

# CEPAL

## Review

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# C E P A L

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# Economic restructuring in Latin America in the face of the foreign debt and the external transfer problem

*Robert Devlin\**

There is a growing consensus in the region that the Latin American economies should become more efficient, more internationally competitive and less insulated from market forces, even if this restructuring is achieved through more pragmatic and selective instruments than those usually proposed by the Centre.

This economic restructuring is being frustrated by the heavy economic and social burden involved in transferring internal resources abroad to service the foreign debt. Attempts to confront the so-called "transfer problem" have been very costly due to both internal and external factors. The external environment has been hostile, involving grossly inadequate and costly finance, rigid conditionality, adverse trading conditions and world economic instability.

Thus, concomitant with the serious domestic efforts being made in the debtor countries to restructure, the creditors must contribute with finance, a readiness to grant debt forgiveness for borrowers who are insolvent, more pragmatic conditionality, and more serious efforts to correct macroeconomic disequilibria in the North itself. Unless this is done, sporadic moratoria and more inward-looking economic policies could be perceived by debtors as an attractive second-best solution to the region's problems.

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## Introduction

Capitalist development is dynamic (Schumpeter, 1980). Growing economies do not simply reproduce the prevailing productive structure, but rather undergo a constant transformation or restructuring. While the process of restructuring, both social and economic, is present to some degree in all nations that experience sustained economic expansion, its importance is relatively more accentuated in the economic growth of societies at lower levels of development —those we usually term developing countries.

In the post-war period Latin America underwent important socio-economic transformations (ECLAC, 1979, pp. 3-26). The economic strategy underpinning the process has been characterized as "inward-oriented import substitution". Although it has been pointed out that Latin America's transformation in the post-war period lagged behind some other countries which employed "an outward-oriented export-led growth strategy" (Balassa and others, 1986, pp. 1-74), the region's economic performance was certainly respectable up until the 1980s, with an average annual growth of per capita product of slightly less than 3% between 1950 and 1980. Since the explosion of the crisis in 1982, however, economic activity has stagnated, and by 1986 per capita product was 8% below the level recorded in 1980 (table 1).

By most estimates the 1980s will be a "lost decade" for Latin America in terms of economic growth and socio-economic development. While the region undeniably faced some unusually adverse external conditions at the outset of the 1980s (high international interest rates, recession in the OECD countries, etc.), the severity and prolonged nature of the crisis suggests that the prevailing development strategy left most of the countries excessively vulnerable to unfavourable shifts in external parameters and not well situated to respond dynamically to them.

These circumstances have placed demands on the region to rethink its development strategy and make the necessary adjustments to confront the changing external environment. Some formulas emanating from the North suggest that the panacea is a fashionable outward-oriented strategy based largely on exports, "correct", free market-determined prices, and

private initiative (Balassa and others, 1986). Others, even while sharing some of the goals of this formulation such as the need to increase domestic savings, raise productivity and international competitiveness, expand export activity and rationalize the State, find it essentially overly simplistic (ECLAC, 1986b and Fishlow, 1985, pp. 137-168). This latter analysis gives much greater attention to issues related to institutional development, growth of endogenous technological capacities, sectoral industrial strategies, exports of manufactures, selectivity in the use of policy instruments and incentives, government intervention in the market place, as well as normative questions of equity and democracy.

Although there are important differences in their conception and policy mix, the aforementioned two views on the future requirements of Latin America indisputably converge on the issue of a development crisis in the region and the need for a dramatic restructuring of the econ-

omies. However, this "crisis of development" and the need to pursue economic restructuring over the medium term is frequently overshadowed by discussion of the "debt crisis" and the immediate need for external adjustment of the balance of payments. So much attention has focused on debt and adjustment because these are the aspects of the development crisis which involve the most immediate short-term links between North and South. On the one hand, the health of the North's private banks—the region's principal creditor—and of its financial system is influenced by how quickly Latin America adjusts its balance of payments to demands for repayment of its large US\$380 billion foreign debt. On the other, as we will see later, the payment of debt service involves a huge outward transfer of resources from the region that drains resources needed for investment, socio-economic restructuring and growth.

This paper proposes to address the question of economic restructuring in Latin America by

Table 1

## LATIN AMERICA: MAIN ECONOMIC INDICATORS

Indicators	1980	1981	1982	1983	1984	1985	1986 <sup>e</sup>
Gross domestic product at market prices (index base year 1980 = 100)	100.0	100.5	99.0	96.6	99.7	102.4	105.9
Population (millions of inhabitants)	355	363	372	380	389	398	406
Per capita gross domestic product (index base year 1980 - 100)	100.0	98.1	94.5	90.1	90.9	91.3	92.4
Growth rates							
Gross domestic product	5.3	0.5	-1.4	-2.4	3.2	2.7	3.4
Per capita gross domestic product	2.8	-1.9	-3.7	-4.7	0.9	0.4	1.2
Consumer prices	56.1	57.6	84.8	131.1	185.2	275.3	69-1
Terms of trade (goods)	4.3	-5.8	-9.0	1.1	6.5	-5.0	-8.7
Purchasing power of exports of goods	10.3	1.9	-7.6	10.1	13.3	-4.8	-9.7
Current value of exports of goods	32.3	7.6	-8.8	0.1	11.7	-5.9	-14.8
Current value of imports of goods	34.9	8.1	-19.8	-28.5	4.0	0.3	2.4
Billions of dollars							
Exports of goods	89.1	95.9	87.4	87.5	97.7	92.0	78.3
Imports of goods	90.4	97.6	78.3	56.0	58.3	58.5	59.9
Trade balance (goods)	-1.3	-1.9	9.1	31.5	39.4	33.5	18.4
Net payments of profits and interest	17.9	27.2	38.7	34.3	36.2	35.3	30.7
Balance on current account	-28.3	-40.3	-41.0	-7.6	-0.2	-4.0	-14.2
Net movement of capital	29.4	37.5	20.0	3.2	9.2	2.4	8.6
Global balance <sup>f</sup>	1.4	-2.8	-21.0	-4.4	9.0	-1.6	-5.6
Total gross external debt	230.4	287.8	330.7	350.8	366.9	373.2	382.1

Source: ECLAC, on the basis of official data.

<sup>e</sup>Preliminary estimates subject to revision.

Variation from December to December.

<sup>f</sup> Includes net unrequited private transfer payments.

Includes long and short-term capital, official unrequited transfer payments and errors and omissions.

<sup>g</sup>Relates to the variation in international reserves (of reverse sign) plus counterpart items.

studying the dynamics of the outward transfer of resources being effected from debtor nations to creditor nations. The result will be to show that, independently of the debtor countries' domestic efforts, the policies of the creditors and their governments have decisively contributed to making the short-term economic adjustments needed to bring about an outward transfer extremely costly for Latin America, and have not been broadly supportive of the medium-term objective of economic restructuring. Indeed, the short-term adjustment process has been so costly that it might actually place in jeopardy the economic restructuring of the region that almost everyone admits is necessary. Thus, without a

more far-sighted policy in the creditor countries the efforts of Latin America to restructure its economies could be frustrated.

The organization of this paper is as follows. Section I will examine the general nature of the transfer issue and the magnitude of Latin America's transfers. Section II will focus primarily on those external factors that have most contributed to making these payments so difficult to effect and the reasons why the transfers have undermined the process of economic restructuring. Finally, section III provides the conclusions and suggestions for a more appropriate policy focus.

## I

### External adjustment and resource transfers

Since 1982 analysis of the Latin American economic situation has centered largely on the question of the external debt and adjustment. Viewed in its simplest and most commonly referred to form, the process of adjustment in a developing country normally involves a reduction (or elimination) of the current account deficit of the balance of payments, with corresponding reductions in the requirements for external finance and debt accumulation. The reduction of the negative current account balance can be voluntary, as when a country's authorities seek a lower deficit in order to accommodate a lower *ex-ante* "desired" annual level of external finance and indebtedness. Alternatively, the

reduction of the current account balance may be a non-voluntary *ex-post* response to a lower *available* annual volume of external finance. (Deficits cannot occur unless they are validated by finance.)

As we will see in more detail later, the reduction of Latin America's current account deficit—from US\$41 billion in 1982 to an average of less than US\$7 billion per annum in 1983-1986 (table 1)—was largely non-voluntary. In cases of non-voluntary adjustment, analysis can be conveniently organized around the inherent tension that arises between creditor and debtor when the former insists on a reduced financial commitment to the latter.

#### A. The unilateral external demand for an outward resource transfer: an overview

The aforementioned tension in the adjustment process expresses itself in the two major components of a current account deficit: i) a financial component in the form of interest payments on the foreign debt and ii) a trade component in the form of the balance of imports over exports.<sup>1</sup>

The former involves a legal contract which creditors are disposed to enforce and therefore is

theoretically rigid and not subject to compression. The latter, on the other hand, is theoretically flexible and responsive to domestic policy.

<sup>1</sup>For the sake of exposition, we can momentarily assume that there is no direct foreign investment and therefore no profit remittances to be concerned about. In Latin America roughly 90% of all factor payments contributing to the current account deficit take the form of interest payments.

