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Review

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Another view of the Latin American crisis: domestic debt

Carlos Massad and
Roberto Zahler***

Closely linked to the external financing difficulties of Latin America is the problem of domestic financing and debt, a problem less studied and understood but no less important. In many countries of the region this problem has helped to delay economic recovery and discourage the accumulation of capital, and sometimes the steps taken to solve it can work against the programmes and policies designed to cope with the problem of the region's foreign debt.

The increased supply of international liquidity and inappropriate domestic policies encouraged domestic over-indebtedness which, by virtue of its extent, duration, concentration and risk, distorted and impeded economic growth and the efficient allocation of resources and undermined the stability and solvency of domestic financial systems.

This has been the experience, to greater or lesser extent, of the countries of Latin America in recent years; although the process can be seen as a simple transfer of wealth, in practice it usually involves numerous economic costs for society. In a search for some way of preventing a recurrence of the problems of domestic over-indebtedness, the authors of this article have drawn lessons for the formulation of macroeconomic financial policies. Prudence in the management of certain key prices, co-ordination of economic reforms, caution in integration in international markets, and establishment of a system of financial institutions adapted to the goals and designed to trigger alarm signals are some examples of the action lines indicated by the region's experience.

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I

Is domestic debt a problem?

The external financing crisis which has been affecting the region since the beginning of the 1980s has become the central focus of attention of international bodies, analysts, and national economic authorities. Closely linked to the external financing difficulties of Latin America is another less studied and understood yet critical factor — domestic financing. In several countries this problem has helped to delay economic recovery and discourage the accumulation of capital, and sometimes the steps taken to solve it have worked against the programmes and policies designed to cope with the region's foreign debt.

As is the case with foreign debt in normal periods, the countries usually operate with certain levels of domestic debt. The various initial stocks of resources and capacities of economic agents, the age-distribution of the population, the structure of its priorities, and the potential to generate investment projects are just some of the factors which ensure that lending and borrowing units interact, basically through intermediary institutions (mainly the financial system), in domestic borrowing and lending. As in the case of the foreign debt, if the domestic debt is to serve the process of economic development, there must be a degree of correspondence between the amounts, periods and rates of growth of the debt, on the one hand, and the dynamism of the economy (and of exports, in the case of the foreign debt) on the other, and indeed between the interest rates charged on loans and the productivity of capital. When this correspondence is lacking and the imbalances last for significant periods, what is a usual and useful process for economic development in normal situations can become a serious impediment.

In the study of domestic debt it is customary to distinguish between public and private debt. Public Domestic debt has been analysed extensively in the literature, because it forms part of fiscal policy and because it is assumed that from the economic standpoint the government can and usually does behave differently from the private sector. The study of domestic debt has covered topics such as the transfer of welfare

from the present to the future (i.e., the intergenerational distribution of welfare), the effect of the public debt on the private sector's rate of capital accumulation, the displacement or supplementing of private expenditure by public expenditure, the effect of the public sector debt on the interest rate and ultimately on the net risk, and the reaction of the private sector. These phenomena depend on expectations about the mechanisms which will be used by the government to service its debt and on the expected evolution of the debt over time.

Private domestic debt, in contrast, has received much less attention in the literature, especially from a macroeconomic perspective, because it has usually been assumed that the net effect of the economic behaviour of lenders and borrowers tends to be nil (since each debt has an equivalent loan). This means believing that the market mechanisms which transfer rights of ownership from some owners to others in the private sector are merely making transfers of assets, without there being any net losses of capital resulting from possible negative effects of the domestic debt on the allocation of resources, the volume of investment or other factors.

However, what has happened in recent years suggests that in a large number of countries the domestic debt of the private sector has symp-

toms and characteristics which make it a major obstacle to economic reactivation and mastery of the crisis which has been affecting the region since the beginning of the 1980s. Table 1 shows that the domestic debt of Argentina, Chile, Ecuador and Mexico grew very quickly between the mid-1970s and the early 1980s. Similar results were observed in Uruguay and Venezuela as well. In the cases of Colombia and Peru, although there was some increase in the ratio of private debt to product, it was not very large. However, in Brazil this ratio declined, owing partly to a crowding-out effect of pressure from the public sector on the monetary systems.

Owing to the magnitude, duration and scope (in different areas of economic activity) of the domestic debt in the majority of the countries of the region, the time needed for and the cost of transferring assets between lenders and borrowers have been greater than usually assumed in theory. Moreover, the diversity of the agents involved (borrowers, financial intermediaries, depositors, foreign banks, governments) and the widespread nature of the situation have made the legal procedures for redefining and reallocating rights of ownership more lengthy and difficult.

All this has meant greater arrears on the part of the debtor banks and larger matured and

Table 1

PRIVATE DOMESTIC DEBT, 1975-1985"*(As a percentage of the gross domestic product)*

	Argentina	Brazil	Colombia	Chile	Ecuador	Mexico	Peru	Uruguay	Venezuela
1975	8	25	12	5	12	5	10	14	19
1976	6	25	12	5	13	5	9	16	24
1977	10	24	11	9	13	6	8	18	29
1978	12	24	11	16	15	12	7	21	30
1979	15	21	10	19	16	14	5	23	28
1980	22	18	10	25	16	13	7	27	25
1981	26	14	12	39	18	14	9	33	26
1982	22	14	14	60	19	13	11	39	28
1983	18	12	15	57	20	10	10	46	30
1984		10	14	53	22	8	9	40	28
1985			14	52		9	8	38	30

Source: International Monetary Fund, *International Financial Statistics*, Yearbook 1986 and several monthly issues up to June 1987.

