	7.0	...	4.0	4.0	0.81	1.25	1.25	125	21.6
Costa Rica	1.13	2.25	-	6.0	8.5	-	...	3.0	-	1.23	...	-	...	...
Cuba	1.00	2.25	-	5.0	8.0	-	...	3.2[d]	-	0.88	1.25	-	28	19.9
Ecuador	0.74	2.25	-	8.0	9.0	-	...	2.0	-	0.97	1.25	-	146	26.1
Mexico	0.65	1.88	2.25	7.6	8.0	6.0	...	4.0	3.0	0.70	1.0	1.25	181	23.5
Peru	1.12	2.25	2.25	8.2	8.0	8.0	...	3.0	3.0	1.07	1.25	1.25	97	18.6
Uruguay	0.98	2.25	2.25	9.1	6.0	6.0	...	2.0	2.0	...	...	...	...	...

Note: Dots indicate data that are not available or not separately reported. Dashes indicate that amounts are nil or negligible. The information in the table is provisional and subject to revision. Columns headed 1980-1981 show average credit terms in 1980 and the first half of 1981. Columns headed R relate to rescheduled maturities. Columns headed AC relate to terms for additional credits.

[a] Calculated as percentages of the face value of the loans and represent a flat payment at the time of signing the loan contracts

[b] Based on the index of the cost components of credit that are subject to negotiation, as shown in the note to Table 14.3

[c] Assumes a LIBOR in real terms of 5 percent for 1980-1981 and for the rescheduled debt/new loans of 1982-1983 and adds the effect of commissions and margins by the formula C/P + M where C = commissions, P = amortization period, and M = margin. Averages are weighted by values. For Peru one finds a financial cost of 6.25 percent for 1980-1981 and 7.41 percent for the 1983 rescue package.

[d] Weighted average

Source: Robert Devlin, "Renegotiation of Latin America's Debt: An Analysis of the Monopoly Power of Private Banks," CEPAL Review, no. 20, August 1983.

and the support of the IMF, Peru's economy went into a tailspin. Interest payments alone represented more than 31 percent of 1983 export earnings, and although the banks effectively refinanced part of these payments with the so-called new loans, Peru had to generate a trade surplus to help finance the balance of these payments. The surplus (estimated at US$130 million)[37] had to be effected in an environment of depressive world trade and severe natural disasters in Peru (floods in the north coast, droughts in the Altiplano), and the weight of adjustment fell on imports: Estimates have it that volume declined by 27 percent in 1983. It is not surprising that per capita income fell by an amazing 14 percent (to the level recorded in 1962[38]), underemployment exceeded 50 percent of the work force, and--in the face of an average rate of inflation of 111 percent--real wages fell sharply. Also, the government was unable to comply with the IMF program targets; at the end of 1983 it had to begin negotiations for a new agreement. Peru entered 1984 facing severe social unrest of both a political and an economic nature. Furthermore, in the midst of these difficulties there were reports manifesting another of Peru's perennial problems: The military was seeking to purchase fighter planes worth US$700 million.

Finally, in February 1984 Peru reached a tentative settlement with its 280 private banks for payments falling due that year. Peru's advisory committee had apparently agreed to restructure US$1.56 billion. This involved US$950 million of short-term working-capital obligations that were to be converted into medium-term debt and another US$610 million of maturities falling due in the period March 1984--July 1985. The terms would be nine years of amortization including five years' grace, at 1.75 percent over LIBOR (information is not available on commissions). At the same time, trade-related short-term credit lines were to be rolled over until November 1985.[39] These conditions, for reasons to be explained in the next section, are much softer than those in effect in the first round of reschedulings.

PERU AND THE BANKS: SOME THEORETICAL AND PRACTICAL ISSUES

This section will briefly address some of the conceptual issues behind Peru's debt problems. The first part will outline what is felt to have been an erroneous borrowing strategy by the Velasco regime that was responsible for the initial debt buildup that has underlain much of Peru's current difficulties. The second part will suggest that Peru (as well as other Latin American countries) perhaps misinterpreted the proper theoretical framework for undertaking the rescheduling

exercises.

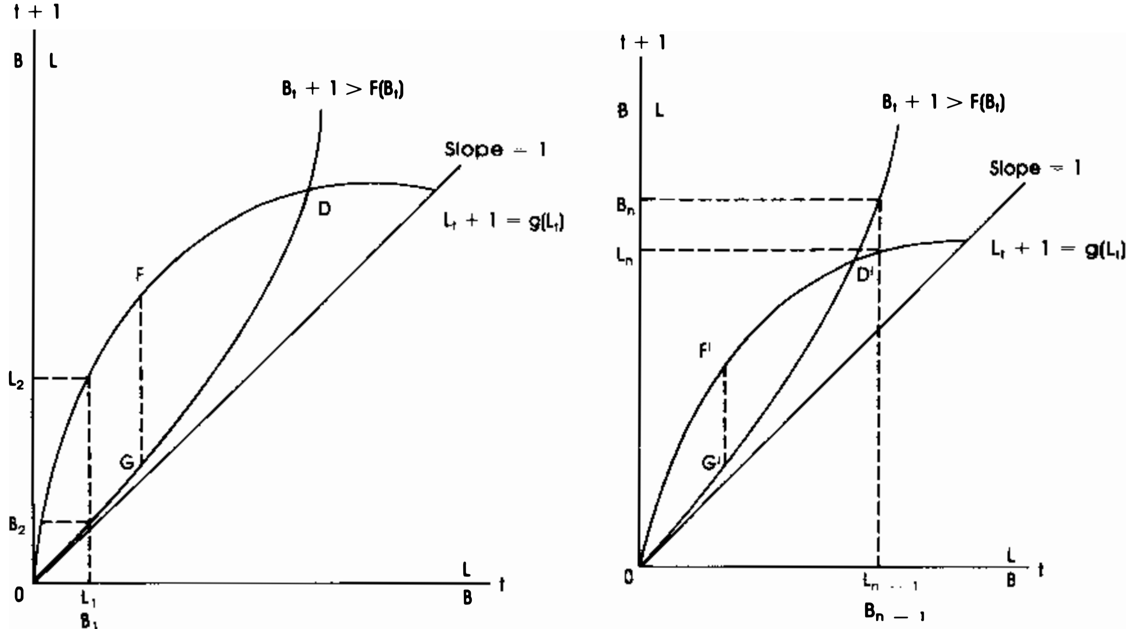
Supply-Led Indebtedness

In dealing with private banks, borrowers must remember that commercial lenders are very exposure conscious.[40] Thus banks are especially attracted to what might be termed "virgin borrowers," countries that meet some minimum standard of creditworthiness but have little or no exposure with the lending institution. For a bank, a decision to lend under these circumstances is an extremely easy one: Portfolio diversification means the cost of running the risk of a new loan is nominal, whereas the profitability of the loan can be considerable since new borrowers often must pay stiff premiums on their loans (as did Peru in 1972) until their recognition factor is higher and competition among the banks flattens out the price structure of credit. But as the borrower's participation in the portfolio of the bank rises, the lender can become more conscious of exposure considerations, and enthusiasm for new loans shifts into greater degrees of reticence. In these circumstances bargaining power slowly shifts to the lender: As the eagerness to lend becomes relatively less pronounced, the eagerness to borrow is on the rise, if for no other reason than to roll over the exponentially growing debt-service payments to the banks. These exposure considerations--and the consequent erosion of the bargaining power of the borrower--can be offset only by an improved image of creditworthiness, an expanded supply of deposits in international financial markets, new entrants to international lending that intensify competition, or new premiums on the price of the loan. But even here there is a limit to the granting of credit given any capital and reserve structure of the lending institution.

This evolution of bargaining power is illustrated in Figure 14.2. The figure represents two potential points in the borrowing cycle, labeled *a* and *b*. It is assumed that the number of lenders, the level of international liquidity, and the perceptions of creditworthiness remain unchanged throughout the cycle.

On the horizontal axes there is borrowing *B* by a country and lending *L* awarded to it by the banks in period *t* (obviously, $B_t = L_t$); on the vertical axes are the borrowing requirements and loan availability for the country in the subsequent period $t + 1$. On the basis of the amount borrowed and lent in period *t*, a certain price for credit is established; at this given price future borrowing and lending become a function of the previous period's borrowing and lending. The second derivative of the borrowing function is positive, reflecting the fact that there is an increasing

Figure 14.2 The Evolution of Bargaining Power In the Borrowing Cycle



L=Lending
B=Borrowing

propensity to borrow as a result of expanding absorptive capacity in the country and the growing requirements for the refinancing of old debt. For the banks, however, the second derivative is negative, reflecting exposure and risk considerations as the country's position in the banks' loan portfolio rises.

Segment (a) of Figure 14.2 depicts an early phase in the borrowing cycle. In period t the country has borrowed B_1, and the banks have lent an identical amount L_1, the transaction being cleared at a given market price. For reasons of the asymmetry of scale between the banking system and an individual borrowing country at this given price, what the banks are able to lend in period $t + 1$ (L_2) is considerably more than what the country is able to effectively demand (B_2). This is not a stable situattion. In effect, private commercial banks are very concerned about their market position vis-à-vis competing institutions; banks will therefore seek to gain a footing in the demand-constrained credit flow. Thus, in the initial periods of borrowing where $L_{t+1} > B_{t+1}$ the country can affect the terms of credit (both the price and nonprice components). In other words, the country's bargaining position is potentially very strong. To the extent that there are new entrants to international lending (as was the case in the 1970s[41]) the bargaining power of the borrower is further enhanced.

Ceteris paribus, the country's situation can deteriorate as the demand for credit rises. Segment (b) of Figure 14.2 displays a potential position in an advanced stage of the borrowing cycle. Here the demand for credit has been pushed beyond point D', and negotiating power has decisively shifted in favor of the lenders as future borrowing needs exceed available loans. The terms of credit (both price and nonprice) can now severely deteriorate for the borrower simultaneously with a restriction in supply.

In view of the foregoing, an advantageous strategy for the borrower during the course of a credit cycle is to locate itself in or around the area $F'G'$--the maximum divergence between demand and available supply of credit and hence the strongest bargaining position--and still maintain an adequate growth of the flow of credit for investment and finance needs. One possible strategy is to assuage the growth of the demand for foreign credit via increased domestic savings, thus shifting the curve ODB_{t+1} downward and to the right and enhancing overall bargaining power. But there also is a "dividend" to this strategy: Raising domestic savings will probably improve the image of creditworthiness and shift the curve ODL_{t+1} upward and to the left, as would any policy that improves that image. The net effect, then, is a broadening of the opportunity for new borrowing under favorable

terms.

What we posit here is what might be termed an active and "defensive" borrowing strategy vis-à-vis the banks. In the face of a rapidly expanding supply of bank loans, a country should attempt to keep the banks "on the hook" by minimizing the share of foreign commercial resources in the financing of development. This is done through the raising of domestic savings, the promotion of exports, the efficient minimizing of foreign content in projects, the establishment of extremely controlled interface with commercial creditors, and so on. Essentially what is being exploited here is the principle that private banks are most eager to lend to borrowers that do not need the resources.

Peru, during the Velasco regime, pursued policies that were not in accordance with such principles, and in the absence of some precise countervailing strategy the country eventually put itself into the deteriorating bargaining position pictured to the right of point D in Figure 14.2. The regime correctly viewed the bank loans as a new and timely instrument to support its objectives, yet it did not realize that the instrument cuts two ways and that when employed carelessly, it could actually run counter to objectives and undermine an entire political program directed at reducing foreign dependency. Instead of establishing a carefully planned defensive relationship with the banks, the public authorities, in moments of objective bargaining strength, became engulfed by the forces of the market, thereby letting enthusiastic bankers dictate the volume of credit.

In fact, once authorities received favorable signals from the commercial banks, they did not establish a reserved borrowing posture, but rather readily accepted all the credit available to them regardless of whether it could be deployed efficiently or not. Moreover, the situation was aggravated by the fact that private banks evidently do not seriously evaluate government-guaranteed projects and that they displayed an amazing willingness to extend free disposition credits during the Velasco period (see Table 14.11),[42] all of which essentially allowed borrowing to be delinked from effective absorptive capacity.[43] As a consequence, overborrowing took place, that is, borrowing in excess of absorptive capacity (productive use of resources). When overborrowing occurs, foreign capital does not necessarily translate itself into a larger economic surplus, but rather can encourage a misallocation and wastage of resources through increased consumption and imports, speculation and inflation, as well as capital flight. It also can culminate in loss of creditworthiness and economic crisis.

In effect, a massive influx of loans that exceeds productive possibilities can convert itself into an opiate that provides a false sense of security and hides the need for adjustment in economic policy. Just prior

Table 14.11 Peru: Distribution of Commercial Bank Loans According to Purpose, 1971-1976

Capital Goods Imports	Other Imports	Refinance Credits	Free Disposition Credits	Projects	Nationalizations	Other	Total
2.0	0.1	48.6	27.8	14.7	6.1	0.7	100.0

Note: Excludes loans with export credit guarantees

Source: Robert Devlin, Los Bancos Transnacionales y el Financiamiento Externo de América Latina: La Experiencia del Perú, 1965-1976 (Santiago, 1980), p. 86.

to gaining access to credit from international banks the Velasco regime displayed a credible performance in stabilizing the internal and external accounts. However, this effort slackened considerably once authorities confronted a seemingly endless flow of bank loans. Consumption went on the rise; export coefficients declined dramatically in the face of expanding import coefficients; tax pressure stagnated or fell while public-sector deficits reached highly inflationary levels and exchange-rate parities encountered marked deterioration. All this was sustainable as long as flows of commercial bank loans and international commodity prices were high. However, the latter are notoriously transitory, and the volume of bank loans is itself very sensitive--albeit with a deceptive lag--to the level of these prices and current account deficits more generally. The current account, of course, is in turn adversely affected by the relaxation of monetary, fiscal, and exchange-rate discipline that the bank loans themselves facilitated. In sum, authorities failed to realize the contradiction between maintenance of the growth of bank loans and deterioration of basic economic parameters. Eventually the contradiction between eroding creditworthiness and growing exposure led the banks to react, and only then did the latent economic crisis come into full focus.

Of course the second Belaúnde administration attempted to correct this situation. But the mountain of debt had already been accumulated, making the task a difficult long-term venture. Moreover, attempts to rectify the situation were based to a large extent on very favorable external factors that were unlikely to persist, and the advent of a prolonged world recession and restrictions on access to new credit quickly put Peru back in the so-called debt trap with its consequent political and socio-economic costs.

The Cost of Rescheduling: A Case of Monopoly Rents

It is common practice[44] for private banks to sharply raise the price of credit when forced refinancing/rescheduling exercises are undertaken.[45] This happened to Peru in 1969-1971, 1976, 1978, and 1983. The bankers have given various market-oriented arguments to justify the practice, among them: (1) the market perceives more risk in the country and therefore demands a higher price for the right to reschedule; (2) competition had driven the price of credit too low, therefore necessitating an adjustment by the banks during the relief exercise; (3) the payment of a higher price for credit is viewed as the best way to induce the banks to reschedule and to grant future credit flows, and (4) the banks must be reimbursed for the time and money spent on a rescheduling exercise.

Peru and most countries in Latin America have traditionally accepted these arguments and when faced with a rescheduling, they have acted as if they were in a market situation where the price of credit has risen simply as a result of an upward shift in the supply curve. This would appear, however, to be a misconception that has serious ramifications for policy during a rescheduling exercise.

It must be remembered that private banks develop loan portfolios under assumptions of risk. Risk is evaluated and taken into account in two ways: portfolio diversification and risk premiums. Thus, when a bank lends it incorporates a risk premium into the price of the credit based on its evaluation of the risk involved. Theoretically, should a borrower be unable to pay, an efficient bank would have incorporated the risk into its portfolio and would be in a position to draw on the premiums if and when the risk materializes. Moreover, in a competitive market situation, banks would have to accept the losses involved with having clients unable to pay, and banks that had inefficiently evaluated risk would go bankrupt because the premiums collected (and diversification) would not be adequate to absorb the materialized risk.

This is what happened in the 1930s. When developing-country borrowers were unable to liquidate their bond obligations, creditors took heavy losses and some went bankrupt. Today, however, bankers can do something that dispersed and anonymous bondholders could not do at that time: coordinate their action vis-à-vis a borrower through the so-called banking advisory committee. Moreover, there is a strong incentive for cooperation among the banks given the binding nature of the cross-default clauses present in practically all loan agreements. In other words, the banks can group together in a bloc and effect a rescheduling of the debtor's obligations to avoid a default and losses. Seen from this angle, a

rescheduling, rather than being the curse that bankers often imply as they justify the high price of such an exercise, is a great "historical privilege" that allows banks to elude the losses that a competitive market would impose on them.

The same perspective allows one to better understand the banks' strategy: The increase of the price of credit upon rescheduling is an effective *ex post* adjustment of terms that passes the cost of an erroneous evaluation of risk onto the borrower. This, of course, could not be done in a competitive market environment. Furthermore, countries like Peru could have explored ways to avoid this higher cost because the extra charges on a rescheduling are a monopoly rent that in theory and practice can be reduced.

In rescheduling a loan there is no real credit transaction with a supply price since the operation simply consists in the administration of a loan already granted and not immediately recoverable. Nor does rescheduling imply *additional* risks or costs for the banks since the alternative is a stoppage of payments and liquidation of part of the portfolio; indeed, the banks gain additional security and lower risk in the form of IMF agreements and state guarantees on private debt. In practice, then, rescheduling effectively reduces the risk of default and therefore of major losses. As for the outlays on telex, cables, travel, and so on connected with the negotiation of a rescheduling operation, these are expenses that should already have been incorporated in the risk premium paid for by the country when it originally contracted the debt. Thus, any increase in the margin over the base interest rate and payment of commissions on the amount of rescheduled debt signifies rent; that is, it constitutes an income in excess of economic costs, which is generated by virtue of the bargaining power of the few large banks that control access to credit for a country of questionable creditworthiness. In other words, the bank charges extra for an administrative operation (the rescheduling of debt service) necessary in any event to avoid large losses; therefore, the additional income it receives on reprogramming the debt is an "excess profit."

The so-called new credits offered to Peru in the 1982-83 round of reschedulings in Latin America must be viewed in the same perspective. The new credits were extended to effectively refinance about 60 percent of the interest payments to the banks that otherwise would be in arrears. In other words, the new loans are an integral part of the administration of old debt: They are a disguised rescheduling of interest payments that permits the country to keep current its interest payments on past debt and thereby permits the banks to avoid having their assets classified as nonperforming by their local banking supervisors. In sum, these loans too are nonmarket

transactions.

What one faces in a rescheduling exercise is really a bilateral monopoly; the country on one part and the banks on the other negotiate to determine how losses on a weak portfolio will be shared. The price of credit is not a market-determined price but rather a negotiated price that is indeterminate and depends on the cat-and-mouse game of a bilateral monopoly. Nevertheless, the practice that the banks have of sharply boosting the cost of credit upon rescheduling involves rents, and Peru could have attempted to capture some of these.

