

CEPAL Review

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*Deputy Executive Secretary for
Economic and Social Development*
Gert Rosenthal

*Deputy Executive Secretary for
Co-operation and Support Services*
Robert T. Brown

Technical Secretary
Adolfo Gurrieri



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From austerity measures to structural adjustment

*Lucio Geller and
Victor Tokman**

The decade of the 1980s already has considerable experience of economic policies to cope with the crisis and its consequences, experience which should serve as a mandatory reference point for the formulation of new action strategies. This is what the authors do as they make a critical assessment of the policies pursued, as an introduction to their own proposal.

They begin by considering "recessionary adjustment", describing its assumptions, measures and tools and the rounds of renegotiation which this policy has produced. They acknowledge the considerable reduction of the external deficit but stress the high cost in terms of product, employment, wages and investment and the inability of this policy to improve the terms of the debt; all of this has arisen, in particular, from the mistaken forecasts about the development of the international economy, from the policy's weak theoretical basis and the use of unsuitable instruments.

Given this failure, other policy options have been formulated to cope with the debt problem, such as the Baker Plan, and these too are considered. The authors argue that it is not possible to devise a universal solution because of the great variety of factors in play and the different ways in which they affect the countries of Latin America, but they stress the fact that the present external debt cannot be either paid or collected and the need to make full use of payment mechanisms which involve a depreciation of the capital.

In their final section they examine the main aspects of the "structural adjustment" proposed more recently, criticizing its excessive emphasis on the liberalization of the external sector and the role of the market, and suggesting other measures to combine the "generation of foreign exchange" with the encouragement of public and private investment, employment and satisfaction of postponed social needs.

*Staff member and Director respectively of the Regional Employment Programme for Latin America and the Caribbean I/HI:AL/O

Introduction

Some of the international initiatives taken with respect to Latin America's external debt, in particular at the 1985 IMF meeting in Seoul, point to a change of emphasis in the adjustment strategy. The new approach focusses attention on adjustment with growth, whereas the previous one linked adjustment with stability. The first approach does not replace the second but reinforces it. It is therefore interesting to look back in the analysis of the crisis and extract the main lessons of the adjustment policies pursued in recent years.

As usual, the first topic which must be considered in connection with the financial crisis is that of the responsibility for the present situation. The analysis of the debt process over the past decade shows clearly that the responsibility is shared by debtors and creditors. In particular, the 1980 situation was caused by the reluctance of the Latin American countries to make the necessary adjustments after the first oil crisis (1974-1975)- The majority of the countries of Latin America passed through the crisis without any reduction in production, employment or wages, this being achieved thanks to the high level of international liquidity, the low level of debt which the region's countries had at that time, and the low inflation rate in the OECD countries. The developing countries were attractive customers for the excess of liquid resources in the international financial system originally produced in petrodollars. This financial liquidity was channelled through the private international banks, thus changing the traditional nature of Latin America's external financing. Private financial flows began to predominate and this led to changes in the terms of the loans. The interest rates were variable and higher, and the repayment periods shorter. These debt modalities were rationalized as being a correct trend, for it was assumed that the private sector would spend these resources on productive activities which would generate the foreign exchange needed to meet the repayments.

The second oil crisis (1979) found the world economy and the Latin American economies in very different situations. Inflation was higher and sustained in the OECD countries, and the economic policy of the United States gave priority to stabilization, a goal pursued primarily by monetary methods. Consequently real interest rates climbed sharply. Moreover, the Latin American Governments had the worst of both worlds: inflation was accelerating in their countries, their indebtedness was much higher than in 1974, and the cost of external financing had increased considerably. What was even more serious, the external funds were out of phase: instead of increasing when they were most needed they declined at the first signs of the difficulties of the countries of the region in servicing their debts (PREALC, 1985a).

The international financial community began to realize the dangerous situation of debtors and creditors when Mexico announced in August 1982 that it was unable to meet the payments on its external debt. The first reaction to the crisis was to blame the debtors, in particular for their mistaken economic policies and irresponsible use of external resources. The solution adopted at that time was based on two main assumptions. Firstly, since the situation was the result of wrong behaviour on the part of the debtors, they should bear the whole cost of the adjustment. Secondly, the crisis should be handled as a problem of lack of liquidity and not of insolvency, so as to avoid the financial panic. In other words, there was a cash-flow problem but the debtors would be able to pay the debt servicing as long as they made the appropriate adjustments in their economies.

The adjustment proposed was to correct the external imbalance in accordance with forecasts that the traditional forms of adjustment would be successful, on the assumption that international trade would recover and interest rates decline. It thus had to be hoped that Latin American exports would increase both in volume and in price, while the restrictive domestic policies would hold imports down. At the same time, the adjustment of domestic prices would shift resources from the production of non-marketable goods to the production of exportable and imported goods. In a few years the region would be in a position to generate the current-

account surpluses needed to avoid a collapse of the international financial system.

In order to make this forecast probable it was necessary for the parties involved in the debt crisis to commit themselves to the reprogramming of the debts. From 1982, indeed, all the countries of Latin America took part in this exercise, which involved postponing the repayment of capital and in some cases accepting delays in the payment of interest.

By the beginning of 1986 there had already been three debt-reprogramming rounds of differing kinds (Devlin, 1985). There was some improvement in the terms of payment, although still insufficient for the recovery of the Latin American economies. The cost of the reprogramming declined from 2.25% in the beginning to an average of 1.38% above the LIBOR rate. The repayment periods were extended and they now range from 10 to 14 years. No commissions were charged in several of the latest negotiations, although they were the general rule in the first two reprogramming rounds. The grace periods have been extended and they are now six years in the case of Mexico and Venezuela. The reprogramming has covered up to 65% of the debts owed to private banks. Although the participation of the International Monetary Fund has been important in these transactions, there were a few cases which did not require a prior agreement with that body concerning negotiation with the private banks. However, very little progress was made with respect to "new money". The new loans obtained in the 1985 negotiations did not reach the 1984 figure and, in any event, they were lower than the total interest paid by the region. This means that for the fourth year in succession Latin America is making a net transfer of resources to the international private banks (ECLAC, 1985).