"Monetary system loans to the private sector as at the end of the first quarter of each year.

high-risk portfolios in the national financial system, whose liquidity and even solvency have been severely affected. The reduced supply of resources for lending for profitable and dynamic activities and the increased cost of credit have aggravated even further the position of the borrowers in the banking system and reduced their capacity to service their domestic debt. This has undermined the expansion of productive capacity and complicated and obstructed even further the possible ways of solving the problem.

The magnitude and widespread nature of private domestic debt and its close links with the national financial systems, together with the recession in recent years and the high domestic interest rates, demanded a massive transfer of ownership as a means of solving the problem. This transfer was impossible owing to the great political and economic costs which it would have involved. This helped to weaken the national financial systems, paralyze investment and the

supply of bank credit and encourage the flight of capital. These very tangible phenomena have imposed a major restriction on the recovery and future expansion of the production apparatus. No less tangible and important have been the adverse redistributive effects of the allocation of public resources to the maintenance of certain economic activities, including of course those of the financial sector, in the search for a "solution" to its debt problems.

All of this justifies the attempt made in the following pages to understand the common features of the present process of domestic borrowing in the region and its consequences. After a brief analysis of the origins and the recent development of the domestic debt, its main effects will be described and the implications of possible alternative solutions to this problem will be explored, with, lastly, an indication of the main lessons of the recent experience of excessive domestic debt in Latin America.

II

Main causes of domestic over-indebtedness

At the beginning of the 1980s the domestic debt of most of the countries had grown to such an extent that if the assets representing the current value of the income expected from the (consumption or investment) projects financed by the debt had had to be sold to pay it off, the amount obtained would not have been sufficient to cover the payment and the creditors would have been faced with an uncovered capital loss. This high level of domestic debt originated in the very high level of expenditure in Latin America in the boom period of the second half of the 1970s. The external and internal conditions underlying that boom were transitory, so that when they disappeared the precariousness of the national economies stood revealed: excessive levels of internal and external debt and inability of national financial and productive systems to recover and expand.

One of the factors which most encouraged this unbridled expenditure in the region was the abundant influx of foreign capital between 1974

and 1981. The changes in the world monetary system and the increasing privatization of international liquidity, the macroeconomic policies of the industrial countries and the impact of the sharp increase in hydrocarbons prices, in conjunction initially with the low concentration of loans from private international banks in Latin America, explain the great influx of external credit into the region, initially at low cost. This increased supply of international liquidity greatly expanded the possibilities of direct borrowing from abroad—mainly for governments, public enterprises and banks—and increased the capacity of national financial systems to make domestic loans.

Domestic policies also stimulated the demand for internal and external financing. The greater the speed of the financial reforms, which almost all the countries of the region carried out to some extent, the more they encouraged domestic borrowing by national economic agents. The domestic financial liberalization,

also called financial deregulation, was a process designed to eliminate or reduce some of the restrictions on the region's financial systems. Prominent among them were interest rate controls, the amount and composition of the assets and liabilities portfolios of the financial system, and the rules governing the type and nature of the financial instruments which financial intermediaries were authorized to issue and place on the market. All these restrictions had impeded the proliferation of informal financial markets.

The links between domestic borrowing and domestic financial liberalization were very close. The rapid decontrol of interest rates caused, amidst anti-inflationary policies, high real lending and borrowing rates,¹ although positive real rates did not occur in all cases (table 2). The real rates attained were much higher than historical interest rates.

National-currency deposits in the national financial systems grew very strongly in real terms and also as a percentage of the gross domestic product,² enabling these systems to increase their lending capacity, with a consequent increase in financial assets.

Moreover, the financial deregulation in economies unaccustomed to operating competitively in this sector encouraged financial intermediaries to be over-bold in their efforts to increase their lending. Accustomed to operating in the pre-reforms market, the banks based their risk and solvency analyses on the past performance of their clients* and on their real guarantees,⁴ rather than on a technical evaluation of the quality of the projects and the net earnings expected from them. This encouraged the imprudent expansion of bank investments. Very optimistic expectations about the economic future, confidence in the stability of macroeconomic policies and the prevailing "up-beat" economic atmosphere helped to distort the perception of the real possibilities of economic

growth. This euphoric atmosphere was often encouraged by the national economic authorities themselves and even by international financial bodies. This generated widespread over-borrowing on the part of domestic agents and business sectors and an over-expansion of lending even by more professional financial institutions.

A last factor of fundamental importance in the financial liberalization was the lack of adequate supervision and control of the financial sector, in conjunction with an institutional system conceived for a much more regulated and interventionist context. This facilitated, more by omission than commission, excessive financial laxity, which was closely associated with the domestic over-indebtedness.

The financial deregulation briefly described above played an especially important role in

Table 2

REAL INTEREST RATES,
1975-1985"

(Annual percentages)

	Argentina		Chile		Uruguay	
	Lend- ing	Bor- rowing	Lend- ing	Bor- rowing	Lend- ing	Bor- rowing
1975			114.8*	18.6"		
1976			51.3	0.0		
1977	15.9"	-6.3 ⁶	39.2	5.1	5.3	-12.1
1978	0.9	-14.6	35.1	18.7	19.1	0.8
1979	-2.2	-9.4	16.6	4.4	-9.6	-21.7
1980	5.7	-4.4	11.9	4.7	16.7	5.1
1981	19.3	9.3	38.7	28.5	23.9	12.8
1982	11.4	-19.7	35.1	22.4	34.0	27.2
1983		-30.2	15.9	3.9	28.3	12.3

Source: Argentina and Uruguay: Joseph Ramos, *Neoconservative Economics in the Southern Cone of Latin America, 1973-1983*, Baltimore, Johns Hopkins University Press, 1986.