What are the limits of tolerance of bankers? This is hard to say, but the bankers' evident reluctance to declare a default on borrowers even in the face of a large accumulation of arrears suggests that their fear of the precedent of default and accounting losses could have been better exploited. It must be remembered that the banks' marginal cost of funds is the LIBOR and any interest rate above this enters into the terrain of profits. In other words, a bank could very well reschedule at, for example, 1 percent over LIBOR for fifteen-year maturities and still be much better off than if it had to declare a default on the borrower.[46] The bank benefits because it avoids accounting losses; indeed its books will show a profit, albeit profits much reduced from those achieved in the first round of rescheduling and probably even with respect to those on the originally contracted debt. The country also benefits because it gains a rescheduling that has terms more consonant with a positive adjustment process, that is, one that facilitates development and growth and minimizes costs--economic, social, and political. Moreover, since the banks avoid accounting losses--even while making real sacrifices--the country in all likelihood will find a renewed access to autonomous credit flows from the banks once its economic situation improves (the likelihood of which is enhanced by a more equitable rescheduling exercise).

In all fairness to Peruvian authorities, however, the financial crisis of 1982 erupted suddenly, and the precedent of the higher cost of debt upon rescheduling was on the side of the banks. This, coupled with the tremendous power wielded by the banking committee and the fact that Peruvian authorities (along with the rest of their Latin American counterparts) acted--erroneously--as if they were competitors with other countries for bank credit, helps to explain the high cost of the 1983 rescheduling. Fortunately, Peruvian authorities were clever in rescheduling only one year of maturities instead of the two years sought by many other countries: The margins and commissions invariably charged by the banks on rescheduled 1982-83 debt in Latin America were equivalent to the highest ever imposed on a commercial transaction[47]; thus there was very little chance of the cost rising in 1984 and a good probability that it would

fall. Indeed, consternation in influential circles of the North and South about the excessive cost of the 1982-83 reschedulings in Latin America induced a willingness on the part of the banks to lower the cost of rescheduling-refinance exercises in 1984, an event that, as mentioned earlier, Peru itself apparently is taking advantage of. It also is interesting to note in closing that the softened terms in 1984 have occurred at a time when most of the countries benefited are deeper in crisis and many have accumulated substantial arrears; this is good empirical evidence of the rents captured by the banks in the first round of reschedulings in Peru and Latin America more generally.

NOTES

The views expressed in this chapter are those of the authors and not necessarily those of ECLA.

1. See Devlin (1983b); and Ffrench-Davis (1983).

2. See Fitzgerald (1979, chap. 7); and Thorp and Bertram (1978, chap. 14).

3. For a most interesting "insider's" account of economic policy of the Belaúnde administration, see Kuczynski (1977). Also see Devlin (1980).

4. However, authorities remained within the limits of the traditional liberal state, restricting activities to infrastructure and the like, leaving commercially productive activities to the private sector.

5. Calculated on the basis of fiscal data in Kuczynski (1977), deflated by the consumer price index.

6. In total there were only twenty-seven commercial banks lending to Peru. The most important medium-term lenders were Manufacturers Hanover Trust, Bankers Trust, Bank of America, Chase Manhattan, Citibank, and Continental Illinois, institutions that provided 72 percent of all medium-term loans.

7. For the analysis of economic policy in this period see Pinto and Assael (1981); and Schydlowsky and Wicht (1983).

8. The results of the 1969-1971 stabilization effort are reviewed in Cabrera (1978).

9. The plan called for a rise in the global investment coefficient from 13 percent in 1970 to 21 percent by 1975; the participation of the public sector in total investment was to rise from 36 percent to 58 percent over the same period.

10. A detailed analysis of Peruvian military expenditures is to be found in Encinas del Pando (1983).

11. The negotiations were initiated in mid-1973 by a delegation headed by James Greene, a former vice-president of Manufacturers Hanover Trust. The end result was a US$150 million payment from the Peruvian government to its U.S. counterpart to be distributed by the latter as

it saw fit among the affected enterprises. Much of the payment was financed by a US$76 million syndicated loan--on terms very favorable to Peru--organized by Morgan Guaranty Trust.

12. See Fitzgerald (1976, 89).

13. See Encinas del Pando (1983, 85).

14. See Thorp and Bertram (1978, chap. 11).

15. See Stallings (1983).

16. See Stallings (1979).

17. The entire plan is republished in Devlin (1980, annex 5).

18. The details on the disputes are found in Devlin (1980, 171-172).

19. Banco Central de Reserva del Perú (1981, 11).

20. See Silva Ruete (1981).

21. Banco Central de Reserva del Perú (1981, 11).

22. Banco Central de Reserva del Perú (1984).

23. See Daly (1983, chap. 4).

24. Total output from all sources in 1979 was 190,000 barrels a day, and local consumption was 130,000 barrels a day. See Pontoni (1981, 21).

25. See World Bank (3d and 4th quarters 1979). Interestingly, there is evidence once again of a "Peruvian connection" in the renewed interest of the banks. One of the earlier loans to Peru came from LIBRA Bank where a former public servant held a high executive post. However, Peru's good reception apparently was not uniform: Ugarteche (1983) argues that although U.S. and Canadian banks were quite disposed to lend to Peru, European and Japanese institutions were relatively more restrictive.

26. See Banco Central de Reserva del Perú (1981) and Banco Central de Reserva del Perú, _Memoria_, 1982.

27. See Economic Commission for Latin America, _Economic Survey for Latin America_, 1982, table 42.

28. A coefficient of 20 percent is considered a sign of trouble by bankers.

29. See Banco Central de Reserva del Perú, _Memoria_, 1982; and De la Piedra (1983).

30. See Economic Commission for Latin America, _Economic Survey for Latin America_, 1982.

31. See Banco Central de Reserva del Perú, _Reseña Económica_, March 1982.

32. Inflation in 1980-1982 was roughly 70 percent annually on a December to December basis; on the same basis the exchange rate was adjusted 37 percent in 1980, 48 percent in 1981, and 95 percent in 1982. See Banco Central de Reserva del Perú, _Nota Semanal_, no. 33, 1983; and Economic Commission for Latin America, _Economic Survey for Latin America_, 1982.

33. At the same time, however, the dollar share of the money supply grew by 31 percent, speeding up the so-called dollarization process of the economy. Hence, the participation of soles in the domestic money supply

dipped from 72 percent of the total at the end of 1981 to only 65 percent at the end of 1982. See Banco Central de Reserva del Perú, Nota Semanal, no. 33, 1983.

34. In June 1983 Peru signed an SDR735 million Extended Fund Facility credit and a compensatory financing agreement for SDR225 million. For data on Peru and other Latin American countries, see Economic Commission for Latin America, Economic Survey for Latin America, 1982, table 46; and Ground (1984).

35. See Chapter 4 by Iglesias in this book.

36. See the Andean Report, April 1983, p. 57.

37. See Chapter 4 by Iglesias in this book.

38. According to data furnished by ECLA's Division of Statistics and Quantitative Analysis, National Accounts Section.

39. See Perú Económico, February 1984.

40. A more elaborate analysis of the following points can be found in Devlin (1983a).

41. Estimates have placed this at sixty new banks per year. See Bank for International Settlements, Press Review, November 2, 1983, no. 214, pp. 1-6.

42. In terms of the lack of seriousness in evaluation of projects, this was most evident in the loans to the petroleum sector. It also should be mentioned that refinance loans can have an effect similar to free disposition credits inasmuch as they free resources that otherwise would be destined for debt-service payments.

43. It should be noted that freely disposable resources are clearly a blessing for a country with adequate absorptive capacity and a coherent program of adjustment, but in the absence of these two conditions they can become a vice as resources find their way into activities of questionable merit. Precisely because of this latter problem, Peru's dependency on the foreign banks became extreme, and the regime paid a high political and social cost when the banks lost confidence in the economic program and decided to restrict their exposure in the country.

44. This is elaborated on in greater detail in Devlin (1983c); and Economic Commission for Latin America (1984).

45. The difference between a forced refinancing and a rescheduling is only a cosmetic one.

46. Peru also should attempt to use its bargaining power to achieve a 90 percent refinancing of interest payments.

47. For information on the terms and conditions of the first and second round of rescheduling, see Economic Commission for Latin America (1984).

BIBLIOGRAPHY

American Express Bank. Amex Review. London. Monthly publication.
The Andean Report. Lima. Monthly publication.
Banco Central de Reserva del Perú. Nota Semanal. Lima. Weekly publication.
___. Memoria. Lima. Annual publication.
___. Reseña Económica. Lima. Quarterly publication.
___. 1981. Desarrollo de la Deuda Externa Peruana, 1968-1979. Research Document no. 1. Lima.
___. 1984. El Proceso de Renegociación de la Deuda Externa Peruana: 1978-1983. Lima.
Cabrera, Cesar Humberto. 1978. "Perú: La Crisis y la Política de Estabilización." Serie Materiales de Trabajo no. 17. Lima.
Daly, Jorge. 1983. The Political Economy of Devaluation: The Case Study of Peru, 1975-1978. Boulder, Colo.
De la Piedra, Enrique. 1983. "Peru: Debt and Crisis, 1977-1983." Santiago, United Nations ECLA, Economic Development Division. Mimeo.
Devlin, Robert. 1978. "External Finance and Commercial Banks: Their Role in Latin America's Capacity to Import Between 1951 and 1975." CEPAL Review, no. 5 (Santiago). First semester.
___. 1980. Los Bancos Transnacionales y el Financiamiento Externo de América Latina: La Experiencia del Perú, 1965-1976. Santiago.
___. 1983a. "Banca Privada, Deuda y Capacidad Negociadora de la Periferia: Teoria y Práctica." Notas Técnicas, no. 60. Santiago, November.
___. 1983b. "La Banca Privada Internacional y el Endeudamiento de América Latina." Comercio Exterior, vol. 33, no. 7 (Mexico). July, pp. 641-643.
___. 1983c. "Renegotiation of Latin America's Debt: An Analysis of the Monopoly Power of Private Banks." CEPAL Review, no. 20 (Santiago). August.
Devlin, Robert, and Michael Mortimore. 1983. Los Bancos Transnacionales, el Estado, y el Endeudamiento en Bolivia. Estudios e Informes no. 26. Santiago.
Economic Commission for Latin America. Economic Survey for Latin America. Santiago. Annual publication.
___. 1984. Policies on Adjustment and Renegotiation of the External Debt. E/CEPAL/SES.20/G.17. Santiago.
Encinas del Pando, Jose. 1983. "The Role of Military Expenditure in the Development Process: Peru, a Case Study, 1950-1980." Ibero-Americana, Nordic Journal of Latin American Studies, vol. 12, nos. 1-2.
Ffrench-Davis, Ricardo. 1983. "El Problema de la Deuda Externa en América Latina: Tendencias y Perspectivas en 1983." Integración Latinoamericana, no. 83. September.

Fitzgerald, E.V.K. 1976. The State and Economic Development: Peru Since 1968. Cambridge.
___. 1979. The Political Economy of Peru 1956-1978: Economic Development and the Restructuring of Capital. Cambridge.
Ground, Richard Lynn. 1984. "Los Programas Ortodoxos de Ajuste en América Latina: Un Examen y una Crítica de las Políticas del Fondo Monetario Internacional." Santiago. United Nations ECLA, Economic Development Division. Mimeo.
Iglesias, Enrique. 1983. "Reflections on the Latin American Economy in 1892." CEPAL Review, no. 19, April.
___. "External Debt Problems of Latin America," Chapter 4 in this book.
Inter-American Development Bank. 1982. External Debt of the Latin American Countries. Washington, D.C.
International Monetary Fund. 1983. Recent Multilateral Debt Reschedulings with Official and Bank Creditors. Occasional Paper no. 25. Washington, D.C.
Kuczynski, Pedro-Pablo. 1977. Peruvian Democracy Under Economic Stress. Princeton, N.J.
Perú Económico. Lima. Monthly publication.
Pinto, Anibal, and Hector Assael. 1981. Peru 1968-1978: La Política Ecónomica en un Proceso de Cambio Global. Estudios e Informes no. 2. Santiago.
Pontoni, Alberto. 1981. Transnacionales y Petróleo en el Perú. Lima.
Schydlowsky, Daniel, and Juan Wicht. 1983. "The Anatomy of Economic Failure." In The Peruvian Experiment Reconsidered, edited by Cynthia McClintock and Abraham F. Lowenthal. Princeton, N.J. (Abridged from the Spanish version Anatomía de un Fracaso Económico: Peru 1968-1978. Lima, 1979.)
Silva Ruete, Javier. 1981. Yo Asumí el Activo y el Pasivo de la Revolución. Lima.
Stallings, Barbara. 1979. "Peru and the U.S. Banks: The Privatization of Financial Relations." In State and Capitalism in U.S.-Latin American Relations, edited by Richard Fagen. Stanford, Calif.
___. 1983. "International Capitalism and the Peruvian Military Government." In The Peruvian Experiment Reconsidered, edited by Cynthia McClintock and Abraham F. Lowenthal. Princeton, N.J.
Thorp, Rosemary, and Geoffrey Bertram. 1978. Peru 1890-1977: Growth and Policy in an Open Economy. New York.
Ugarteche, Oscar. 1980b. La Banca Transnacional, la Deuda Externa, y el Estado: Perú 1968-1978. Lima.
___. 1980a. Teoría y Práctica de la Deuda Externa en el Perú. Lima.
___. 1983. "Concentración del Crédito y Fragilidad Financiera." Actualidad Económica. Lima. August.

World Bank. *Borrowing in International Capital Markets*. Washington, D.C. Periodic publication.

15
The Role of External Debt Problems in Central America

Jorge González del Valle

INTRODUCTION

The five Central American countries (Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua) have traditionally been rather cautious and conservative as far as foreign borrowing is concerned. This is probably a result of the long-lasting unfavorable experiences arising from the failure to service external debts arranged in the first three decades of this century. Some of those countries (Guatemala and El Salvador) had to pay dearly for the refinancing of such debts, and Nicaragua actually suffered foreign military intervention prompted by the excuse of financial default.

Another important reason for the limited reliance of the Central American countries on external financing appears to be a generally conservative attitude of governments and central banks as regards fiscal policy, foreign-exchange management, and domestic credit regulation. It is well known that in the Latin American context the Central American countries have for a long time been able to maintain stable exchange rates, positive net international reserves, and low rates of inflation. Thus capital formation has been financed primarily with domestic savings and whatever long-term foreign investment is attracted by economic growth and stability in the region.

Still another factor that explains the limited role of external debt in Central America's economic performance is the strong influence of official development financing based on rather liberal terms in the last twenty years. It may be recalled that the Central American integration program, which began in 1961, was particularly attractive to the novel concessional lending of the Alliance for Progress agencies and the social progress fund of the Inter-American Development Bank. Moreover, the Central American countries in 1961 established their own regional development bank (the Central American Bank for Economic Integration) with the

specific purpose of mobilizing long-term, low-interest foreign borrowing to finance both public and private priority projects.

In fact it is only in recent years that the external debt burden and refinancing have become important in Central America's economic policy. Even so, except in the case of Costa Rica, such problems have not exerted a decisive influence on the direction of the adjustment policies adopted by all countries to minimize the adverse effects of the economic recession. This is probably due to the relatively successful combination of exchange controls, trade restrictions, and reserve utilization in the context of a depressed economic performance that has discouraged new investment and reduced import demand. In short, the external dependence of the Central American economy is more a problem of international markets for primary goods than a problem of foreign financing for capital formation.

FOREIGN DEBT STRUCTURE AND TRENDS

It was estimated that by the end of 1983 the overall external debt of the five Central American countries would amount to some US$10 billion, only about 3 percent of the Latin American total. This is slightly higher than the 2.5 percent that the five countries' combined GDP represented within Latin America in 1981 and therefore closely corresponds to their economic importance in the subcontinent. On the other hand, there are significant differences as compared with other Latin American countries regarding the pattern of debt accumulation, the sources of external financing, average cost burden, and apparent ability to pay.

The Trend of Debt Accumulation

For the Central American region as a whole, foreign indebtedness doubled between 1980 and 1983, reflecting a marked and progressive deterioration of the external sector as a result of the world economic recession. It must be recalled that in spite of important achievements in the industrialization process during the last ten to fifteen years, the five countries still depend heavily (perhaps up to 70 percent) on the exportation of a few primary products that are subject to pronounced recession-induced shortfalls in international markets, such as coffee, bananas, cotton, sugar, and fresh meat.

The pace of debt accumulation was relatively more accelerated in Guatemala, El Salvador, and Honduras, whose aggregate external debt accounted for less than 37 percent of the region's total in 1977 but increased to more than 50 percent in 1983. Moreover, the average

ratio of external debt to GDP of the three countries was 31 percent at the end of 1983, as compared with only 12 percent in 1977. On the other hand, the external debt of both Costa Rica and Nicaragua increased in a rather normal fashion during the six-year period (see Table 15.1).

Table 15.1 Central America: External Debt Outstanding (millions of U.S. dollars)

	1977	1979	1981	1983[a]
Costa Rica[b]	1,160	1,750	2,240	2,640
El Salvador	360	610	860	1,400
Guatemala	270	590	1,300	1,960
Honduras[b]	590	880	1,330	1,670
Nicaragua[b]	870	1,110	1,980	2,380
Total	3,250	4,940	8,710	10,050
As percent of GDP	21.6	27.4	41.5	43.7

[a]Estimated

[b]Long-term debt only

Source: World Bank and International Monetary Fund.

To illustrate the severe impact of the world recession on the external position of the Central American countries it may be appropriate to point out a few key macroeconomic indicators. First, whereas the annual growth of the region's real GDP averaged 2.9 percent in the period 1977-1979, the average annual shortfall reached the depression level of -7.9 percent in the period 1981-1983. Second, net aggregate international assets (in U.S. dollars) fell from 1,090 million in 1978 to -570 million in 1981 and further to -1,040 million in 1983. Third, the region's deficit on current account increased from 28 percent of exports in 1978 to 49 percent in 1981 and then fell to 36 percent in 1983 only because imports were reduced by 18 percent in the two-year period.

It is evident therefore then the accumulation of external debt in Central American has been quite abnormal since 1979 and is directly related to the region's overall economic deterioration. This in turn was precipitated by the world recession, but there is little doubt that the political events in both Nicaragua and El Salvador also played an important role. In Nicaragua, for instance, real GDP fell by 26 percent in 1979, the year in which a violent change in government took place; in El Salvador real GDP fell by 19 percent in 1979 and 1980 as the civil war took an initial, destructive impulse.

The Maturity and Interest-Rate Terms

The predominant reliance on borrowing from international financial institutions has helped the Central American countries to avoid the complicated accumulation of service payments at difficult times that many Latin American countries have faced in the last two years. Borrowing from such institutions is normally linked to the financing of long-term development projects and to interest charges somewhat lower than those of the financial markets.

In connection with the maturity profile, the average long-term external debt to official creditors increased up to 70 percent of the total debt outstanding by the end of 1983 from about 54 percent in 1981. This improvement was particularly marked in El Salvador, Honduras, and Nicaragua, whose bilateral debt to foreign governments almost trebled after 1980. On the other hand, Guatemala substantially increased its borrowing from private creditors, which was virtually nonexistent in 1980 (see Table 15.2).

Table 15.2 Central America: Long-Term External Debt to Official Creditors (percent of total outstanding)

	1977	1979	1981	1983[a]
Costa Rica	40.8	40.2	37.6	45.1
El Salvador	80.7	76.5	88.4	90.2
Guatemala	96.3	99.5	66.3	52.0
Honduras	76.9	76.3	76.4	81.9
Nicaragua	51.8	62.3	61.2	75.8
Average	60.1	62.1	53.9	70.0

[a]Estimated

Source: World Bank and International Monetary Fund.

