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ADJUSTMENT POLICIES AND RENEGOTIATION OF THE EXTERNAL DEBT

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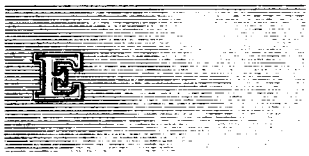

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ADJUSTMENT POLICIES AND RENEGOTIATION OF THE EXTERNAL DEBT

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/E. TOWARDS

/Introduction

Introduction

In the last two years many Latin American countries have applied adjustment policies and taken steps to renegotiate their external debt. In essence, the two processes represent an initial, short-term response, in terms of economic policy, to the challenge posed by the profound and widespread economic crisis which has affected the region since 1981.

In some cases, the adjustment policies -designed to reduce the external disequilibrium- have been applied in conjunction with stabilization programmes aimed at slowing down the rate of inflation. In practice, the results achieved reflect the effect of both policies as well as the impact of external factors over which the national economic authorities have little or no control.

Up to now, both the adjustment process and the renegotiation of the external debt have proved very costly for the countries of the region, while between 1981 and 1983, they did achieve a substantial reduction in the deficit on the balance-of-payments current account, thus meeting the basic objective of the adjustment policies, this was due almost exclusively to the tremendous reduction in the volume of imports. Under such circumstances, the adjustment has been sharply recessive in nature and in many countries has gone hand in hand with a considerable slowdown of domestic economic activity and a deterioration of the employment situation. At the same time, the debt-renegotiation agreements, which have enabled them to avoid even more serious balance-of-payments crises, have also contributed towards a sharp increase in the cost of external financing to the Latin American countries, as a result of which the benefits of such financing have been distributed very unevenly between the countries and the creditor banks. Finally, in many cases, the stabilization programmes have only slightly reduced the rate of inflation.

This document presents a preliminary description and analysis of the policies applied and the results obtained through internal adjustments and the renegotiation of external commitments. It is based on the various experiences of the region in this regard and is not intended to reflect the specific experience of any given country or group of countries.

The purpose of this study is not to give precise and generally applicable formulas for overcoming the shortcomings noted up to now in the adjustment and renegotiation processes. It is recognized that there is no easy solution to the problems faced by the countries of the region in this regard and that in the design and application of economic policies, account must be taken of the special characteristics of each country and of the fact that there are often distinct differences between the Latin American countries.

All in all, however, two aspects of the adjustment and renegotiation processes that are considered to be generally valid are stressed throughout this report.

The first of these is the severe limitation which the prevailing external environment imposes on economic policy in the great majority of countries of the region. It is evident that unless the former dynamism of international trade is

/restored and

restored and the recent rend towards increased protectionism in many industrialized economies is clearly reversed, it will become more and more difficult and costly to foster the growth of Latin American exports; consequently, the same will be true of any effort to progress from the current recessive adjustment -based on an untenable contraction of imports- to a growth-oriented adjustment, based on the expansion and diversification of exports. Similarly, it is evident that if external financing continues to be as scarce as it was during the period 1982-1983 and international interest rates remain close to the high levels now prevailing, the region will continue making a real transfer of resources to the exterior and a greater proportion of the deficit on current account will have to be covered through costly adjustment policies.

The second general aspect is the excessively aggregated nature of the economic policies applied to reduce the external disequilibrium and the cost which they entail in terms of the slowing down of economic activity and the reduction of employment. In some cases, at least, this cost could have been lower if the economic policy instruments had been used more selectively and pragmatically, bearing in mind the fact that the reallocation of resources is a more rigid and slow-moving process, especially over the short term, in economies as structurally heterogeneous as the Latin American ones.

Finally, mention should be made of the emphasis which has been placed in this study on the issue of adjustment. As is well known, this is a process which is more closely linked to short-term policies and conjunctural problems than to long-term strategy and the major structural changes that are characteristic of the development process and which make it possible. The fact that the question of adjustment is studied in detail does not mean that the importance of the longer term aspects -which are still essential- are being underestimated, but rather that an effort is being made to study and understand a given problem- a problem which poses one of the greatest challenges of the present time and which must be overcome if any progress is to be made in future towards achieving a more dynamic, autonomous and equitable development.