Chile: Roberto Zahler, "Las tasas de interés en Chile, 1975-1982", in *El desarrollo financiero de América Latina y el Caribe*, Instituto Interamericano de Mercados de Capital, Caracas, 1985.

"Nominal interest rates deflated by the consumer price index.

The second half extrapolated for the whole year, after the financial liberalization had begun.

*The borrowing rates expressed in dollars had values much higher than the international rates.

²Taking the place to some extent of other forms of wealth retention, so that their net impact on domestic saving was generally much lower than on financial saving.

³Which can be and usually is radically altered by tariff, price, tax and other reforms.

⁴Which can be exaggerated by speculation in certain assets markets or by policies which encourage overvaluation of the currency.

Table 3

EVOLUTION OF REAL EXCHANGE RATES, 1975-1986°

(Index: 1980 = 100)

	Argentina	Brazil	Colombia	Chile	Ecuador	Mexico	Peru	Uruguay	Venezuela
1975	196	71	120	131	109	102	76	108	112
1976	129	70	113	115	102	108	82	118	108
1977	166	69	101	111	98	119	90	116	103
1978	149	72	103	127	99	115	113	112	107
1979	111	82	99	114	100	109	107	98	109
1981	143	89	97	93	90	91	84	96	91
1982	170	86	91	112	92	135	87	102	84
1983	167	96	91	118	90	174	90	132	92
1984	163	91	97	118	121	128	86	122	101
1985	190	91	110	138	116	136	99	118	91
1986	191	88*	133	147	130	155	78*	114*	99

Source: ECLAC, on the basis of information from the International Monetary Fund.

°The average of the indices of the real exchange rate of the currency of each country against the currencies of the main countries from which it imports, weighted according to the imports structure.

Preliminary figures.

Argentina, Chile and Uruguay and, more recently, in Venezuela, Ecuador and Bolivia. The external financial openness, which was particularly developed in the countries of the Southern Cone, expanded even further the capacity of national financial systems to increase their investments; domestic borrowing was encouraged by strong expectations of interest rate cuts, in the hope of a swift and considerable fall in the cost of borrowing. Furthermore, the greater facilities and incentives for borrowing abroad,⁵ offered to financial intermediaries in particular, encouraged the acquisition of external financial resources for subsequent intermediation in local markets.

Thus the financial deregulation made a decisive contribution to the encouragement of the domestic demand for financing (which by the very nature of the market in loan funds in countries such as those of Latin America tends to exert pressure on bank lending) and the increased supply of funds for domestic lending

⁵By means of sharp differentials between the domestic interest rates, adjusted in expectation of devaluation, and the international rates, a situation caused to a large extent by the financial deregulation itself.

by the financial system, which grew very strongly.

In many of the countries of the region macroeconomic policies, and in particular those designed to check and reverse inflationary processes, also helped to encourage expenditure and domestic borrowing, especially in the framework of the financial reforms described above.

The influence of the so-called monetarist approach of the balance of payments was felt strongly in Latin America in the second half of the 1970s, not only through the policies on financial openness and foreign currency reserves but also through the stabilization programmes. In the light of the theory of parity of purchasing power and in anticipation of the increasing importance of internationally tradeable goods in the national economies, it was thought that exchange rate policy could play a fundamental role in containing inflation. There was widespread acceptance of the idea that an increase in domestic prices was closely linked to the future movement of the nominal exchange rate through the direct impact of the exchange rate on both production and financial costs (by its effect on tradeable goods and inputs and on the indexed prices and costs characteristic of the

economies in the region with high inflation) and on expectations of inflation. Because it was thought that the current and programmed movement of the exchange rate would have a strong influence on the anticipated exchange rate, there was a tendency in practice to devalue at a slower rate than was consistent with movements in prices and other key economic variables.⁶ This retardation of the exchange rate was particularly serious in the cases of Argentina, Colombia, Chile, Uruguay and Venezuela, even though it was quite apparent in Mexico and Peru at different periods (table 3).

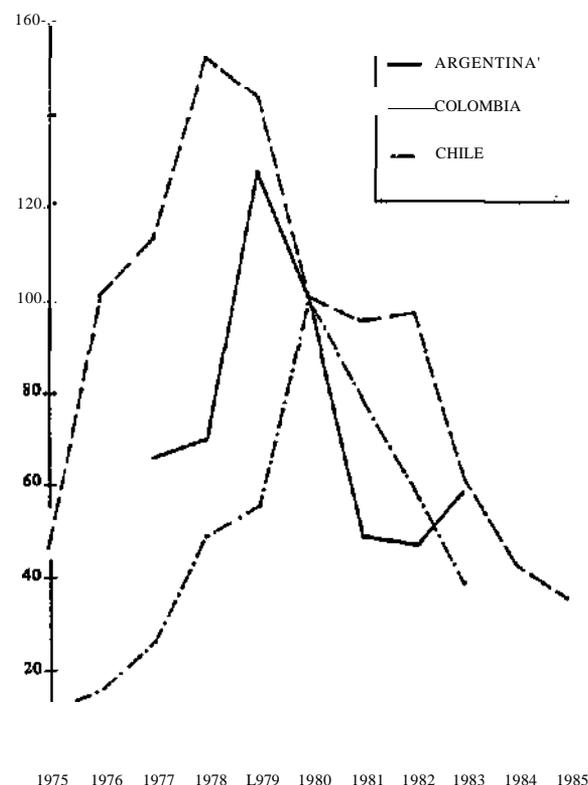
The tendency to overvalue the exchange rate, in conjunction with an external financial openness usually implemented without due care or adequate supervision encouraged excessive domestic borrowing by various means. On the one hand, it gave a powerful boost to expenditure on internationally tradeable goods. Furthermore, the retardation of the exchange rate not only helped to accentuate the deficit in the trade account of the balance of payments, but also pushed up the domestic interest rate in the local currency, by virtue of the expectation of devaluation, as it stimulated the demand for domestic credit intermediated by financial institutions. Lastly, and this was certainly of great importance in several countries of the region, the overvaluation of the currency and the external financial openness, in the absence of compensating macroeconomic policies or adequate control and supervision of external borrowing, tended to reinforce themselves and cause an increase in the relative prices of goods and assets which were not internationally tradeable. In several countries the inflation of assets prices (the price bubble) to levels which subsequently proved not to be those of equilibrium, generated an apparent increase in wealth which encouraged expenditure and the demand for financing even further and at the same time contributed to the overvaluation of the real worth of bank guaran-