Table 2

**LATIN AMERICA: FINANCIAL RESOURCE BALANCE (REGISTERED LOANS  
AND DIRECT FOREIGN INVESTMENT)<sup>a</sup>**

	Millions of dollars								Millions of 1980 dollars <sup>6</sup>							
	Direct foreign investment			Loans					Total balance 3+7	Direct foreign investment			Loans			Total balance 11-15
	Net in- flow (1)	Profit remit- tances (2)	Balance 1-2 (3)	Net nflow Medium term (4)	Short term (5)	Gross interest paid (6)	Balance 4+5-6 (7)	Net in- flows (9)		Profit remit- tances (10)	Balance 9-10 (11)	Net nflow Medium term (12)	Short term (13)	Gross interest paid (14)	Balance 12+13-14 (15)	
Average																
1961-1965	330.8	1 147.2	-816.4	615.0	-70.8	410.6	133.6	-682.8	1 120.0	3 902.5	-2 782.6	2 126.2	-236.7	1 391.0	498.5	-2 284.1
Average																
1966-1970	726.0	1 676.0	-950.0	1 282.8	452.8	885.6	850.0	-100.0	2 263.5	5 236.8	-2 973.2	4 000.3	1 410.5	2 764.7	2 646.1	-327.1
Average																
1971-1975	1 711.8	2 228.4	-516.6	6 602.6	1 128.2	2 973.2	4 757.6	4 241.0	3 758.4	5 086.3	-1 327.9	14 100.4	2 261.1	6 308.7	10 052.8	8 724.8
Average																
1976-1980	3 714.8	3 360.4	354.4	17 932.8	2 086.0	13 021.4	6 997.4	7 351.8	4 645.0	4 346.5	298.4	23 365.1	3 067.1	15 875.0	10 557.2	10 855.6
1978	3 814.0	3 503.0	311.0	21 676.0	-1 522.0	10 327.0	9 827.0	10 138.0	5 231.8	4 805.2	426.6	29 733.9	-2 087.8	14 166.0	13 480.1	13 906.7
1979	4 938.0	4 014.0	924.0	17 247.0	4 188.0	15 731.0	5 704.0	6 628.0	5 871.6	4 772.9	1 098.7	20 507.7	4 979.8	18 705.1	6 782.4	7 881.1
1980	5 487.0	4 000.0	1 487.0	22 068.0	6 892.0	25 377.0	3 583.0	5 070.0	5 487.0	4 000.0	1 487.0	22 068.0	6 892.0	25 377.0	3 583.0	5 070.0
1981	7 185.0	4 997.0	2 188.0	38 547.0	2 138.0	37 291.0	3 394.0	5 582.0	6 759.2	4 700.8	2 058.3	36 262.5	2 011.3	35 080.9	3 192.9	5 251.2
1982	5 688.0	5 097.0	591.0	27 888.0	-4 326.0	46 572.0	-23 010.0	-22 419.0	5 330.8	4 766.9	553.9	26 136.8	-4 054.4	43 647.6	-21 565.1	-21 011.2
1983	3 123.0	3 521.0	-398.0	20 237.0	-18 451.0	39 925.0	-38 139.0	-38 537.0	3 014.5	3 398.6	-384.2	19 533.8	-17 809.8	38 537.6	-36 813.7	-37 197.9
1984	3 093.0	3 411.0	-318.0	15 301.0	-10 236.0	43 092.0	-38 027.0	-38 345.0	3 017.6	3 327.8	-310.2	14 927.8	-9 986.3	42 041.0	-37 099.5	-37 409.8
1985	3 680.0	3 860.0	-180.0	6 855.0	-6 016.0	40 466.0	-39 627.0	-39 807.0	3 586.7	3 762.2	-175.4	6 681.3	-5 863.5	39 440.5	-38 622.8	-38 798.2

Source: Calculated from the balance of payments series constructed by ECLAC's Division of Statistics and Quantitative Analysis.

<sup>a</sup>All private and official creditors, except IMF. Note that net inflows exclude interest earned on deposits and loans placed abroad, and disbursements of grants and other transfers. The errors and omissions line of the balance of payments is also excluded.

<sup>6</sup>Nominal data were deflated by an index of unit prices for imports of goods and services.

Thus, in circumstances where interest payments are treated as sacrosanct, the weight of adjustment really falls on the trade deficit (and hence the domestic economic parameters of the borrower) rather than on the current account deficit as such.

Foreign creditors decisively influence the degree of tension between the financial and trade components of the current account. During the expansive phase of a credit cycle new lending by private creditors can often exceed annual interest payments and amortization on the debt owed to them. In effect, the private credit system as a whole makes no effective "demand" for payment by the borrower; debt service is accommodated easily through a semi-automatic roll-over of payment obligations and, moreover, additional capital is typically made available to support a trade deficit. In these circumstances, there is a positive transfer of resources from creditor to debtor and no apparent tension between the financial and trade components of the current account.<sup>2</sup>

The above situation could be favourable for a developing country because the creditors' positive transfer—if not offset by a net outflow on other types of transactions—permits investment to exceed internal savings, providing important stimulus for growth and development. Indeed, a protracted period in which foreign resource transfers are positive is traditionally considered to be a normal and desirable stage in the process of development.<sup>1</sup>

Throughout the 1970s and in the early years of the 1980s Latin America enjoyed a positive resource balance on the total of registered for-

ign loan and direct foreign investment transactions. The positive balance was extraordinarily large in both nominal and real terms and had most of its origin in loan transactions (table 2, column 8). The dynamic loan account in turn basically reflects the fact that during this period private international banks initiated their massive penetration of Latin American markets, expanding lending in the region at a rate of more than 25% per annum (Morgan Guaranty Trust Co., 1983, p. 6).

It can be expected that at any given time private creditors may view the existing trade deficits and financing of the borrowing country as excessive, calling forth adjustment on the part of the debtor. However, as long as the financial system does not demand effective payment of debts,—i.e., new net lending remains above interest payments—trade deficits can still be run and resource transfers for investment and growth remain positive. The need to reduce trade deficits in response to tighter external financing conditions is not an uncommon event in the debt cycle of a developing country. Moreover, if the earlier financing exceeded the absorptive capacity of the borrower with respect to efficient investment, somewhat lower financing, as part of a programmed reduction of the current account deficit, could be a helpful form of discipline consistent with a strengthening of overall economic performance.

It is also possible that the net annual financing may fall below levels required for the roll-over, or refinance, of interest payments. The situation may be part of a natural and voluntary process, as in the case of a developing debtor nation which, through the sagacious deployment of earlier loans, has reached a stage in development where the internal savings and foreign trade gaps have been closed, making resources available to effectively pay all or part of the interest on the foreign debt. Alternatively, the reduction in available finance may be imposed unilaterally on the borrower by its creditors, which for any number of reasons begin to "demand" effective payment of interest (and perhaps even amortization) on the debt. An unexpected demand for payment can be very disruptive to the process of savings, investment and growth in the debtor country and fully exposes the tension between the financial and trade components of the current account deficit,

<sup>1</sup>*In* theory some tension should always arise from the so-called "discipline of the marketplace", which rests on the notion that private creditors continuously evaluate the creditworthiness of their clients and effectively translate that evaluation into their credit decisions. Private banks have in fact been found to carry out creditworthiness evaluation, and employ as a prime indicator the rate of growth of exports. (Group of Thirty, 1982, p. 41.) However, there is also evidence that during most of the 1970s the so-called discipline of the marketplace was not felt by most Latin American borrowers, because of deficiencies in the banks' creditworthiness analysis and/or difficulties in institutionally translating that evaluation into credit decisions. Indeed, the credit environment in the 1970s can be best characterized as having been permissive and full of deceptive signals as to the long-term availability and cost of finance. (See Devlin, 1986.)

<sup>2</sup>One of the best expositions of the classic debt cycle hypothesis of a developing country is still Avramovic and others (1964). Also see Ohlin (1966).

which during the upswing of the credit cycle had been hidden by the veil of abundant and unconditional finance.

Once the private creditors make effective demands for payment of interest, the full weight of adjustment must theoretically fall on the flexible trade balance, because the deficit on factor services (interest payments) is a rigid contract. Unless financing is available from the country's accumulated reserves or other official compensatory sources, the trade balance must register a surplus equivalent to that part of the interest payments not covered by new loans from the creditors. Meanwhile, the domestic counterparts of the trade surplus are that internal savings

must be greater than investment and domestic absorption less than the product. In these circumstances the flow of resources reverses itself, as the debtor must now transfer net resources to its private creditors in an amount equivalent to the trade surplus and the excess of internal savings over investment.

Any non-voluntary transfer of resources from debtor to creditor is difficult and raises tensions between the two parties. But when the non-voluntary transfer occurs at an unnatural stage of development —i.e., when there is a genuine savings-investment gap to be filled for the purpose of development— the situation can be particularly delicate.

### B. Latin America and the outward resource transfer

In recent years Latin America has been effecting large and protracted net payments to its private bank creditors that are largely non-voluntary and considered by many to be premature with respect to the region's stage of development. The general phenomenon appeared in 1982, although for some countries it began earlier.

The effect of those net payments on the total resource balance for loans and direct foreign investments can be observed in table 2. There it can be seen that the average annual resource balance for the region as a whole in 1982-1985 was negative to the tune of US\$35 billion. Table 3 presents the same balance for 10 indi-

Table 3

#### TEN LATIN AMERICAN COUNTRIES: RESOURCE BALANCE OF REGISTERED FOREIGN FINANCIAL TRANSACTIONS, 1978-1985<sup>a</sup>

(Millions of dollars)

	1978	1979	1980	1981	1982	1983	1984	1985
Argentina	-721	2 894	-280	-2 868	-3 158	-5 431	-2 727	-3 260
Brazil	5 783	-272	1 500	1 373	-3 204	-6 187	-7 786	-12 394
Colombia	-279	416	229	795	517	-311	-631	231
Costa Rica	314	202	592	-64	-166	-106	-339	-181
Chile	1 430	1 454	2 009	2 704	-1 394	-1 417	-283	-876
Ecuador	370	242	346	-92	192	-484	-801	-796
Mexico	449	465	6 026	12 926	-5 800	-12 881	-13 308	-12 439
Peru	-430	-781	-261	-734	546	-634	-419	-935
Uruguay	3	345	547	429	739	•66	-261	-506
Venezuela	2 171	1903	-1 769	-4 897	-5 854	-7 711	-8 433	-5 549

Source: Calculated from data in the balance-of-payments series prepared by ECLAC's Division of Statistics and Quantitative Analysis. <sup>a</sup>The sum of DFI +L - U, where DFI is net direct foreign investment, L is short and medium term loans net of amortization and U is profit remittances on direct investments and gross interest payments on the foreign debt. The balance is analogous to column 8 of table 2.



**Table 4**  
**COMPARISON OF LATIN AMERICAS**  
**NEGATIVE RESOURCE BALANCE ON**  
**REGISTERED FOREIGN FINANCIAL**  
**TRANSACTIONS WITH THE WAR**  
**REPARATIONS OF GERMANY**  
**AND FRANCE<sup>0</sup>**

(Percentages)

	Transfer		Per-centage of debt with private banks (1985) <sup>1</sup>
	GDP <sup>6</sup>	EX <sup>2</sup> ports <sup>c</sup>	
Germany 1925-1932 <sup>1</sup>	2.5	13.4	
France 1872-1871 <sup>2</sup>	5.6	30.0	
Latin America			
1982-1985*	5.3	32.5	65.0
Argentina	5.6	38.2	59.7
Brazil	3.3	28.9	75.4
Colombia	0.1	1.1	50.3
Costa Rica	6.3	16.7	20.4
Chile	4.8	21.7	70.2
Ecuador	3.8	16.5	70.8
Mexico	7.4	40.0	76.2
Peru	1.7	9.4	40.6
Uruguay	0.4	1.7	39.8
Venezuela	11.7	42.3	76.4

Source: Germany and France: Calculated from data in Machlup (1976, pp. 378-386) and Reisen (1986). Latin America: Estimated from data in the balance-of-payments and national income data series of ECLAC's Division of Statistics and Quantitative Analysis.