In short, it was clear who should pay the debt and how payment should be made. The Latin American countries were to bear the burden of the adjustment, which would be achieved by modifying their levels of activity to restore external balance. The creditors would assist in this process by agreeing to reprogramme the debts under the supervision of the IMF but without sacrificing their profits. Indeed, according to Foxley (1985), the private banks had recovered the position they occupied before the crisis

by the middle of 1985. This improvement was achieved by reducing the volume of new loans and the reinvestment of a higher proportion of profits to cover the risks of bankruptcy of the debtor countries. Meanwhile, since the crisis

erupted the big commercial banks of the United States had seen an increase in their profits, in their share prices and in their dividends (Joint Economic Committee, Congress of the United States, 1986).

II

The effects of adjustment with stability

The majority of the Latin American countries followed the internationally agreed recipe and proceeded to reprogramme their debts and apply adjustment policies in accordance with the traditional criteria. Good results were obtained in the restoration of the external balance. In fact, the current-account deficit in Latin America's balance of payments declined from US\$ 27 700 million in 1980 to US\$ 2 600 million in 1984. As a result, the balance of payments began to produce most of the resources needed to service the external debt. The next question is how was this possible.

Although the traditional adjustment model was followed, the basic assumptions concerning both the international scenario and the prescribed policies did not prove correct. There was no significant recovery in the world market. The interest rate did not decline to levels which would compensate fully for the deterioration in the terms of trade. As a result, Latin American exports have not increased since 1982. The adjustment was achieved by means of a sharp reduction of imports, which by 1983 had declined by 43% in comparison with 1980. This decline was the result of the austerity policy pursued in that period which produced a fall of 9% in Latin America's per capita GDP.

This domestic austerity in turn affected the labour market (PREALC, 1985a). The decline in activity meant a slower rate of job creation and therefore a higher level of *open unemployment*. This open unemployment climbed to 11% by 1985. The increase was bigger than the figures suggest. On the one hand, the historic trend for the rate of open unemployment to hover around 7% came to an abrupt end. On the other, this

increase occurred at the same time as a fall in the participation rates as a result of the lack of job opportunities. According to the information for some countries, if the participation rates had not declined, the rates of open unemployment would have been 1% higher. Lastly, there was a change in the structure of unemployment: there was an increase in the participation of heads of family and, in general, of the more active age groups, and unemployment lasted longer. Those most affected were women, young people and persons in the older age groups.

There was also an increase in visible underemployment, measured primarily by the number of hours worked, which indicates an underestimate of open unemployment. The information available for some of the countries of the region indicates that open unemployment should be adjusted upwards by 1% as a result of the visible underemployment.

Another consequence affecting all the countries of Latin America was the drop in real wages—a result to be expected since wages were originally seen as a decisive factor in the traditional adjustment policies. The reduction of real wages has several purposes in this adjustment model: to re-establish balance in the labour market; to restore international competitiveness; to reduce inflationary pressures; and to cut back effective demand. The decline in real wages—caused by rapid inflation which eroded nominal wages—was also a result of the weakened negotiating power of labour organizations affected by the higher rate of open unemployment.

In addition, there was a rapid increase in the occupations most vulnerable to underemployment, such as those in the informal sector, the

public sector, small businesses and services. The corresponding average incomes also declined. The importance and the interrelationship of these employment and income factors were different in each country. In some countries, the effect of the adjustment was felt mainly in an increase in open unemployment and in lower real wages, while in others its main effect was on employment in the sectors mentioned. The redistributive impact of these different forms of adjustment varied in each situation. The weakest redistributive effect was produced in those cases in which the adjustment led primarily to an increase in open unemployment. The least harmful results were produced when the adjustment was achieved by means of increases in informal employment and declines in average incomes. This latter form of adjustment operates as an unemployment insurance paid by the poor in the countries which do not have protection systems.

Lastly, the crisis jeopardized future employment levels by reducing public and private investment. Public investment suffered as a result of the decision to correct the fiscal deficits, and all the more so in those countries which showed the greatest reluctance to reduce public expenditure. Roads, bridges, railways, storage facilities and basic services in the urban centres deteriorated without the necessary reinvestment being made in the majority of cases. The same

thing happened with private investment, especially in machinery and equipment. It is not easy to recover the lost ground: businessmen are anything but optimistic and real domestic interest rates are high. The way out of the crisis which combines the solution of the debt problem with an increase in employment levels depends on our countries producing more, i.e., on their making better use of their productive resources and investing on a sustained basis.

In 1984 there was an improvement in Latin America's indicators, but this was not repeated in 1985. Following the recovery of the world economy, mainly in the United States, economic activity revived in Latin America and was accompanied by increases of 11% in the value of exports and 5% in the value of imports. However, the 1985 figures show a discouraging development in the countries of the region as a whole which is all the greater if Brazil and Cuba are excluded from the calculations. The volumes of exports and imports declined in that year, the terms of trade deteriorated, and the growth rate of the per capita product was negative if those two countries are not included (ECLAC, 1985).

Furthermore, no result for 1984 and 1985 shows an improvement in the conditions in the labour markets. Some countries achieved reductions in open unemployment, while in others the situation continued to deteriorate. In the majority of the countries for which information is available real wages continued to fall.

III

Adjustment with stability: the lessons of experience

The readjustment policies laid down in the debt reprogramming did not have the predicted results. While it is true that the external imbalance was corrected, this was achieved only at a high domestic price paid mainly by the poorest sectors. This failure can be attributed to mistaken calculations and unforeseen factors in the analysis of the possible international situation and to the faulty theoretical bases of the adjustment policies recommended.

The world economy did not recover as forecasted in the 1982 and 1983 studies. The increase in the volume of Latin American exports was fully offset by the deterioration in the terms of trade. Although the indicators recovered in 1984, the process was not sustained and proved insufficient. The interest rate remained at intolerable levels during the first years of adjustment.