/I. THE

I. THE ECONOMIC CRISIS OF LATIN AMERICA */

A. THE ECONOMIC CRISIS

Over the last three years, Latin America has experienced its most serious, prolonged and widespread economic crisis since the Great Depression of the 1930s. This crisis has been caused by a complex set of factors; although external factors have played the main role in creating this situation, the shortcomings and excesses of national economic policies have also played a decisive part in it. The crisis has seriously affected all the economies of the region, although with varying degrees of intensity, and in most of them it shows no sign of abating.

From the long-term historical perspective of Latin American development over the last forty years, it may be said that the most important and unusual feature of the current situation is the fact that so many economies of such different types have suffered the impact of the crisis. Another unique and no less disturbing and unusual characteristic of the crisis has been the widespread, simultaneous and persistent deterioration of most of the main economic indicators.

Thus, as may be seen in table 1, from 1981 onwards there was a sharp drop in the economic growth rate, which fell in absolute terms in 1982 and again dropped, even more sharply, in 1983. As a result of this trend and of the increase in population, the per capita product of Latin America fell in each of the last three years and in 1983 was almost 10% lower than in 1980. Moreover, this decline was widespread, inasmuch as, after having dropped, in 1982, in all the countries of the region for which comparable data are available, except Panama, the per capita product again fell in 1983 in all of them with the sole exception of the Dominican Republic.

Needless to say, this pronounced slowdown went hand in hand with a sharp rise in open unemployment -which in some of the main urban centres rose to over 15% and even 20% of the labour force- and an increase in the various forms of underemployment. Moreover, the negative social effects of the deterioration of the employment situation were further aggravated, in many countries, by a simultaneous and substantial decline in real wages.

Despite the slowdown of economic activity, the increase in unemployment and the decline in wages -as well as the weakening of inflationary pressures from abroad-, the rate of increase of prices continued to rise in most of the Latin American economies and in the region as a whole reached unprecedented levels in 1982 and again in 1983. Indeed, the simple average rate of increase of consumer prices rose from 29% in 1981 to 47% in 1982 and around 70% in 1983, while the average rate weighted by the population rose even more, i.e., from 61% in 1981 to around 86% in 1982 and over 130% in 1983.

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*/ This discussion is based on and brings up to date the concepts presented in the document entitled The international economic crisis and Latin America's capacity to respond to it (E/CEPAL/G.1249, Santiago, September 1983).

/Table 1

Table 1

LATIN AMERICA: MAIN ECONOMIC INDICATORS a/

	1975	1977	1978	1979	1980	1981	1982	1983b/
Gross domestic product at market prices (billions of dollars at 1970 prices)	263	292	305	326	345	350	347	335
Population (millions)	303	318	326	334	343	351	359	369
Per capita gross domestic product (dollars at 1970 prices)	868	916	936	974	1 007	997	965	911
Per capita gross national income (dollars at 1970 prices)	867	918	929	972	1 009	985	938	883
	Growth rates							
Gross domestic product	3.7	5.0	4.7	6.6	5.9	1.5	-1.0	-3.3
Per capita gross domestic product	1.2	2.4	2.2	4.0	3.4	-0.9	-3.3	-5.6
Per capita gross national income	-0.3	2.5	1.3	4.6	3.8	-2.4	-4.8	-5.9
Consumer prices c/	57.8	40.0	39.0	54.1	52.8	60.8	85.6	132.9
Terms of trade (goods)	-14.0	6.0	-10.9	4.4	4.2	-7.3	-7.0	-7.2
Current value of exports of goods	-7.1	18.9	7.5	34.3	30.1	7.0	-8.5	-1.3
Current value of imports of goods	7.0	14.8	13.8	25.8	32.3	7.6	-19.9	-28.7
	Billions of dollars							
Exports of goods	35.0	48.2	51.8	69.6	90.5	96.8	88.6	87.5
Imports of goods	40.4	48.3	55.0	69.1	91.5	98.4	78.9	56.3
Trade balance (goods)	-5.4	-0.1	-3.2	0.5	-1.0	-1.6	9.7	31.2
Net payments of profits and interest	5.7	8.5	10.5	14.1	18.5	28.0	37.0	33.9
Balance on current account d/	-13.7	-11.7	-18.3	-19.6	-27.7	-40.4	-36.4	-8.5
Net capital movements e/	14.7	17.3	26.3	29.0	30.2	38.1	16.8	5.5
Global balance f/	0.8	5.6	8.1	9.4	2.2	-2.3	-19.8	-3.0
Gross global external debt g/	89	105	133	166	205	259	290	310