<sup>a</sup>In view of the dates of the German and French cases, data and comparisons should be viewed with appropriate caution and taken as estimates of rough orders of magnitude.

The denominator is national income in the case of Germany and France and GDP in the case of Latin America. Note that GDP is larger than national income for debtor nations.

<sup>b</sup>Goods and services for Latin America and presumably just goods for France and Germany.

Data on bank debt are drawn from the statistics of the Bank for International Settlements in Basle. Their reporting system tends to underestimate the banks' assets so that this column may underestimate the respective percentage of bank debt in each country.

<sup>c</sup>War reparations of Fr. 5 000 million as part of the 1871 peace treaty of Frankfurt which ended the Franco-Prussian War.

<sup>d</sup>War reparations to victorious nations of RM 10 720 million in currency and payments in kind as formulated in the 1919 Treaty of Versailles.

<sup>e</sup>Net payments to foreign capital calculated as DFI + I - U, where DFI is net direct foreign investment; I, is short- and medium-term loans net of amortization and; U is profit remittances plus gross interest payments on foreign debt.

vidual Latin American countries. Only Colombia—a country which clearly was cautious about going into debt with the banks during the 1970s—has escaped a persistent negative balance.<sup>4</sup>

By any measure Latin America's negative resource balance with its foreign creditors and investors is large. It is estimated to have been equivalent, on average, to roughly 5% of the region's GDP and 30% of its export earnings over the period 1982-1985. Moreover, the cumulative negative balance over those 4 years (US\$3139 billion) is more than double the cumulative positive balance during the previous 11 years (table 2).

The negative balance on the aforementioned capital transactions is a rough indicator of the foreign creditors' effective demand—taken as a whole—for an outward resource transfer. The Latin American debtors' compliance with that demand is to a large degree non-voluntary. It is this non-voluntary character which makes for an interesting comparison with two historically famous transfer cases involving war reparations: France in the 1880s after the Franco-Prussian War and Germany's payments to victorious nations after World War I (table 4).<sup>5</sup> Here it can be seen that the magnitude of the demand for a transfer in terms of the Latin American debtor nations' income and exports is large: it is approximately double that of Germany's and it is roughly comparable to France's. Going beyond

<sup>4</sup>Up until 1980 Colombia—in contrast to most other Latin American countries—was a very cautious user of bank loans. In his study of developing country borrowers in the Eurocurrency market Wellons (1976) classified Colombia as an "ambivalent" borrower. However, during 1980-1981 the country became a more aggressive borrower, in part because of the monetarist economic orientation of the Turbay administration. When the crisis broke out in Latin America in 1982 Colombia became engulfed in the negative externalities created by payment problems in neighbouring countries and found access to new credit exceedingly difficult. Nevertheless, it is the only major Latin American debtor to avoid a need for a rescheduling of its foreign obligations.

<sup>5</sup>Of course, war reparations are essentially different from debt service. Debts are voluntarily contracted, while war reparations are imposed. In theory, debts should generate a return on capital that make them self-liquidating; there is no such dynamic in war reparations. However, if the *ex-post* return on capital is not sufficient to service the debt—as is the case in most Latin American countries—the creditors' insistence on effective payment represents a type of lien on the economy that, in terms of its effects, may be not entirely dissimilar to a demand for war reparations.

Table 5

**CUMULATIVE TRADE SURPLUS OF FRANCE, GERMANY AND LATIN AMERICA  
DURING PERIODS OF NON-VOLUNTARY TRANSFERS**

*(Percentages)*

	As a percentage of income <sup>11</sup>		As a percentage of exports		Increase in reserves <sup>^</sup>
	Trade surplus (goods)	Trade surplus (goods and services)	Trade surplus (goods)	Trade surplus (goods and services)	Trade surplus (goods and services)
France 1872-1875	<b>2.3</b>		12.3		
Germany 1925-1928					
1929-1932	2.5		13.8		
Latin America 1982-1985	4.3	<b>3.5</b>	31.1	21.4	4.0
Argentina	5.9	5.6	48.0	38.1	-
Brazil	3.7	<b>2.7</b>	34.6	22.9	17.0
Colombia	-2.2	<b>-2.9</b>	-25.0	-25.7	-
Costa Rica	-0.4	<b>0.3</b>	<b>-1.5</b>	0.8	
Chile	2.6	0.8	14.3	<b>3.7</b>	-
Ecuador	<b>6.6</b>	4.5	32.2	19.7	-
Mexico	<b>7.0</b>	<b>7.3</b>	46.8	39.3	2.0
Peru	<b>2.3</b>	1.2	15.8	<b>6.8</b>	60.6
Uruguay	<b>4.6</b>	<b>2.9</b>	24.0	11.4	-
Venezuela	11.2	<b>7.2</b>	43.3	26.0	12.3

Source: See table 4.

"For France and Germany, the denominator is national income, whereas in the case of Latin America it is GDP. For a developing country, GDP is normally larger than national income.

"The first column corresponds to exports of goods and the second column to exports of goods and services.

<sup>^</sup>The increase in reserves is divided by the trade surplus. Note that the trade surplus is a faithful reflection of the transfer when there is no increase in reserves. Only in the case of Peru is there a very large increase in reserves.

Table 6

**LATIN AMERICA: TRADE SURPLUS (GOODS AND SERVICES) AS A PERCENTAGE  
OF NET FACTOR PAYMENTS, 1982-1986<sup>o</sup>**

*(Percentages)*

	1982	1983	1984	1985	1986 <sup>o</sup>	Annual average 1982-1986
<b>Latin America</b>		77	97	85	51	61
Argentina	53	59	59	83	51	61
Brazil		37	99	96	87	56
Colombia					64	
Costa Rica	19		7		31	7
Chile		32		30	33	13
Ecuador		85	73	90	26	51
Mexico	49	154	138	101	49	98
Peru		3	67	93		17
Uruguay		75	61	66	124	66
Venezuela		320	510	230	74	201

Source: Calculated from data in the balance-of-payments series prepared by ECLAC's Division of Statistics and Quantitative Analysis.

<sup>o</sup>Factor payments comprise net interest payments on the foreign debt and profit remittances on foreign direct investments.

Very preliminary figures.

the regional average, it can be seen that the individual Latin American countries facing relatively high demands for a transfer are Argentina, Brazil (in terms of exports), Costa Rica (in terms of income), Mexico and Venezuela. Moreover, with the exception of Costa Rica, the countries facing the greatest relative demand for a transfer are those with proportionally more debt with private banks.

While the creditors' effective demand for a transfer from Latin America in the 1980s generally compares unfavourably with the transfers demanded from nations defeated in war, the real burden of payments apparently compares even more unfavourably. The real burden depends partly on the degree to which the required transfer can be financed with other sources of foreign exchange. For instance, during 1925-1928 Germany received foreign loans well in excess of the requirements for war reparation payments. Only during 1929-1932 did those outward payments actually exceed the inward flow of resources made available through foreign borrowing. In the case of Latin America, during 1982-1985 it was able to finance part of the net payments to creditors through a draw down of international reserves, a small annual inflow of grants, and roughly US\$10 billion per year (average) from interest earnings on deposits and loan placements abroad —although for the region as a whole all this finance was partially offset by a negative Errors and Omissions line in the balance of payments averaging some US\$3 billion per year.

If financing available from other sources is greater than the required transfer, a country can still run a trade deficit while effecting payments. In contrast, if other income falls short of the required transfer, the payments can be made

only by converting a trade deficit into a trade surplus. In other words, as described earlier, a real effective transfer creates a tension in the external accounts in the form of an excess of exports over imports. We have seen that, in the case of Germany, it did not have to generate a trade surplus until 1929- France ran a surplus throughout 1872-1875, while Latin America has had a trade surplus since the outbreak of the crisis in 1982. However, the required trade surplus in Latin America has been roughly double the magnitude of that registered in France and Germany, whether measured as a percentage of income or of exports (table 5).

At the level of individual Latin American countries, one can see from the same table how their trade surplus compared with the two nations defeated in war. Those countries which compare quite unfavourably with the two cases of war reparations are Argentina, Brazil, Ecuador, Mexico, Uruguay and Venezuela.<sup>6</sup>

While Latin America's transfers are obviously extremely large, they still have generally fallen short of the required payments for interest and profit remittances on foreign capital (table 6), not to mention amortization of the debt. Thus, even after effecting a large outward transfer to creditors the region's debt has not been reduced: indeed, it has continued to grow, albeit at rates far below those registered up until 1982 (table I).

<sup>6</sup>The trade surplus is an accurate picture of an effective outward transfer to the degree that there is no significant accumulation of international reserves. The last column of table 5 shows that in 1982-1985, for the region as a whole, there was no significant reserve accumulation *l*<sub>ii</sub>-*j*-*r*<sub>ii</sub> the trade surplus. At the level of our 10 selected countries, only Brazil, Venezuela and Peru used any noticeable part of the trade surplus to accumulate international reserves. Thus in these three cases the trade surplus overstates the transfer, but this is of an important magnitude only in Peru.

## II

### The degree of tension in the transfer of resources

Cases of non-voluntary transfers of resources are generally controversial. The French transfers effected in the last century were accompanied by violent social disturbances and economic dislocations (Keynes, 1929a, p. 406). The German

transfers after World War I, although apparently less burdensome than the French case, set off a long and famous debate (found in Moggridge, 1983, pp. 451-480) over the "transfer problem" and how best to deal with it.

**Table 7**  
**LATIN AMERICA: SELECTED ECONOMIC INDICATORS, 1980 AND 1985**  
 (% GDP)

	Domestic savings		Gross investment		Consumption		Imports <sup>†</sup>		Memo item:
									1982-1985 trade surplus
	1980	1985	1980	1985	1980	1985	1980	1985	Domestic savings (annual average)
<b>Latin America</b>	22.4	23.2	23.7	15.8	79.2	77.7	14.6	9.1	15.6
Argentina	20.7	18.6	22.8	11.5	79.3	81.4	8.5	3.8	28.6
Brazil	20.2	22.4	22.6	16.1	79.8	77.4	11.1	6.1	12.9
Colombia	18.3	16.5	18.7	16.5	81.7	83.5	16.3	14.7	-21.7
Costa Rica	17.1	21.3	26.6	19.0	82.9	79.0	34.3	26.3	-1.4
Chile	17.2	22.1	21.0	12.2	82.1	77.9	25.5	15.3	4.5
Ecuador	25.6	29.5	26.2	16.9	74.4	70.5	24.9	16.3	16.7
Mexico	26.9	27.7	28.2	19.8	73.1	72.3	13.8	8.3	26.3
Peru	22.2	20.7	18.3	9.1	77.8	79.3	20.0	14.2	6.0
Uruguay	11.3	16.6	17.4	8.0	88.8	83.9	21.3	12.4	18.1
Venezuela	28.6	28.9	24.8	16.3	67.1	73.0	25.5	17.0	26.8

Source: Calculated from national accounts and balance-of-payments data prepared by ECLAC's Division of Statistics and Quantitative Analysis.