The financing of the fiscal and external imbalances of the United States led to a high interest rate (which was swiftly transferred to the international financial market) and to the overvaluation of the dollar. The United States became the principal debtor in the world economy, even when only the foreign creditors are taken into account. The overvaluation impaired the international competitiveness of United States production. The result is an imbalance in the external accounts which will have to be corrected when the loans mature. The United States also has domestic problems in sustaining the level of activity and employment (Bergsten, 1985; Tavares, 1985). An initial change in the economic policy has produced a *de facto* devaluation of the dollar by means of intervention agreements with the monetary authorities of the central countries in the money markets. More recently monetary policy has been made more flexible in order to permit a reduction in interest rates. Both actions are designed to sustain the expansion of the United States economy. In addition, the United States Congress has been under growing pressure to set up protectionist barriers. If it yields to this pressure, the other industrialized countries will certainly take counter measures. In any event, the volumes and prices of Latin American exports would be harmed as happened in the case of Argentina's agricultural exports when the United States Government decided to protect its farmers with subsidies. In short, the directions taken by United States economic policy will affect international developments in the near future.

The uncertainty about the economic policy of the central countries, and of the United States in particular, has introduced an element of inefficiency in the reprogramming of loans, for the creditor countries have not been obliged to create favourable international conditions to solve the debt problem of the developing countries. Some signs of recognition of this uncertainty began to appear recently: the reprogramming agreement signed by Venezuela with the private banks included a contingency clause providing for a new reprogramming exercise in the event of further falls in the oil price. For the same reasons Mexico too has tried to negotiate with the IMF to ensure that its latest adjustment programme should include anticyclical loans.

Another factor which impaired the efficiency of debt reprogramming was the wish of the international private banking system to accept only new timetables for cash flows. Even for so little the price was high. The private banks increased the margin added to the LIBOR rate and introduced an additional financial charge for renegotiation. Moreover, in the majority of cases the private banks obtained public guarantees of earlier loans even though they had been made to the private sector of the Latin American countries. These benefits were not accompanied by new loans. On the contrary, there was a clear reduction in the new funds made available by the private banks, taking into account the need to reduce their net participation in investment, the increase in bank reserves and the increase in loans merely for the payment of interest (Foxley, 1985). It was against this background of uncertainty and contraction of international lending that the IMF tried to impose its conditional terms. The second lesson to be drawn from the application of the policies of adjustment with stability is that the basic theory did not correspond to reality. When a country has an external imbalance, the traditional analysis assigns the blame to an excess of domestic expenditure and the loss of international competitiveness when changes in the exchange rate and domestic inflation are out of phase. The solution proposed is to reduce expenditure by means of policies of monetary and fiscal restraint and to restore competitiveness by adjusting relative prices to promote the production of marketable goods. The main tool for attainment of this latter objective is devaluation. This traditional approach was then extended to include situations in which the current-account imbalances resulted from internal problems (increases in real wages above increases in productivity) or external ones (deterioration in the terms of trade). The combination of policies does not differ greatly in either situation, except that in the case of external factors the monetary and fiscal policies should not be so restrictive as to soften the impact of the decline in real wages on the production of non-marketable goods (Ahamed, 1986).

It was originally maintained that the recession and the regressive distribution of income resulting from the fall in real wages were not necessary results since devaluation acts as an

incentive to export and thus becomes a force for economic expansion, and since the changes in relative prices in favour of marketable goods do not necessarily entail an increase in the cost of living, which is the representative indicator used in the analysis of real wages. This theoretical and practical stance was called in question as soon as its assumptions were analysed in the context of the Latin American economies (PREALC, 1985a and 1985c; Meller and Solimano, 1985).

The Latin American countries have a high degree of structural heterogeneity, which means that the differences in productivity between and within sectors are higher than in the central economies. There is thus little elasticity in supply and this means in turn that the production system is slower to react to policy changes. The traditional theory holds that the production system is very sensitive, but the positive effects of expansion and reallocation of resources are not felt in the short term. This conclusion leads to the second argument about the effects of devaluation.

It is obvious that the package of adjustment measures would definitely promote recession unless it included devaluation as a tool of expansion. However, some studies on Latin American countries indicate that the expansionist effect of a devaluation is not felt for two years, so that it produces recession in the short term.

There are several reasons why economies do not react immediately and positively to devaluation. Devaluation is less effective in a situation of universal international recession and growing protectionism and when it is used at the same time by the majority of the debtor countries in urgent need of foreign exchange. Moreover, the foreign trade structure of the Latin American economies is dominated by exports of commodities and foodstuffs which have poor demand elasticity. Manufactures still represent a small proportion of total exports. This reduces the effect of devaluation on exports. In the case of imports (with the exception of certain countries in which consumer goods represent a substantial proportion), the main components are raw materials, intermediate products and capital goods. Domestic demand is relatively unresponsive to prices and the only means of reducing these imports is to cut back production. If the price elasticity of the trade balance is low and

does not meet the Marshall-Lerner condition, devaluation worsens the trade balance in the short term. Lastly, devaluation has a further restrictive influence on effective demand. On the one hand, consumer prices move in step with the devaluation and real wages fall unless money wages are fully indexed. Since this is rarely the case, effective demand declines. On the other hand, the inflationary effect of devaluation produces a rise in interest rates. Since the greater part of the private sector is heavily indebted in the national currency and in dollars, the devaluation means an increase in financial costs. The private sector cannot react by increasing production because it has to cope with these financial restrictions aggravated by the limitations imposed on monetary expansion.

Another problem of these adjustment measures is their lack of selectivity. This produces excessive contraction. The proposed policies are based on the use of a few universal instruments. However, owing to structural differences, some sectors will receive excessive profits while others will not have enough. This example is very clear when devaluation is used as a means of stimulating exports. It can be redundant in the case of traditional exports but insufficient to promote exports of manufactures.