Source: ECLA, on the basis of official figures.

a/ The figures for the product, population and income relate to the following countries: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela. The consumer price figures refer to all the above countries, plus Barbados, Guyana, Jamaica and Trinidad and Tobago (with the exception of Guyana in 1982 and of Guyana and Haiti in 1983). The data for the external sector refer to all the countries listed other than Jamaica, except in the case of the figures for the external debt, which also exclude Barbados and Trinidad and Tobago.

b/ Preliminary estimates, subject to revision.

c/ Variation from December to December.

d/ Includes net unrequited private transfer payments.

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

f/ Corresponds to the variation in international reserves (with the opposite sign) plus counterpart entries.

g/ 1975-1980: Includes public and State-guaranteed private external debt plus the long- and short-term non-guaranteed debt with financial institutions reporting to the Bank for International Settlements. Excludes both guaranteed and non-guaranteed debts with other commercial banks, as well as suppliers' credit without State guarantees. The 1981-1983 period includes official estimates of the total external debt; the figures therefore have a broader coverage and cannot, in a strict sense, be compared with those of the preceding period.

/These unfavourable

These unfavourable changes on the domestic front were closely linked with other, no less negative ones in the external sector, which appeared most clearly in the serious balance-of-payments crises, the frequent and often enormous increases in exchange rates, the depletion of international reserves and, very especially, the untenable and exhausting burden represented by the service of the external debt.

The fact that the current crisis is exceptionally profound and widespread becomes even more evident when it is considered in the context of the evolution of Latin America during the postwar period. From this standpoint, the recent economic contraction marks the end of the prolonged stage of growth and transformation which began in most of the Latin American countries following the Second World War and which was generally characterized by an appreciable degree of economic dynamism. Indeed, between 1950 and 1980, the gross domestic product of the region grew at an average annual rate of 5.5%, which meant that in 1980 the volume of total economic activity was five times that of 1950. Industrial production -which increased more than sixfold during this time- and capital formation grew at an even higher rate and, the investment coefficient rose gradually but steadily from the mid-1960s onwards.

In addition to representing the end of the prolonged growth cycle of the postwar period, the many serious economic problems which began to show up throughout the region from 1981 onwards also brought about a crisis in the development strategy which many Latin American countries had adopted, to a greater or lesser degree, during the 1970s and especially after the first series of oil-price increases. This strategy consisted of taking advantage of the unique conditions which were created on the world economic scene after the first oil crisis, particularly in the financial field, to attract substantial and rapidly increasing amounts of external savings. Thanks to the income from these resources and also to the substantial and steady increase in the volume of their exports during the period 1976-1980, the region was able constantly and significantly to raise the volume of its imports. It was thus able, during that time, to maintain an economic growth rate which, although lower than the exceptionally high rate of the first half of the 1970s, was considerably higher than the growth rate of the industrialized countries. As a matter of fact, not only did their easy access to external credit enable most of the Latin American countries to avoid with relative ease the effect of the international recession of 1974-1975, but it also enabled them, during the next five years, considerably to dissociate their overall economic growth from that of the industrialized countries.

Nevertheless, it was inevitable that this situation, which was up to a point unprecedented in the contemporary economic history of the region, should also require an extraordinary increase in the external debt, as well as a very rapid increase in the current-account deficits of most of the Latin American countries. Thus, in practice, a country's ability to maintain a relatively high growth rate depended more and more directly on its ability to attract increasing amounts of external resources and to continue rapidly increasing the volume of its exports.