tees and, therefore, to the increased supply of bank credit. Figure 1 shows the evolution of real share prices in Argentina, Colombia and Chile.

In some countries of the region tax policies caused the financing of enterprises and the formation of capital to come to depend much more on the financial sector and external capital than on share issues and direct participation in enterprises. The tax incentive to increase domestic borrowing at the expense of capitalization arose when interest payments came to be classed as costs deductible from the taxable income of enterprises. This exemption was not extended to other forms of investment financing (or housing purchases) such as share issues, inputs of own capital, etc.

Lastly, the domestic over-indebtedness in some countries of the region was also encour-

Figure 1
REAL SHARE PRICES
(Index: 1980 = 100)



Source: Argentina: Joseph Runos, *Neoliberal Economics in the Southern Cone of Latin America, 1973-1983*, Baltimore, Johns Hopkins University Press, 1986; Colombia: *MF, International Financial Statistics Yearbook, 1986*; Chile: Roberto ZOA, *Las tasas de Interés en Chile, 1975-1981*, in *El desarrollo financiero de América Latina y el Caribe*, Instituto Interamericano de Mercados de Capital, Caracas, 1985.
*For Argentina the 1977 value is the price in the second half-year, after the financial liberalisation had begun.

⁶This management of the exchange rate was made possible and in most cases stimulated by the ample supply of foreign exchange resulting from the dramatic increase in the international liquidity flowing into the region and from the proliferation of policies of financial and trade openness in Latin America during this period. Furthermore, the increase in foreign currency reserves resulting from the greater net inflow of capital, and in some cases from stricter control of the public sector deficit, strengthened the arguments in favour of this exchange policy.

aged by the extensive interests of economic conglomerates in the ownership of the banks. The activities of these groups, such as the creation of "paper businesses" or the use of financial practices at odds with the techniques of risk evaluation and concentration of credit, were decisive in increasing arrears of payment and the value of the exposed portfolio, the related portfolio⁷ and

the matured portfolio of the banking system, thereby jeopardizing the solvency of the financial intermediaries and even, on occasion, causing their failure or State intervention or both.

⁷The related portfolio is the portfolio made up of loans granted by the banking system to enterprises whose owners have an interest in the ownership or management of the lending banks.

III

Growth and effects of domestic over-indebtedness

The growth of domestic borrowing and the persistence of the factors which stimulated it had a number of effects on the economy in general, and on the financial sector in particular, which have been of great importance in the crisis affecting several countries of the region since the early 1980s.

Theorists and those responsible for carrying out the financial reforms believed basically that both the "financial expansion", which ultimately consisted of an increase in the liabilities of domestic origin in the financial system, and the contribution of external saving to the formation of capital would promote greater volume of saving and a better allocation of loan funds.

In practice, the results in most of the countries of the region were very different from what had been expected. This was due to the very rapid introduction and inadequate regulation of the financial reforms, to the volume and rapidity of the net influx of foreign capital, and to the simultaneous implementation of other policies and reforms whose end result was to promote consumption and capital flight rather than saving, speculation rather than production, and imports rather than exports. Although financial expansion became widespread in the region there was also an increase in domestic borrowing, which is nothing more than the other side of the coin viewed from the standpoint of the assets (domestic credit) of the financial system. In the long run the magnitude, short-term concentration and excessive risk of the domestic over-borrowing distorted and impeded economic growth and the efficient allocation of resources

and very seriously undermined the stability and solvency of the domestic financial systems.

The effects of the financial reforms, the lack of coherence of the macroeconomic policies, the excessive influx of external credit, the lack of adequate control of the financial sector and the domestic over-borrowing itself tended to feed on each other and spread to other areas of the economy. With the exceptions of Brazil and Ecuador, the financial expansion was reflected in an increase in the financial system's liabilities (table 4) but not in concomitant increases in saving, which also fell in some countries as financial saving grew. Other policies boosted total consumption.

The financial deregulation encouraged a greater variety of financial instruments designed to attract funds from different income groups and offering various incentives to save. However, the expectations generated by the external financial openness with respect to a rapid and large fall in the domestic interest rate to international levels, in conjunction with the high and erratic inflation rates and the uncertainty about the stability and duration of the financial reforms, meant that both saving and lending were very short term.

The increasing financial intermediation, the rise of which was explosive in some cases, led to a sharp increase in the debt-capital ratio in the majority of the countries, in both financial and non-financial enterprises. These latter enterprises became more vulnerable to interest rate increases and to declines in economic activity and other changes unfavourable to business

profitability, and the financial enterprises were more vulnerable to payment difficulties and the larger amounts of arrears accumulated by the non-financial enterprises, as well as to unexpected withdrawals of domestic deposits and external loans. Owing to the importance of external loans, exchange rate fluctuations had a strong impact on businesses borrowing in dollars and in many cases on the financial system itself.