Some recent works have concluded with a partial recognition of the force of these criticisms. For example, it has been accepted that the effects of devaluation on production are uncertain and depend in the end in the structure of the economy and the terms of the devaluation. In other words, the question is empirical rather than theoretical (Ahamed, 1986). Other analyses accept that the adjustment programmes reduce short-term absorption but argue that this contraction should not be seen as a cost since the affected economy was engaged in a process of rapid but unsustainable growth. The adjustment programmes ought to set the economies on the road to stable and sustained medium-term growth by means of the incentives which they offer for saving and domestic investment (Khan and Knight, 1985). However, the validity of this proposition has not been verified. Saving does not seem to be very sensitive to the interest rate and large increases would have to be made in that variable to produce any change in the saving coefficient. Furthermore, even allowing that

saving increases, it is not clear that they go into investment if the interest rate remains at very high real levels. This possibility has been recognized but only for the short term; beyond that, the time relationship between saving and investment would have beneficial effects on medium-term investment, always provided that the economic policy ensures that the interest rate remains positive (Molho, 1986). The temporal connection between saving and investment is probable in the case of a normally imbalanced

situation, but improbable in the present critical conditions when increases in saving go on the payment of interest on the external debt. These considerations would suggest that a theory of stable and sustained growth would be better served by an investment theory which places greater emphasis on profit factors and frees the interest rate from its function of adjusting the balance of payments and shifts it to this appropriate sphere of investment decisions.

IV

Adjustment without settlement of the external debt problem

The negative effects on production and employment generated by the adverse international conditions and the adjustment strategy adopted to cope with the problem of external debt were not accompanied by any significant improvement in the debt indicators.

The ratio of external debt to exports for the whole of Latin America remained at the same high level (4.0) in 1985 as in 1983 (3.9). The indicators for Argentina, Chile, Mexico and Peru were higher than these averages and deteriorated between the two years. In contrast, the increases in the exports of Brazil and Colombia brought about an improvement in the ratio in this period.

The differences between countries suggest a need for a case by case analysis which cannot be undertaken in this paper. The following considerations apply therefore to the region as a whole. The performance of the ratio of external debt to exports is attributed to a reduction in the growth rate of the central economies and a decline in international commodities. A recent study argues that the minimum growth rate of the industrialized countries would have to be 4.5% for the exports of the debtor countries to recover (Massad, 1985). In the first forecasts prepared to assess the viability of solving the debt problem by exclusively market means it was concluded that a growth rate of 3% in the central economies would be sufficient to stimulate the exports

of the debtor countries (Cline, 1983)- The growth of the OECD countries was originally estimated at around 3% for 1986, an estimate which seems very optimistic in view of the sluggish performance of the United States economy in the first half of the year. In these circumstances, the prospects of Latin American exports do not seem very rosy.

Of even greater importance than this financial indicator of the capacity to pay is the ratio of external debt to gross product, which measures the debt burden on the production capacity of the debtor countries. Between 1983 and 1985 Latin America's external debt increased by 7%, while the gross domestic product increased at a slower rate (6%). The indicators for Argentina, Chile and Peru showed a tendency to decline, while those for Mexico, Colombia and Brazil, especially the latter two countries, showed an improvement.

It can thus be concluded that the liquidity and solvency indicators (measured partly by the two ratios mentioned above) have deteriorated for the region as a whole. The heterogeneity of debt situations is evidence, in any event, that the criteria used up to now do not have universal validity as means of solving the debtors' problems. Even for Brazil and Colombia the net payments of profits and interest remain a very heavy burden on their exports and their gross domestic product. The fact that some countries

have improved their debt situation does not excuse the international community or the debtor countries from the obligation to take more decisive action to solve this problem.

The issue of external debt seems to be bogged down. If the debtor countries, or some of them, decided to interrupt payment of debt servicing, the counter measures taken by the creditors might affect the growth rate of exports and the gross product of the countries concerned. The interruption would in turn lead to a devaluation of the bank loans, which could be re-bought by the debtor countries. This result came about in fact in the 1930s and laid the foundation for the importance which the Latin American countries attach to their financial commitments. Most of the studies conclude that the costs associated with a moratorium are higher than the benefits, for the uncertainty about the chain of actions and reactions set in motion by a moratorium adds a greater specific weight to costs (Krugman, 1985; Simonsen, 1985). However, as Diaz-Alejandro (1985) has pointed out, a unilateral moratorium is becoming increasingly attractive in the light of the meagre progress achieved in the overall situation and the forecasts of stagnation up to the end of the present decade.

If on the other hand the interruption of the payment of interest and capital was not unilateral but agreed between debtors and creditors for a determined period, as Prebisch suggested to the United States Congress, in order to enable the debtor countries to resume their growth, it would take a long time for the solvency and liquidity indicators to return to their historical levels. This period is in direct proportion to the initial magnitude of the ratio of external debt to gross domestic product or exports, to future interest rates and to the objective difficulties of restoring growth or winning external markets, and it is in indirect proportion to the international inflation rate. However, this solution is not attractive to the international banks which would have to lend involuntarily at a rhythm determined by interest rates.

The private creditors, for their part, insist that the debtor countries should generate a surplus on their trade balances sufficient to pay the interest at least, and they are not prepared to make new loans. In the banks' view, the international inflation rate and the growth rates of the

gross domestic product or exports, no matter how low, would help to improve the solvency and liquidity of the debtors. It is clear that this approach assumes that the repayment of the debt should be completely reprogrammed and brought into line with the fact demonstrated by experience that the present external debt cannot be collected or paid. The key factor determining whether the debtor countries can bear the debt is a reduction in international interest rates. A certain downward trend is visible in the money markets of the central economies, especially since the United States Monetary authorities agreed to relax some of the criteria governing the expansion of the money supply in the light of that country's present economic weakness. However, this process takes time, for the reduction of interest rates requires co-ordination of the monetary policies of several central countries. Unilateral action by the United States would be incompatible with the size of its fiscal and external deficits, which require financing from the rest of the world. In addition, this process has a lower limit determined by the difficulty of correcting these United States deficits, since its economy has lost its external competitiveness and its authorities are persisting with the political policies underlying the fiscal imbalances.