<sup>†</sup>Goods and services.

Latin America's transfer is today the subject of heated debate and at times has given rise to social unrest in a number of countries.

Broadly speaking, classical transfers in the form of war reparations conceptually have two different stages: first there is a budgetary phase in which a government must tax away resources from its citizens, and second there is the translation of those resources into foreign exchange through the generation of a trade surplus. During the great debate in 1929 about the German transfer problem some economists thought that once the budgetary problem was resolved, the transfer phase followed so automatically, due to the natural working of market forces, that in practice it was not really a phase at all.<sup>7</sup> Keynes (1929b), on the other hand, argued that an automatic transfer was not so simple and could be hindered by a number of internal and external factors, although he stressed that he was not positing the technical impossibility of the transfer, only that it could be "politically and humanly difficult" (Keynes, 1929a, p. 405).

Latin America's transfer of resources has some clear technical analogies with the classical

war reparations cases. A budgetary issue certainly exists because most of the foreign debt was contracted by the State; moreover, foreign banks unquestionably pressured debtor governments to provide, in one form or another, *ex-post* guarantees on private sector debts that the banks were originally willing to grant without any public guarantees.<sup>8</sup>

Thus most of the transfer has had to come directly or indirectly out of government budgets. Reisen (1986, pp. 151-152) has shown that Latin America's budgetary phase was generally

<sup>7</sup>See Machlup (1976, pp. 396-416) for a review of the logic. The insistence on *ex-post* guarantees has no justification from the standpoint of conventional economic criteria. The banks supposedly evaluated the risk of default of lending to private entities without public guarantees, and charged the appropriate premiums, when they originally authorized the loan. To demand a guarantee after that risk materializes is entirely arbitrary, unless the banks are willing to pay the State guarantor an insurance premium. And this insurance premium would have to be quite high—indeed infinite in some cases—because many of the private sector debts are quite simply bad. The banks generally have not paid premiums for the State guarantees, although a token fee was granted to the Government of Chile in its third round of debt rescheduling in 1985, when it reluctantly renewed its guarantor status on private debts.

not resolved during the 1982-1985 adjustment process because governments found it "impossible" to enforce fully the required restrictive fiscal and credit policy. Deficits resulting from the transfer burden and other factors were therefore financed by borrowing from the domestic banking system with inflationary consequences. According to Reisen, this fiscal dilemma of the debtor governments "will surprise only those who are not aware of the huge budgetary burden involved" (in the transfer).

But aside from the budgetary problem it is also evident that the transfer phase as such has not been easy either. Indeed, the large transfers (via trade surpluses) referred to earlier have absorbed a very large share of the domestic savings of the borrowers, and have been realized largely at the expense of sharply reduced domestic investment, import volumes and economic growth (tables 7 and 8). Moreover the high social costs of the economic depression are quite unsettling (World Bank, 1986). The transfer problem is related both to internal and external factors.

As regards the internal factors that have hindered a smooth adjustment to the external demand for a transfer, a recent paper (Bianchi, Devlin and Ramos, 1987) has examined them in detail as part of an evaluation of Latin America's adjustment process over the period 1982-1986. The study concludes that the domestic effort to adjust has been considerable, but that nevertheless domestic factors have clearly contributed to the costliness of the economic adjustment needed to effect a transfer of resources. The major domestic factors cited are:

- The high level of the foreign debt in terms of exports (2.5 in 1981 compared to 1.0 in South Korea);
- The high percentage of the debt contracted with a floating interest rate (66% versus 33% for South Korea);
- In the case of some countries, there was inefficient use of borrowed resources during the 1970s, as reflected in high capital/output ratios, failed projects, conspicuous consumption and over-dimensioned military sectors;
- The low levels of exports relative to GDP (13% compared to 38% in South Korea), which provided a low base on which to generate trade surpluses through increased sales of domestic products abroad;

Table 8

**LATIN AMERICA: REAL AVERAGE ANNUAL GROWTH RATES OF SELECTED INDICATORS, 1982-1985"**

(Percentages)

	Gross investment	Consumption	Imports of goods and services	Per capita GDP
<b>Latin America</b>	-7.7	0.3	-10.3	-1.7
Argentina	-12.7	-1.2	-15.7	-2.9
Brazil	-2.1	2.3	-9.1	0.8
Colombia	-3.5	2.4	-1.1	0.2
Costa Rica	5.7	1.0	1.5	-1.5
Chile	-3.5	-3.5	-13.5	-2.8
Ecuador	1.3	-0.9	-6.1	-0.7
Mexico	-7.9	0.3	-9.2	-2.3
Peru	-19.5	-2.0	-12.5	-4.1
Uruguay	-18.4	-5.7	-15.4	-5.2
Venezuela	-3.2	-1.2	-8.7	-4.8

*Source:* Calculated from national accounts data prepared by ECLAC's Division of Statistics and Quantitative Analysis. "At constant 1980 prices.

- A high dependence on primary commodity exports (80% of the total), which have relatively low supply and demand elasticities;
- Domestic policies which, while usually moving economies in the right direction, sometimes suffered from sluggishness, incoherence and lack of continuity. This was due to flawed conceptions and/or weak State bureaucracies, which were unable to fully carry out the selective policies that could have ameliorated some of the costs of adjustment; and
- Capital flight which, while difficult to define and quantify, was a problem in many countries, particularly Mexico, Venezuela and Argentina.

Notwithstanding these limitations of domestic policy, it is also evident that the external environment for making a transfer was extremely adverse. Indeed, Bianchi, Devlin and Ramos (1987) conclude that the hostile external environment was the most general weak link in the adjustment process and frustrated the efforts of the debtor countries to adjust at minimum social cost. The rest of this section will therefore concentrate its attention on these external factors. Moreover, in examining them in more detail, we will find that they were mostly directly and indirectly related to creditor and creditor government policy.

## A. The insufficiency and high cost of finance

### 1. *The role of finance in adjustment: theory*

Unless a country is at a very mature stage of development, it would presumably prefer to avoid an outward transfer of financial resources; that way trade deficits could be run, investment could remain higher than internal savings, and growth could be accelerated. If obliged to undertake a premature transfer, the adjustment to this situation should be ideally as socially efficient as possible.

In simple terms, for an adjustment process to be socially efficient, the trade surplus which is necessary to effect financial transfers must be mostly "produced" through a rise in savings and in the output of tradeable goods —i.e., exports and import substitutes— rather than "created" through a reduction in domestic expenditure, output and hence imports. When a trade surplus is "produced" a nation's total absorption will necessarily be less than its output, since part of what is produced must be turned over to foreign creditors, but at least economic activity and employment remain robust and standards of living can theoretically still rise. However, when a trade surplus is "created" through an economic recession, not only must total absorption be less than the domestic product, but economic activity, employment and standards of living must fall for the purpose of squeezing foreign exchange out of the economy for payments on the debt.

The problem confronting an efficient adjustment is that to produce more tradeable goods, resources must be switched, or reallocated, to this activity. Economists, to borrow from Keynes' insight (1929b, p. 5), often think of economies as if they were a liquid; in practice, however, they are more viscous in the short term as there are definite rigidities in the reorientation of internal expenditure and production. These rigidities exist even in the most developed economies (hence the discussion of the *j*-curve in the question of the reduction of the U.S. trade deficit), and are usually considerably more pronounced in more disarticulated economies such as those found in underdeveloped regions (and

are further aggravated if borrowed/lent resources were deployed poorly). In other words, for an adjustment to be socially efficient and based mostly on the production of tradeable goods it must be gradual. This requirement increases proportionately with the level of underdevelopment and structural problems of the adjusting economy. Thus, while shock treatment can be effective for an efficient stabilization programme, it can never be compatible with an efficient adjustment programme (Bianchi, Devlin and Ramos, 1987). Efficient adjustment simply is constrained by the factor of time.

Consequently, while an economy is going through the process of reallocating resources to the production of tradeable goods it often needs considerable amounts of compensatory financing. In other words, initially financing must rise above that which private markets might feel naturally comfortable with; later, when adjustment policies and the *production* of tradeable goods (and a trade surplus) begin to take hold, that financing can be gradually pulled back.<sup>9</sup> If adequate financing is not available to support the adjustment programme, it cannot be efficient. In these circumstances the adjustment will be largely based on a compression of domestic expenditure and economic activity, which in turn leads to reduced imports and lower trade and current account deficits.

Outward transfers of resources that are squeezed from an economy via recessionary adjustment are perverse in general, but especially so for developing countries where the opportunity cost of lost income is presumably greater than that in wealthy and developed countries. This type of adjustment is negative in character because it unnecessarily weakens the debtor country and its productive capacity through a deep and/or prolonged recession that indiscriminately eats into the productive muscle of the economy as well as the fat. National resources potentially available for the production of tradeable goods and a trade surplus lie

<sup>9</sup>The transitory boost in financing required for expansive adjustment is nicely analysed in Selowsky and Van der Tak (1986).

idle because a scarcity of foreign exchange blocks the purchase of complementary imported inputs. Moreover, recessionary adjustment prejudices the growth of savings and investment (including investment in human capital) that is so necessary in cases where economic restructuring is vital in order to produce new types of tradeable goods and to improve international competitiveness through productivity gains rather than falling real wages. The payment of debt in the midst of a situation where an economy is stagnating or contracting also exacerbates the tension between creditor and debtor that inevitably occurs when a trade account is pressured by requirements for factor payments.

In sum, transfers based on recessionary adjustment are so perverse because payment is made at the expense of the present and future productive capacity of the borrower. Moreover, they are especially damaging when circumstances demand an important restructuring of the debtor economy's productive structure, as opposed to a mere expansion along a path which is similar to the existing production pattern. In contrast, with appropriate time and finance, cooperative debtors can be made to efficiently produce the trade surplus needed to pay debts. In any perspective other than a short-sighted one this is clearly a more satisfactory solution for both creditor and debtor.

*2. External finance in practice;  
the pro-cyclical retreat of creditors*

We have just seen that socially efficient adjustment demands adequate finance. But in the case of Latin America, there was an even stronger case for financing the adjustment process because the crisis itself was widely diagnosed in the North as one of illiquidity, not of insolvency (Cline, 1984a; Sprinkel, 1984). If Latin America was indeed illiquid at the outset of the crisis, financing a systemic regional adjustment problem made eminent sense for the creditors too, for without a critical mass of external finance there were serious risks of generating a vicious circle of recession and negative expectations which could cause an initial condition of illiquidity to degenerate into one of insolvency.