These were the circumstances which prevailed when Latin America began to feel the full impact of the prolonged and intense recession that had started in the industrialized economies in 1980. Thus, the region was obliged to address itself to the profound changes which occurred in the international capital markets from that year on.

/These events

These events affected the development of the region in three main areas. The first and most traditional was the deterioration of the terms of trade; the second was the dramatic rise in the real level of international interest rates, and the third -and most devastating- was the sharp drop in the net inflow of capital. Although, as will be seen, in many countries the origin and magnitude of the crisis was largely due to the shortcomings of the economic policies applied, to social and political conflicts and even to natural disasters, it was the unique and unprecedented convergence of unfavourable external factors that was mainly responsible for the unleashing, the duration and the general nature of the crisis, as well as the high cost of the adjustment process and the fact that such a large number of countries were obliged to take steps to renegotiate their external debt.

B. EXTERNAL CAUSES

1. The international recession and the deterioration of the terms of trade

As is well known, the early 1970s saw the culmination of the prolonged phase of growth of the central economies which had begun in the early 1950s. During that period, economic activity had increased vigorously and steadily and international trade had grown even more rapidly, at an unprecedented rate. Nevertheless, because of certain structural changes that tended to slow down the growth rate of some of the main industrialized countries, which had begun even before the first major rise in the international price of oil, and also because of the impact of the sharp rise in the cost of oil, the central economies suffered, in the mid-1970s, the most serious contraction of the entire postwar period.

Although economic activity in the industrialized countries began to grow again from 1976 onwards, it did not come near to regaining the intensity of the preceding period. Moreover, in addition to being relatively weak, this recovery was marred by other problems: on the one hand, fixed investment was low and, on the other, unemployment and inflation rates somewhat surprisingly, remained much higher than they had been up to 1973.

It was largely as a result of these circumstances that the second series of oil-price increases had a much more serious effect on the industrialized economies than the previous oil crisis and that the economic policies applied in response to it were also very different.

Indeed, as may be seen in table 2, although the recession which began in 1980 was less severe than the recession of 1974-1975, it had a much more lasting effect on the level of economic activity in the industrialized countries. Moreover, since a much higher proportion of the labour force of the industrialized countries was unemployed as the new recession began than had been the case at the beginning of the previous recession, the stagnation of economic activity brought with it the highest unemployment rates recorded in the industrialized countries since the Great Depression of the 1930s.

/Table 2

Table 2

OECD: GROSS DOMESTIC PRODUCT, INFLATION AND UNEMPLOYMENT

(Annual growth rates)

	1962-1971	1973	1974	1975	1976	1977-1979	1980	1981	1982 a/
Gross domestic product	5.0	6.1	0.7	-0.5	5.3	3.6	1.3	1.2	-0.5
Consumer prices	3.7	7.8	13.4	11.3	8.6	8.9	12.9	10.6	8.0
Unemployment b/	3.0 c/	3.2	3.5	5.2	5.3	5.2	5.8	6.8	8.5

Source: OECD, Economic Outlook (various issues).

a/ Preliminary figures.
b/ Percentages.
c/ Refers to the period 1966-1972.

/As had

As had been the case with other recessions, the stagnation of economic activity in the industrialized countries had a negative effect on their demand for imports and consequently on the rate of growth of international trade. This time, however, many of these negative consequences were aggravated by the revival of protectionist practices in the trade policies of many of the central economies, which applied them more frequently and more strictly as unemployment grew and the recession continued. Under such circumstances, the volume of international trade, the accelerated growth of which had played a fundamental role in the growth of the world economy during the postwar period, grew very little in 1980, was almost completely stagnant in 1981, and fell by 2% in 1982.