But this is not the whole story. It has always been maintained, and it remains true, that the growth capacity of the Latin American countries depends to a large degree on their import capacity. This means that harmonization of the strict payment of interest and an increase in import capacity depends on the growth of exports. Increased exports are dependent to a large extent on the growth capacity of the central economies and on their political will to remove the protectionism affecting the exports of the debtor countries. It is doubtful whether this growth can take place at an adequate rate, and there is little manifestation of the political will to achieve this. If the debtor countries sought to overcome these difficulties by limiting the payment of interest to a fraction of their exports, the private international banks would be compelled to lend against their will, and this would run counter to their policy of reducing their net participation in lending to the developing countries.

As can be seen, the solution of the external problem is subject to such a large number of

variables that it is very difficult to guarantee a universal solution. A lower oil price helps to reduce inflationary pressures and leads to lower interest rates. These results are favourable to the debtor countries, especially for oil importers, but harmful to oil exporters, and they also bring about a reduction of international liquidity. A monetary policy designed to bring interest rates down benefits the debtor countries, always provided there is no reaction against stagnation or recession in the central countries to cancel out the advantages to the developing countries. The lack of a universal solution should be acknowledged through a greater supply of new credits, but the private banks do not seem disposed to grant them. The result is clear as the day: the solvency and liquidity indicators are stationary for all the debtor countries; the contradictory situation has been reached in which the developing countries are transferring real resources to the developed countries (US\$ 100 000 million in the last four years); the joint responsibility of debtors and creditors is a dead letter.

The Baker Plan, presented by the United States Treasury Secretary in October 1985 in Seoul, acknowledges this situation: the proposal admits that there is no solution to the problem without additional liquid resources. The structural changes needed if adjustment with growth is to happen require new financing. The increased liquid resources and the reprogramming of the debts imply a policy of partial refinancing of interest. The Baker Plan is also designed to strengthen conditionally, giving greater weight to the World Bank and to the regional multilateral lending institutions. It is proposed that the World Bank should maintain closer collaboration with the IMF in the allocation of its loans. In these conditions it would be possible to increase the loans of the multilateral banks to the main debtors by about 50% in the first three years of the application of this policy, without any need to call for new inputs of capital for these institutions. The World Bank would also act as guarantor of investments involving non-commercial risks through a recently established body (Multilateral Investment Guarantee Agency (MIGA)).

The World Bank has been making structural adjustment loans since 1980, but the Bank's administration has imposed restrictions on these loans, which may not exceed a limit 10% of

new commitments or represent a significant proportion (more than 30 to 40%) of the loans made to each country (Bacha and Feinberg, 1986). In consequence, the World Bank made only 16 transactions of this kind in the first five years, and seven of them concerned five Latin American countries (Bolivia, Guayana, Panama, Costa Rica, and Jamaica on three occasions). This small number of transactions was not due only to the earlier decisions of the World Bank, which it is now trying to correct, but also to the fact that the developing countries were not very anxious to commit themselves to a 'double conditionally'. The structural adjustment loans require that the recipient countries shall have entered into commitments with the IMF and they have recently been the object of increasing demand from several other countries of the region.

From the point of view of the multilateral lending institutions, this greater insistence on structural adjustments is justified. The IMF began to concern itself with these matters in the 1970s when it became apparent that many external imbalances were not the result of an excess of demand or of faulty management of foreign-exchange policy, but rather of problems of supply resulting from the failure of certain economies to adapt to the changes occurring in the international economy. However, the IMF could not delve deeply into these matters for various reasons —realizing, for example, that the political difficulties of negotiating with the countries which sought its loans would be fewer if it did not encroach on their sovereignty by going into the details of the goals and tools of economic policy. Its operations would be easier if the discussions were limited to global goals and tools. Furthermore, in its lending practice the IMF had not developed the necessary experience to tackle all the problems connected with the increase of global supply.

The sectoral loans of the World Bank had always been subject to conditions, but the reforms which it recommended had to be in keeping with its mandate of promoting the development of productive resources. For this reason, the Bank's theoretical and professional practice was not capable of replacing the IMF when the external imbalances were caused by factors not connected with supply.

Some of the contradictions could be removed by means of complementary action and cooperation between the two multilateral institutions. For example, the World Bank required Argentina to reduce its export duties before agreeing to a loan for that country's agriculture negotiated in 1986. Realizing that this measure could prejudice the commitments signed by Argentina with the Fund to reduce its fiscal deficit, the Bank devised another measure: replacing export duties with a tax on income from landholding. Furthermore, many debtor countries are not prepared to enter into agreements with the IMF but they would be less unwilling to do so with the World Bank. These new trends are not without their difficulties. The IMF authorities do not seem very willing to participate in the monitoring of structural adjustment programmes in which it has not played a leading role. Nor are the World Bank's conditions easy for the debtor countries to accept—in particular, the Bank's objections to State enterprises, its desire for rapid adjustments, its habit of promoting far-reaching reforms without adequate knowledge of the situation in the country concerned, and its occasional attribution of excessive importance to efficiency without taking into account the employment problem or the basic needs (Bacha and Feinberg, 1986).

But these are not the only difficulties which the Baker Plan has to overcome, there is another more contentious one: the Plan originally required the commitment of the commercial banks to offer new loans over the next three years in the amount of US\$ 20 000 million. Since the private-bank debt of the 15 main debtors covered by the Plan was US\$ 275 000 million at the end of 1984 (75 million short-term and the rest long-term),

the effort required from the banks was to increase their net participation in these investments at an annual rate of 2.5%, an apparently small increase. The net long-term credits (for periods longer than 12 months) received by the 10 Latin American countries which may opt for the Baker Plan amounted to US\$ 12 000 million in 1983 alone. However, a very large proportion of these loans was made involuntary. Furthermore, and in accordance with the World Bank's forecasts, these 10 Latin American countries would have to pay interest amounting to more than US\$ 32 000 million to the private banks between 1986 and 1988; the figures proposed in the Baker Plan are therefore difficult for the private banks to accept and insufficient for the debtor countries.