The role of bilateral external debt has probably been enhanced in El Salvador and Nicaragua as a result of the special aid granted those countries by different governments to finance economic reconstruction associated with the internal military activity. In Nicaragua external financing from private sources virtually ceased in 1980, shortly after the revolutionary government took over, and bilateral borrowing became the main factor in the external debt structure. In the case of El Salvador a similar trend in debt accumulation began in 1981, so that bilateral borrowing now represents 41 percent of the total debt outstanding, as compared with 24 percent in 1980.

As far as the cost of external debt is concerned, the Central American countries have been unable to avoid the impact of high international interest rates during

the world recession. On the average, however, the ratio of payments abroad on account of interest and other charges to total debt outstanding has been moderate by Latin American standards. This appears to be primarily due to the substantial increase of low-interest bilateral loans received by El Salvador between 1981 and 1983, as well as to the doubling of Guatemala's debt to international financial institutions in the same period, including the use of IMF credit for the first time in many years (see Table 15.3).

Table 15.3 Central America: Apparent Overall Cost of External Debt[a] (percent per annum)

	1977	1979	1981	1983[b]
Costa Rica	5.9	8.0	13.7[c]	20.6[c]
El Salvador	8.8	11.8	7.4[d]	4.5[d]
Guatemala	11.8	7.8	8.4	6.6
Honduras	7.1	8.2	9.5	10.7
Nicaragua	5.7	5.6	6.1	10.8
Average	6.9	8.0	7.3	10.8

[a]Investment income payments abroad (except on direct foreign investment) as percent of total external debt outstanding at the end of year

[b]Estimated

[c]Probably overstated because of interest payments on short-term debt for which no data are available

[d]Mainly bilateral official credits on concessional terms

Source: International Monetary Fund.

The exceptional case of abnormal increases in external debt costs in Costa Rica since 1980 requires some explanation. In the first place, Costa Rica is the only country in the region whose reliance on private international financing has exceeded 50 percent of total debt outstanding, which means a substantial vulnerability vis-à-vis the evolution of market interest rates. In the second place, the ratio of external-debt interest payments to debt outstanding is probably overstated in the case of Costa Rica because of the impact of interest charges on an undetermined (but perhaps considerable) amount of direct private foreign debt. Finally, there are indications that as a result of the complex combination of exchange-rate devaluation and exchange controls adopted in 1981, payments abroad on account of external debt outstanding include unspecified refinancing and/or default charges.

The Repayment Capacity Position

In the absence of comprehensively reliable data on the repayment schedules of the Central American external debt, estimates on the evolution of their ability to pay are restricted to interest charges. From this standpoint it is evident that the region's ratio of interest payments to exports has deteriorated markedly since 1980, but is still far below the Latin American overall level, which is estimated at 40-50 percent. There are, however, significant discrepancies among the five countries that correspond to the varied characteristics of each country's external debt profile (see Table 15.4).

Table 15.4 Central America: Apparent External Debt Burden on Interest Account (percent of merchandise exports)

	1977	1979	1981	1983[a]
Costa Rica	8.2	14.9	29.9	50.2
El Salvador	3.3	6.4	8.1	8.3
Guatemala	2.8	3.8	9.1	11.0
Honduras	7.9	9.5	16.2	22.9
Nicaragua	7.8	11.5	24.2	34.0
Average	5.4	8.6	16.5	25.3

[a]Estimated

Source: International Monetary Fund.

On the one hand, the interest-payments burden of Costa Rica appears to approach a critical point, the main reason being a threefold increase of debt-related payments abroad from 1980 to 1983, since the value of exports actually recorded an 8 percent growth in the period. This in turn is a result of the excessive reliance on both public and private borrowing from commercial banks and import suppliers, which reflects the abnormal increases in market interest rates. On the other hand, El Salvador's interest-payments burden has stabilized at a very favorable low level despite a crushing 29 percent shortfall in the value of exports from 1980 to 1983. The obvious reason behind this performance is the overwhelming incidence of both institutional and bilateral borrowing from official creditors within the debt structure. In particular, it is presumed that the fast-growing importance of foreign aid in the form of bilateral loans also carries an interest-subsidy element.

The unfavorable trend of the interest-payments burden in Guatemala, Honduras, and Nicaragua is the result of a combination of increased debt charges and weak export performance. Whereas Guatemala and Honduras suffered export value shortfalls of 24 percent and 8 percent from 1980 to 1983 respectively Nicaragua enjoyed an 11 percent

increase. However, in the same period payments abroad related to the external debt increased by 79 percent in Honduras, 39 percent in Guatemala, and 13 percent in Nicaragua.

DEBT-RESCHEDULING EFFORTS

Efforts by the Central American countries to restructure their external debt have been going on since 1980, when the adverse effects of both the world economic recession and the internal political disturbances began to seriously weaken their external sector. Such efforts, however, have not followed any uniform pattern in the region and are conducted instead in a pragmatic fashion by the national authorities according to their own needs and possibilities. The most publicized cases of debt rescheduling and refinancing are those of Nicaragua in 1980-81 and Costa Rica in 1982-83, but both Honduras and El Salvador have also undertaken similar efforts involving small portions of their external debt to private creditors.

The debt-rescheduling package of Nicaragua is notable on three accounts: (1) it took place at a time when the external-debt problem had not reached any critical proportions in the Latin American context; (2) it involved a comprehensive revision of maturity, amortization, and interest-rate conditions of both public and private debt; and (3) it was based on joint negotiations with the private creditors with a view to standardizing the rescheduling terms. The negotiations lasted almost two years, involved about 65 percent of Nicaragua's external debt outstanding at the end of 1979, and were arranged in four different stages in accordance with the type of borrower.

It is no secret that Nicaragua's successful external-debt renegotiation was helped by the private creditors' realization that the new revolutionary government had the option to simply disregard foreign obligations for which it had no responsibility, particularly in view of the abundant accusations of corruption and immorality that befell the former dictatorship. Moreover, the nationalization of banks, financial entities, and large agricultural and industrial holdings after the devaluation clearly left the foreign creditors in a weak bargaining position.

In the end, the Nicaraguan government was able to refinance a substantial part of the overall debt to private international lenders on the basis of a ten-and-more years' maturity, average five-year grace period, and a 7 percent fixed interest rate. However, the direct obligations of former private banks and private enterprises were refinanced at variable maturities and interest rates, depending on the original loan conditions and the

expectation of further financing from the international creditors. As a rule, the new debt schedules were linked to the projected payment capacity of the government and the nationalized borrowers.

Costa Rica's external-debt renegotiation took place in a radically different environment as regards both the international financial conditions and the bargaining position of the borrower. Among other things, by the time negotiations started, Costa Rica had substantially devalued the national currency, exhausted international reserves and short-term foreign credits, established a complex exchange-control system, and incurred considerable debt-service arrears. Moreover, because of the change in government, negotiations had to be delayed until the second half of 1982, precisely the period when international lending was drying up, interest rates were rising to record levels, and fears of a world debt muddle were spreading. Negotiations were also conducted by stages and on the basis of joint agreements with the creditors. The Paris Club rescheduling was completed in early 1983 and had the conventional outcome: the postponement of amortization payments falling due in the short run without a full restructuring of official bilateral obligations. Nevertheless, it represented about 10 percent of the overall external debt outstanding at the end of 1982. On the other hand, it must be noted that both official and private creditors insisted that negotiations were linked to Costa Rica's performance under a standby arrangement with the IMF, which in turn would release fresh balance-of-payments financing.

Costa Rica's negotiations with private international banks took longer, were difficult most of the time, and were not completed until the end of 1983. Rescheduling of external debt held by such banks involved about 45 percent of the total debt outstanding at the end of 1982 and was intended to link service payments to the projected capacity to pay of the Costa Rica government in the medium term. Amortization payments may be postponed by up to three years and involve some refinancing of overdue interest payments. However, the cost of rescheduling is higher than originally expected due to the uniform application of the higher market interest rates, plus refinancing fees and commissions.

The debt-rescheduling operations of Honduras, El Salvador, and Guatemala are rather insignificant by comparison with the previous two cases. Honduras undertook a limited rescheduling of government-guaranteed debt in 1983 due to certain specific problems of the official finance corporation that might affect adversely to government's fiscal position. This operation was related to a small group of private international banks and in no case would represent more than 13 percent of the total external debt outstanding at the end of 1982. The details of the agreement reached with the banks have not

been publicized.

Finally, neither in Guatemala nor in El Salvador does the external debt problem appear to have reached the point at which an overall rescheduling policy is required. The still modest importance of external debt to private creditors (5 percent in El Salvador, 8 percent in Guatemala) is the main reason, and whenever there is a need to avoid an unfavorable concentration of service payments the national authorities apparently favor a case-by-case approach based on direct and informal arrangements with their creditors. However, the possibility of rescheduling policies might become greater if the external position of both countries does not improve in 1984.

THE PROBLEM OF INTRAREGIONAL DEBT

Since 1961 the Central American countries have settled all payments arising from intraregional trade through a clearing house. Until 1980 this mechanism operated normally, but as soon as global balance-of-payments difficulties began to appear debtor countries were unable to honor their obligations. In order to avoid an unmanageable accumulation of such balances, the five governments agreed to establish a new regional financial entity (the Central American Common Market Fund--CACMF) specifically designed to raise medium-term foreign loans that refinance intraregional official debts. Unfortunately the CACMF was unable to borrow more than US$50 million in 1981, which proved quite insufficient as outstanding balances continued to accumulate rapidly in 1982.

As of the end of 1983 unsettled intraregional debts amounted to some US$300 million, of which about 84 percent corresponded to Nicaragua's share of unpaid obligations (equivalent to about 10 percent of Nicaragua's total external debt). On the other hand, the aggregate claims of Costa Rica and Guatemala accounted for 94 percent of total intraregional debts; about one-third of such claims has not been scheduled, and negotiations on possible repayment programs are still going on (see Table 15.5).

Given the practical impossibility of further foreign borrowing by the CACMF to refinance outstanding intra-regional debts, an agreement to reschedule existing obligations in accordance with the projected payments capacity of debtors was reached in January 1984 by the Central American Monetary Council, which coordinates the central bank policies of the five countries. This renegotiation involved some US$235 million, and the standard arrangement was based on a new seven-year maturity including a two-year grace period.

From a broader point of view, the Central American countries are determined to reactivate intraregional

Table 15.5 Central America: Intraregional Debt Positions, End 1983 (millions of U.S. dollars)

	Scheduled Debt	Unscheduled Debt	Total Outstanding
Costa Rica	92.6	63.8	156.4
El Salvador	-36.6	-10.5	-47.1
Guatemala	102.1	23.4	125.5
Honduras	15.6	2.1	17.7
Nicaragua	-217.1	-35.4	-252.5
Total	-43.4	43.4	(299.6)

Source: Central American Monetary Council.

trade and therefore to avoid the inconvenience of debt accumulation in the context of the clearing system. With this objective in mind, a joint program of action that includes foreign borrowing by the CACMF has been agreed upon with the support of the Inter-American Development Bank. Such borrowing, however, would be limited to the financing of a modest portion (perhaps up to one-third) of new unsettled balances within the clearing system. It has been understood that both the creditor and the debtor countries would finance the remainder in equal parts.

16
Where Do We Go from Here?

Miguel S. Wionczek

> The prospects of a major [debt] default is just like a nuclear war: No one wants to talk about what would happen if the bomb went off.
> --Philip Wellons, Harvard Business School[1]

THE OUTLOOK IN 1977

The quote with which this concluding chapter starts did not originate with just any Harvard Business School professor. It comes from an academic expert on the LDC external indebtedness who published in 1976 under the OECD official auspices an almost six-hundred-pages-long study on borrowing by developing countries on the Eurocurrency market in the mid-1970s.[2]

In contrast, I plead guilty to having organized in October 1977, under the auspices of El Colegio de México in Mexico City, a closed international seminar on LDC external debt and the world economy, with participation of some thirty experts and practitioners in the field of North-South financial relations from all over the world. The meeting was attended by people from international agencies (World Bank, OECD, OPEC, and UNCTAD) and from central banks of creditor and borrowing countries, as well as by executives of large private banks from both sides of the Atlantic and academic economists from the United States, Canada, Mexico, Brazil, and Chile, all participating in their individual capacity. The fact that six years later, in 1983, one of the participants of that seminar occupied the post of a vice president of the World Bank, two were finance ministers, one a deputy foreign minister, and one a key adviser at the Commonwealth Secretariat would suggest that the gathering was not exactly a random social get-together of a bunch of radical friends with an amateurish knowledge of the subject.

Careful reading in the winter of 1983-84 of the final report of the 1977 seminar was sort of depressing. Although the correct and detailed diagnosis of where the

LDCs were inexorably heading in a not too distant future and a set of concrete proposals for preventive action as well emerged from that meeting, practically nothing happened during the following six years that might have slowed down, or alleviated at least, the gestation of the full-fledged crisis of global proportions both in respect to the state of the world economy and the LDC indebtedness.

As I might be accused of bias, let two quotations from a report that emerged at the meeting speak for themselves. The first deals with the diagnosis of the LDC debt situation:

> . . . the views seemed to coincide in a number of important points including:
>
> a) the LDC external debt problem must be handled within a larger framework which recognizes global interdependence and covers balance-of-payments adjustments, LDC development needs, official development assistance, "stagflation" in the LDCs, international trade and world economic recovery;
> b) finding solutions to the debt problem is the joint responsibility of the LDC borrowers and the DC lenders;
> c) the LDC's external indebtedness is only one face of the general problem of ensuring "acceptable" growth rates in the LDCs;
> d) up till now, the problem of the debt and declining net financial flows to the LDCs has been treated in a piecemeal and haphazard ex-post way;
> e) *the LDC debt built up in 1974-1976 cannot be repeated--not so much because of its aggregate size but because of its structure* [italics added];
> f) linking short-term stabilization and adjustment with long-term economic growth and development finance would make it possible to combine the generalized and the case-by-case approach;
> g) the combination of the generalized and the case-by-case approach must take into consideration the different situations of the poor and the middle-income LDCs;
> h) the balance-of-payments adjustment facilities available to the LDCs need to be strengthened and expanded; exclusive emphasis on short-term finance for adjustment purposes is not enough;
> i) in addition to expanded adjustment facilities, the poorest LDCs need a continuous increase in long-term official concessionary assistance;

j) the debt of the middle-income LDCs might be handled by increased official lending at non-concessionary terms and by international private capital markets, but only if there is a speedy recovery in the world economy;
k) it would be much easier to solve the middle-income LDC debt problem if new mechanisms were devised to recycle more OPEC surpluses into capital formation, through--inter alia--more OPEC investments in middle-income LDCs;
l) even if adjustment facilities were strengthened and development financing increased, the trade policies of the developed countries, particularly on nontraditional (manufactured) LDC exports, would have to be liberalized; and
m) a satisfactory solution to the problem of LDC indebtedness and development financing depends heavily upon the pace of world economic recovery.[3]

Recalling the guidelines elaborated already in 1975 in Geneva by the ad hoc UNCTAD Group of Governmental Experts on Debt Problems of Developing Countries, even more applicable to the 1983-84 conditions than to those prevailing in 1977, the second quote from the same report suggested that:

a) Debt re-organization should take into account the development prospects of the debtor country, to enable it to continue debt servicing payments and restore its credit-worthiness.
b) Re-organization should be conducted within the customary multilateral framework with the aim of concluding an agreement as speedily as possible to avoid prolonged uncertainty regarding the availability of foreign exchange.
c) The terms of debt relief, such as consolidation, repayment, grace periods and interest rates, should take into account both the anticipated long-term debt servicing capacity of the debtor country and the legitimate interests of the creditors.
d) Debt re-organization arrangements should provide for flexibility to review the situation at the end of the consolidation period in the light of unforeseen circumstances. They should also provide for accelerated repayments in an agreed upon manner if the debtor's economic situation improves more rapidly than anticipated.[4]

Moreover, the report stressed, again reflecting consensus, that the developed lender countries must keep in mind that the problem of LDC indebtedness can be managed in the long run only if LDCs are assured a constant flow of development finance on terms and conditions that are in accordance with the goal of "acceptable" growth rates and that take into account their repayment capacity. The LDCs' repayment capacity will depend not only on these terms and conditions but also on world trade that, in turn, will depend to a great extent upon the growth rate of the advanced economies. *Quelle sagesse*--Voltaire's Candide would have said in 1983--*quelle sagesse*!

THE OUTLOOK IN 1984

The absolute lack of such elementary *sagesse* among all actors of the international indebtedness game, which brought most debtors countries, some creditor countries, and the whole fabric of the international financial system to the brink of disaster by 1982-83, has been convincingly documented in this book by fifteen experts of many nationalities with varied experiences at global, regional, and national levels. In spite of large differences between individual contributors' approaches, the content of the volume makes even more depressing reading than the results of the 1977 Mexico City exercise, independently of whether the present authors have a background in international financial agencies, have been or are actually involved in central and private banking activities, or are competent academics from the social sciences.

If any sort of consensus emerges from this book it can perhaps be summarized in four points. First, the prospects for the world economy and the LDCs of getting out of the present mess, which is more serious than is generally thought, are uncertain. Second, although the debt-service burden of all LDCs but the poorest ones continues to increase even in the few cases of "successful" debt renegotiations, the inflow of new net public and private capital resources to the whole developing world has practically been brought to a standstill, forcing the LDC debtors into a reverse transfer of their savings abroad to pay just a part of the interest accrued on the accumulated external debt. Third, all the major actors (international agencies; national governments of the creditors and the debtor countries; actual lenders and borrowers, whether public or private; and private financial intermediaries) share responsibility for the debt crisis. Fourth, at international operational levels, all these major actors continue business as usual under the most optimistic assumptions about the prospects for worldwide economic recovery, the subsequent expansion of

international trade, and the orderly functioning of the international financial system in spite of the impressive growth of competent literature questioning convincingly all these assumptions. Although it is not the purpose of this concluding chapter to treat with detail these four key characteristics of the present situation, some additional evidence supporting them may be in order.