This evolution of international trade had an extremely harsh effect on Latin America, as it brought about a sharp drop in the international prices of most commodities and Latin America's terms of trade fell steadily and sharply during each of the last three years, with the total cumulative loss amounting to around 20%. Although during this period there was a deterioration in the terms of trade of both the oil-exporting countries and of the other economies of the region, the loss was particularly serious in the case of the non-oil-exporting countries, whose terms of trade had already declined sharply during the triennium 1978-1980. Thus, between 1977 and 1983, the terms of trade of the non-oil-exporting countries fell by almost 38%, so that their average for the period 1981-1983 was considerably lower than it had been during 1931-1933, the most critical period of the Great Depression.

2. The high cost of external credit

The exceptionally high interest rates applied in recent years on the international financial markets also had extremely serious repercussions on Latin America.

Indeed, because of the fact that most of the industrialized countries had given high priority to reducing inflation, that in so doing they had placed special emphasis on controlling the money supply and that some of them had persistently high deficits in their public finances, interest rates rose markedly in the main international financial centres from 1978 onwards. In real terms, during the last three years interest rates reached the highest levels recorded since the Great Depression. This situation was also in marked contrast with that which had prevailed during the crisis of the mid-1970s, when the real interest rate was constantly negative (see figure 1).

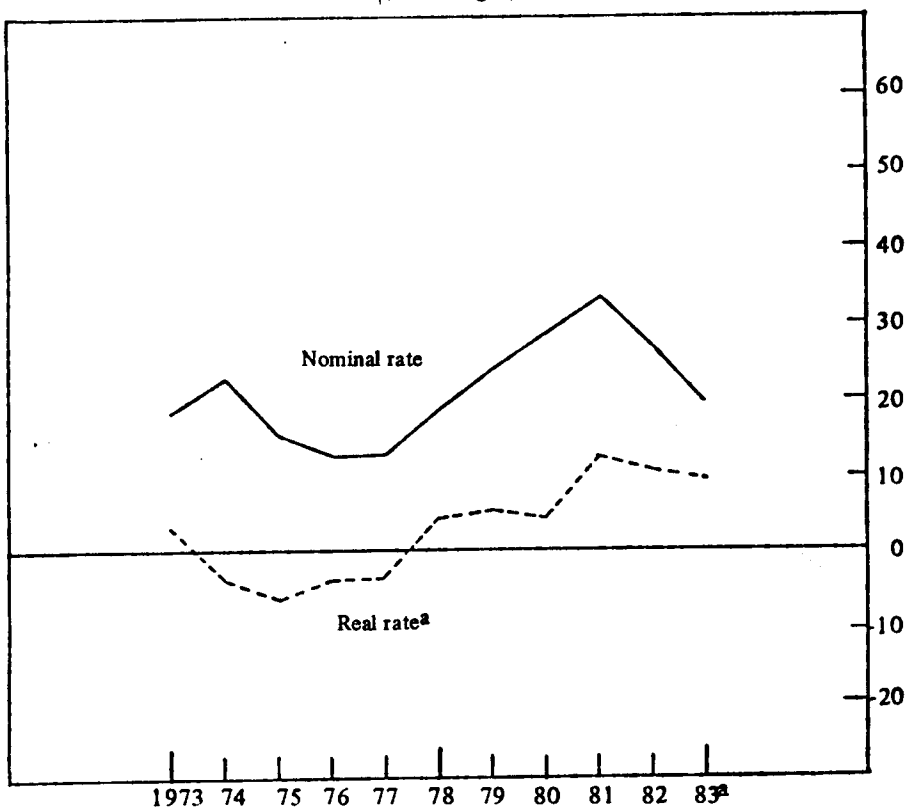
These exceptionally high interest rates contributed towards unleashing and aggravating the crisis of Latin America in two ways. On the one hand, by putting a halt on the recovery of the industrialized economies, they tended to reduce the demand for exports from Latin America. On the other hand, by increasing the service of the external debt, they greatly increased the deficit on current account and, as will be seen later on, contributed towards generating a considerable transfer of resources to the exterior.

/Figure 1

Figure 1

INTEREST RATES FOR 180-DAY EURODOLLAR DEPOSITS

(Percentages)



Source: Morgan Guaranty Trust Company of New York, *World Financial Markets*, various issues.