These risks are unfortunately looming nearer than ever. The financing of adjustment

has been extremely tight, even by orthodox standards. The latter employ a relatively restrictive criterion for financing adjustment: only deficits due to transitory shocks merit financing, while those due to permanent shocks must be adjusted to. However, a recent study by Ground (1986, p. 78) has found that during 1982-1985 external finance covered only 37%, 25%, 36% and 16% of the respective annual apparent transitory components of the deficits of the non-oil exporters. The effect of the underfinancing was a massive "over-adjustment".

As can be seen in table 9, the combination of normal internal rigidities and abnormally low external finance caused adjustment in the first two years to be disproportionately based on a near free-fall of import volumes, with its consequent negative effects on economic growth. In the next biennium export volumes were generally better, while import volumes slowed their fall, or even rose. This, coupled with the reappearance of albeit extremely modest growth of the GDP, led some to conclude that the debt problem was finally beginning to resolve itself. In 1986, however, adjustment fatigue in the debtor countries contributed to a decisive upward shift in import volumes; although this stimulated modest economic growth, export volumes failed to keep the pace established in 1984-1985. The result of this erratic path is that after five years of arduous adjustment, per capita GDP is still below 1980 levels for most countries, and as highlighted in a recent ECLAC report (1986a, pp. 7-8), at the end of 1986 most indicators of most countries' debt burden (debt/exports; interest payments/exports, etc.) were approximately as bad as, or worse than, they were at the outset of the crisis.

The first major factor behind the paucity of financing relates to the pro-cyclical retreat of the region's private creditors. As seen in table 2, net registered medium- and long-term lending to Latin America fell from an average of US\$25 billion per annum in 1978-1981 to only US\$14 billion per annum in 1983-1985. The contraction of nearly 50% in lending was due largely to a retreat by private banks. Data from the Bank for International Settlements (1983) show that the banks had expanded their assets in the region at an annual average rate of about 26% per annum between mid-1978 and mid-1982. However,

with the outbreak of the crisis in August of the latter year, lending collapsed: the same BIS (1985, and 1986abc) data indicate that the banks claims in the region rose by only 4% in 1983, 2% in 1984 and 3% in 1985. Moreover, preliminary data for 1986 suggest that claims did not grow at all in that year and perhaps fell in absolute terms.

An examination of U.S. banking, where there is relatively more openness with data, is

illustrative of the nature of the retreat of the banks. Here it can be found that over the period June 1982-March 1986 U.S. banks actually reduced their total exposure in Latin America by 2%. This represents the net effect of a 6% expansion by the country's 9 big money centre banks, coupled with a 15% contraction in the exposure of the remaining small and medium-sized institutions (table 10). At the level of individual countries, over the last four years only

Table 9

**LATIN AMERICA: ANNUAL GROWTH RATES OF VOLUME OF EXPORTS AND IMPORTS OF GOODS**

(Percentages)

	1982-1983 <sup>h</sup>		1984-1985 <sup>o</sup>		1986 <sup>*</sup>		1982-1986 <sup>a</sup>	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
<b>Latin American</b>	4A	-21.7	4.5	4.7	-2.5	7.1	3.1	-5.4
Argentina	5.8	-25.4	3.4	-4.8	-5.9	14.3	2.5	-9.2
Brazil	5.1	-13.7	10.3	-3.3	-7.6	26.0	4.6	-1.6
Colombia	-4.1	1.9	15.7	-6.1	30.9	14.3	10.8	1.2
Costa Rica	-3.6	-2.7	4.4	6.7	-0.1	6.3	0.3	2.9
Chile	10.3	-27.0	6.2	2.5	5.4	11.6	7.7	-7.5
Ecuador	3.7	-22.9	14.4	3.7	4.0	20.8	8.0	-3.5
Mexico	19.1	-39.2	2.0	22.8	-14.1	-12.6	5.6	-1.2
Peru	1.3	-11.4	9.6	-12.2	-5.3	30.7	3.3	-3.3
Uruguay	4.3	-30.0	-12.4	-5.7	34.4	25.4	3.6	-9.2
Venezuela	-7.8	-18.0	-1.4	12.7	13.9	1.8	-0.9	-1.8

Source: Calculated from data provided by ECLAC's Division of Statistics and Quantitative Analysis.

<sup>h</sup>Average annual rate.

<sup>\*</sup>Very preliminary estimate.

Table 10

**EXPOSURE OF U.S. BANKS IN LATIN AMERICA**

(Billions of dollars)

	June 1982			March 1986			June 1982/March 1986 (growth rates)		
	Top 9	Rest	Total	Top 9	Rest	Total	Top 9	Rest	Total
<b>Latin America</b>	49.1	33.4	82.5	52.2	28.4	80.6	6.3	-15.0	-2.3
Argentina	5.6	3.2	8.8	6.0	2.5	8.5	7.1	-21.9	-3.4
Brazil	12.3	8.2	20.5	16.0	7.7	23.7	30.1	-6.1	15.6
Colombia	2.0	1.0	3.0	1.6	0.7	2.3	-20.0	-30.0	-23.3
Costa Rica	0.2	0.2	0.4	0.2	0.2	0.4	-	-	-
Chile	3.3	2.8	6.1	4.0	2.3	6.3	21.2	-17.9	3.3
Ecuador	1.3	0.9	2.2	1.2	0.8	2.0	-7.7	-11.1	-9.1
Mexico	13.6	11.6	25.2	13.8	10.4	24.2	15	-10.3	-4.0
Peru	1.3	1.0	2.3	0.8	0.6	1.4	-38.5	-40.0	-39.0
Uruguay	0.4	0.3	0.7	-	-	-	-	-	-
Venezuela	7.2	3.5	10.7	6.9	2.8	9.7	-4.2	-20.0	-9.3

Source: Calculated from U.S. Federal Financial Institutions Examination Council (1982 and 1986).



Brazil has experienced any noticeable expansion of net lending from U.S. institutions: 16%, giving a modest average annual rate of 4%.

The different trends among U.S. banks reflect the conflicting interests of the institutions. The big banks are very heavily exposed in Latin America *vis-à-vis* their capital and therefore have been more inclined to lend for the partial refinance of interest payments in order to avoid default. Most of the other lenders are much less exposed in the region and therefore were willing and able to pull out of the region when any opportunity presented itself.<sup>10</sup>

Indeed, this conflict of interests—which is general in the world banking system—was only assuaged, and an even more severe collapse of lending avoided, by the imaginative policy of the IMF and its then Managing Director, J. de Larosière. In order to avoid a wholesale panic among the banks, and consequent massive defaults by the debtors, in mid-1982 the IMF began to act as a "catalyst" for private funds by conditioning its willingness to monitor standby programmes in the debtor countries with an *ex-ante* commitment from the banks to support those programmes with specific quantities of new loans—termed non-voluntary lending. The original formula called for the banks to expand their portfolio by 7% per annum—which in the first round of reschedulings in 1982/1983 would have allowed for refinancing of roughly half of the interest payments to the banks." This, coupled with IMF lending and the banks' rescheduling of amortization and maintenance of short-term credit lines, was the creditors' contribution to the debtors' adjustment process.<sup>12</sup>

New forced lending from the banks totalled some US\$14 billion during the first round of the rescheduling exercises. However, we saw earlier that the actual expansion of the banks' exposure was less than 1%—this was due to the ability of many banks to pull out of other types of lending, especially short-term lines of credit. We have

also observed that in subsequent rounds of rescheduling bank lending has fallen off sharply from the original 7% formula, and it dried up altogether in 1986.

In sum, the innovative arrangements for non-voluntary bank lending *cum* rescheduling of amortization were clearly successful in terms of staving off defaults, big losses for the banks, and disruptions in world financial markets. They were dramatically less successful, however, in terms of supporting efficient adjustment in the debtor countries.

The second major factor in the paucity of financing was the inability of governments and official lenders to fill in the gap left by the retreating banks. The pro-cyclical behaviour of the private banks during the crisis really should have come as no surprise, since private capital often behaves that way. Indeed, Bretton Woods' public lending institutions were created in part to counterbalance this pro-cyclical tendency of private capital and thereby provide more stability for the world economy. However, during the 1960s and 1970s authorities in the OECD countries oversaw a hyper-expansion of the pro-cyclical component of the world financial system (private banks), coupled with an atrophying of its anti-cyclical components—as witnessed by the fact that at the outset of the crisis IMF quotas were equivalent to 4% of the annual value of world trade, compared to 10% in 1970 (Cline, 1984b, p. 124). The structural weakness of the world financial system is illustrated by the following fact: between 1981 and 1983 the commercial banks' net lending to the world's non-oil developing countries fell from US\$51 billion in 1981 to only US\$17 billion in 1983, while the IMF could boost its lending over the same period only from US\$6 billion to US\$10 billion (Feinberg, 1985, p. 29). Overall, the net transfers from the Bretton Woods twins to Latin America have been tiny compared with the withdrawal of the banks. What is most incredible, however, is that in 1986 the IMF became a net recipient of resources from the region (table 11).

The third factor in the scarcity of financing was the capital flight we referred to earlier. In effect, such financing as became available was sometimes partially eroded in its effect by a simultaneous outflow of private capital to northern financial centres (this outflow was voluntary

<sup>10</sup>At the outset of the crisis, loans by U.S. banks to Latin America represented about 130% of their capital; however, for the top 9 banks the figure was 181%. Morgan Guaranty Trust Co. (1984, p. 4) and Bank for International Settlements (1986d, p. 2).

<sup>11</sup>For more detailed analysis of the rescheduling exercises see ECLAC (1985, pp. 47-98); Brau and others (198\*) and Dillion (1985).

<sup>12</sup>For more analysis on the relationship between the IMF and the banks see ICLAC (1985), pp. 76-77 and pp. 85-86.

at the private level and presumably non-voluntary at the public level). The existence of capital flight clearly undermined the legitimacy of new lending to the region.

Capital flight can undoubtedly be attributed mainly to domestic dynamics in the debtor countries. However, external factors clearly complicated the problem. On the one hand, the massive procyclical retreat of private creditors, and the consequent collapse of economic activity in the debtor countries, had a destabilizing effect and aggravated—and indeed validated—any negative expectations of private domestic capital. Second, as the late Carlos Diaz-Alejandro (1984, pp. 377-380) pointed out, many foreign private banks and financial institutions were accomplices of capital flight as competitive pressures induced them to actively solicit deposits from private economic agents in the region.