THE CONTINUING DEBT CRISIS

With 1984 being an election year in the United States, much has been made of the recovery of the U.S. economy following three years of Reaganomics. Official forecasts made public at the beginning of 1984 put real GNP growth for the whole year at close to 5 percent with price increases of only about 4.5 percent and a considerable decline in unemployment. Alongside a rather strong consensus in U.S. financial circles and among business economists that the administration's economic performance targets for 1984 are attainable, there is, paradoxically, a sizable number of nonpartisan observers who express most serious doubts about the duration of the U.S. recent strong recovery beyond 1984. As a prestigious and widely read monthly, the Morgan Guaranty Survey, put it in late 1983:

> Against the background of major surprises in 1983, continued advance in the economy--while the most likely expectation--cannot be taken for granted. One obvious source of concern is the fragile debt condition of developing countries. Another is the policy drift in Washington on ways to narrow massive budget deficits. A further uncertainty is the still unsettled state of Federal Reserve policy.[5]

Any careful and constant reader of U.S. financial journals and magazines in early 1984 discovered that the minority concern about the possibility of a new cyclic downturn of the U.S. economy in 1985 was increasing steadily instead of diminishing. In a survey of the current thinking about the U.S. economic prospects a very reliable source noted that a growing minority of analysts believes that the optimistic majority consensus has no solid and convincing base and "some are even predicting a new recession before the year is out."[6]

But regardless of who will prove to be right in the present controversy about the duration of the U.S. recovery, the OECD made it clear in late December 1983 that even strong recoveries in 1984 in the United States (and Japan) will not be sufficient to bring an equivalent resurgence in West European countries whose economies, in marked contrast, will grow very little if at all, one

more year and where unemployment will continue to rise. The weak West European performance means that the recovery in the whole nonsocialist industrial world will remain disappointingly slow. The OECD warned, as it has done regularly in past few forecasts, that the large U.S. budget deficits, together with the high interest rates and the strong dollar they cause, remain a threat to the economic recovery of the United States and to the upturn in the rest of the OECD region.[7]

One may add, not for the purpose of spreading more gloom but in the way of supporting evidence for this point, that a number of private research centers in Japan and the key Western countries released forecasts for 1984 and beyond that are considerably more pessimistic than even the OECD latest figures. In Japan, the economic research department of one of the largest banks forecast for the next three years (1984-1986) an average annual growth rate of 2.8 percent in real terms as against the OECD's 4 percent.[8] The National Institute of Statistics and Economic Studies in Paris has predicted that the French economy could remain sluggish--at close to a zero growth rate--for another five years.[9] Moreover, reports from West Germany stressed that despite some positive signals

> . . . a peculiar sense of fragility hangs over the recovery. Real interest rates, pushed up by central banks seeking to stem capital outflows to the United States, remained uncomfortably high, crimping investments. Export orders, despite the 1983 autumn upswing, remained roughly at 1982's depressed levels. And tough wage negotiations were approaching, with the threat of higher production costs and reduced profits.[10]

In the face of all this evidence it takes heroism or wishful thinking to assert that the recovery of Western industrial economies is in the cards for the mid-1980s, thus becoming the engine of growth for the LDCs through the expansion of international trade. What must be kept in mind is that under the renegotiation arrangements signed in 1982 and 1983 and those (the majority) that are still pending, the LDC debt-ridden economies will have to increase by 1985-1986 the repayment not only of accumulated interest charges but also of sizable portions of the principal of their external debt. Nobody seems to know how these ambitious targets that were the base of all renegotiations arrangements in process through 1984 will be reached.

In 1982, the "bad boys" who were unable or unwilling--according to different schools of thought in the creditor countries--to pay their external obligations on time were Latin Americans and a few socialist economies like Poland and Yugoslavia. In 1983 the "debtors crowd

on the brink" expanded to all latitudes by the addition to the list, among the others, of the Philippines and potentially South Korea in Asia; Nigeria, Ivory Coast, Morocco, and Sudan, without counting the hopeless case of Zaire, in Africa; Portugal in Western Europe; and Israel, whose external per capita debt happens to be the highest in the world. The little-known fact that France's external debt is estimated at about US$50 billion suggests that the list of "bad boys" may grow even more in the years to come. Asking himself in the fall of 1983 how serious was the international debt crisis, the chief economic commentator of the New York Times said "The short answer is 'Very'."[11]

The chapters in this book by such contributors as Dragoslav Avramovič, senior adviser to the UNCTAD Secretary General; Albert Fishlow from the University of California at Berkeley; Enrique Iglesias E., secretary general of the UN Economic Commission for Latin America; and Pedro-Pablo Kuczynski, the former minister of energy of Peru and president of First Boston International, together with the seven Latin American case studies, provide almost excessive detailed factual evidence that the debt crisis is not only very serious but very, very serious indeed. Since the crisis does not limit itself only to Latin America, even such conservative sources as the Wall Street Journal complain about the fact that within less than a year after the beginning of the present debt crisis in August 1982

> . . . the crisis atmosphere has faded and a routine has set in. Banks work out complicated plans to postpone debt repayments and lend new money. Countries borrow from the International Monetary Fund, too, agreeing in return to change their economic policies. International bankers assure everyone that everything is under control. . . . The result is that a second debt crisis, or "second wave" is beginning and is likely to become more pronounced soon. The second wave is simply defined as what happens when the initial rescue packages fall apart.[12]

THE LATIN AMERICAN SCENE

Against the voices that claim that in Latin America things are getting slowly under control, the latest developments suggest that the progress in the region presents not only a very complicated and difficult picture but on the debt-rescheduling front is extremely limited in spite of high economic and social costs. Argentina's external debt at the beginning of 1984 was officially estimated at US$43.6 billion as compared with US$387 million available in foreign-exchange reserves. Because

of the lack of long overdue data on some debts contracted outside the country and the fact that about US$1 billion of the private and state agencies' debt had not been properly registered with central-bank authorities, it is quite probable that the Argentine total debt is of the order of US$45 billion rather than the 40 billion used as a reference figure throughout 1983. Since Argentina's arrears in its external-debt repayments amount to close to US$3 billion, the new president of Banco Central, Enrique García Vázquez (given this post by the Alfonsin government, the first civilian government since 1976), announced that Argentina would not be able to renegotiate its foreign debt or to pay interest on it until mid-1984 but would seek a new agreement with the IMF for an immediate loan of US$900 million. The delay of renegotiations is explained by the fact that the new government needed time to determine which borrowings by the former military regimes were legitimate. In the meantime, the new economy minister, Bernardo Grinspun, held periodic talks in Washington, D.C., with the president of the World Bank, A. W. Clausen; the managing director of IMF, Jacques de Larossière; and high U.S. Treasury officials and told the U.S. commercial bankers in New York that Argentina would need a considerable amount of short-term trade credit to meet pressing import requirements if it was expected to raise foreign exchange to pay interest on the outstanding external debt. Although the international private banking community does not foresee Argentina's formal declaration of unilateral moratorium on debt payments, European banks are presumably very wary of extending the country additional short-term trade finance, and the discussions on this relatively minor but important point may last quite a time.

Following three and a half months of traveling the world over to persuade private creditor banks to participate in Brazil's financing program for 1984, the country's minister of planning, Delfim Netto; minister of finance, Ernane Galveas; and president of Banco Central do Brasil, Alfonso Celso Pastore, at the end of January 1984 in New York signed another four-part package agreement with more than 550 commercial banks that included the rescheduling of about US$5 billion of loans that mature in 1984, the maintenance of US$10.3 billion of short-term trade financing, US$6 billion of interbank credit lines, and a US$6.5 billion "jumbo-loan" of "fresh money." A US$5.4 billion loan program from the IMF was expected to follow the agreement with private banks. Since some 150 U.S., Spanish, Latin American, and Middle East banks with relatively small exposure opted out of the "jumbo loan" operations, it took the Brazilian negotiating team supported by high IMF officials almost two months to raise the US$500 million needed to reach the "jumbo loan" target. For the loan to be adequate to meet foreign-exchange needs in 1984, Brazil committed itself to follow

an adjustment program even tougher than in the previous year, including a US$9 billion trade surplus. A drastic reduction in imports was crucial in Brazil's ability to run a US$6 billion trade surplus in 1983.

In the fall of 1983 Bolivia defaulted on the US$30 million debt-interest payment agreed on previously as a precondition for a further rescheduling of US$450 million in foreign debt falling due in 1984 and 1985. The country's total foreign debt is of the order of US$3 billion, but its extreme shortage of foreign exchange continues to be exacerbated by the inability of Argentina to pay for Bolivian exports of natural gas. Bolivia has been negotiating a US$350 million extended fund facility with the IMF, a first step toward rescheduling its commercial loan obligations, which have been technically in default since September 1982. Private foreign banks demand that the country repay all the interest due before any serious discussions of debt restructuring take place.

Chile in early 1984 was in the midst of protracted negotiations with the IMF, which was not showing any willingness to accept the country's request to raise the public-sector deficit from 2.3 percent to 5 percent of GDP. The delays in the IMF approval of reflationary policies in the country, whose GDP dropped by 14 percent in 1982 and an additional 5 percent in 1983, cast serious doubts about Chile's access to "new money" from abroad. Its central-bank estimates in that respect amounted to about US$1 billion. In 1984 Chile is due to pay US$1.8 billion in interest on its foreign public debt of US$18 billion.

Ecuador, whose external debt stands at US$6.6 billion (US$4.7 billion public and 1.6 billion private), has been reported to have accepted the interest rate set at 2.25 points above LIBOR or 2.125 points over U.S. bank prime rate. However, the actual agreement with foreign banks signed at the end of January 1984 covered only US$300 million falling due in the first half of the year. Short-term trade credits totaling some US$700 million were extended through individual agreements between the Ecuadorian government and private creditor banks that reserved to themselves the right to change the recipients of these credits. About half of the private-sector debt is being converted into obligations of the central bank.

Peru, with its external debt estimated at US$12.8 billion at the end of 1983, expected to sign a stabilization agreement with the IMF in the spring of 1984. The agreement would presumably pave the way for refinancing and rolling over of about US$3 billion of short- and long-term debt and for disbursement of some US$250-300 million of "fresh money" from the foreign commercial banks. The country's net international foreign-exchange reserves dropped in early 1984 to US$500 million, sufficient only for two months' imports. The draft letter of intent, presumably agreed to in principle by Peru and the IMF, provided, among other things, for the reduction

of the public-sector deficit from 10.3 percent of GDP in 1983 to 4 percent in 1984 and the cutting of the inflation rate from over 100 percent to 70 percent. The country's GDP declined in real terms by 11 percent in 1983, the sharpest drop in Latin America, and the government's failure to meet the targets of its US$700 million extended facility program with the IMF led to the delay in about US$500 million of credit, including US$200 million from the World Bank for specific investment projects.

Finally, in the expectation of the change of government in Venezuela in early February 1984, negotiations on the debt issue were suspended for many months. After having taken office, the new president of Venezuela, Jaime Lusinchi, declared immediately that his country would repay the debt, estimated conservatively at US$33 billion, "to the last cent." The Venezuelan debt renegotiations will be complicated, as will be those in other countries, by some three-quarters (US$18.4 billion) of the public-sector debt falling due in 1983 and 1984, neither interest nor principal having been paid recently on the private debt of some US$8 billion, and Venezuelan oil-exports value having declined from the peak reached in 1981 of US$20 billion to US$14 billion in 1983. Advisers to the new government intimated that Venezuela will seek extension of debt repayment over eight to ten years with a three- to four-year grace period on the repayment of principal. For a number of reasons the process of investigating the size of the private debt and settling it is expected to take as long as one year.

The only Latin American country doing better than all others seemed to be Mexico. This results partly from such facts as that its debt crisis came after four years of a very rapid oil-fed economic growth, it was the first to recognize the seriousness of the situation, and its financial negotiators proved to be experts of the first order. Last but not least, the country's size and its closeness to the United States forced its powerful neighbor--at the same time its largest creditor--into a more conciliatory stance than is the case of the rest of the subcontinent. But even in Mexico nobody really knows what may happen if all the optimistic external assumptions go awry in 1985 and 1986 unless a broad longer-time rescheduling of the debt payments due between 1985 and 1988 goes through.

A NEED FOR WORLDWIDE SOLUTIONS

At the international level the present routine is of a negative kind. Although on the one hand after several years of the predominance of international private intermediaries in the financial flows to LDCs, the International Monetary Fund recovered its leadership role in setting the conditions of access to external dwindling

private resources,[13] the toughness of the IMF adjustment programs, on the other hand, has not been accompanied by the adequate expansion of the IMF lendable resources.

In the aftermath of the difficulties that arose in the U.S. Congress in 1983 in respect to the increase of its IMF quota by US$8.4 billion as a part of a general round of the expansion of the member countries' contributions to the IMF (difficulties that took several months to overcome), the IMF Executive Board formally approved in early January 1984 a limitation in the amount of loans that needy countries may obtain. Under the previous policy, a member country could borrow up to 150 percent of its IMF quota with a ceiling of 450 percent over three years. The new rule reduces these ceilings to between 102 and 125 percent a year, or 375 percent over three years, depending on how stringent an austerity program a country adopts "to put its economy in order." Furthermore, a new limit has been put on the amount the member countries may borrow from the IMF compensatory financing fund, designed to help debtor countries offset the impact of falling commodity prices, to 83 percent of their quotas rather than 100 percent as was the case before. And the borrowing limit on a companion buffer stock fund was reduced to 45 percent of a quota from 50 percent. Finally, the IMF agreed to increase gradually the interest it pays countries whose money it uses for loans to debtor countries. Present rates, which stand at 85 percent of prevailing market rates, amount to 7.39 percent annually. They will be increased between 1984 and 1987 by at least 3.3 percentage points a year until the rate is just below market rates by 1987 or shortly later.

Even though the latest restrictions on the IMF lending seem to be relatively small, they send several disquieting signals: the expectation that the number of the countries that will come to the IMF to negotiate stabilization agreements will increase very considerably in the near future, the concern at the IMF in respect to the possible rapid exhaustion of its loanable resources in spite of the most recent overall increase in the IMF quotas, and the awareness of the fact that the next round of general quota increases will be very difficult and will take a long time unless there is a sustained recovery of the industrial countries' economy accompanied by the unlikely disappearance of their national budgetary difficulties. In the past, under much easier international conditions, it used to take about five years from the initial proposal to raise IMF quotas to the actual ratification of their increase by all member countries. Presently, the prospects for initiating a new round of increases are very dim both on political and economic grounds. Bringing the IMF lending interest level to prevailing market rates, expressly asked for by the U.S. Congress as one of the conditions of the approval of the increase in the U.S. quota, eliminates any concessional

element from the IMF stabilization agreements and may increase the debt-service burden--albeit slightly--if international interest rates continue as high as they are now. Here again no good news for the debtors can be expected either from the United States or Western Europe.

It is of common knowledge that during 1982-83 all debt-rescheduling negotiations with international private banks were accompanied by an increase in the total cost of debt servicing through augmented spreads over LIBOR or the U.S. bank prime rate and through additional charges and commissions known in the international banking parlance as front-loading or up-front fees, imposed by creditors on the debtor countries. Although no global estimates of these additional costs exist because private banks generally do not disclose how much they earn from loan rescheduling, the available scant information strongly suggests that the total amounts are substantial.

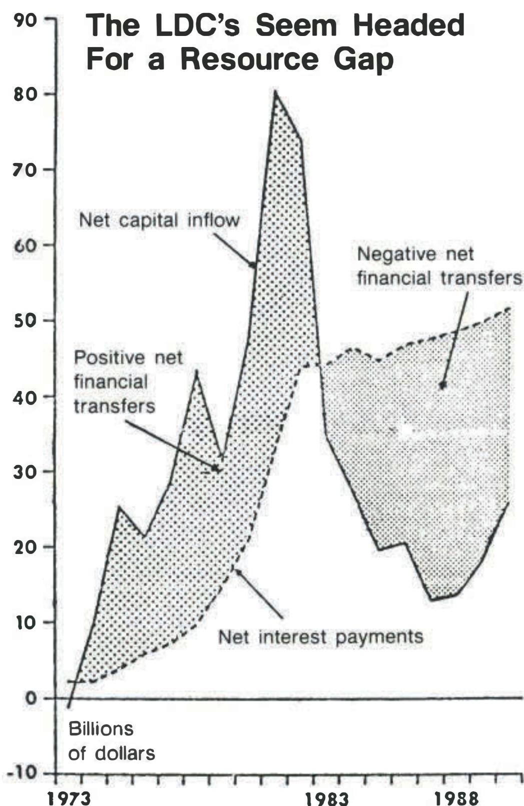
Debtor countries argue correctly but without success that spreads should fall instead of rising, because refinancing arrangements improve the quality of the portfolios of loans and the signing of a rescheduling agreement does not involve any additional risks for the private banks. Consequently, renegotiators from the debtor countries in Latin America and elsewhere express with growing frequency (at least privately) opinions that by taking undue advantage of the weak negotiating position of debt-burdened countries, international private banks work in the long run against their own interests. The extra costs of debt service might become in some cases a burden that debtor countries will not be able to bear. But since business is business, private creditors as in the past care only about fattening their immediate profits.

Thus, for example, Albert Fishlow, one of the contributors to this volume, estimates that the nine largest U.S. banks together earned between US$70 million and US$130 million extra in 1983 thanks to stiffer terms and up-front fees on debt-rescheduling operations with seven Latin American countries including Argentina, Brazil, and Mexico. These windfall profits contributed between 14 and 26 percent of the 1983 profit gain of the same banks, which at the same time were able to cut their exposure to developing countries (including seven Latin American debtors) by about US$500 million in the first half of 1983.[14] Moreover the same trends can be observed on the global scale. At the very end of 1983 OECD reported that the non-OECD borrowing (both bank loans and bond issues) on the international capital market amounted to slightly over US$25 billion in that year.[15] Once the OPEC members' borrowing of US$9 billion is excluded from this total, some US$16 billion only corresponds to the non-OPEC LDCs and the socialist bloc, with the largest part representing several "jumbo loans"

to major Latin American debtors. In other words, with few exceptions, the outflow of new capital resources from the industrialized countries was brought to an abrupt stop in 1983.

These two parallel developments--first, increases in interest rates on rescheduled debt, which often includes not only the principal but the overdue original interest rates cost, and second, declines in "new" lending--add greatly to the net reverse financial transfers from LDCs to the creditor countries that started taking place in 1982. If unchecked, these "perverse" capital movements may become--perhaps long before the end of the present decade--the proverbial straw that will break the camel's back. The nature of the global problem of the LDC resources gap that urgently needs to be filled, if only to cover now the present interest payments on the accrued LDC debt and within a couple of years to start repaying the rescheduled principal, is finally becoming recognized in some international banking circles as suggested by Figure 16.1 that originated with Morgan Guaranty Trust.

Figure 16.1



Even in the face of the potential magnitude of this problem, the low-key discussion in international agencies and private financial centers of the issues involved limits itself as yet to suggestions of a possible interest-rate relief for "needed countries" if, of course, they behave. Speaking lately before international finance audiences in the United States and Western Europe, both the president of the World Bank, A. W. Clausen, and the managing director of the IMF, Jacques de Larossière, called for "reasonable terms" on credits to heavily indebted countries. Clausen noted that although in 1981 private capital sources in the developed market-economy countries had made a net transfer of US$16 billion in medium- and long-term lending to the LDCs, the negative transfer of some US$7 billion from LDCs to the creditor countries took place in 1982 and increased to over US$21 billion in 1983. In the World Bank president's words "Productive investment yields a return and foreign investors should get back more than they invest. But it is premature for developing countries, as a group, to be transferring resources to the high income countries on this scale."[16]

Senior economist of Morgan Guaranty Trust Rimmer de Vries went one step farther in an interview granted in mid-December 1983 to the International Herald Tribune in Paris by suggesting that large private banks from industrial countries may see themselves forced to "reduce substantially," by two to three percentage points, interest rates to countries like Argentina and Brazil if these countries "are ever to become credit worthy." Rate relief--added the same New York banker--would be applied discriminately to countries that have no other way out of the debt trap and that have the domestic policies needed--those aimed at increasing exports and at soliciting foreign direct investment--already in place.[17]

These signs of concern about the LDC "debt trap," an expression coined in the mid-1970s by radical economists and accepted by now by at least some bankers, are accompanied by a growing number of calls from the LDCs for a world financial and monetary conference. Such a conference would include in its agenda four closely interrelated topics: debt reorganization, reconstruction of the international monetary system, reform of development finance, and reorganization of international financial institutions.