[a]Nominal six-month LIBOR rate, deflated by the consumer prices of the industrialized countries.

[b]January-October average.

/Thus, Latin

Thus, Latin America's gross remittances for interest payments rose at a dizzying rate, from somewhat under US$ 6.9 billion in 1977 to over US$ 39 billion in 1982. Although they decreased to approximately US$ 36 million in 1983, as a result of the decline during that year of nominal interest rates on the main international financial markets, this amount was still almost six times higher than the total recorded only six years before. The fact that the increase in international interest rates played a decisive role in this regard becomes quite clear when the increase in interest payments is compared with the increase in the external debt. Whereas between 1977 and 1983 the total debt rose by 195%, interest payments rose by 415%. This extraordinary increase meant that the part of the current-account deficit which was attributable to net payments for interest and profits rose steadily. Indeed, this part of the deficit, which in 1975 was only slightly over 42%, rose to 75% in 1981, to somewhat over 100% in 1982 and to an unprecedented level of 400% in 1983 (see table 1).

3. The decline of the net inflow of capital and the transfer of resources

All things considered, however, and despite the effect of the aforementioned factors, what most contributed to aggravating the crisis was the sharp drop in the net inflow of capital, which began in 1982 and increased sharply in 1983. The negative impact of this decline in the inflow of loans and investments was particularly severe for three reasons. In the first place, it occurred after a long period during which the net inflow of loans and investments had risen considerably and during which not only the evolution of the external sector but also the overall operation of many Latin American economies had begun to depend considerably on the constant increase in external financing. In the second place, this phenomenon was procyclical in nature, as it occurred simultaneously with the decline in the purchasing power of exports and the severe deterioration in the terms of trade caused by the international recession. In the third place, the decrease in the net inflow of capital was of an unusual magnitude and this, along with simultaneous increase in net payments for interest and profits, led to a dramatic reversal in the direction of the transfer of resources between Latin America and the rest of the world.

Table 3 clearly shows how exceptionally serious this situation was. It shows how the net inflow of capital, after increasing steadily and substantially during most of the past decade and after reaching a record US$ 38 billion in 1981, fell to less than US$ 17 billion in 1982 and to an estimated amount of barely US$ 5.5 billion in 1983. The table also shows that the magnitude of the contraction does not change much -although, of course, the absolute figures are different- when one bears in mind the transactions that are not recorded in the balance of payments (so-called "errors and omissions"), which usually, -although not always, reflect the outflow, or "flight", of capital. In that case, the actual net inflow of capital falls from around US$ 49 billion in 1981 to approximately US$ 12 in 1983.

/Table 3

Table 3

LATIN AMERICA: NET INFLOW OF CAPITAL AND TRANSFERS OF RESOURCES

(Billions of dollars and percentages)

	Net effective capital inflow a/	Unrecorded transac-tions b/	Net capital inflow	2/1	Net pay-ments of profits and interest	Transfer of resources		Exports of goods and services	6/8	7/8	Real transfer of resources c/	
	(1)	(2)	(3) (1+2)	(4)	(5)	(6) (1-5)	(7) (3-5)	(8)	(9)	(10)	(11)	(12)
1970	4.1	0.1	4.2	0.9	3.0	1.1	1.2	17.9	6.5	6.7	1.2	1.2
1971	5.2	-0.1	5.1	-2.3	3.2	2.0	1.9	18.8	10.3	9.7	1.8	1.7
1972	5.9	1.3	7.2	22.9	3.3	2.6	3.9	21.8	11.9	18.1	2.3	3.5
1973	8.8	-0.7	8.1	-7.5	4.4	4.4	3.7	30.3	14.3	12.1	3.4	2.9
1974	13.3	-1.7	11.6	-13.1	5.3	8.0	6.3	46.0	17.5	13.7	4.7	3.7
1975	16.4	-1.7	14.7	-10.3	5.7	10.7	9.0	43.7	24.3	20.4	5.7	4.9
1976	18.9	-0.7	18.2	-3.6	7.0	11.9	11.2	50.0	23.9	22.5	6.2	5.9
1977	15.8	1.5	17.3	9.8	8.5	7.3	8.8	58.7	12.3	15.0	3.6	4.3
1978	24.6	1.7	26.3	7.4	10.5	14.1	15.8	64.5	22.0	24.6	6.5	7.3
1979	27.4	1.6	29.0	5.8	14.1	13.3	14.9	85.8	15.5	17.4	5.4	6.0
1980	35.9	-5.7	30.2	-16.1	18.5	17.4	11.7	110.9	15.6	10.5	6.1	4.1
1981	48.8	-10.7	38.1	-21.8	28.0	20.8	10.1	119.6	17.4	8.5	6.8	3.3
1982	26.9	-10.1	16.8	-37.5	37.0	-10.1	-20.2	108.9	-9.2	-18.5	-3.2	-6.5
1983 d/	12.0	-6.5	5.5	-54.1	33.9	-21.9	-28.4	105.0	-21.0	-27.0	-7.7	-10.0