An additional difficulty in the implementation of this proposal is that it would restrict the independence which the commercial banks have had in all the reprogramming operations if another institution had to be set up to administer these financial resources. The commercial banks are very wary and not willing to commit themselves before the governments of the other central countries do so and until they are certain as to the nature of these commitments. In particular, the commercial banks are watchful of the official initiatives for commercial loans to be made on more favourable payment terms and for modification of the banking regulations to allow a greater net participation in the loans. The participation of the big banks also depends on a favourable commitment on the part of the banks (some 150 of them) which account for 85% of the external debt with private financial institutions. Meanwhile, time is slipping away and the Baker Plan is in decline.

V

The external debt must be settled

The original merit of the Baker Plan was its recognition of the political content of the relations between debtors and creditors which justified official intervention. Up till then, the Policy of the United States Government had been one

of non-involvement, on the ground that the issue of foreign debt was an essentially private one. The wider role assigned to the World Bank in the achievement of structural adjustment was also important. However, these advantages did

not offset the weaknesses: the Plan's content had not been discussed in depth with other creditors (hence the difficulties of instrumentation); the Plan applies to only a few countries; the new resources are clearly insufficient; and the solution includes not one original element which would bring definite relief for the 15 debtors covered by the Plan. It is not surprising that this proposal of the United States Treasury Secretary has become so diluted that he is trying to disassociate his name from the Plan.

The Baker Plan has been strongly criticized by the United States Congress. A group of experts prepared a report for the Joint Economic Committee (1986) which linked the external debt crisis of the Latin American countries with the decline in export prices and the damage caused to United States farmers, especially in the wheat, maize and soya markets. This decline in international prices was caused by the need of the debtor countries to obtain foreign exchange for their financial payments, even at the cost of neglecting the food requirements of their peoples. On the other hand, the big commercial banks in the United States have improved their profitability. A situation has been reached, the report goes on, in which the United States Government has compensated the institutions which played an important role in precipitating the financial crisis and has punished the productive sectors which bore no responsibility for it. The report says that the Baker Plan does not offer a fundamental solution representing an advance over earlier policies, for it does not focus on the true dilemma of economic growth and interest payment. The Committee's report therefore recommends reducing interest rates, limiting interest payments to a specific proportion of the export income of the debtor countries (25%), and awarding a conditional devaluation of the debts of those countries which meet these objectives (1% a year for 10 years). The report estimates that this policy could reduce the interest payments of Latin America by US\$ 12 000 million a year from 1985, which would facilitate the increase of imports without which it is difficult to sustain a development process. Another work (Orlando and Teitel, 1985) also concludes that the increase in import capacity implicit in the Baker Plan permits the Latin American countries only very moderate growth and there-

fore an expansion of employment smaller than the growth of the labour force.

It is important that reports such as the ones described should begin to be given a public hearing, as has been done by Senator Bradley and Mrs. Fitzpatrick, at a time when signs of fatigue are already appearing in the Latin American countries and are leading in some cases to greater political tensions. Peru has been declared unqualified to receive new loans from the IMF; the decision of the United States Government to sell subsidized grain to the Soviet Union has stirred up political sectors in Argentina, including the military, which are calling for a change in the strategy for the negotiation of the external debt; Venezuela had to invoke the contingency clause in an agreement concluded with private banks scarcely two months after its signature, when oil prices continued to decline; Mexico has initiated a new reprogramming exercise with the IMF and the private banks in order to cope with the low oil prices and the political requirement for a return to growth in 1987 after the contraction of 1986; Brazil has postponed its renegotiation with the Paris Club owing to the demand of its official creditors that it should conclude an agreement with the IMF, a demand which Brazil had circumvented in its negotiations with the private banks (Financial Report, 1986).

This story is repeated time after time in the other Latin American countries. Every case demonstrates that from the stand point of the national interest (which is more general than that of the private commercial banks), the external debt cannot be paid or collected. For the debt to be paid, the debtor countries would have to generate a trade-balance surplus equivalent to a net transfer of resources incompatible with their status as developing countries. For the debt to be collected, the creditor countries would have to tolerate a trade-balance deficit equivalent to a reduction by an equal amount in the profits of their productive sectors (Geller and Vuskovic, 1983). While the external debt is a dead weight in the sense that a very large part of it represents an outflow of capital, the interest payments are simply a transfer of income and not remuneration for productive services.

All the criteria used in the renegotiation of the debt, including the studies which produced

optimistic forecasts of the feasibility of servicing the debt, are designed to intervene in the free play of market forces. Given the fiction of reprogramming which merely replaces old loans with new ones without supplying new financing and of loans whose only purpose is to complete the payment of interest, the credits remain on the books at their nominal value, which is higher than the current quotations in the secondary markets. In June 1986 the promissory notes of the external debt of the Latin American countries were quoted below their nominal value (Colombia 85%; Venezuela 78%; Brazil 77%; Uruguay 72%; Chile 69%; Argentina 66%; Mexico 60%). As a matter of simple arithmetic, it would be advantageous for the debtor countries to apply their trade-balance surplus to paying off the debt instead of paying interest. The development of a secondary lending market has been opposed with the argument that the debtor countries would be given an incentive to have deliberate recourse to moratorium. This market might stop undervaluing the loans, and interest rates would be forced upwards (Simonsen, 1985). However, the accumulation of reserves by the banks means a *de facto* marking-up of

the loans. The point now is that there should be a corresponding depreciation of the debts of the countries of the region. Without this depreciation it is going to be very difficult to find a permanent solution to the problem of the external debt, especially a solution in which the banks actually assume their share of the responsibility (Geller, 1983). If this depreciation could be agreed between debtors and creditors, the cost-benefit ratio for the world economy would be increased to the maximum. It really is a question of negotiating a solution that allows this practice which is already being used by some countries (Chile is one example) to become universal, so that a part of the debt is recovered by selling assets of enterprises operating in the country to purchasers of external debt notes quoted below their nominal value in the secondary markets. For the moment, this practice implies definite advantages for certain private national sectors or the denationalization of domestic assets when the purchasers are foreign investors. It is thus necessary to find other solutions which extend these advantages to the public sector as well and reduce the risks of denationalization of enterprises in the debtor countries.