All these LDC initiatives and exhortations, however, fall on the deaf ears of the powerful Group of Ten consisting of the United States, Canada, Japan, and major West European nations. Their deputies met in Paris in mid-November 1983 for just one day, agreeing only to seek in the next few months new contributions by the IMF, BIS, and OECD to further analysis of international monetary problems. The agenda for the next Group of Ten meeting to be held in the spring of 1984, once again at the deputy level, was to cover three points: possible

steps to stabilize currency values, ways to help the IMF tighten discipline over the economic policies of the member countries, and ways to maintain sufficient worldwide liquidity to continue financing the emerging economic recovery. Press reports from the Paris meeting made it clear that it concentrated on conflicts between Western Europe and the United States with regard to the U.S. budgetary and fiscal policies and did not dedicate any attention to the LDC debt problems and their international economic implications. Within this political framework, what 1984 could bring to the LDC creditors, if anything, was some "interest-rate relief."

It is obvious that whatever interest-rate relief is finally granted by international private creditors to LDC debtors, it will again be equivalent to treating a very serious and protracted disease with aspirin. As the content of this volume amply demonstrates both at global and national levels, because of their short-term approach the "rescue packages" of 1982 and the subsequent debt-rescheduling operations are not linked in any way with a much wider range of worldwide economic, financial, and monetary issues whose adequate solutions cannot be postponed indefinitely. As a U.S. banker quoted in the opening chapter by Dragoslav Avramovič put it bluntly in the spring of 1983,

> The flaw in the current strategy is that there is not enough _direct_ [italics in the text] emphasis on the LDC growth. We are all talking about growth, but there is too much risk that current policies won't be sufficient. Without faster growth, we are buying not only economic and financial chaos, in my view, but _de facto_ defaults on the order not yet seen.[18]

Facing such prospects, it is not enough to ask the question, How much austerity can Latin America take? and to answer it with another question to the effect that "rescue, in the form of economic growth, could come as the world economy slowly recovers, but will it come soon enough?"[19] Neither is it of great help to arrive at the conclusion that the crisis is clearly going to last a long time, and that because the situation will be gloomy, "it is conceivable that . . . people will become resigned to low growth as the only available option, and refinancing negotiations will become institutionalized, so that a new normalcy will appear."[20]

Under the demographic, political, and social conditions prevailing in most of Latin America, analyzed in this volume by Víctor L. Urquidi, chances for a "new normalcy" of this sort in the medium and long run seem to be close to nil. In the 1930s under the impact of the Great Depression, all the subcontinent, except Mexico, fell into the hands of military dictatorships. Fifty

years later, in the mid-1980s, the contrary political wave is taking place judging by the recent developments in Argentina, Nicaragua, and Brazil and the growing challenge to the authoritarian regimes in Chile, Uruguay, and Central America.

In the final analysis, supported by the contents of this volume, what is at stake is not whether the private and not so private creditors of Latin America and of other LDC regions as well will recover or to what extent their financial investments will be repaid through technically ingenious monetary bailout operations, revolving debt-rescheduling agreements and interest-rate relief measures, supported by stringent IMF stabilization programs. From the Latin American viewpoint the issues involved form a key part of the dilemma of how to reconcile the stiff austerity programs required by the IMF and international private creditors in spite of the worldwide economic crisis with the rising popular and far from radical demands in the region for relief from negative economic growth and widespread distress. No satisfactory solution for this dilemma has been found any place as yet, if only because in the industrial North--and not only in Latin America and elsewhere in the South--all rules of economic, fiscal, and financial rational behavior have been violated many times over during the past ten years to the detriment of all parties involved.

Without expanding further on this last subject, which would merit at least another volume, it may be worthwhile to recall only that world military expenditures in 1983 surpassed the whole LDC external outstanding debt. Although in many quarters the debate continues as to whether the LDC debt issue is that of temporary illiquidity or of more basic long-run insolvency, I may as well close this concluding chapter with the quotation offered at its beginning from the 1977 diagnosis of the world economy ills and the LDC indebtedness: "The LDC external debt problem must be handled within a larger framework which recognizes global interdependence and covers balance-of-payments adjustments, LDC development needs, official development assistance, 'stagflation' in the LDCs, international trade and world economic recovery."[21] As long as this general proposition is not translated into meaningful policy at international, regional, and national levels, one can expect only the worst for the not so distant future in Latin America and elsewhere.

As far as Latin America is concerned, a first--albeit limited--step in the right direction might have been the implementation of a common strategy--not to be confused with a "debtor cartel"--proposed in September 1983 jointly by ECLA and SELA (Latin American Economic System), a consultative body formed by the governments of the region. Starting with the warning that the IMF,

the World Bank, and the Inter-American Development Bank resources would not be sufficient to meet the demands made on them in the near future by the LDC borrowers, the proposal suggested a new Latin American strategy composed of six major points: (1) the creation of a new tranche of Special Drawing Rights by the IMF to be assigned to developing countries; (2) an institutionalized procedure for the restructuring of the debt in the form of a joint effort by the IMF and the World Bank; (3) rescheduling, which would effectively transform some countries' short-term and medium-term debt into long-term obligations; (4) the provision of additional resources to allow countries to service their accumulated debt and at the same time to continue their normal international trade; (5) relief from the present high costs of refinancing; and (6) access to additional public credit to stimulate economic development.[22]

The fact that most of the substance of these proposals was diluted beyond recognition at the Latin American Economic Conference held in Quito in early 1984 strongly suggests that not only international agencies and creditor countries but Latin American debtors as well still give preference to business as usual on the debt front in spite of all its obvious longer-term risks. _Quelle sagesse_!--Voltaire's Candide would say again, this time ironically--_quelle sagesse_!

POSTSCRIPT--LATE 1984

The main body of this final chapter was written in early 1984 when the LDC indebtedness looked particularly grave as witnessed by the detailed global and regional analysis and the seven Latin American case studies contained in the book. In the fall of 1984 when this volume goes to press the indebtedness situation of a few major Latin American debtor countries looks somewhat less bleak in short and medium terms, especially from the creditors' viewpoint. The limited but painful debt renegotiation progress achieved by Mexico and Brazil does not warrant, however, the wave of optimism in the lending countries that accompanied the agreement in principle on the rescheduling in early September of about half of the Mexican public debt and the agreement reached at about the same time (also in principle) on the content of the Brazilian letter of intent deposited at the IMF.

Although some of the rules of the debt-rescheduling game underwent certain adjustments, the general approach toward the indebtedness problem continues without major change, and the parameters of the global economy perhaps look even worse than a year ago. What seems assured if other conditions are fulfilled (the world-wide reasonably strong economic recovery, the compression

of the U.S. domestic budget deficit, and the overall decline of interest rates, among others) is that the private creditors of Latin America will be paid--over one decade or so--interest on the outstanding debt, interest slightly lower than that in force during the debt crisis years of 1982-1984. And since international banks live from profits and not from the debt repayments, they may feel quite relieved by the disappearance of the sudden moratorium threat hanging over their heads and of its pyramiding consequences for the whole international financial system.

Looking with more detachment at the agreements already reached in principle with Mexico and Brazil or emerging from the current discussions with Argentina and Venezuela, one comes to two inescapable conclusions. The first is that the price paid by creditors for all these deals is rather low. Second, the new arrangements amount only to once again buying more time by both creditors and debtors.

No serious attempt to adopt the more stable approach to the underlying nonviability of international economic, financial, and trade relations between the industrialized and the underdeveloped worlds can be detected in the 1984 rescheduling exercises. In other terms, while Pedro-Pablo Kuczynski's explicit predictions in Chapter 6 to the effect that the "second act" of debt negotiations in Latin America would be accompanied by great difficulties proved correct, the "third act" (postponed for a while) will be--one can predict safely--even more complicated than the second one. Even before the second act ended, the questions being asked raised some serious doubts about its successful conclusion. Three such questions were asked by The Economist in early September 1984, a few days after Brazil agreed on a new letter of intent with the IMF and a few days before the terms of the longer-term rescheduling agreement with private creditors were made public by Mexico and before Venezuela disclosed its renegotiation proposals. If the negotiations are to end successfully, certain questions have as yet to be answered, according to this influential British source speaking for Latin America's creditors from all over the world. How much new money will the private banks put up? What to do with short-term loans made to the banks of the debtors' countries, loans known in technical jargon as interbank credits? Who will monitor the debtor countries' economies after Mexico's IMF agreement expires in December 1985 and Brazil's in February 1986 and while Venezuela insists on renegotiating its debt without IMF intermediation?

These three questions of political and technical character are of very tall order. Their clumsy handling by both the private creditor community and the public debtors may break the deals made "in principle." There

are reasons to assume that the debtors' negotiators believe that from the creditors' viewpoint the costs of "no deal" would be very much higher than those of coming closer to the position of the countries in debt. Brinkmanship and suspense will not be absent from the rest of the second act negotiations, particularly as it seems quite obvious that the lessons of the series of regional consultations started with the Cartagena meeting of June 1984 will be put to the best use by Latin Americans.

The not yet answered questions of The Economist deal with the short-term horizon. An impressive list of longer-term issues and problems appears in the most recent overview of the situation, written by William R. Cline of the Institute for International Economics (established in early 1982 in Washington, D.C., to study world economic and financial problems with emphasis on international debt). In his latest contribution on the prospects of LDC indebtedness, Cline is far from optimistic by stating that in spite of the "impressive cases of recovery in Mexico and Brazil" the 1980s will amount to the "lost decade" in terms of Third World growth and development.[23]

The same highly regarded author puts the responsibility for such present and future developments in the LDCs on the doorsteps of the Reagan administration. In his opinion the present U.S. fiscal and budgetary policy will most probably lead to the further increase of domestic and international interest rates that, in turn, may cancel all recent growth rate improvements in LDCs and in most of them may bring again pressures--impossible to contain--in favor of a moratorium of payments on account of external debt. According to Cline, if one demands from political leaders of developing countries the application of highly unpopular measures of economic adjustment, it is impossible not to demand from leaders of advanced nations the correction of budgetary disequilibria and of other economic errors whose elimination would offer the only road to international sustained and balanced economic growth. With this admonition, I may as well end this volume.

NOTES

1. Quoted in Art Pine, "Theodore Roosevelt Knew How To Collect on Defaulted Loans--He Would Send the Marines to Protect U.S. Bankers from 'Deadbeat' Nations," Wall Street Journal, January 12, 1984.

2. P. A. Wellons, Borrowing by Developing Countries on the Eurocurrency Market, Paris, 1976, p. 585.

3. Miguel S. Wionczek (ed.), LDC External Debt and the World Economy, Mexico City, 1978, pp. 445-446.

4. Ibid., p. 457.

5. Morgan Guaranty Trust, *Morgan Guaranty Survey* (New York), November 1983.

6. Alfred L. Malabre, Jr., "Gloomy Minority--More Analysts Doubt Consensus Prediction of Brisk 1984 Growth," *Wall Street Journal*, January 19, 1984.

7. Organization for Economic Cooperation and Development (OECD), *Economic Outlook* (semiannual survey), Paris, December 1983.

8. *DKB Economic Report*, vol. 13, no. 1 (Tokyo, Dai-Ichi Kangyo Bank, January 1984).

9. "French Study Says Economy May Stay Sluggish for 5 Years" (dispatch from Paris), *Wall Street Journal*, January 17, 1984.

10. John Tagliabue, "Recovery Cautious for West Germany" (dispatch from Bonn), *New York Times*, January 26, 1984.

11. Leonard Silk, "Economic Scene--Debtors Crowd on the Brink," *New York Times*, October 5, 1983.

12. S. Karene Witcher and Lawrence Rout, "The Second Wave--New Crisis Has Begun in International Debt, Banking Experts Warn," *Wall Street Journal*, June 8, 1983.

13. According to *Financial Times* Washington, D.C., correspondent, "No detail of an adjustment programme with even the smallest member, be it Fiji or Haiti, can be agreed without the Larossière's personal imprimatur." Anatole Kaletzky, "Where the World's Credit Is Rated," *Financial Times*, September 23, 1983.

14. Federal Financial Institutions Examining Body, *A Survey of the U.S. Banks Exposure, January-June 1983*, Washington, D.C., December 1983.

15. "International Loans Fell by 19% in '83, OECD Analysts Say," *Wall Street Journal*, December 30, 1983.

16. As quoted in Jonathan Carr, "World Bank Chief Seeks End to 'Negative Transfers,'" *Financial Times*, January 27, 1984.

17. Carl Gewirtz, "Bankers May Cut Rates on Latin Loans," *International Herald Tribune*, December 12, 1983.

18. Jeffrey E. Gasten from Lehman Brothers Kuhn Loeb Inc., New York, "Sovereign Debt: Next Step," International Monetary Conference, Brussels, May 18, 1983.

19. "How Much Austerity Can Latin America Take?" *The Economist*, July 16, 1983.

20. Thomas O. Enders and Richard P. Mattione, *Latin America: The Crisis of Debt and Growth*, Brookings Discussion Papers no. 9, Washington, D.C., December 1983, p. 78.

21. See Note 3.

22. Economic Commission for Latin America/Latin American Economic System (ECLA/SELA), Bases for Latin American Reply to the International Economic Crisis (Caracas, August 1983, mimeo.).

23. William R. Cline, International Debt: Systemic Risk, and Policy Response (Washington, D.C., 1984).

SELECTED BIBLIOGRAPHY

Abbott, George C. International Indebtedness and the Developing Countries. London, 1979.

Adler, John E. (ed.). Capital Movements and Economic Development. New York, 1967.

Avramovič, Dragoslav. Debt Servicing Capacity and Postwar Growth in International Indebtedness. Baltimore, 1958.

Avramovič, Dragoslav, et al. Economic Growth and External Debt. Baltimore, 1964.

Bell, Geoffrey. The Euro-Dollar Market and the International Financial System. New York and Toronto, 1973.

Bindert, Christine. "Debt: Beyond the Quick Fix." Third World Quarterly (London), vol. 5, no. 4 (October 1983).

Bitterman, Henry J. The Refunding of International Debt. Durham, N.C., 1973.

Bolin, William H., and Jorge del Canto. "LDC Debt: Beyond Crisis Management." Foreign Affairs (New York), vol. 61, no. 5 (Summer 1983).

Cline, William R. International Debt and the Stability of the World Economy. Washington, D.C., September 1983.

Cleveland, Harold, and W. H. Bruce Brittain. "Are the LDCs in over Their Heads?" Foreign Affairs, vol. 55, no. 4 (July 1977), pp. 732-750.

Collyns, Charles. Alternatives to the Central Bank in the Developing World. Occasional Paper no. 20. Washington, D.C., July 1983.

Cuddy, John. "Third World Liquidity Needs, 1984-86." Third World Quarterly (London), vol. 5, no. 4 (October 1983).

Dale, Richard S., and Richard P. Mattione. Managing Global Debt. Washington, D.C., 1983.

Dhonte, Pierre. "Describing External Debt Situations: A Roll-over Approach." International Monetary Fund Staff Papers, vol. 22, no. 1, March 1975, pp. 159-186.

Enders, Thomas O., and Richard P. Mattione. Latin America: The Crisis of Debt and Growth. Brookings Discussion Papers in International Economics, no. 9. Washington, D.C., December 1983.

Ferreira, Luís Pinto. Capitaís Estrageíros e Dívida Externa do Brasil. São Paulo, 1965.

Ffrench-Davis, R. "El Problema de la Deuda Externa en América Latina: Tendencias y Perspectivas in 1983." Integración Latinoamericana (INTAL, Buenos Aires), año 8, no. 83 (September 1983).

Friedman, Irving S. The Emerging Role of Private Banks in the Developing World. New York, 1977.
Group of Thirty (Consultative Group on International Economic and Monetary Affairs). Annual Report. New York, 1983.
Helleiner, G. K. (chairman). Towards a New Bretton Woods: Challenges for the World Financial and Trading System. Report by a Commonwealth Study Group. London, 1983.
Kuczynski, Pedro-Pablo. "Latin American Debt." Foreign Affairs, vol. 61, no. 2 (Winter 1982-1983).
Lieftinck, Pieter. External Debt and Debt-Bearing Capacity of Developing Countries. Princeton, N.J., 1966.
Naciones Unidas, Consejo Económico y Social. Balance Preliminar de la Economía Latinoamericana Durante 1983, CEPAL, Comisión Económica para América Latina, Documento Informativo, December 16, 1983.
Nogueira Batista, Jr., Paulo. Mito e Realidade na Dívida Externa Brasileira. Rio de Janeiro, 1983.
Payer, Cheryl. The Debt Trap: The International Monetary Fund and the Third World. New York and London, 1974.
Saddy, Fehmy. "OPEC Capital-Surplus Funds and Third World Indebtedness: The Recycling Strategy Reconsidered." Third World Quarterly (London), vol. 4, no. 4 (October 1982).
Sargen, N. P. "Commercial Bank Lending to Developing Countries." Federal Reserve Bank of San Francisco Economic Review, Spring 1976.
Solomon, Robert. "A Perspective on the Debt of Developing Countries." Brookings Papers on Economic Activity 2 (1977).
UN Conference on Trade and Development (UNCTAD). "The Current World Economic Crisis." Trade and Development Report, 1983. Report by the Secretariat of the United Nations Conference on Trade and Development, Geneva, September 7, 1983 (UNCTAD/TDR/3).
___. Debt Problems in the Context of Development. Report by UNCTAD Secretariat, New York, 1974 (United Nations publication TD/B/C.3/109/Rev.1).
___. Multilateral Debt Renegotiations--Experience of Fund Members, 1971-1974. Study prepared by the staff of the International Monetary Fund, note by the UNCTAD Secretariat, Trade and Development Board, Committee on Invisibles and Financing Related to Trade, Ad Hoc Group of Governmental Experts on the Debt Problems of Developing Countries, 2d sess., Geneva, December 11, 1974 (TD/B/C.3/AC.8/R.2).
___. Trade Prospects and Capital Needs of Developing Countries, 1976-1980. Report by the UNCTAD Secretariat, Trade and Development Board, and Committee on Invisibles and Financing Related to

Trade, April 15, 1976 (TD/B/C.3/134).
Watson, Paul M. Debts and the Developing Countries: New Problems and New Actors. Overseas Development Council Development Paper no. 26, NIEO Series. Washington, D.C., April 1978.
Wellons, P. A. Borrowing by Developing Countries on the Eurocurrency Market. Paris, 1976.
Williams, Richard, et al. International Capital Markets, Developments and Prospects, 1983. Occasional Paper no. 23. Washington, D.C., July 1983.
Wionczek, Miguel S. "La Deuda Externa de los Países de Menor Desarrollo y los Euromercados: Un Pasado Impresionante, un Futuro Incierto." Comercio Exterior (Mexico), vol. 27, no. 11 (November 1977).
___. "External Indebtedness of Less Developed Countries." In The Year Book of World Affairs 1981. London, 1981.
Wionczek, Miguel S. (ed.). International Indebtedness and World Economic Stagnation. London, 1981.
___. LDC External Debt and the World Economy. Mexico City, 1978.