When real interest rates rose, businesses which had had access to bank credit before deregulation found their financial burden increased. Those agents which had been kept out of the formal financial market, and especially the consumers, were relatively advantaged by the new interest rates because, although they rose very high, they were generally lower than the rates prevailing in the informal credit markets. Where savings were concerned, as stated above, the sharp increase in financial saving was not reflected in total saving as measured in the national accounts.

From another angle it must be stressed that, as the cases of Argentina, Chile and Uruguay show, despite the influx of external credit, the

dollar levels of domestic interest rates were much higher than the corresponding international rates (table 5). The causes of these high levels included risk components and national situations; government demand for loan funds; the sharp increase in the demand for domestic credit stimulated by inflation of assets prices and in some cases by the artificial demand from economic groups with an interest in the ownership of the banks; the excess demand for financing which existed before the financial reforms; and the high costs of intermediation.

To the factors described above must be added the effect of exchange rate policy and the external financial openness on the expectations of devaluation and thus on the real interest rates in most of the countries of the region during the second half of the 1970s. As stated above, the greater availability of foreign exchange through the capital account of the balance of payments affected the exchange market and contributed to the overvaluation of national currencies, which was fed back in the anti-inflationary use of exchange rate policy in most of the countries. Accordingly, although for some time the global balance of payments presented no problems, and

Table 4

FINANCIAL EXPANSION, 1975-1985

(As a percentage of GDP)"

	Argen- tina		Brazil		Chile		Colom- bia		Ecuador		Mexico		Peru		Uruguay		Vene- zuela	
	Qua- si- mon- ey	M,																
1975	6	15	1	15	7	11	4	16	4	20	3	12	4	22	3	12	10	28
1976	2	12	1	13	4	8	4	16	4	18	5	13	3	20	10	21	13	33
1977	7	17	1	12	7	11	5	17	4	20	5	13	3	18	14	24	16	38
1978	12	22	2	12	8	13	5	17	4	19	15	25	3	16	18	28	16	40
1979	12	20	2	11	10	14	4	16	4	19	15	25	4	14	23	33	15	35
1980	14	20	1	9	11	17	4	15	4	20	16	25	7	19	22	29	14	31
1981	15	19	1	7	17	23	6	18	4	19	18	27	8	18	30	38	14	31
1982	12	17	2	7	23	29	8	19	4	20	19	26	11	19	38	45	19	36
1983	10	14	2	6	18	24	7	18	3	18	17	23	11	19	40	46	21	41
1984			3	5	19	25	8	17	4	16	19	24	11	17	30	35	21	42
1985						22	26	8	17			17	22			30	35	

Source: International Monetary Fund, *International Financial Statistics, Yearbook 1986*, and several monthly issues up to June 1987.

"Quasi-money and M₂ as at the end of the first half of each year, as a percentage of gross domestic product.

Table 5
BORROWING RATES IN DOLLARS,
1975-1983"

(Annual percentages)

	Argentina	Chile	Uruguay	LIBOR
1975		3.1 ^e		7.7
1976		44.3		6.1
1977	16.1 ^c	19.6	2.2	6.4
1978	37.2	32.7	12.9	9.2
1979	34.6	25.9	19.5	12.2
1980	45.7	37.4	26.8	14.0
1981	-30.5	40.8	26.3	16.7
1982	-62.9	-20.4	-30.0	13.6
1983	-22.2	6.4	32.8	9.9

Source: Argentina and Uruguay: Joseph Ramos, *Neoconservative Economics in the Southern Cone of Latin America, 1973-1983*, Baltimore, Johns Hopkins University Press, 1986.

Chile: Roberto Zahler, "Las tasas de interés en Chile, 1975-1982", in *El desarrollo financiero de América Latina y el Caribe*, Instituto Interamericano de Mercados de Capital, Caracas, 1985.

LIBOR: IMF, *International Financial Statistics, Yearbook 1986*.

^aThe nominal rates adjusted for exchange rate variations.

^bThe average annual interest on six-month dollar deposits.

^cThe second half rate extrapolated for the year, after the financial liberalization had begun.

even registered increases in foreign exchange reserves, the sustained and at times growing deficit in the current account of the balance of payments fuelled expectations of devaluation, which in turn produced higher domestic interest rates.

The effects of the high interest rates on domestic borrowers were very considerable. With real lending rates which exceeded five, ten and even more times the rate of economic growth, domestic borrowers had serious difficulty in paying the interest, especially as these rates were also applied to the total previous debt. The explicit or implicit reason why domestic borrowing continued at such rates lay in the excessively optimistic view of future income and expectations of rapid and large falls in the interest rate. When these hopes were disappointed, the borrowers, who were already over-committed, continued to seek loans to try to

defer indefinitely the liquidation of the assets with which they had backed their debt, but whose value was now insufficient. For this reason alone, borrowers had nothing to lose. This stimulated greater borrowing in the hope of improvement in the conditions described above, and this increased the upward pressure on interest rates.