### 3. *The cost of credit*

The adjustment process was also handicapped by the extremely high cost of credit. First, and most importantly, the tight monetary policy prevailing in the OECD countries helped to cause world interest rates, which were applied to Latin America's floating-rate debt, to rise to record levels; this acted simultaneously as a factor in the need to adjust, as well as—given the theoretical rigidity of factor payments—in the costliness of the process. Table 12 shows that LIBOR reached record levels in the 1980s. It peaked at an average of 16.5% in 1981 and was at an average of 10.7% in 1982-1985. In 1986 the average was 6.7%, with LIBOR hovering around 6% at end-year—its lowest level since 1977. On balance,

then, LIBOR tended to decline over the period of adjustment.

Any decline in this rate represented marked savings for the region: indeed, in recent years a one-point drop in LIBOR has represented a saving of about US\$2.5 billion in interest payments (ECLAC, 1986c, p. 10). The net effect of declining interest rates on the region's interest payments (taking into account the growing stock of debt) was as follows (excluding Panama), US\$ billions: 1981 (32); 1982 (41); 1983 (36); 1984 (39); 1985 (37); and 1986 (32).

While nominal rates declined and eventually reached an ostensibly reasonable level (6%) in 1986, real rates remained persistently high. The real LIBOR, measured by the industrial countries' rate of inflation, averaged 5% in 1982-1986. This compares with an average real rate of zero between 1971-1980 and a long-term historical rate of around 2%.

But this tells only part of the story. The burden of interest payments depends too on the dollar value of the debtors' exports. When this is falling, every dollar of interest paid costs more in terms of what the country sells abroad. Latin America's exports suffered generally declining prices during the adjustment period. As a consequence, the average annual real interest rate from the debtors' perspective was an extraordinarily high 17% for the period 1982-1986. This compares with an average of -4% during the period 1971-1980 when most of the region's foreign debt was contracted (table 12).

A second factor is that private banks aggravated the problem of the cost of credit by jacking up their spreads and commissions, as well as

Table 11

#### LATIN AMERICA: NET TRANSFERS FROM THE IMF AND WORLD BANK<sup>a</sup>

(Billions of dollars)

	1980	1981	1982	1983	1984	1985	1986
IMF	6	0.3*	1.9*	6.9 <sup>b</sup>	3.2	0.5	-1.0
World Bank <sup>c</sup>			0.6	0.6	1.1	1.2	0.2

**Source:** Richard Feinberg and Edmar Bacha, "When supply and demand don't intersect: Latin America and the Bretton Woods Institutions in the 1980s", Paper presented to a Seminar on the world economy and Latin American development, sponsored by SELA in Caracas, Venezuela, May 1987.

<sup>a</sup>Balance of net disbursements and interest payments.

<sup>b</sup>Net disbursements only.

<sup>c</sup>Fiscal year.

Table 12  
INTERNATIONAL RATES OF INTEREST, NOMINAL AND REAL  
(Percentages)

	Nominal LIBOR"	Consumer prices, industrialized countries	Percentage variation, unit price of exports of Latin America	Real LIBOR <D/(2)	Real LIBOR (D/(3)
	Ⓒ	(2)	(3)	(4)	(5)
1970	8.47	5.6	8.1	2.7	0.3
1971	6.79	5.2	1.9	15	4.8
1972	5.41	4.7	9.2	0.7	-3.5
1973	9.31	7.7	33.0	15	-17.8
1974	11.20	13.3	57.5	-1.9	-29.4
1975	7.61	11.1	•5.7	-3.1	14.1
1976	6-12	8.3	8.1	-2.0	-1.8
1977	6.42	8.4	10.6	-1.8	-3.8
1978	8.33	7.2	-3.7	1.1	12.5
1979	11.99	9.2	21.0	2.6	-7.4
1980	14.15	11.2	21.2	2.0	-5.8
1981	16.52	9.9	-2.8	6.0	19.9
1982	13.25	7.5	-11.2	5.3	27.5
1983	9-79	5.0	-6.5	<b>4.6</b>	17.4
1984	11.20	4.8	2.6	6.1	8.4
1985	8.64	4.2	0.6	4.3	9.3
1986	6.71	1.8	-12.7	4.8	22.2

Source; Calculated from data in Morgan Guaranty Trust, *World Financial Markets*, and IMF, *International Financial Statistics*, various issues.

" 180 days.

shortening amortization periods, on rescheduled debt and fresh credit during the first round of the rescheduling exercises in 1982/1983. The negotiated cost of credit (based on spreads, amortization period and commissions) rose in most debtor countries by between 100% and 250% (table 13)- This rise—which has been shown to have little or no economic justification (Devlin, 1985, pp. 74-89)—was apparently not seriously questioned by the IMF and served to increase the burden of debt at an already critical moment, as well as to irritate the debtors and even the U.S. Congress. (See OAS, 1984.)

In subsequent rounds of rescheduling, the private banks have reduced the negotiated cost of credit in response to the stiffer bargaining positions of the debtors and criticism at home. Concessions have included multi-year reschedulings, lower spreads, longer amortization periods and the foregoing of commissions. By the third round the negotiated terms were only slightly above, or even below, those that countries were

contracting before the crisis. While the concessions have been welcome and helpful, they arrived late in the adjustment process and in general have still lagged behind the reality of the situation of many borrowers. In other words, although the banks made important concessions, they kept the negotiated terms at commercial levels even though a number of problem borrowers clearly were in need of non-commercial repayment terms if they were to effect efficient adjustment *cum* socio-economic restructuring.

#### 4. The structure of the market<sup>1\*\*</sup>

The market structure also worked against the debtors. We pointed out earlier that interest payments were a theoretically rigid component of the balance of payments. In practice, however, these payments have traditionally been flexible

<sup>1</sup>For more details see Devlin (1985 and 1986).

due to the competitive market's mechanism of default. That is, when the burden of an outward transfer to creditors has reached certain critical levels, debtor nations have simply stopped paying. Financial history is full of examples of country defaults, many of them committed by today's creditor nations.

Default is an effective risk-sharing device. In theory, creditors evaluate the risk of default, and cover for it by charging the borrower a special risk premium on the loans and by diversifying their portfolio. In the event of the materialization of that risk, the bank must confront the consequences. If the risk has been efficiently

evaluated, the creditor is in a condition to absorb the losses. The default, of course, temporarily releases the debtor from payment and can be an important source of relief, especially if costly sanctions are avoided.

During the 1930s Latin America defaulted on its foreign debt due to the vertical fall of its export earnings during the Great Depression. By 1935 the defaults brought a wholesale decline —75%— in the value of the governments' foreign debt, which was freely traded in foreign markets and subject to a market valuation. Indeed, some countries bought back part of their debt at a fraction of its cost (ECLAC, 1965, pp. 29-30).

Defaults were not without costs, especially in terms of the loss of access to new credit. But the countries did not suffer sanctions, and the loss of new credit was less of a sacrifice than it might at first appear, because financial markets were generally in disarray and not disposed to lend to Latin America in any event. Although loans made to Latin America were on the whole profitable (ECLAC, 1965, p. 30 and Folkerts-Landau, 1985), those profits were dented by the default mechanism, which passed a significant part of the adjustment cost onto the holders of debt paper. Latin America's economic performance benefited as a consequence (Díaz-Alejandro, 1985).

Why is there a difference between this situation and the 1980s? It is partly related to market structure. In the 1930s Latin America's debt took the form of bond issues. Bonds were purchased anonymously by disperse economic agents, ranging from great corporations to little old ladies. The bonds were openly traded and their value was competitively "marked to the market". When the countries defaulted, the bonds' prices automatically declined. Moreover, the disperse and anonymous nature of the bondholders made it difficult for them to organize themselves for the purpose of imposing sanctions, or having their governments do it for them.<sup>14</sup>

The debt of the 1980s, in contrast, is largely in the hands of international commercial banks. The international banking market is oligopolis-

Table 13

**LATIN AMERICA: CONDITIONS OF INDEBTEDNESS WITH PRIVATE BANKS\*\***

(Index: 1980-June 1981 = 100)

	Reschedulings		
	First round 1982- 1983	Second round 1983- 1984	Third round 1984- 1985
Gauntry			
Argentina	317	-	116
Brazil	144	108	43
Costa Rica	133	.	84
Cuba	148	93	65
Chile	250	151	89
Dominican Republic	235	.	61
Ecuador	342	191	109
Honduras	153	-	63
Mexico	281	160	83
Panama	274	-	79
Peru	197	133	-
Uruguay	349	-	97
Venezuela	-	-	68

Source; Calculated on the basis of data provided by the Economic Development Division of ECLAC

\*\*Based on an index of elements of the cost of credit which are subject to negotiation. The formula is:

$$\left( \frac{C_1 + M_1}{A_1} \right) / \left( \frac{C_0 + M_0}{A_0} \right) \ll 100$$

where: C = commissions; A = amortization period; M = margin over LIBOR and the subscript 1 refers to conditions during the respective reschedulings, while 0 refers to the conditions of the normal credit market of 1980-June 1981.

During the reschedulings the banks often forced the State to assume responsibility for unguaranteed private sector obligations. This deterioration of terms is not captured in the index.

<sup>14</sup> bondholders did organize councils in New York and London to protect their interests, but they were largely ineffectual (ECLAC, 1965, pp. 27-32).

tic, with a relatively small number of large banks dominating lending activity. The big banks dominated the inter-bank market and loan syndication and did most of the lending to the region. They all know each other, communicate on a regular basis, can co-ordinate among themselves much more easily than bondholders and can be politically well connected with their governments as well. Moreover, their loans do not generally trade freely in markets, but rather sit quietly on balance sheets.

Thus, when the crisis broke out, the banks were able to quickly form steering committees to co-ordinate their position and to negotiate *en bloc* with individual borrowers. The steering committee is undoubtedly a socially valuable mechanism to the extent that it helps avoid a panic retreat by the banks and random sanctions; however, it also unfortunately has acted in practice as a cartel. Since the creditors' cartel insisted on, and the borrowers willingly accepted, the case-by-case approach to negotiations, its bargaining power *vis-a-vis* individual countries could be enormous. This bargaining power was further enhanced by the action of the IMF and creditor government central banks, which helped the steering committee to persuade the more reticent small and medium-sized lending institutions to join a common bargaining position *vis-a-vis* individual debtor countries. They also helped the committee to encourage borrowers to accept an orthodox adjustment programme and massive outward transfers. Meanwhile, the banks could protect their loans from a market valuation because their assets are not marked to a market; moreover, secondary market trading in those assets is only now developing and is still thin and very personal in nature.