VI

Adjustment with growth: a review of development issues

For the moment, the political negotiations are not proceeding along these lines. From different angles the recent discussions in international circles, especially since the Seoul meeting, have placed the emphasis on structural adjustment to cope with the problem of external debt. The Baker Plan introduced other considerations, in addition to the financial ones, which we have already commented on. They acknowledge the failure of the adjustment with stability which was tried in the period 1982-1985 and, what is perhaps even more important, they recognize that any relief will be temporary unless structural changes are made. Structural imbalance has been under discussion for a long time in Latin America. The experience of the past 10 years

with the adoption of neo-liberal doctrine in the economic policy of the majority of the countries of the region, especially those of the Southern Cone, was the result of a questioning of the traditional patterns of economic development followed by those countries. The crisis interrupted the liberalization process, which was already exhibiting some of its main shortcomings. However, economic analysis since the crisis seems to be reviving the positions argued at the beginning of the 1970s without taking into consideration the nature and number of these shortcomings.

The basic goals of the proposed model are to move the economies towards free trade, which means liberalizing the external sector and alio-

wing greater play to the laws of the market. In both cases the purpose is to ensure a better allocation of resources and to enable the private sector to assume the primary responsibility in the accumulation process. These goals are permanent ones but they are now being consolidated by the crisis. It is thought that the liberalization of the external sector is the only possible way in which the countries of Latin America can generate the necessary foreign exchange to pay their external debts. Moreover, government intervention is interpreted as interference in relative prices and distortion of resource allocation. The State is thus competing with private enterprises and impairing their accumulation capacity.

The proposed policy is based on increasing exports, and a set of measures is proposed for this purpose, including currency devaluation and tariff reductions. In particular, this reduction would reduce the cost of producing exports and would oblige domestic producers to increase their productivity in order to compete with imports. An effort is also being made to reduce the public sector deficit, mainly by cutting public expenditure but also by eliminating the price controls and subsidies which produce distortion.

There is no doubt that, not only in times of crisis but also in the periods of economic growth experienced by the Latin American countries, high priority should be given to the generation of foreign exchange. There is no great disagreement on this point. The problem lies in the instruments which are recommended. As has been argued above, devaluation can have its effect limited by the characteristics of Latin America's productive systems, while tariff reduction has shown a marked bias against employment, as was clearly the case in the trade-liberalization programmes of the 1970s, particularly in the manufacturing sector.

The questioning of policies does not necessarily mean returning to the instruments of the past or to the way in which they were used. On the contrary, development thinking in Latin America is being continuously renewed and critical examination of past experience suggests that there was an abuse of protection as a means of stimulating domestic production. In particular, this universal protection did not discriminate among activities and led to the production of a

great assortment of goods with high levels of inefficiency, as well as affecting the export capacity of non-traditional goods.

However, since the world economy is not recovering the rapid growth rates of the past, access to international markets will be neither easy nor stable. For this reason alone it will not be sufficient to rely exclusively on prices to stimulate exports. International trade is increasingly conducted by means of direct negotiations between countries (the recent agreement between Argentina and Brazil is one example). Consequently, other instruments will acquire increasing importance and will have to be explicitly included in the policies. This does not mean that there is no place for the use of the traditional instruments. The question is how to do it. Of course, the main objective is to generate foreign exchange, but it's also to ensure a high level of employment, so that it is necessary to identify the activities which can offer advantages in the world markets and contribute to rapid growth in employment.

Several proposals have been put forward in Latin America along these lines, notably the proposal of French-Davis (1985) that the tools of trade policy should be used selectively. This proposal requires the selective use of tariffs, with greater protection for the activities which can generate most jobs. This will eliminate the discrimination against jobs contained in the liberalization policies. The probable cost increase which might discourage exports could be offset by a subsidy which would form part of the policies. In addition, there would have to be a high and stable exchange rate, e.i., neither fixed nor entirely floating exchange rates should be adopted (to avoid in the latter case unnecessary fluctuations in this decisive price). It is therefore proposed that variations in the exchange rate should be regulated in accordance with medium-term forecasts of the balance of payments.

The second objective is based on the assumption that the private sector will react positively to a reduction in State participation. The Latin American experience does not offer grounds for optimism in this respect. Analysis of the investment process over the last 30 years (Tokman, 1985) shows the lack of independence in the accumulation process. Although investment in Latin America has been high, at least in compari-

son with the central countries, it depended very much on foreign investment and external financing. In fact, instead of the direct foreign investment of the 1950s, external financing came to predominate in the 1970s. This significant proportion of external investment or financing in domestic investment means that part of the control over the direction of the accumulation process is not in the hands of the countries of the region.

Analysis of the investment process shows that the public sector has accounted for a large part of capital formation. For Latin America as a whole the proportion of public investment in total investment has been three times higher than it was in the United States at the beginning of the century. In some countries of the region this proportion is over 50%. It can be concluded that not only have many of the decisions been taken outside the country but that internally the public sector has played a large part in the accumulation process. It can also be concluded that the private agents who supposedly ought to be the leaders in the process of economic growth have not fulfilled that function in recent decades.

These data could also be interpreted to mean that private investment was not dynamic because of excessive public intervention. The experience of the 1970s in the Southern Cone, and in Chile in particular, indicates that this interpretation and the consequent reduction of public investment prompted no reaction from the private sector, except for heavy financial speculation. The history of investment in Latin America suggests that in many countries the public sector has had to make investments in areas in which the private sector was not interested. This is certainly the recent experience in Brazil.