The very essence of the boom which followed the oil price increase in the 1970s, a boom financed by foreign debt and domestic over-indebtedness, was its inherent transitoriness. For the reasons given above, the change in relative prices stimulated production, mainly in the sector of goods which were not internationally tradeable, such as construction and services. Particularly affected were services connected with the import trade (very dependent on the increasing foreign debt financed by the great influx of international capital) and financial services (owing to the enormous margin between lending and borrowing rates); this was also reflected in the greater participation of the financial sector in the gross domestic product. The excessive expenditure, which overstimulated the production of goods which were not tradeable internationally and the purchase of consumer goods and imports, was destined to disappear with the cessation of the influx of capital and deposits which fuelled it. The international situation changed towards the end of the 1970s: the terms of trade worsened, the dollar climbed, interest rates rose in the international markets, and recession set in in the United States and Europe. The boom came to a sudden stop, and the onset of recession was accompanied by a sharp increase in real international interest rates, which was transmitted to the domestic economy and helped to make the burden of debt incurred in the boom years unsupportable.

The recession at the beginning of the 1980s brought with it a sustained increase in arrears and a large number of bankruptcies, which hurt the assets portfolio of the financial system. This had particularly adverse effects on those economies in which the financial sector and the overall debt-capital ratio had expanded sharply. In these cases the effect of the recession on the capacity of domestic borrowers to pay was even greater, and they had serious difficulties in servicing their debt; the capacity of the financial system to cope

with the reduced recovery of its loans was also affected. Both the official backing of the foreign debt and the State guarantees of deposits, *de facto* or *de jure*, made the banks less vigilant about the quality and the risk element of their assets portfolio, and at the same time encouraged them to increase the lending rates effectively paid by the more efficient or more responsible borrowers (aggravating their already difficult situation) and their borrowing rates, in order to attract more deposits and thus cope with their liquidity problems.

The general economic decline, in conjunction with the reduced influx of foreign capital and the need to devalue local currencies, burst the bubble of inflated prices of assets in goods which were not internationally tradeable. The upward trend of these prices, extremely speculative in many cases and unsustainable in the medium term, was partly responsible for the expansion of the supply of bank credit and of domestic borrowing by some sectors, despite the high interest rates. When this bubble burst, the value of the real guarantees of the financial system's debtors fell, aggravating the system's situation even further. Domestically, the capacity of the financial systems to increase their

deposits in a situation of already high interest rates was made even more difficult owing to the increasing vulnerability of domestic borrowers and of the financial intermediaries themselves. Expectations of devaluation, which were fairly widespread in the early 1980s, meant that interest rates in local currencies were increasing in real terms, exacerbating the problem of domestic debt; on the other hand, the effective depreciation of local currencies, which affected the whole region, increased the problems of foreign-currency borrowers.

The magnitude, far-reaching effects and duration of the crisis of the 1980s exacerbated the situation of domestic borrowers, with the result that the search for a solution to the problem of domestic debt was constantly postponed. In its turn, the fall in the real value of assets hit the financial system especially hard. In order to prevent this situation from worsening, several financial institutions had to be merged, liquidated or subjected to intervention by the authorities. The resulting economic cost has affected the recovery capacity of the region's economies and has generally had a marked regressive impact on distribution.

IV

Some choices in the quest for solution of the domestic debt problem

The magnitude and universality of the domestic debt problem and the fragility of domestic financial systems forced governments to seek solutions which usually took the form of official assistance for debtors and financial intermediaries and indirectly for domestic and foreign depositors and creditors. This situation arose because the economic authorities did not foresee the seriousness of the approaching problem or its effects on bank liquidity and solvency and the interest rate, nor did they allow the failures of financial institutions seriously to affect depositors or foreign creditors.

The different methods of solving the domestic debt problem have equally different effects on

incentives and the allocation of resources and on wealth distribution, for the crux of the domestic debt problem lies in the transfer of ownership among different economic agents.

An outline of a bank's balance sheet will help to explain the nature of the problem. A common feature of the banks is that they work with a high leverage, i.e., they can invest much more than their paid-up capital (10 to 20 times more in most of the countries of Latin America). In order to do this, the banks have to obtain deposits and loans for an amount equivalent to the difference between their loans and investments and their capital. Accordingly, the paid-up capital of the banks is a small percentage of their loan portfo-

lio and their third-party debt. Another feature of the banks is that the value of their assets portfolio fluctuates in step with the conditions facing their borrowers, but this is not true of the value of their liabilities portfolio. The knowledge that (here will be a State guarantee for deposits and official backing for the foreign debt means that in practice the value of bank liabilities tends to be fairly inflexible on the down side; this sets a rigid lower limit which can cause serious distortions if the economic value of bank assets falls below that of their liabilities.

There are several factors which can render a domestic debt problem more serious. A recession, inefficient allocation of credit, excessive concentration of bank loans, bursting of an assets price "bubble" (with a consequent fall in the real value of guarantees), the impact of a devaluation on foreign-currency debtors in the banking system, a decline in the terms of trade, or any other factor which has an adverse effect on the current value of income from bank loans produces a discrepancy between the (lower) economic value of bank assets and the (rigid) value of their liabilities. In terms of reserves, this situation amounts to a loss of bank capital. Owing to the high value of these institutions' own loans-capital ratio, when a percentage (even a fairly small one) of total loans is considered irrecoverable, a procedure must be devised to distribute the loss among the bank's owners (who put up its capital), foreign depositors and creditors, the banks' debtors and eventually other economic agents.

The universality of the domestic debt problem, together with its duration and magnitude, meant that in the majority of cases the own capital and reserves of the banks were insufficient to cover the loss of capital. Deposit insurance or a political decision not to permit significant losses to depositors, the official backing of the foreign debt and the power of the foreign creditors, together with other characteristic features of the banking system, meant that depositors and creditors neglected to control the banks' administration and to evaluate their operational results. The State was compelled to intervene to capitalize the banks and/or distribute the capital loss and make the necessary transfers of assets.