Acronyms

ASEAN	Association of Southeast Asian Nations
BCRA	Banco Central de la República Argentina
BIS	Bank for International Settlements
CACMF	Central American Common Market Fund
CEPAL	Comisión Económica Para América Latina
CETES	Treasury Certificates
CIEPLAN	Corporation of Economic Research for Latin America
CORFO	Development Corporation
DRI	Data Resources, Inc.
ECLA	UN Economic Commission for Latin America
EEC	European Economic Community
GAB	General Agreement to Borrow
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
G-10	Group of Ten
IDB	Inter-American Development Bank
IDS	Institute of Development Studies, Sussex University, England
IISS	International Institute of Strategic Studies
IMF	International Monetary Fund
LAFTA	Latin American Free Trade Association
LAIA	Latin American Integration Association
LDC	less developed country
LIBOR	London Inter-Bank Offer Rate
NAFINSA	Nacional Financiera
NIC	newly industrializing country
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
PEMEX	Petróleos Mexicanos
RECADI	Office for the System of Differential Exchange Rates
RIAL	Program for Joint Studies on Latin American International Relations

SBM	supernational bank money
SDR	Special Drawing Right
SELA	Latin American Economic System
SEPAFIN	Ministry of National Properties and Industrial Development
TNC	transnational corporation
UNCTAD	UN Conference on Trade and Development
UNESCO	UN Educational, Scientific, and Cultural Organization

About the Contributors

Dragoslav Avramovič is a former official of the World Bank, former director of the Secretariat of the Independent Commission on International Development Issues (the Brandt Commission), and senior adviser to the UNCTAD Secretary General. He is the author of Debt Servicing Capacity and Postwar Growth in International Indebtedness (1958) and Economic Growth and External Debt (1964).

Ariel Buira served as an executive director of the International Monetary Fund from 1978-1982 and is currently deputy director of the Bank of Mexico in charge of international organizations and agreements. His recent publications include "IMF Financial Program and Conditionality," Journal of Development Economics, vol. 12, no. 1/2 (February-April 1983); The Mexican Exchange Crisis and Adjustment Program, Institute for International Economics, Washington, D.C., 1983; and On the Nature and Direction of International Monetary Reform, Group of Twenty-Four, 1983.

Enrique de la Piedra has been working since 1980 in the United Nations Economic Commission for Latin America (ECLA), first as an expert in the United Nations Development Program/ECLA project on critical poverty and afterward as economic affairs officer in the Economic Development Division. He has drafted several papers on the subject of poverty and is responsible for the preparation of the survey on Peru for ECLA's annual economic survey of Latin America.

Robert Devlin is economic affairs officer of the Economic Development Division of the United Nations Economic Commission for Latin America. He has worked for a number of years on the subject of foreign debt and private banks and has written books on the experiences of Peru and Bolivia (the latter with Michael Mortimore), as well as a number of articles on the subject.

Marcelo Diamond is an Argentine industrialist and economist. He is the author of Doctrinas Económicas, Desarrollo e Independencia (1973) and "La Estructura Productiva Desequilibrada y el Tipo de Cambio," Desarrollo Económico (1972).

José Luis Feito is alternate executive director of the International Monetary Fund. He has been director of the International Economic Studies Department of the Ministry of Economy, Finance, and Trade of Spain and has served as financial analyst to several Spanish private agencies.

Ricardo M. Ffrench-Davis is director of the Corporation of Economic Research for Latin America (CIEPLAN). Professor of economics at the University of Chile until 1973, he has been a visiting fellow at Oxford and Boston universities. He is the author of Economía Internacional: Teorías y Políticas para el Desarrollo (1979), Políticas Económicas en Chile, 1952-70 (1973), and numerous articles on development, economic policies, trade, and international finance.

Albert Fishlow is professor of international economics at the University of California-Berkeley, the author of many books and articles on the U.S. economic history and Latin American development problems, including American Railroads and the Transformation of the Ante-Bellum Economy (1965) and Rich and Poor Natives in the World Economy (1978).

Jorge González del Valle is an economist at Universidad de San Carlos, Guatemala, Columbia University, Yale University. He was the director of the Center of Monetary Studies for Latin America (CEMLA) and from 1968 to 1978 executive secretary of the Monetary Council for Central America. From April to December 1983 he was president of the Banco de Guatemala.

Enrique V. Iglesias was chairman of the Central Bank of Uruguay and is currently secretary general of the United Nations Economic Commission for Latin America. He is a member of the Third World Foundation, the Society for International Development (SID), the North-South Round Table, and other developmental institutions.

Pedro-Pablo Kuczynski is president of First Boston International and a managing director of the First Boston Corporation. From 1980 to 1982, he was Minister of Energy and Mines of Peru. Previously, he served at the World Bank, the International Monetary Fund, and the International Finance Corporation, and in the private sector has been a partner of Kuhn, Loeb & Co. International and the president of Halco Mining, Inc., in Pittsburgh. He is the author of Peruvian Democracy under Economic Stress: An Account of the Belaunde Administration, 1963-68.

Eduardo Mayobre is deputy minister of finance for Venezuela, formerly director general of the Ministry of Finance, adviser to the Council of National Economy, executive director of the International Monetary Fund, executive director of the World Bank, and director of economic research of the Ministry of Finance.

Daniel Naszewski is an Argentine economist.

Paulo Nogueira Batista, Jr., is professor of economics at Catholic University of Rio de Janeiro; a member of the research staff at the Center for Monetary Studies of the Getulio Vargas Foundation; and author of the book Mitoe Realidade na Dívida Externa Brasileira [Myth and Reality of the Brazilian External Debt], Rio de Janeiro, 1983.

Luciano Tomassini was formerly an adviser to the president of the Inter-American Development Bank (IDB). He is now a consultant for the United Nations Economic Commission for Latin America and coordinator of the Programme of Joint Studies on Latin American International Relations (RIAL), as well as the editor of the journal Estudios Internacionales. Among other works, he edited Relaciones Internacionales de la América Latina, Fondo de Cultura Económica, México, 1981.

Víctor L. Urquidi is president of El Colegio de México, former president of the International Economic Association, and a member of the Club of Rome. He is author and editor of a number of books on global and Latin American economic development problems.

Miguel S. Wionczek is a senior research fellow and director of the Energy Research Program at El Colegio de México. He is author and editor of many books on problems of development, including Some Key Issues for the World Periphery (1982) and World Hydrocarbon Markets: Current Status, Projected Prospects and Future Trends (1982).

Ernesto Zedillo Ponce de León is director of the Trust Fund for Coverage of Exchange Risks (FICORCA) of Banco de México, where previously he served as deputy manager of the economic research department. He teaches international economics at El Colegio de México.

Index

Adjustment process, 90-92, 93-94, 110, 130, 135, 137, 146, 153-154, 180-181, 183, 206-207, 208-210, 223, 285-288, 438. See also International Monetary Fund, adjustment packages; Mexico, Economic Adjustment Program
Aerolineas Argentinas, 260, 261, 272
Afghanistan, 55
Africa, 11, 50, 51, 64, 149, 152. See also individual countries
Alemann, Roberto, 253, 255
Alfonsin, Raul, 128
Algeria, 8(table), 27-28(tables), 30(table), 102-103(table), 150(table)
Alliance for Progress, 427
Alzamora Traverso, Carlos, 17
Amortization, 9, 10, 23-24, 26, 82, 86, 94, 109, 130, 146, 160, 177, 188, 190, 411(table)
Ampliaciones presupuestales, 312
Anchovy disappearance, 394
Andean Pact (1969), 39, 165
Apertura, 406. See also Open economies
Argentina
  agriculture, 235, 238, 239, 240, 245, 252, 267, 268-269
  balance of payments, 234, 238, 241, 242, 243, 245, 246, 247(table), 251, 259
  balance of trade, 247(table), 248, 252
  banks, 246, 254
  brain drain, 233
  capital inflow, 246, 254
  capital outflow, 13, 111, 231, 242, 246, 247(table), 248, 249, 253, 269
  consumption, 106, 231, 232(table), 254
  current account, 18, 24, 243, 246, 255
  debt payments, 77, 152, 155, 232-233, 243, 253, 254-255, 256, 260, 262, 270, 290
  debt per capita, 7, 27(table)
  debt proportion of exports, 325
  debt renegotiations, 175-176 (table), 257-262, 265, 270-272, 411(table), 454
  debt-service ratio, 9, 30-31(tables), 151
  devaluation, 153, 231, 238, 239, 240, 245, 250, 251, 252-253, 256
  domestic market, 166, 256
  economy, 40, 98, 231-232, 233, 234, 240, 243-246, 248-251, 255-256, 266, 270, 273
  exports, 235, 236, 238, 246, 248, 251, 252, 259, 267-268, 271
  external debt, 7, 8(table), 28(table), 48, 49, 73, 74(table), 76(table), 98, 102-103(table), 110, 128, 129, 131, 148, 150(table), 232, 233, 235,

Argentina (continued)
236(table), 238, 242-243, 246, 247(table), 249, 252, 255, 264, 326, 443-444
floods, 264
and foreign loans, 13, 238, 240-241, 249, 259, 262, 263(table)
GDP, 231, 232(table), 233, 243, 244, 255, 259
GNP, 153
government, 273, 274, 452
and Great Britain, 19, 254, 255, 257
and IMF, 146, 238, 257, 258-262, 263(table), 264, 265, 270, 271
imports, 19, 84, 238, 239, 246, 248, 249, 252, 254, 259, 271, 445
import substitution, 238, 252, 267
industry, 17, 43, 235, 236, 239, 241, 243, 244, 245, 246, 249, 255, 267, 268
inflation, 40, 130, 153, 231, 238, 239-240, 244, 245, 246, 251, 252, 253, 256, 263, 264
interest rates, 231, 239, 240, 241, 244, 249, 250, 251, 255, 256, 269
internal debt, 130
middle class, 232
military purchases, 13
as NIC, 65
and oil, 38
politics, 238, 255, 257, 273, 274
price controls, 244
private sector, 254, 255, 256
public sector, 153, 242, 253, 258
recession, 231, 232, 238, 239, 240, 243, 254, 255, 264, 266
rural, 238
savings, 269
stabilization policies, 238-242, 243, 245, 250, 252, 253, 264
state enterprises, 260, 261
subsidies, 269
tariffs, 244, 245, 246, 252, 267
taxation, 268, 269
terms of trade, 242, 249
tourism, 247(table), 249
trade surplus, 85
urban, 238
and U.S., 20, 448
value-added, taxes, 253
wages, 232, 238, 239, 240, 243, 244, 252, 253, 255
working class, 238
See also under Venezuela
Artus, J. R., 321
ASEAN. *See* Association of Southeast Asian Nations
Asia, 11, 12, 50, 51, 64, 111, 116(table), 139-140(tables), 152, 159, 167, 203, 204(table). *See also individual countries*
Asian Development Bank, 162
Association of Southeast Asian Nations (ASEAN), 12
Atlantic alliance, 54, 55
Austerity programs, 127, 128-129, 130, 145, 158, 165, 447, 451, 452
Australia, 9
Authoritarian regimes, 127, 129, 451-452
Avramovic, Dragoslav, 443

Balance of payments, 18, 40, 41, 61, 69, 83, 85-86, 87, 88, 91-92, 100, 101, 104, 109, 113, 114, 119(table), 122, 123, 125, 126, 149, 170, 172, 181, 184, 185, 209-210, 237-238, 285, 438, 452. *See also under individual countries*
Balassa, Beli, 301
Bananas, 428
Banco Central (Argentina), 246, 248, 255, 256, 257, 261, 264, 266, 444
Banco Central (Spain), 410
Banco Central do Brasil, 281, 285, 444
Banco de la Nación Argentina, 254
Banco de los Trabajadores de Venezuela, 327, 331
Banco de México, 320
Banco do Brasil, 281
Bank capital, 19-20, 21-22. *See also* International bank loans

Bank for International Settlements (BIS) (Basel), 16, 87, 98, 132, 133, 151, 173, 178, 179, 209, 262, 263(table), 280, 284, 316-317, 356, 450
Bank Herstatt (Germany), 396
Bank of America, 400
Bank of England, 11
Bank of Nova Scotia, 410
Bank of Tokyo, 410
Bank shares, 22
Bank surcharges, 92
Belaúnde Terry, Fernando, 386, 406
Bertram, Geoffrey, 394
Bipolar world, 54, 56, 58
BIS. See Bank for International Settlements
Bolivar, 332-333, 334. See also Venezuela, devaluation; Venezuela, overvaluation
Bolivia
 and Argentina, 445
 debt payments, 77, 445
 debt renegotiations, 175-176(table)
 debt-service ratio, 31(table)
 exports, 445
 external debt, 74(table), 76(table)
 and foreign loans, 13, 392(fig.)
 natural gas, 445
 oil, 38
Bonds. See Zero-coupon bonds
Brain drain. See under Argentina
Brandt Commission reports, 51, 63
Brazil
 adjustment program, 445
 automotive exports, 12
 balance of payments, 81, 110, 238, 278, 279(table), 290
 balance of trade, 279(table), 288, 289
 banks, 280, 283, 286
 capital inflow, 165, 289
 capital outflow, 13
 consumption, 106(table), 289
 current account, 18
 debt payments, 81, 152, 155, 158, 284, 288, 291
 debt per capita, 7, 27(table)
 debt proportion of exports, 325
 debt proportion of GNP, 8, 25, 28(table), 105
 debt renegotiations, 175-176 (table), 277-278, 281, 283-288, 291, 411(table), 453, 454
 debt-service ratio, 30-31(tables), 151
 devaluation, 153
 domestic market, 166
 economy, 37, 38, 98, 100, 105, 110-111, 154, 278, 455
 exports, 19, 116(table), 139(table), 152, 278, 289
 external debt, 7, 8(table), 20, 25, 26, 48, 49, 73, 74(table), 76(table), 98, 102-103(table), 104, 110, 111, 131, 148, 150(table), 171, 277, 280-281, 286, 289, 326
 and Federal Republic of Germany, 19
 foreign investment in, 285, 289
 and foreign loans, 13, 20, 151, 171, 278, 284, 290, 391, 392(fig.), 444-445
 GNP, 153
 government, 128, 452
 and IMF, 20, 49, 99, 132, 146, 158, 277, 278, 280, 281(table), 284, 285, 286, 287, 288, 289, 453, 454
 imports, 19, 111, 287, 445
 import substitution, 36
 industry, 17, 46
 inflation, 40, 130, 140(table), 153, 288, 291
 internal debt, 130
 internal migration, 46
 international reserves, 280, 281-283(tables), 286, 291
 investments, 18, 105, 288
 labor market, 45
 as NIC, 64, 100
 oil imports, 37-38
 public sector, 153
 terms of trade, 116(table), 140(table)
 trade surplus, 85, 285, 445
 transfer of resources, 288, 289, 291
 and U.S., 20, 277, 448
 See also under Mexico
Bretton Woods system (1944), 18, 136, 200, 213, 214, 215, 217, 220

Bridge loans, 259, 260, 280, 284, 387
Buenos Aires (Argentina), 154
Business cycle phenomena, 193, 195(table), 197, 198, 199, 201-207, 218, 219, 222, 223

CACMF. See Central American Common Market Fund
Calvo doctrine, 186
Canada, 9, 157, 400, 410, 450
Capital
- accumulation, 11
- controls, 198, 199, 202
- exports, 13, 111, 166, 179, 183, 187, 449
- formation, 13, 105
- -goods exports, 18, 78
- -goods imports, 62, 237, 248
- inflow, 23, 78, 86, 87, 88, 89, 90, 105, 126, 146, 151-152, 153, 156-157, 159, 164, 165, 177, 178, 184, 186, 189, 196, 237
- markets, 6, 7, 13, 14, 65, 82, 107, 109, 110, 133, 161, 165, 170, 190, 193, 199, 200, 203, 206, 207, 211, 222, 302, 350-351, 357, 439
- markets growth, 170-172

Carbon-steel imports, 121
Caribbean, 37, 148, 151, 152, 156. See also individual countries
Caribbean Common Market, 39
Cavallo, Domingo, 255, 256
Celso Pastore, Alfonso, 444
Central African Republic, 175-176(table)
Central America, 37, 41, 44, 45, 46, 77, 427-436, 452. See also individual countries
Central American Bank for Economic Integration, 427
Central American Common Market, 39
Central American Common Market Fund (CACMF), 435, 436
Central American Monetary Council, 435
Central Bank (Chile), 358, 361, 362, 375
Central Bank of Venezuela, 333-334, 339, 346
Central banks, 15, 17-18, 24, 83, 98, 100, 132, 209, 214, 217, 218-219, 220, 221, 222, 223, 246, 319, 403, 406, 442
Cereals, 39
CETES. See Treasury Certificates
Chase Manhattan Bank, 335, 400, 410
Chemicals, 36, 64
Chile
- adjustment, 364-365, 374
- balance of payments, 238, 362, 365
- banks, 353, 354, 356, 360(table), 369, 370, 375, 445
- capital inflow, 353, 354, 359, 361, 365, 367, 371
- capital movements, 353-360, 367, 376, 377
- consumer credit, 368
- consumption, 106, 371, 377
- current account, 354, 355(table), 356, 361, 365, 372
- debt payments, 152, 155, 356, 445
- debt per capita, 7, 27(table)
- debt proportion of exports, 325
- debt proportion of GNP, 8, 28(table)
- debt renegotiations, 175-176 (table), 350, 373, 374, 411(table), 445
- debt-service ratio, 30-31 (tables), 355(table)
- devaluation, 153, 363, 364, 365, 369, 370, 375
- domestic market, 350, 362, 371, 376
- economy, 40, 348-350, 360-361, 362, 369, 372-373, 374
- exports, 355(table)
- external debt, 8(table), 13, 48, 49, 74(table), 76(table), 102-103(table), 110, 129, 148, 150(table), 326, 349, 350, 353-354, 356-357, 358(table), 359, 360-361, 367, 371-374
- foreign investment in, 353
- and foreign loans, 356, 359, 370, 371, 375
- GDP, 353, 356, 361, 365, 367, 372, 373, 445
- gold, 360

Chile (continued)
 government, 128, 348, 452
 and Great Britain, 19
 and IMF, 146, 373, 445
 imports, 19, 84, 110, 348, 349, 372
 industry, 17, 349, 371
 inflation, 40, 352, 363, 365, 367
 interest rates, 349, 350, 353, 365-370, 371
 international reserves, 354, 360, 361, 362, 373
 investment, 351, 355(table), 368, 371-372, 375, 376
 nationalization, 354
 private sector, 348, 350, 352, 358(table), 360, 362, 373
 public sector, 359, 360(table), 361-362
 savings, 350, 352, 368, 371
 taxation, 377
 trade, 85, 348, 372, 373
 wages, 364, 369
China, People's Republic of, 101, 161
Citibank (U.S.), 131
Citicorp (U.S.), 132, 400, 410
Civil society, 56
Clarin (Buenos Aires), 259
Clausen, A. W., 444, 450
Cline, William R., 11, 20, 22, 23, 112, 114, 117, 118, 119, 120, 122, 455
Clothing and footwear, 64
Club of Rome, 59
Coffee, 44, 84, 235, 428
Cold war, 54
Colombia
 balance of payments, 238
 coffee, 44
 consumption, 106(table)
 debt-service ratio, 31(table)
 expenditures, 106
 external debt, 8(table), 27-28(tables), 74(table), 76(table), 149
 labor market, 45
 and oil, 38
Commercial banks. _See_ International bank loans
Commodity Credit Corporation, 316
Commodity prices, 172, 195(table), 196, 203, 219, 417
 export, 6, 10, 14, 15, 78, 79, 84, 118-119, 124
 dollar price index, 15
Consumer goods, 42, 60, 62, 78, 248
Consumption, 11, 40, 82. _See also under individual countries_
Cooper, Richard N., 127
CORFO. _See_ Development Corporation
Costa Rica, 13, 37, 49, 74(table), 77, 175-176(table), 411(table), 428, 429(table), 430(table), 431, 432, 433, 434, 435, 436(table)
Cotton, 38, 428
Council of Economic Advisers (U.S.), 25
Credit, 23, 25, 65-66, 67, 79, 82, 98, 104, 131, 171, 172, 177, 185, 187, 202, 207, 237, 290, 418
 bridge, 259, 260
 demand, 77, 78, 171, 201, 368
 domestic, 125
 export, 23, 152, 185
 insurance, 165, 166, 186, 256
 long-term, 9
 medium-term, 9, 40
 private bank, 171, 186
 short-term, 9, 41, 97, 105, 444
 stand-by, 387, 402
 supply, 206
 trade, 9, 19, 69, 109, 152
 tranche drawings, 179
Credit Lyonnais, 410
Crocker National Bank, 410
Cuba, 13, 31(table), 77, 175-176(table), 411(table)
Current accounts, 122
 deficits, 18, 22-23, 40, 68, 83, 85, 108(table), 109, 110, 111, 114, 119(table), 171, 177, 188, 203, 274
 financing, 171
 surplus, 100
 See also under Gross domestic product; Latin America; _individual countries_