The upshot of the above is that a modern international banking market can exercise considerable control over debtors and assets, as reflected in the fact that default has been avoided despite public debt service ratios in Latin America of more than 40% of exports. In the 1930s massive defaults occurred with ratios at half that level (ECLAC, 1965, p. 8 and IDB, 1986, p. 28).

This also explains the anomaly that in the middle of their gravest financial crisis since the 1930s the banks have generally been reporting robust profits (Salomon Brothers, 1983, 1984, 1985 and 1986). Those which have not, such as Bank of America and the formerly bankrupt Continental Illinois, have owed their problems to bad returns on domestic energy and farm loans, in which borrowers are protected by the rules of the game established in Chapter 11 of the U.S. bankruptcy laws (it is unfortunate that no such laws exist to protect international borrowers).

In sum, the market structure, aided by the creditor governments' overriding concern for the health of their financial systems, has been very helpful in avoiding defaults and any potential sanctions that the debtors could incur. However, this has been achieved by passing the bulk of the cost of a problem with inherent co-responsibility onto one party: the debtor countries in Latin America. In the light of what has happened so far in the decade, and the not easily reversible revulsion of private credit markets with respect to voluntary lending to Latin America, it is not at all obvious that the debtor countries would have been worse off with full or partial conciliatory defaults and acceptance of the risk of significantly costly sanctions, which, incidentally, appears to have been exaggerated by some analysts in the North (see Kaletsky, 1985).

##### 5. Recessive conditionality

Another adverse factor was the creditors' conditionality. This has been a subject of intense debate for many years and there are so many critiques of conditionality that space can be saved by referring the reader elsewhere (Dell and Lawrence, 1980; Killick and others, 1984; and Ground, 1984). I am, however, inclined to agree with those who argue that there is a recessionary bias in conventional conditionality and that this fact—perversely consistent with the more fundamental problem of the underfinancing of the adjustment process—further aggravated Latin America's problems.

### B. Adverse trading conditions

The difficulty in effecting a transfer abroad also depends on the behaviour of the creditor nations' economies. The faster they grow, and the higher are the price and income elasticities for the debtors' exportables, the more the debtors' transfer can be "pulled in" from abroad; in inverse circumstances, the more the transfer must be "pushed out" of the debtor country (Machlup, 1976, pp. 425-477). The former process can be relatively painless, while the latter can be difficult and unpleasant.

During Latin America's adjustment in 1982-1986 benign external circumstances were much rarer than one could have hoped for. With the exception of 1984, economic growth in the industrialized countries during 1982-1986 was well below the annual average rate of 3-5% registered in 1968-1977. The same holds true for world trade volume, the growth rate of which was considerably below the 7.9% annual average mark registered over 1968-1977 (IMF, 1986, pp. 38-58). Moreover, the high rates of growth of 4.8% (OECD product) and 8.6% (world trade) recorded in 1984 were disproportionately reliant

on the extremely robust expansion of the U.S. economy. Indeed, after its 1982 slump, the U.S. was the only major industrialized country whose economy grew at a rate equal to, or greater than, its 1966-1978 average. Growth was exceptionally vigorous in 1983-1984 (annual average rate of 5.5%), and over that period the country's trade deficit trebled to US\$123 billion (*Economic Report of the President* 1986, pp. 254 and 370).

The fact that the U.S. economy was an exception to the rule did make the industrialized economies' sluggish performance less painful for Latin America, because it is the region's number one export market. Indeed, the U.S. trade deficit pulled in the bulk of the region's marginal exports (especially from Brazil) during the adjustment process (table 14). It was also a factor in the improvement of the evolution of the region's GDP from negative growth rates in 1982-1983 to a modest positive rate in 1984 (table 1), suggesting to some that a recovery was underway and that the debt problem was licked (Hector, 1985).

Table 14

#### LATIN AMERICA: GROWTH OF EXPORTS AND IMPORTANCE OF UNITED STATES MARKET, 1982-1985

(Millions of dollars)

	Total exports		Exports to the United States		Increments		
	1980-1981	1982-1985	1980-1981	1982-1985	2-1	4-3	6 / 5 "
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
<b>Annual averages</b>							
Argentina	8 584	8 036	791	936	-548	145	
Brazil	21 731	23 659	3 811	5 926	1 928	2 115	109.7
Colombia	3 451	3 248	881	1 004	-203	123	
Costa Rica	995	946	329	345	-49	16	
Chile	4 318	3 752	590	922	-566	332	
Ecuador	2 508	2 184	895	1 395	-324	500	
Mexico	17 469	23 137	10 394	13 451	5 668	3 057	53.9
Peru	3 581	3 152	1 174	1 115	-429	-59	
Uruguay	1 116	1 067	89	209	-49	120	
Venezuela	11 632	15 583	5 229	5 404	-4 049	175	

Source: ECLAC calculations on the basis of data from International Monetary Fund, *Direction of Trade*, various issues.  
"Percentage.

Table 15  
 LATIN AMERICA: SELECTED TRADE INDICATORS  
 (Coefficients)

	1982-1986 (average)			1982-1985	1986	
	Increase in value of exports	Increase in volume of exports	Increase in value of exports	Effects of change of trade	Net interest payments	Net interest payments
	Increase in volume of exports	Increase in real effective exchange rate	Increase in real effective exchange rate	Net interest payments	Current value of exports	Current value of exports at 1980 prices
<b>Latin America</b>	70.4	...	...	-72.6	35.1	24.2
Oil-exporting countries	53.9			-63.6	36.1	19.9
Non-oil-exporting countries	85.5			-78.9	34.5	27.6
Argentina	68.5	77.9	54.1	-78.0	58.6	37.2
Brazil	86.7	111.7	97.4	-69.0	36.7	29.8
Colombia	118.1	111.5	131.9	-37.1	19.3	20.2
Costa Rica	106.7	113.6	134.5	-99.4	25.0	24.0
Chile	74.2	88.1	66.6	-93.6	39.4	25.2
Ecuador	55.1	93.0	51.2	-65.5	36.0	19.4
Mexico	61.6	74.3	41.8	-74.9	47.5	26.6
Peru	67.2	116.4	77.9	-69.7	31.3	21.0
Uruguay	78.0	77.8	60.5	-122.1	27.4	20.3
Venezuela	47.6	94.5	45.0	-4.1	18.4	9.2

Source: Bianchi, Devlin and Ramos (1987), table f1.

Notwithstanding this help by the U.S. in making possible the resource transfer, the world economy has nevertheless been unusually sluggish and the overall trading environment not propitious. Moreover, the slowdown of the U.S. economy in 1985-1986 aggravated the problem. This situation is reflected in table 15.

The burden of effecting a transfer becomes heavier if export prices fall in the face of rising export volume. The first column of table 15 confirms that this happened for nearly all the countries, as the increase in the value of exports over the period 1982-1986 was but a fraction of the rise in export volume. As might be expected, the most severe cases are the oil exporters, but non-oil exporters such as Argentina, Chile, and Uruguay also had a big part of their export effort frustrated by falling world prices for their goods. Brazil suffered somewhat less. Only Costa Rica and Colombia escaped the treadmill of falling prices, mostly because of skyrocketing prices for

coffee in 1986. Coffee also obviously helped Brazil.

It may also be noticed in the second column that for the majority of countries real devaluations during 1982-1986 were associated with a more than proportional movement in export volume. However, the corresponding relation for export value finds only Colombia and Costa Rica with a coefficient greater than 100, and then only modestly so.

Why the persistently weak export prices? Full answers must await more research, but several hypotheses may be advanced. One is related to price elasticities: while they could be acceptably high for any single primary commodity exporter in isolation, they could be quite low for all producers taken as a group. With the outburst of generalized debt problems in the developing world, most debtor countries simultaneously entered into distress selling in order to accommodate the trade surpluses demanded by their

IMF adjustment programmes. Primary commodities—which dominate the exports of most developing countries—generally may be more vulnerable than manufactured goods to this type of competition. Another problem may have been that productivity gains in the use of synthetic substitutes outpaced the growth of competitiveness of Latin America's primary commodity exports.

Besides the negative effects of sluggish growth of income in creditor countries, it is also possible that income elasticities for primary commodities have undergone a long-standing decline. One frequently encounters observations to the effect that miniaturization, energy conservation and changing eating and drinking habits in the North have all adversely affected the demand pull for primary commodities out of every dollar of growth of the industrialized countries' income. Meanwhile, others have pointed to a high value of the dollar and high real world interest rates as a partial cause of weak commodity prices (The Amex Bank Review, 1986).

Another way of examining the adverse impact of trade conditions on transfer efforts is to examine the region's terms of trade, which incorporate the effects of variations in both export prices and import prices. Over the period 1982-1985 the loss of income due to adverse movement in the terms of trade has been gener-

ally large. Moreover, it can be seen in table 15 that the cumulative dollar loss was equivalent to nearly three-quarters of the region's total bill for net interest payments. Indeed, for Costa Rica and Chile the loss was roughly equal to the value of net interest payments and for Uruguay it was substantially greater.

What would have happened if export prices had held their ground while the countries increased the volume of their exports to effect a transfer? The last two columns of table 15 are suggestive. Valuing 1986 exports at 1980 export prices gives a sharp fall in the region's net interest payments/ export coefficient from its actual high 1986 level of 35% to only 24%. All countries except Colombia and Costa Rica (due to the high 1986 coffee prices) show important declines in their respective coefficients. Some countries, such as Ecuador, Peru and Uruguay display what might be termed acceptable coefficients when their exports are valued at 1980 prices, while Venezuela's coefficient turns out to be a remarkably low 9%.

Finally, there is the subject of protectionism. Even though the world trading system has remained remarkably open in the face of sluggish growth and high unemployment in the North, protectionism, or threats of protectionism, have nevertheless plagued some exporters (ECLAC, 1987).

### C. The unstable behaviour of the world economy

In addition to the above factors which are linked in one way or another to policy variables in the creditor countries, it must also be admitted that managing adjustment has undoubtedly been unusually difficult because of erratic features in the world economy. The first rise in OPEC prices was generally viewed as temporary, but it proved to be more permanent than originally thought. The second price hike was generally viewed as permanent, but we now have more reason to believe it was temporary. The dollar has soared and tumbled in a six-year period. Nominal international interest rates skyrocketed at the turn of the decade. In 1982-1983 rates began their

downward course, but not before an unexpected and worrisome rise in 1984. Moreover, rates remained persistently high in real terms even after an extended period of world price stability. Meanwhile, recovery from the world recession in 1981-1982 has been slow and uncertain, and the hope for the beginning of a strong recovery in the OECD economies in 1983-1984 did not materialize. In subsequent years the industrialized countries' annual performance has disappointed and frequently required downward revisions of world growth projections. And, of course, looming large is the question of adjustment in the North and how quickly the U.S.,



Germany and Japan will adjust to their respective trade deficits and surpluses, and the effect this will have on Latin America.