Different mechanisms have been used in different countries. In a few countries part of the loss was borne by the foreign creditors. In others such as Argentina, the domestic borrowers were the beneficiaries, mainly at the expense of the depositors, in the process called "liquidation of debts", when the real value of bank deposits was cut sharply by means of interest rate controls and accelerated inflation.

In Chile the official intervention in most of the private banks did not greatly affect either depositors or foreign creditors. The capital loss was borne by the State by means of official contributions to liquidated banks and the purchase by the Central Bank of part of the matured portfolio of the banking system, with a commitment by the banks to use their future profits to buy back this portfolio. There was also direct aid for foreign-currency debtors (as there was in Venezuela) by means of a subsidy for the "dollar debtor", the price of which remained far below the market value of that currency. More recently, the reprivatization of banks has gone ahead in Chile with financing from the private sector and with the stimulus of generous tax incentives.

In Uruguay several banks had to be sold as a result of the decline in the real value of the financial system's assets. In order to facilitate the sale, the Central Bank intervened, as it did in Chile, by taking over part of the bad debts of these institutions.⁸

The other countries of the region had tackled the problem of their domestic debt with a combination of the methods described above, with Peru as perhaps the main exception. In this country the distribution of the burden of the domestic debt affected foreign creditors; for their part, the debtor enterprises managed to transfer to the rest of society most of the impact of the recession by means of cuts in real salaries and lower tax payments, while negative real interest rates improved their net worth. For these reasons, the financial system was not so seriously affected in Peru as in most of the other countries of the region by a widespread deterioration in its loans portfolio.

⁸In another type of operation the Central Bank of Uruguay also bought doubtful debts from private banks, which undertook to put in new foreign financing. This was a fruitless attempt to maintain its exchange rate policy at a time when access to international loans had declined sharply.

These methods of "solving" the domestic debt problem in the region have usually been supplemented by measures to make it easier for debtors to pay by means of the rescheduling of payment periods and some reductions in financial costs. Behind this policy stands the assumption that the conditions which created the problems of domestic borrowers would soon change; therefore, in order to gain time, the relief provided by the rescheduling or refinancing secured in the foreign debt negotiations which the countries of the region have engaged in since the end of 1982 is transferred to the domestic debtors. Perhaps the main negative aspect of this type of measure is that it offers no incentives to domestic debtors to meet their financial commitments; they continue to expect to obtain similar facilities in the future, something which is increasingly less likely if the arrears are not reduced and the problem remains widespread.

Viewing the situation from another standpoint, a distinction must be made between debtor enterprises which are economically inefficient and those which are financially non-viable. The enterprises in the first group—which produce losses even in the best possible operating conditions—have no valid reason, either economic or financial, to remain in existence, for their market value is nil (or negative). The enterprises which are economically efficient but not financially viable owing to the excessive debt burden are different. These enterprises perform a useful social function, for they generate an economic benefit even when their shareholders are suffering financial losses. The economic value of such enterprises at social prices is usually positive; in normal conditions their situation is resolved by an equity loss on the part of their shareholders, which ought not greatly to affect their economic efficiency since, in principle, the generation of the product is not necessarily impaired by the price at which ownership rights are transferred.

This reasoning seems to suggest that in reality there is no "problem" of domestic debt, for economic mechanisms exist to prevent the excessive debt from affecting the overall efficiency of the economic system. However, when the domestic debt is very large, when it is widespread and of long duration and jeopardizes the

financial system's stability and solvency (all conditions pertaining in Latin America in recent years to one extent or another), what is in theory a simple transfer of wealth, usually involves in practice considerable net economic costs for society.

These costs arise in part because under the conditions just described the transfers of wealth and ownership among debtor enterprises does not correct the asymmetry between the value of the assets and liabilities of the financial system. This occurs because the fall in the value of the guarantees of the doubtful loans is such that they cannot recover their original value and because the depositors and creditors of the financial system do not bear their full share of the capital loss involved. Moreover, the widespread nature of the problem has impeded and delayed the legal process of liquidating enterprises, and this process indeed is not cost-free and can help to erode even further the value of the real guarantees and thus the overall quality of the banks' portfolio.

Accordingly, the solutions to the problem of domestic over-indebtedness have large economic costs. These costs include the fiscal burden resulting from the direct contributions by the Treasury or the Central Bank to capitalize the financial system. There are other indirect costs connected with the purchase of matured portfolios, subsidy of interest rates and the foreign exchange price (this to ease the situation of foreign currency debtors) and, in more general terms, with resources furnished to different pressure groups which are trying to solve their own domestic debt problems. The over-indebtedness also generates very tangible costs, owing both to the effect of the uncertainty about ownership rights on private investment and to the restrictions imposed on lending by the financial system to those activities which could recover more easily or which offer clear advantages for the resumption of recovery and growth.

All this leads to the conclusion that the region's excessive domestic debt has become a serious problem which is impeding the reactivation and expansion of the productive capacity, owing both to its effect on enterprises in the real sector of the economy and to its effect on financial institutions. As a result of institutional and legal rigidity and the downside inflexibility of the nominal value of bank liabilities, ownership

must be transferred and capital losses recognized; the effects of these processes are not neutral from the perspective of either efficiency or equity.

Experience suggests that in order to minimize the economic costs, preference must be given to rapid solutions which, in view of the discrepancy between the size of the problem and the available resources, should be of a selective kind. The legal and institutional problems which are delaying the normalization of economic activity must be solved, so that the financial sector can provide new resources for activities which are economically efficient in terms of the viability of the debtor enterprises and of the contribution which they can be expected to make to recovery and economic growth. In this same spirit, the solution to the domestic debt problem should give priority to the meeting of commitments and encourage the reduction of the arrears, while at the same time discouraging expectations of future financial pardons.