In the long term the lack of reaction on the part of private businesses may be accentuated by the crisis. The outward-looking strategy may stimulate a small number of businesses. At the same time, according to Foxley (1985), the micro-economic conditions are too weak to sustain investment. Companies are heavily in debt and they are paying interest rates generally two or three times higher than the international rate, and the macro-economic conditions are restricting the markets. The result is that companies are not only incapable of investing but also cannot solve their own debt problems.

Here the experience of Brazil is illuminating. The Brazilian economy is the only one in Latin America which has apparently introduced structural adjustments to cope with the increases in the price of oil (PREALC, 1985). The 1984 data on Brazil's balance of payments and the estimates for 1985 show an impressive growth in the trade-account surplus as a result both of the expansion of exports and of extensive imports substitution. Brazil was fully dependent on imported oil at the beginning of the 1970s. Oil imports were reduced from US\$ 9 400 million in 1980 to US\$ 4 800 million in 1984 by means of the heavy expansion of national production of alcohol, charcoal and coal. In addition, major substitutions were made in cement, pulp and paper, petrochemicals, fertilizers, and machinery and equipment. In fact, in some of these branches Brazil became an exporter as a result of the comparative advantages acquired (Barros de Castro, 1985).

These changes in Brazil's balance of payments are the fruit of a planned investment policy which has taken many years to mature. Throughout much of the 1970s the Brazilian Government undertook programmes and projects implemented directly or indirectly by the public sector. A large part of this investment amounted to direct State intervention in agreement with private enterprises. This is a clear example of an association between government and private business resulting in major investments.

The Brazilian Government used many tools to support private investment. It assured high rates of profitability by offering investment funds at negative interest rates. In conjunction with these incentives, the exports promotion policy combined direct negotiations promoted by the government to open up new markets with subsidies to provide incentives to the private sector in external markets (Beckerman, 1986; PREALC, 1982). As a result, manufactures today account for more than half of Brazil's exports.

Although the case of Brazil may be considered exceptional by reason of the negative interest rates, the opposite is the case in the majority of the countries of Latin America. The monetary and fiscal policies pursued during the adjustment period combined to produce high interest rates which had an adverse effect on investment decisions. The high interest rates

have been justified as a means of increasing domestic saving and encouraging the repatriation of the capital which had flowed out of the region. In fact, domestic saving appears to be relatively uninfluenced by interest rates (Kahn and Knight, 1985), and there is no incentive voluntarily to return the exported capital owing to the economic depression prevailing in the countries of the region. Of course, fiscal policy could help to increase saving and investment by penalizing the distribution of profits and rewarding their reinvestment. Moreover, restrictions on speculative movements of capital could temporarily enhance a more independent monetary policy designed to bring interest rates down. This does not mean that interest rates have to be negative. It is a question of combining a gradual liberalization of tariff protection with administered restriction of capital movements, so that the joint pressure on companies to achieve greater productivity coincides with incentives to invest.

It is not enough to correct the external imbalance and restore investment levels. There is also an historical social debt which has been increased by the crisis. To service this debt it is necessary to generate productive jobs, increase real wages and cater for the essential needs of the poorest groups.

The crisis has brought about a significant increase in unemployment and in underemployment through expansion of the occupations most vulnerable thereto (informal and public jobs, and employment in tertiary activities and small businesses). It is therefore necessary both to create jobs and to correct the existing imbalances in the structure of employment which have led to losses of productivity in the economy. This imposes certain conditions on the adjustment, including the need to avoid certain measures which seek to achieve macro-economic balance but have the effect of aggravating the social situation. This happens when the reduction of the public sector following cutbacks in expenditure brings about a decline in public employment. This sector has played an important role in absorbing manpower over the past three decades and, in particular, it has played an anticyclical role in the present situation and prevented an even sharper rise in the unemploy-

ment rate. Any reduction in public employment should be offset by increased absorption in the private sector. Unfortunately, the few countries which tried to achieve this during the 1970s were not effective in shifting employment from one sector to the other, and the inevitable result was open unemployment (PREALC, 1985 b).

An analysis should also be made of the relationship between wages and profits. A policy to promote private investment might propose an increase in profit margins leaving little room, if any at all, for increases in real wages. This issue seems even more important when it is remembered that real wages have declined since the outbreak of the crisis and that the majority of the countries of Latin America have undergone a process of democratization. From the political standpoint governments need to encourage the restoration of real wages and from the technical standpoint it seems necessary to explore ways (not necessarily new ones) of combining the political requirements with the requirements of growth. Policies for the distribution of income or ownership could be agreed jointly with a view to increasing productivity.

Finally, attention must be given to the question of social benefits, in particular social expenditure in favour of the poor and unemployed. The experience of the past 10 years shows clearly that such programmes are the first to be cut back when a reduction of public expenditure is sought. Moreover, the poorest sectors are the ones that have suffered most during the crisis and it is unfair, as well as unfeasible in the present political conditions in Latin America, to think of further cutbacks in the public budget affecting them. On the contrary, the challenge is how to extend the cover provided by these programmes. In other words, the problem is how to furnish resources to the public sector to cover these expenditures rather than to cut back such high priority programmes. This ought to lead to an analysis of policies of fiscal expenditure and income, and not simply from the limited perspective of encouraging the process of private accumulation. It is thus necessary to explore the restructuring of public expenditure. There is no doubt that much public expenditure is excessive: military, transfers to weakened financial systems, and subsidies which benefit the upper levels of the middle class.

VII

Conclusion on adjustment

The problem which Latin America must tackle is not one involving extreme decisions. It is sufficient to point out that the democratic nature of many governments of the region would not allow exclusive solutions, especially if use is made of mechanisms for consulting the organized social forces and the political sectors. Free trade should not be the solution for a closed economy. Public intervention should not run counter to the laws of the market. The region's

experience is that extreme solutions do not work efficiently and that a balanced approach is needed. This means greater selectivity in the use of the instruments and improved timing in the interventions of the public sector. The important role of the State in the Latin American economies is beyond discussion. The question is how to make this intervention effective in a democratic framework.

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