The ups and downs of the world economy have undoubtedly had their corresponding effects on the adjustment process of the debtor countries in Latin America. For many, the acute instability may well have been entirely unexpected. On the other hand, well before the crisis there were analysts who had been putting forth

statements about structural problems in the world economic system that were at least suggestive of a possible rough road ahead.<sup>15</sup>

"The 1978 *Annual Report* of the BIS (1978, p. 8) suggested that the world economy might have fallen into a Kondratieff type of downturn. Meanwhile, Nobel laureate W. Arthur Lewis (1980) also suggested that the world economy was in a downward cycle, but shorter than the Kondratieff type, in 1977 the German economist Ernest Mandel (1978) first published a work about a deep structural crisis in the western economy.

### III

## Final remarks and conclusions

Any level of outward transfer is technically feasible if creditors and their governments are willing to exert sufficient political and economic pressure on the debtor country. But as Keynes pointed out, large and protracted transfers can be politically and humanly difficult to effect. This, of course, is even more so if the transfer is demanded at a premature level of socio-economic development, or when a country is in a state of insolvency. Moreover, the financial benefits of the transfer for the creditor countries must be weighed against some important costs.

For the debtor country, the economic cost of an outward transfer is that it siphons off domestic savings that could be used for investment, it puts restraints on import growth and consumption, and it limits the expansion and socio-economic transformation of the economy. These costs can be politically onerous to the degree that they contribute to stagnation, or decline, in the living standards of the debtor country's population. Moreover, transfers based on depressed debtor economies also can be technically counter-productive as physical and human factors of production lay idle and deteriorate, and political problems can progressively create bottlenecks in production. The costs are more tolerable, politically and technically, if the transfer is produced through the expansion of the output of exports and import substitutes. In this case the cost of a transfer does not necessarily have to mean idle resources and stagnating living standards in the debtor country.

For the creditor country the debtors' outward transfer allows its banks to prosper even while they slow, or eliminate, the expansion of loans to the affected countries and thereby redirect their portfolio strategy. However, should the outward transfer be won at the expense of reasonable economic growth in the debtor countries there are important costs for the creditor nation as well. These involve loss of export markets (hence jobs) due to slow growth and import barriers in the foreign exchange-starved debtor countries, and the loss of investment income from home enterprises with direct investments in the debtor countries' depressed economies. The political price can also be high: as internal resentment builds up in the debtor country, politicians and technicians committed to socio-economic restructuring and international integration can have their authority undermined by the growth of political forces more inclined towards political and economic delinking from creditor countries, which can include full or partial default on debts. And, of course, with sporadic defaults banks face highly unpredictable losses, exporters in creditor countries lose even more markets, and the hope of promoting efficient socio-economic restructuring in debtor countries evaporates as economies are forced by circumstances into a siege mentality and an extreme inward orientation.

We have already seen that adjustment in Latin America has been recessive and extremely costly for the debtors. But the costs are also now

rising for the creditors. The exports and hundreds of thousands of jobs lost in the creditor nations due to recession in Latin America are now serious enough to have finally caused considerable alarm and doubt in certain Northern political circles about the wisdom of the creditors' current management of the debt problem (JEC, 1986). There is also concern that the debt burden could be undermining the pragmatic democratic political coalitions that originally arose out of the debt crisis and which have offered such promise for Latin America's full integration into the world's democratic political system (Bradley, 1986).

By now it should be clear that there are two key ingredients for making the socio-economic restructuring of Latin America compatible with the servicing of foreign debt: i) the debtor countries must persist in their internal efforts to make their economies more efficient, more internationally competitive and capable of dynamically generating exports and import substitutes and ii) there must be an external environment that is supportive of these efforts. The latter in turn involves adequate external finance, lower real international interest rates and greater encouragement for Latin American exports via increased growth of the industrialized countries' output and international trade. Without component ii), component i) will be very difficult to achieve and all but the hardest societies will, in frustration, be tempted to seek alternative strategies which are less inspired by current preoccupations concerning the honouring of debts, economic efficiency, and fuller integration into the world capitalist economy and its democratic political system.

In the near term adequate amounts of new finance will probably be the decisive variable. On the one hand, most countries have already demonstrated that they are very disposed to alter their past development pattern, adjust and restructure. On the other, high real international interest rates and sluggish OECD growth reflect the need for internal adjustments in Northern economies that will necessarily be slow in forthcoming. Moreover, the longer the North's macroeconomic problems remain unresolved, the proportionately greater the requirements for new finance will be. Without the required finance world-wide adjustment will be asymmet-

rically biased against the debtor countries and even the best efforts at economic restructuring will risk frustration.

More generally, socially efficient adjustment *cum* restructuring must be dynamic and based on growth. This will require a change in strategy: the outward transfer of financial resources will have to "adjust" to the payment capacity of the debtor countries, with that capacity defined in terms of minimum acceptable rates of investment and economic growth. In other words, investment and economic growth can no longer be the residuals of the debt management strategy. Rather they must be explicit targets that other parameters—in particular the transfer of resources and financing—must accommodate.

There is in fact a growing recognition of the need for this new strategy, proposed by ECLAC (1983a and 1983b) at the outset of the crisis. Indeed, the Baker Plan, announced in September 1985, fully recognizes the need to promote "adjustment with growth". The recent innovative financial package designed for Mexico gave concrete form to the stated principles of that Plan: the traditional economic adjustment parameters, in fact, adjust themselves to the need to support a 3% rate of growth in that country in 1987.

There are, however, at least four major shortcomings of the Baker Plan, which space will permit me to comment on only very briefly. First, many analysts agree that the announced financial commitment of US\$29 billion over three years for 15 problem debtor countries falls considerably short of what is required to stimulate adequate growth (5-6% per annum). The Baker Plan has raised hopes, but in essence it is still founded on the principle of extracting large volumes of resources from Latin America. Indeed, as shown by Ffrench-Davis (1986, p. 11), the shortfall in financing is implicitly admitted in recent IMF projections which contain underlying estimates of large outward financial transfers from Latin America up through the early 1990s.

Second, the limited financing offered by the Baker Plan is also overly reliant on the private banks for the raising of new money, even on a non-voluntary basis. The banks are clearly in retreat, and with growing loan loss reserves are in a progressively better position to resist new

forced lending to Latin America. The difficulty in gaining the co-operation of the banks in the recent Mexico package underlines the fragility of the Baker initiative. Thus, there is no alternative to strengthening the financial power of official lenders and seeking ways to speed up their disbursements.

Third, the Baker Plan insists on commercial terms for dealing with problem debtors, under the pretext that non-commercial terms will ruin the debtors' future access to private credit. However, commercial terms on the debt make no sense for a borrower suffering from symptoms of insolvency. The market already admits to the existence of this problem, as many Latin American country loans experience deep discounts as soon as they confront the fresh air of competitive trade. Even though secondary markets are still underdeveloped and the values on them therefore suspect, any discount of more than a third of face value is a good indication of a bad loan. To charge commercial terms for loans whose real value is less than their face value will merely cause insolvent debtor countries to experience perpetually high or rising debt/export and debt/GDP coefficients. In these circumstances, and also because of the difficulty in reversing "revulsion" in private credit markets *vis-a-vis* Latin America, the probability of significant new voluntary private lending is in fact quite low for many countries. Thus, for those countries where the restructuring problem is severe and a large and protracted overhaul of the economy is required, there is no substitute for debt forgiveness in the form of non-commercial interest rates (negative spreads) and/or a reduction of principal. Banks sometimes forgive debts at home (with the help of their governments) and it would be wise to extend this practice internationally.

Fourth, the Baker Plan's conditionality is rigidly formulated around simplistic notions, such as the assumptions that free markets are the handmaiden of growth; private initiative is virtue while public initiative is vice, and foreign investors are unequivocal energizers of development. While Latin America would undoubtedly benefit from less skepticism of market mechanisms and private initiative, the blanket free-market formulas in vogue today are based more on ideology than on historical experience

(Hirschman, 1986). Development is a rich process in which each country must pragmatically find its own way; success moreover often involves formulas that imaginatively deviate for a time from market principles and involve important State intervention. Any attempt to squeeze debtors into a single magic formula risks encouraging many of them (for technical and/or political reasons) to avoid bilaterally organized adjustment programmes in which debtor and creditor work together in resolving a problem. This would be unfortunate for everyone; although a debtor country "going it alone" can certainly muddle along in a second-best world, and even raise economic growth, the widely accepted goal—both in the North and in the South—of raising economic efficiency becomes more problematic as a result of the creditor cartel's ability to ostracize non-conformists and significantly deprive them of normal channels of finance and trade.

In sum, what is needed is a concerted solution to the debt problem that involves a major contribution from all parties. The debtor countries should commit themselves to a serious and pragmatically designed economic restructuring in return for serious commitments on the part of private creditors (and above all their governments) to support investment and growth. For countries with basically strong economies it is the interest of both creditor and debtor that the finance be on commercial terms. However, for those which are obviously confronting the need of a large and protracted economic overhaul, a degree of debt forgiveness is unavoidable as well as technically appropriate for the banks and the borrowers.

Objections are always raised in the North when there is a proposed solution that uses non-commercial criteria in the management of the debt problem; e.g., the banks cannot afford the cost of providing debt forgiveness; the creditor nations' taxpayers should not be made to bear the cost of underwriting the support of the banks and new public lending, etc. (see BIS, 1986e). But every problem has a cost too. There is co-responsibility in the genesis of the debt problem, yet its costs have been disproportionately borne by the debtor countries. There is an evident tendency in the North to postpone resolving the problem as long as most of the costs can continue

to be externalized. But as demonstrated repeatedly over the last five years of the management of the crisis—and most recently in the 1986 Mexican financial package—the creditor nations' "we can't" quickly turns into "we can" as soon as the weight of the debt burden threatens to provoke major defaults which would internalize the costs of the problem (Devlin, 1987).

In 1987 the debt problem shows signs of being extremely critical even after five years of difficult adjustment in the debtor countries. Moreover, both debtors and creditors are suffer-

ing from severe fatigue. Without new and more equitable approaches there are serious risks of more countries dropping out of organized adjustment programmes, spasmodic defaults, unilateral limitations of debt service and more closed and inefficient debtor economies. This is clearly a second-best solution that few would want, but one that many will find understandable if the creditor countries continue to drag their feet regarding a comprehensive solution to the systemic and protracted debt problem in Latin America.

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