Dagnino Pastore, José María, 255, 256, 257
Daly, Jorge, 403
Data Resources, Inc. (DRI), 120
Deadweight debt, 10
Debt-export ratio, 113, 119, 120
Debt-led growth, 100-104
Debt-income ratio, 129
Debt-service ratio, 8, 9, 29-31(tables), 104, 109, 151, 195(table), 204(table)
 limit, 190(n2)
Deflation, 6, 15, 17, 78, 130, 181, 196, 197, 200, 219, 340, 341
De Larossière, Jacques, 444, 450
Depression, 18, 19, 194, 206-207, 214, 223, 301
Détente, 55, 56
Devaluations, 17, 36, 83, 88, 89, 123-124, 125, 127, 153. See also under Dollar; individual countries
Developing countries, 6, 7-8, 9, 10, 11, 12, 14, 29(table), 55, 61-65
 debt, 97, 99, 102-103(table), 172, 173, 174(table)
 non-oil, 14, 15, 19, 29(table), 78, 100, 116(table), 122, 139-140(tables), 172, 173, 174(table), 177, 195(table)
 trade, 121
 See also Latin America; Less developed countries; Low-income countries; Middle-income countries; individual countries
Development, 40, 44-48, 49, 50, 54, 55, 58, 62, 63, 67, 82, 83, 96, 138, 159, 167, 184, 438
 finance, 170, 178, 180, 189, 452, 453
Development Corporation (CORFO) (Chile), 375
DeVries, Rimmer, 450
Diesel fuel, 42
Disinflation, 125, 126
Dollar (U.S.)
 appreciation, 14, 19, 117, 118, 121, 140(table), 196-197
 depreciation, 117, 118, 119
 devaluation, 114
Domestic markets, 44, 62, 63, 153, 166. See also under individual countries
Dominican Republic, 74(table), 76(table)
Dresdner Bank, 391
DRI. See Data Resources, Inc.

Eastern Europe, 19, 52. See also individual countries
Echeverría, Luis, 295, 297, 304
ECLA. See United Nations Economic Commission for Latin America
Economist, 128, 300, 454
Ecuador, 17
 debt payments, 77, 152, 155
 debt proportion of exports, 325
 debt renegotiations, 175-176(table), 411(table)
 external debt, 74(table), 76(table), 148, 326, 445
 oil, 38
 private sector, 445
 trade surplus, 85
EEC. See European Economic Community
Egypt, 8, 18, 27-28(tables), 30(table), 107
Eighth General Review of Quotas, 178, 210
Electricity, 42
El Salvador, 74(table), 76(table), 427, 429, 430, 431, 432, 434, 435, 436(table)
Energy, 42-43, 56, 59, 60
 demand, 172
 prices, 89, 191(n4)
Environment, 46, 56, 59
Equilibrium, 197-198, 201, 207, 208, 210, 213, 217, 221, 237, 265, 274, 321, 322, 352
Escape-clause actions, 121
Eurocredit syndicates, 308
Eurocurrency market, 66-67, 81, 99, 100, 111, 155-156, 171, 200, 203, 207, 299, 300, 308, 331-332, 389, 406, 408
Eurodollar interbank rate, 157
Eurodollar markets, 170
Europe, 11, 12, 13, 18, 43, 55, 60, 64, 100, 121, 152-153, 157, 387, 389, 400, 450. See also Eastern Europe; individual countries

European Economic Community (EEC), 50, 121
Exchange controls, 36
Exchange rates, 13, 26, 83, 118, 123-124, 126, 198, 200, 215, 235, 241, 252, 253, 259, 269, 297, 300, 302-304, 312, 313, 321-322, 332-333, 334, 363
 devaluations, 153, 256
 overvalued, 167
Exchange reserves, 9, 160, 242, 280, 281-282(tables), 283-284
Exchange shortage, 19
Exchange surplus, 265
Export Development Fund, 166
Export-Import Bank (U.S.), 166
Export manufactures, 10, 11-12, 36, 37, 63, 64, 115-117
Exports, 9, 18-19, 63, 83, 84, 89, 95, 100, 105, 107, 108(table), 115-120, 125, 149, 152, 159, 180, 182, 183, 197, 439
 crisis, 17
 prices, 114, 117-118, 119, 121, 122, 348
 revenues, 14, 15, 110, 134, 149, 151, 188
 value, 85, 86, 117
 See also under individual countries
Extended family system, 154
External debt service, 6-7, 8-9, 10, 13, 14, 56, 65, 69-70, 107, 108(table), 127-128, 134-136, 151, 156, 158-168, 175-176(table), 181, 274, 275, 448
 and banks, 177, 187, 197, 205
 crisis, 6, 7, 9, 15-18, 23, 112, 193, 205
 fund use, 10-13, 377
 long-term, 7, 8(table), 9, 10, 14, 81, 130, 165-167, 180, 189
 medium-term, 7, 8(table), 9, 10, 14, 164, 180
 outlook, 440-441
 per capita, 7, 27(table)
 and politics, 1-2, 6, 18, 23, 65, 68, 128-129, 147, 190
 as proportion of GDP, 65, 177, 429
 as proportion of GNP, 7, 8, 28(table), 97
 proposals, 22-26, 184-188, 439-440, 449-453
 rescheduling, 180, 181-183, 449, 452-453. See also individual countries, debt renegotiations
 short-term, 7, 8(table), 9-10, 16, 66, 81, 180
 social costs, 1, 2, 6, 18, 23, 65, 70, 133, 147, 190
 total, 7, 97, 99
 and trade surplus, 181
 See also Amortization; Debt-service ratio; Interest; under individual countries and regions, debt payments
Exxon subsidiary (Peru), 387

Falklands crisis (1982), 254, 255, 257, 330
Family planning, 45
Federal Depositors' Insurance Corporation (U.S.), 21
Federal Republic of Germany, 17, 18-19, 69-70, 442. See also under Brazil; Mexico; Venezuela
Federal Reserve (U.S.), 21, 98, 99, 319, 441
Financial Times, 331
Fishlow, Albert, 443, 448
Food, 38-39, 59
France, 442
Free-trade policies, 13
Furtado, Celso, 26

GAB. See General Agreement to Borrow
Gabon, 175-176(table)
Galtieri, Leopoldo, 232, 253, 255
Galveas, Ernane, 444
García Vázquez, Enrique, 444
GATT. See General Agreement on Tariffs and Trade
GDP. See Gross domestic product
Gearing ratio, 161
General Agreement on Tariffs and Trade (GATT), 50, 51
 Secretariat, 10, 13
General Agreement to Borrow (GAB), 98, 160, 179
Germany, 236, 345. See also Federal Republic of Germany
Ghana, 175-176(table)

GNP. See Gross national product
Gold, 281(table), 326-327, 331, 360, 403
 standard, 217, 218, 220
Gómez, Vicente, 345
Gonzalez del Solar, Jorge, 261
Gran Minería (Peru), 394
Great Britain, 19, 26, 200, 236. See also under Argentina
Great Depression (1930s), 136-137, 451
Greece, 30(table), 65
Grinspun, Bernardo, 444
Gross domestic product (GDP), 122, 195(table), 196, 204 (table)
 capital import share, 186
 current account proportion of, 12-13, 186-187
 investment share, 12
 manufacturing share, 11
 See also under Latin America; individual countries
Gross national product (GNP), 106, 196. See also External debt service, as proportion of GNP; individual countries, debt proportion of GNP; under individual countries
Group of Seventy-Seven, 51, 55
Group of Ten, 179, 225(n7), 291(n3), 450
Group of Twenty-Four, 93
Growth-led debt, 104-107, 111
Growth rate, 11-12, 17, 22, 50, 59, 62, 63-64, 114, 119, 121, 124, 139-140(tables), 145, 187, 188, 190, 194, 451
 forecast, 442
 and indebtedness, 82, 101, 134, 157, 184-185, 204(table), 438, 440, 455
Guatemala, 74(table), 76(table), 427, 429(table), 430, 431(table), 432, 433, 434, 435, 436(table)
Guyana, 74(table), 175-176(table)

Haiti, 74(table), 76(table)
Hegemony, 57, 58
Honduras, 13, 74(table), 76(table), 429(table), 430, 431(table), 432, 433, 434, 436(table)
Hong Kong, 64
Hungary, 65
Hurtado, Osvaldo, 2

Iglesias, Enrique V., 17, 443
Illiquidity, 112, 159, 238, 264
IMF. See International Monetary Fund
Imports, 13, 62, 114, 121, 122, 196-197, 237
 controls, 36, 83
 expansion, 101, 133
 prices, 117, 118, 125
 reductions, 84, 87, 88, 89, 110, 146, 152, 156
 value, 85
Import substitution, 36, 38, 42, 51, 61-62, 122, 124, 237
Income
 distribution, 44, 45, 62, 129
 growth, 117
 national, 10, 126
 per capita, 9, 11, 63, 64, 101, 146, 154
 real, 6, 50, 124, 154
 rural, 39, 44
 urban-rural differential, 39
India, 7, 8, 12, 27-28(tables), 30(table), 51, 65, 101, 175-176(table)
Indonesia, 7, 8(table), 18, 27-28(tables), 30(table), 102-103(table), 106, 149, 150(table), 332
Industrialization, 11-12, 55, 61, 62, 63, 64, 167, 234, 235, 236-237
Inflation, 9, 40, 67, 78, 79, 82, 88, 96, 109, 114, 117, 118, 119, 121, 123, 126, 130, 147, 153, 154, 172, 194, 196, 205, 214, 221, 223, 300, 359
 exchange rate, 239, 252
 See also under individual countries
Insolvency, 159, 234
Institute for International Economics (Washington, D.C.), 455
Institute of International Finance, 24
Inter-American Development Bank, 46, 68, 94, 156, 161, 427, 436, 453

IADB (continued)
Fund for Special Operations, 161, 162
Interdependence, 48, 56, 97, 137, 157, 198-200, 222, 223, 438, 452
Interest
payments, 17, 23, 24, 26, 73, 81-82, 86, 91, 109, 128, 129, 145, 147, 149, 151, 156, 157, 159, 168, 177, 183, 188, 290, 450
payments, export value of, 73, 76(table), 147, 151
rate reduction, 450, 451
rates, 6, 7, 10, 14, 15, 17, 22, 24, 25, 40, 65, 67, 77, 78, 79, 81, 83, 85, 88, 89, 90, 91, 92, 104, 107, 108(table), 109, 111, 114, 120, 121, 125, 127, 138, 140(table), 145, 148, 149, 155, 157, 162, 163-164, 171, 177, 183, 189, 196, 201-202, 203, 205, 206, 207, 251, 260, 269, 275, 290, 348, 365-366, 407, 442, 448, 449, 454, 455. See also under individual countries
rate subsidies, 94, 167
refinancing, 73, 155, 159, 166, 291
International bank loans, 40, 68, 69, 73-74, 77, 79, 82-83, 87, 131-132, 135-136, 137-138, 145, 146, 148, 149, 151-152, 154-155, 157, 158, 160-164, 171, 173, 184, 207-208, 257-258, 259, 272, 280, 284, 286, 290, 326, 396, 401(table), 410, 413-416, 430-433, 434-435, 448-449. See also Bank for International Settlements; Inter-American Development Bank; International Monetary Fund; World Bank; individual countries, and foreign loans
International credit crunch (1982), 6, 173, 396, 441-443
International Development Association, 161
International economic crisis, 1, 2, 15-18, 53, 54, 58-61, 90, 99, 111-112, 170, 194, 197, 234, 274
International Financial Statistics (IMF), 322
International financial system, 7, 17, 18, 53, 69, 83, 137, 173, 177-178, 188-189, 193-194, 208, 210, 216-222, 440, 441, 450, 454
International Herald Tribune, 450
International Monetary Fund (IMF), 2, 15, 16, 17, 18, 68, 73, 87, 90, 93, 106, 112, 118, 120, 122, 137, 163, 173, 178, 185, 189, 208, 213-214, 256, 322, 431, 434, 443, 444, 446-448, 450, 452, 453
adjustment packages, 98, 99, 122-130, 132-133, 146, 149, 165, 179, 209-210, 447, 452
compensatory credit facility, 337
General Resources Account, 213
Occasional Paper, 107
quotas, 135, 158, 160, 178-179, 210-211, 212, 447
See also Special Drawing Rights; under individual countries
International Monetary System Board of Governors, 210
International reserves. See under Brazil; Chile; Peru; Venezuela
International system, 54-58
International tabular standard, 219-220, 221, 226(n17)
Intraregional debt. See Central American Common Market Fund
Investment
domestic, 11, 12, 17, 19, 24, 40, 41, 67, 83, 88, 90, 94, 105, 106, 130, 146, 166, 202, 206
equity, 126
foreign, 86, 114, 184, 185, 191(n5)
private, 146, 165, 170
rate, 66, 145, 180, 181
See also under individual countries
Iran, 65, 332
Iran-Iraq war, 107
Israel, 7, 8, 27-28(tables), 65, 443
Italy, 345

Ivory Coast, 30(table), 443

Jamaica, 175-176(table)
Japan, 43, 50, 60, 121, 152, 441, 442, 450
 banks, 13, 157, 389, 400, 409, 410

Keynes, John Maynard, 132, 136-137, 218-220, 221
Keynesian economics, 40, 214, 223-224(n1), 266
Korea. See South Korea
Kramer, Pinto, 261
Kuczynski, Pedro-Pablo, 443, 454

Labor force, 17, 45-46, 167, 237. See also Segmented labor markets; Unemployment; Wages
LAFTA (Latin American Free Trade Association). See Latin American Integration Association
LAIA. See Latin American Integration Association
Latin America
 agriculture, 38-39, 44
 banks, 444
 birthrate, 45, 47
 current accounts, 13, 83, 85, 146, 156, 164
 economies, 39-41, 53, 54, 58, 59, 67, 82, 83, 87-88, 91, 153, 167, 452
 education, 44, 45, 46-47
 export prices, 77
 external debt, 1-3, 49, 53, 54, 65-70, 73-77, 81, 82, 86, 87, 89, 92, 93-94, 96, 111, 145, 148, 149, 150(table), 174(table), 442
 foreign investment in, 66, 156
 GDP, 36, 41
 governments, 451-452
 health, 44, 45, 47-48
 imports, 152
 industrialization, 42-43, 44, 46, 51, 64
 infrastructure, 44, 167
 manufacturing, 11, 12, 36, 167
 military expenditures, 45
 mortality rate, 46
 net available financing, 75(table)
 oil-exporting countries, 38. See also individual countries
 political instability, 41
 private sector, 153, 157
 recovery policies, 92-96
 regional integration, 39-40, 49, 92, 95
 rural, 39, 44, 46
 savings, 12, 156
 social security, 45, 67
 and Third World, 50-52
 trade surplus, 87, 89, 92, 183
 and U.S., 152
 See also Southern Cone; individual countries
Latin American Economic Conference. See Quito economic conference
Latin American Economic System (SELA), 2, 41, 49, 51, 452
Latin American Free Trade Association (LAFTA). See Latin American Integration Association
Latin American Integration Association (LAIA), 39
Law for Investment in the Basic Sectors of Production (Venezuela), 346
Law for the Nationalization of the Oil Industry (Venezuela), 346
LDCs. See Less developed countries
Less developed countries (LDCs), 16, 17, 150(table), 171, 177, 180, 203-205, 437-440, 448, 449, 450, 451-453, 455
Lever plan, 191(n7)
Liberia, 13, 175-176(table)
LIBOR. See London Inter-Bank Offer Rate
Lipschitz, L., 322
Liquidity, 211, 212, 215
 crisis, 177, 178, 179, 180, 183, 189, 196, 197
 See also Illiquidity
Loan purchases, 134
Locomotive theory, 90
London Inter-Bank Offer Rate (LIBOR), 10, 14, 22, 79, 80(fig.), 104, 131, 155, 164, 300, 308, 319, 321, 331, 389, 391, 400, 406, 407, 409, 410, 411(table), 412, 445
Lopez, Antonio, 246

López Portillo, Jose, 294, 310, 312, 317
Low-income countries, 8-9, 29(table), 64, 101, 102-103(table)
Lusinchi, Jaime, 446

Madagascar, 175-176(table)
Malawi, 175-176(table)
Malaysia, 65
Malnutrition, 147
Malta, 65
Manufacturers Hanover Trust (U.S.), 20, 400, 407, 410
Martinez de Hoz, José, 242-243, 249, 251
Measures for International Economic Stability (UN), 215
Meat, 236, 248, 428
Metals prices, 15, 78
Mexico
  balance of payments, 301, 314, 315, 320
  banks, 314, 316, 317, 319, 320
  birthrate, 45
  boom (1977-1981), 45
  and Brazil, 280
  budget, 312, 313
  capital inflow, 165
  capital outflow, 13, 111, 166, 300, 302, 313, 314, 315, 317
  and Central America, 46
  consumption, 106(table), 153
  cotton, 38
  current account, 40, 122, 296(table), 298(table), 299, 300, 302, 303(table), 305, 307(table), 309(table), 310, 320
  debt payments, 77, 81, 151, 152, 155, 278, 290, 298(table), 299-300, 317, 320
  debt per capita, 7, 27(table)
  debt proportion of exports, 325
  debt proportion of GDP, 299
  debt proportion of GNP, 8, 25, 28(table), 105
  debt renegotiations, 175-176(table), 319-321, 330-331, 408, 411(table), 446, 453, 454
  debt-service ratio, 30(table), 151, 299
  devaluation, 153, 302, 315, 321
  domestic market, 166, 312
  Economic Adjustment Program, 316, 318, 321
  exports, 38, 301, 302, 310, 313, 318, 320
  external debt, 7, 8(table), 19, 25, 48, 49, 73, 74(table), 76(table), 97, 98, 102-103 (table), 104, 110, 128, 129, 131, 148, 150(table), 153, 171, 294-295, 297-299, 301-302, 305-308, 311(table), 314, 315, 317, 326
  and Federal Republic of Germany, 18-19
  food imports, 38-39
  and foreign loans, 13, 19-20, 171, 294, 297, 299, 302, 308, 310, 314, 316, 321, 392(fig.)
  GDP, 295, 296(table), 298(table), 300, 303(table), 304, 305, 307(table), 308, 310, 313, 317
  GNP, 153
  and Great Britain, 19
  and IMF, 302, 318-319
  imports, 18-19, 38, 84, 110, 301, 302, 305, 310, 312, 314, 318
  import substitution, 36
  income, 146, 154
  industry, 17
  inflation, 40, 130, 153, 154, 295, 296(table), 297, 300, 302, 303(table), 312, 317, 321
  interest rates, 300, 318
  internal migration, 46
  investment, 18, 105, 153, 302, 303(table), 304, 305
  labor market, 45, 46, 305
  literacy, 154
  nationalization, 317
  as NIC, 64, 100
  oil, 37, 38, 41, 42, 43, 97, 303(table), 304, 305, 308, 310, 311(table), 312, 313, 317, 446. See also Petróleos Mexicanos
  overvaluation, 312
  political system, 41, 154
  private sector, 41, 308, 315, 317, 319-320
  public expenditure, 295, 296 (table), 298(table), 299, 304,