Where distribution is concerned, any solution which does not envisage the appropriate

transfer of ownership among the agents directly involved (debtors, owners, depositors and creditors of the banks) must be viewed, essentially, as containing a large element of discretionality or arbitrariness. And the same can happen with certain specific forms of transfer of ownership. At the same time, the direction which official intervention gives to the "solution" of the problem certainly involves a political aspect. No decision, ranging from nationalization of the banking system to its reprivatization, which envisages measures which affect to different degrees and in different ways domestic and foreign depositors and creditors, and taxpayers in general, wage earners, investors, or any other group or sector on which all or part of the cost of financing the capital loss may fall, can be described as based on strictly economic considerations. However, because these decisions have different effects on incentives to save and invest, the flight of capital, the reduction of arrears, etc., they warrant specific study which takes into account the special features of each situation, so that the relative merits of the available choices can be evaluated in their totality.

V

Main lessons of the domestic over-indebtedness of Latin America

The region's recent experience with respect to domestic over-indebtedness has taught several lessons of definite usefulness in the formulation of macroeconomic and financial policies.

Firstly, there seems to be a close link between domestic over-indebtedness and certain modalities of financial deregulation. Abrupt financial reforms without adequate supervision may indeed help to secure a considerable increase in financial savings (financial expansion), but they can also cause an explosion of domestic debt (debt expansion) in relation to other forms and sources of financing of economic activities. This situation in turn makes the economic system more vulnerable to changes in

interest rates, the terms of trade, the net influx of (internal and external) deposits and loans, and economic activity. This is particularly true when interest rates are floating, for their variation will affect both new loans and the total existing debt. In this case, interest rate changes will have significant repercussions, for they will directly affect the net worth and economic viability of existing enterprises.

Secondly, although the decontrol of interest rates can balance the market in loan funds, it can cause the interest rate to rise to very excessive levels with respect to variables with which it ought to maintain some connection (such as, for example, the productivity of capital and the eco-

conomic growth rate), and this tends to cause significant imbalances in other markets. Extremely high interest rates weaken the situation of the debtors and increase the exposure of the assets portfolio of financial intermediaries; they also distort the foreign exchange market by artificially stimulating the influx of capital, they cause the exchange rate to be overvalued, they threaten the dynamism of the sector of internationally tradeable goods, and they have an adverse effect on the current account of the balance of payments. In the long term this last effect tends to undermine the supply of foreign financing and contributes in practice to devaluation of the exchange rate; this affects foreign currency debtors and, through them, the whole of the financial system. Therefore, if certain prices, no matter how free they may be, fall out of line with what would be reasonably normal values, this fact must be given particular weight in order to anticipate problems in the operation of the market concerned or serious imbalances in other markets.

Thirdly, a massive influx of external financing is not sufficient to bring domestic interest rates down and hold them down. The increased risk associated with national situations and the greater expectations of devaluation resulting from the increasing foreign debt and exchange rate overvaluation both have the effect of accentuating the disparity between the domestic and international interest rates. Segmentation of markets, unequal access to external credit, uneven degrees of substitution among various domestic and international assets, and overvaluation of assets which are not tradeable internationally are more likely to cause assets to be overvalued than to reduce interest rates. The wealth generated in this way tends to encourage consumption rather than saving, although at the same time there may be an increase in the holding of financial assets. The lack of correspondence between the massive influx of external capital and domestic investment, together with the impact of financial openness on the exchange rate, which is quite the opposite of what is expected from trade openness, undermine the potential advantages of economic openness and impair the efficient allocation of resources by economic agents who borrow in

foreign currency, and, worst of all, they erode the quality of the assets portfolio of the financial system.

Fourthly, financial reforms in economies little accustomed to operating competitively in this sector are not sufficient in themselves to ensure better allocation of financial resources. The traditional criteria for portfolio management and risk evaluation on the part of financial intermediaries, in conjunction with the legal or *defacto* availability of deposit insurance and official backing of the foreign debt, fuel the upward movement of interest rates and encourage unprofessional and excessively risky management (both of the loans portfolio and of measures to increase deposits) on the part of domestic financial systems. In particular, very harmful effects have resulted from the combination of a free interest rate and State guarantees of the financial system's assets, outmoded banking legislation and inadequate supervision and regulation of the composition and quality of the loans portfolio, and the competition in attracting deposits by means of interest rate manipulation. This combination encourages excessive growth of the financial sector and imprudent and excessively risky bank lending policies, and it fuels the domestic over-indebtedness; it also creates conditions for an unstable interest rate and makes a large part of the financial system very vulnerable if not directly insolvent.

Fifthly, the tax structure and legislation can stimulate domestic borrowing which is excessive and undesirable with respect to other capitalization mechanisms. The tendency to tax dividends and distributed profits and to make interest payments deductible from taxable income creates a clear distortion, and taxation policies must certainly be reexamined in this respect. Sixthly, certain key macroeconomic prices, such as the exchange rate, the interest rate and wages, ought to be managed in a more flexible and coordinated manner. In particular, an attempt should be made to spread the impact of sharp and unexpected changes in the economy among different markets, so as to minimize any price disalignments and influence the movement of those economic variables which are fundamental to proper resource allocation. This means that

no price should be excessively rigid, for this rigidity will isolate the market from the impact of external events and concentrate it in the rest of the economy.

Lastly, an attempt must be made to disconnect the ownership of the big enterprises in the

real sector of the economy from the ownership of the financial system, with a view to reducing the concentration of this system's loans portfolio and thus its exposure as well, and in order to discourage speculative and potentially destabilizing management of the financial sector.