Mexico (continued)
public expenditure (cont.) 305, 307(table), 308, 312, 317, 319, 321
and regional integration, 39
savings, 106
stabilization policies, 129-130, 146, 153, 302
subsidies, 45, 315
taxation, 45, 305, 318
terms of trade, 301
trade surplus, 85, 320
urban, 154
and U.S., 19, 20, 46, 137, 145, 316, 446, 448
value-added tax, 305, 318
wages, 305, 315
Mexico City, 46, 154
Michigan National Bank, 132
Middle East, 11, 18, 54, 152, 444
Middle-income countries, 29(table), 101, 439
Military purchases, 13, 45, 82, 405, 408
Minerals, 145
Ministry of National Properties and Industrial Development (SEPAFIN) (Mexico), 313
Modernization, 58
M_1. See Money stock
Monetarist economic model, 348, 350-352
Money creation, 202
Money stock (M_1), 195(table), 196, 199, 253
Morales Bermúdez, Francisco, 398
Morgan Guaranty Survey, 441
Morgan Guaranty Trust Company of New York, 112, 118, 120, 400, 407, 409, 449, 450
Morocco, 8, 27-28(tables), 30(table), 443
Multilateral Development Bank, 157
Multilateral government-guaranteed fund, 185

Nacional Financiera (NAFINSA) (Mexico), 316
NAFINSA. See Nacional Financiera
National and International Measures for Full Employment (UN), 215
National Bureau of Economic Research, 194
National Institute of Statistics and Economic Studies (Paris), 442
National Westminster Bank, 410
Natural disasters, 88, 264, 412
Natural gas, 42, 445
Netto, Delfim, 444
New International Economic Order, 50
Newly industrializing countries (NICs), 8, 11, 29(table), 55, 64-65, 100, 101-104, 121, 133
Newly Industrializing Countries and the Adjustment Problem, The (Great Britain), 64-65
New York Stock Exchange, 22
New York Times, 255, 260, 443
Nicaragua, 74(table), 76(table), 175-176(table), 427, 429, 430, 431(table), 432, 433-434, 435, 436(table), 452
NICs. See Newly industrializing countries
Nigeria, 8(table), 18, 27-28(tables), 30(table), 97, 102-103(table), 149, 150(table), 332, 443
Nonaligned countries, 51, 55
North-South relationship, 50, 51, 52, 58

OECD. See Organization for Economic Cooperation and Development
Office for the System of Differential Exchange Rates (RECADI) (Venezuela), 333, 339, 347
Oil
benchmark price, 173
prices, 12, 14, 15, 37-38, 50, 53, 66, 67, 84, 101, 104, 105, 107, 149, 170, 172, 173, 203, 274, 335, 337, 405
shocks (1973-1974, 1979-1980), 37-38, 105, 108(table), 111, 112, 172, 278, 301, 396
See also under individual countries
OPEC. See Organization of Petroleum Exporting Countries

Open economies, 40, 110, 232, 241-242, 374
Organization for Economic Cooperation and Development (OECD), 14, 22, 47, 64, 161, 441, 450
economies, 82, 122, 442
GDP, 50, 78
imports, 114
recession, 83, 408
Organization of Petroleum Exporting Countries (OPEC), 8, 14, 15, 55, 59, 111, 335, 337, 439, 448
current account surplus, 100
debt-service ratio, 29(table)
financial surplus, 66, 173, 274
oil surplus, 107
production quotas, 326, 330, 332, 335
Output value, 9
Overborrowing, 203
Overlending, 203, 206
Overvaluation, 40. See also under individual countries

Pakistan, 7, 8(table), 27-28(tables), 30(table), 65, 175-176(table)
"Pampa," 235
Panama, 74(table)
Paraguay, 74(table), 76(table)
Parallel agreement, 339
Paris Club, 287, 403, 406, 410, 434
PEMEX. See Petróleos Mexicanos
Peru
adjustment, 403-405, 407-408, 409
agriculture, 388
arms purchases, 405, 408
balance of payments, 384, 385, 387, 396, 405, 406, 407, 412
balance of trade, 386
banks, 383, 384, 385, 386, 388, 389, 393, 398, 402, 403, 412
budget, 384
capital inflow, 383, 399(table)
consumption, 395(table), 397(table), 417
current account, 395(table), 396, 398, 405, 408, 417
debt payments, 152, 155, 398(table), 402, 410, 412
debt proportion of exports, 325, 390(table)
debt proportion of GDP, 390(table), 396
debt proportion of GNP, 8, 28(table), 386
debt renegotiations, 175-176 (table), 400, 403, 404(table), 406, 410-412, 418-421
debt-service ratio, 30-31(tables)
devaluation, 398, 408
development, 385, 388
droughts, 412
economy, 383, 386, 388, 394, 395(table), 396, 397(table), 398(table), 405, 406, 407, 412, 417
exports, 385, 386, 388, 394, 395(table), 396, 397(table), 398(table), 405, 406, 407, 412, 417
external debt, 8(table), 27(table), 74(table), 76(table), 129, 148, 326, 384(table), 385, 386, 388-389, 390(table), 445
floods, 412
foreign investment in, 385, 394
and foreign loans, 385, 386, 387, 388, 389, 391-393, 394, 396, 398, 400-402, 403, 406-407
GDP, 386, 395(table), 397(table), 400(table), 406, 408, 409-412, 413, 416-417, 446
gold, 403
government, 386, 387, 389, 393, 398, 400, 403, 406
and IMF, 196, 387, 388, 398, 402, 403, 408, 409, 412, 445-446
imports, 84, 393, 394, 395(table), 396, 397(table), 405, 406, 417
income per capita, 412
industrialization, 388, 406
inflation, 386, 408, 417, 446
interest rates, 383
international reserves, 396, 398, 403
investment, 165-166, 383, 385, 388, 393, 395(table), 397(table), 398, 400(table), 405, 406, 408

Peru (continued)
mining, 405
Mining Code, 394
and oil, 38, 107, 385, 389, 393, 394, 398, 405
overvaluation, 386
private sector, 383, 384(table), 385, 393
public expenditure, 154, 384, 385, 386, 393, 395(table)
public sector, 389, 406, 408, 417, 446
savings, 383-384, 388, 398, 400(table), 406, 407
and Soviet Union, 405
stabilization program, 388, 389, 398, 400, 402, 445
taxation, 384, 386, 387, 393, 417
terms of trade, 397(table), 407
trade surplus, 85, 412
and U.S., 391
and U.S. TNCs, 387, 388, 394
and Venezuela, 403
wages, 405
Peso. See Argentina, devaluation; Chile, devaluation; Mexico, devaluation; Mexico; overvaluation
Petrodollars, 99, 100, 315, 316
Petróleos de Venezuela, 331
Petróleos Mexicanos (PEMEX), 132, 308, 310, 311(table), 313
Philippines, 8(table), 17, 18, 27-28(tables), 30(table), 65, 128-129, 149, 150(table), 443
Poland, 13, 55, 65, 175-176(table), 280, 290, 442
"Policy Responses to External Shocks in Developing Countries" (Belassa), 301
Population, 59. See also Latin America, birthrate
Portugal, 7, 8, 27-28(tables), 30(table), 64, 443
Postindustrial society, 59
Prensa, La (Buenos Aires), 259
Primary sectors, 235, 237, 428
Private banks, 2, 13, 23, 66, 68, 69, 74, 87, 99, 104, 171, 173, 178, 180, 186, 189, 210, 386-387, 396, 401, 403, 408, 413, 418, 444, 445, 448, 450, 452, 454
Private sector. See under individual countries
Production, 11, 12, 13, 24, 44, 60, 61, 78, 87, 105, 124, 125, 126, 180, 181, 206, 237, 349
Product markets, 7
Profit motive, 216
Program for Joint Studies on Latin American International Relations (RIAL), 2
Property, 44
Protectionism, 36, 42, 69, 90, 95, 121, 159, 172, 183, 184, 185, 189, 196, 198, 236-237, 241
Public expenditure, 44-48, 49, 60, 67, 83, 89, 123, 125, 153. See also under individual countries
Public sector, 40, 43, 111, 123, 125, 153, 181, 185. See also under individual countries

Quito economic conference (1984), 2, 95, 453

Reaganomics, 109, 441
RECADI. See Office for the System of Differential Exchange Rates
Recession, 1, 14, 17, 66, 67, 77-79, 83, 89, 96, 101, 107, 108(table), 148, 149, 152, 153, 172, 193, 205, 214, 223, 251, 274, 297, 398, 429
Recycling of funds, 178, 186, 190, 200, 249, 315, 439
Regan, Donald, 68, 98
"Rescue schemes," 16-17, 87, 190(n3), 410, 451
Research, 43, 47, 442
Reserve currency countries, 26, 215
Resource allocation, 13. See also Transfer problem
RIAL. See Program for Joint Studies on Latin American International Relations
Risk capital, 184
Romania, 13, 65, 175-176(table)

Santiago de Chile, 154
São Paulo (Brazil), 46, 154
Savings, 12, 82, 90, 105-106, 109, 156, 180, 188. See also under individual countries

SBM. See Supernational bank money
Schmidt, Helmut, 69
SDRs. See Special Drawing Rights
Segmented labor markets, 40
SELA. See Latin American Economic System
Senegal, 13, 175-176(table)
SEPAFIN. See Ministry of National Properties and Industrial Development
Short-term deposits, 171
Sierra Leone, 175-176(table)
Sigaut, Lorenzo, 231, 251, 253
Silva-Herzog, Jesús, 316
Singapore, 64, 101
Socialist economies, 52, 55, 442, 448
Sociocultural transformations, 60-61, 62
Sol. See Peru, devaluation; Peru, overvaluation
Solar energy, 46
Solvency, 112-113, 183
South Africa, 9
Southern Cone, 77, 102-103 (table), 376, 385
Southern Peru Copper Corporation, 394
South Korea, 149
  consumption, 106(table)
  debt per capita, 7, 27(table)
  debt proportion of GNP, 8, 105
  debt-service ratio, 30(table)
  exports, 116(table), 139(table)
  external debt, 7, 8(table), 27-28(tables), 102-103 (table), 129, 150(table), 443
  industry, 17
  inflation, 140(table)
  as NIC, 64, 100
  terms of trade, 116(table), 140(table)
Soviet bloc, 54, 55
Soviet Union, 39, 54-55, 405. See also under United States
Spain, 65, 410, 444
Special Drawing Rights (SDRs), 25-26, 211-213, 222, 281, 453
Speculation, 82, 125
Stabilization policies, 78, 79, 88, 125, 127, 128, 129-130, 133, 146, 149, 154-155, 214, 215, 438, 448, 452. See also under Argentina; Mexico; Venezuela
Stagflation, 56, 438, 452
State enterprises, 153, 167, 260
Suárez-Lamont Agreement (1942), 294
Subcontracting, 43
Subsidies, 42-43, 94, 123, 125, 127
Sudan, 13, 175-176(table), 443
Sugar, 84, 428
Supernational bank money (SBM), 220
Supply conditions, 124-125
Syndicated loans, 66

Taiwan, 30(table), 64, 101
Tariffs, 36, 50, 236-237
Taxation, 40, 45, 67, 123, 125, 127
Technocracy, 128
Technology, 11, 37, 42, 43, 46, 47, 59, 60, 199
Tepoztlan Centre (Mexico), 2-3
Terms of trade, 6, 37, 69, 78, 79, 84-85, 86, 88, 89, 90, 91, 107, 108(table), 111, 114, 116(table), 117, 118, 119, 120, 121, 148, 172, 195(table)
Textiles, 64
Thailand, 30(table), 65
Third World. See Developing countries; Less developed countries; under Latin America
Thorp, Rosemary, 394
Time magazine, 111
TNCs. See Transnational corporations
Togo, 175-176(table)
Tranches, 179, 259, 263(table), 280, 285, 402, 453
Trans-Andean oil pipeline, 394
Transfer problem, 6, 7, 18, 86, 91, 94, 113, 129, 135, 183, 209, 223, 450. See also Brazil, transfer of resources
Transnational corporations (TNCs), 42, 43, 58, 100, 242, 387, 388
Transnationalization, 53, 57-58, 60-61
Treasury Certificates (CETES) (Mexico), 304

Treatise on Money, A (Keynes), 218, 219
Trilateral system, 54, 55
Trinidad and Tobago, 38, 149
Turkey, 8(table), 17, 27-28(tables), 30(table), 64, 175-176(table)

Uganda, 175-176(table)
UNCTAD. *See* United Nations Conference on Trade and Development
Undernourishment, 47
Unemployment, 6, 13, 17, 50, 88, 109, 121, 127, 147, 154, 172, 198, 340, 341, 442
UNESCO. *See* United Nations Educational, Scientific, and Cultural Organization
United Nations Conference on the Human Environment, 46
United Nations Conference on Trade and Development (UNCTAD), 51
- Group of Governmental Experts on Debt Problems of Developing Countries, 439

United Nations Economic Commission for Latin America (ECLA), 2, 41, 452
United Nations Educational, Scientific, and Cultural Organization (UNESCO), 47
United States
- banks, 13, 19-22, 69, 131-132, 133, 157, 277, 387, 388, 389, 391, 393, 400, 407, 409, 444, 448
- capital inflows, 207, 442
- and Central America, 46, 167
- deficits, 121, 198, 207, 454
- economy, 89, 90, 97, 137, 145, 194, 199, 207, 208, 215, 223, 441, 442
- exports, 19, 200
- GNP, 441
- and IMF, 98, 158, 160, 161, 447
- imports, 15, 196, 199, 207
- industrialization, 236
- interest rates, 200, 445
- monetary policy, 172, 195 (table), 196, 197, 200, 202-203, 214, 220, 223, 451, 455
- and oil, 15
- power, 54
- prime rate, 155, 156, 162
- private sector, 198
- as reserve currency country, 26
- security, 58
- and Soviet Union, 39, 54
- Treasury, 20, 280, 284, 316
- *See also* Group of Ten; *under* Argentina; Brazil; Latin America; Mexico; Peru

Urquidi, Victor L., 451
Uruguay, 31(table), 74(table), 76(table), 84, 85, 128, 148, 152, 155, 411(table), 452

Velasco Alvarado, Juan, 387, 398
Venezuela
- and Argentina, 330
- balance of payments, 340
- banks, 327, 331, 333
- capital outflow, 13, 111, 166, 327, 331, 332
- consumption, 106(table)
- current account, 40, 122, 331
- debt payments, 77, 152, 290, 332, 446
- debt per capita, 7, 27(table)
- debt proportion of exports, 325
- debt renegotiations, 325, 326, 327, 329-340, 446, 454
- debt-service ratio, 30(table)
- devaluation, 153, 327-328, 334, 341, 342, 344
- domestic market, 166
- economy, 38, 40, 327, 328-329, 331, 332, 340-344, 346
- exports, 325, 326, 337, 340, 342, 446
- external debt, 7, 8(table), 28(table), 48, 49, 73, 74(table), 97, 102-103(table), 148, 150(table), 325-326, 344, 345-347
- and Federal Republic of Germany, 19
- and foreign loans, 13, 330, 346
- and Germany, 345
- GNP, 343
- gold, 326-327
- government, 446
- and Great Britain, 19, 330, 345
- and IMF, 132, 329, 335, 336-340, 341, 342, 344

Venezuela (continued)
 imports, 19, 84, 328, 334-335, 340, 343, 346
 import substitution, 36, 341
 inflation, 40, 328
 interest rates, 327, 329
 international reserves, 326, 332, 335
 investment, 18, 329, 341
 Investment Fund, 326, 345
 labor market, 45
 nationalization, 346
 oil, 38, 326, 327, 329, 330, 332, 337, 338, 340, 346, 446. See also Petróleos de Venezuela
 overvaluation, 328, 341, 343
 politics, 328, 345
 price system, 333
 private sector, 326, 329, 333, 342
 Public Credit Law, 330
 public expenditure, 328, 338
 public sector, 329, 333
 recession, 340
 Refinancing Law (1981), 329-330
 Sixth National Plan, 329
 stabilization policies, 340-344
 Stock Exchange, 333, 334
 taxation, 338, 342
 trade surplus, 85
 trade unions, 341
 unemployment, 340, 341
 wages, 338, 343
 See also under Peru
Videla, Roberto, 231
Vietnam, 13
Viner, Jacob, 215
Viola, Roberto, 231, 253
Volcker, Paul, 131

Wages, 88, 127, 130. See also under individual countries
Wall Street Journal, 21, 99, 255, 443
Wehbe, Jorge, 257, 258, 263
Wells Fargo (U.S. bank), 389, 391, 400, 407, 409
Wharton World Economic Outlook, 120
Wheat, 236, 248
Williamson, J., 216
World Bank, 10, 12, 14, 23, 63, 64, 68, 93, 94, 112, 113, 134, 137, 156, 161, 162, 185, 187, 190, 225-226(n9), 256, 444, 446, 450, 453
 Consultative Group, 407
World Financial Markets, 130
World trade, 9, 12, 16, 65, 68, 83, 84, 95, 96, 145, 171, 172, 181, 189, 199, 438, 441

Yugoslavia, 8, 13, 18, 19, 27-28(tables), 30(table), 64, 149, 175-176(table), 442

Zaire, 13, 175-176(table), 443
Zambia, 175-176(table)
Zero-coupon bonds, 23

About the Book and Editor

Since 1981 Latin America has been in the midst of a protracted external debt crisis due, among other reasons, to emergency borrowing at record-high real interest rates and the decline in the region's export proceeds. Until now, most literature on the subject originated in industrial lender countries, whose primary concern is the impact of the debt crisis on their own profits and on the world financial system. This volume, written by Latin American experts, presents the Latin American debt experience and difficulties from the viewpoint of borrowers. The first part of the book analyzes links between the international financial crisis and the present external debt difficulties in the region. The second part contains case studies of Argentina, Brazil, Mexico, Venezuela, Chile, Peru, and Central America.

Dr. Miguel S. Wionczek is a senior fellow and the head of the long-term energy research program at El Colegio de México. He is co-editor of *Energy in the Transition from Rural Subsistence* (with Gerald Foley and Ariane van Buren; Westview, 1982) and *Mexico's Energy Resources: Toward a Policy of Diversification* (with Ragaei El Mallakh; Westview, 1985). Dr. Luciano Tomassini is director of the Program for Joint Studies on Latin American International Relations (RIAL) in Santiago, Chile.