Source: 1970-1981, International Monetary Fund, Balance of Payments Yearbook; 1982-1983, ECLA, on the basis of official data.

a/ Equals net inflow of capital less unrecorded transactions.
b/ Corresponds to the "errors and omissions" entry of the balance of payments.
c/ The values shown in columns (6) and (7) are deflated by the index of the unit value of Latin American imports of goods and services (1970 = 100).
d/ Preliminary figures.

/Naturally, such

Naturally, such a radical drop in external financing would have been dangerous under any circumstances. In this case, however, its negative effect was aggravated by the fact that net payments for profits and interest increased considerably at the same time. Up to 1981, the net amount of loans and investments received from abroad was well over the amount paid out for interest and profits in return for foreign capital. The net result of these financial flows was therefore favourable to the region and enabled it to purchase abroad a greater real volume of goods and services than would have been possible with the purchasing power of its exports.

This situation changed drastically, however, beginning in 1982. The new and considerable increase in payments for interest and profits -which rose from US$ 28 billion to US$ 37 billion- and, especially, the drastic reduction in the net inflow of capital, mentioned above, brought about a reversal in the balance between the two financial flows. This meant that, for the first time in its recent history, Latin America had to transfer to the exterior a considerable amount of real resources, estimated at between US$ 10 billion and US$ 20 billion.*/

The situation continued to worsen in 1983, when the positive effect of a slight decline in payments for interest and profits was neutralized by the new and serious decline in the net inflow of capital.

Thus, even under the most conservative estimates, during the last biennium, Latin America transferred abroad resources amounting to over US$ 30 billion. However, this figure -the equivalent of 15% of Latin American exports of goods and services for the same period- underestimates the magnitude of the reversal represented by the sharp drop in the net inflow of capital between 1981 and 1983, viewed from the standpoint of the region's importing capacity. Indeed, as may be seen in table 3, in 1981 the positive difference between the net inflow of capital and payments for interest and profits added to the region's importing capacity the equivalent of about 17% of its exports of goods and services. In 1983, on the other hand, the negative difference between these two financial flows took away from the region's importing capacity the equivalent of around 21% of its external sales of goods and services. Consequently, the change which took place in this regard in just two years was equivalent to a deterioration in the terms of trade of around 38%. To appreciate fully what this means, one should remember that the actual decline in the terms of trade during this period amounted to about 14%. Consequently, as regards the region's importing capacity, the negative effect of the drop in the net inflow of capital, together with the increase in payments for profits and interest, more than doubled the negative effect of the deterioration in the terms of trade.

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*/ The difference between the two figures depends on whether or not the estimate takes into account the "errors and omissions" item in the balance of payments. Since it is quite likely that in 1982 this item was mostly made up of outflows of capital, the lower figure may better reflect the transfer of resources that actually took place. It should be noted, however, that the amount of the reversal in the transfer of resources that took place between 1981 and 1982 is practically the same under either method of estimation (see table 3).

/C. INTERNAL

C. INTERNAL CAUSES

As already indicated, elements of an internal nature have also had a decisive influence in the gestation and growth of the economic crisis now besetting Latin America. Of course, the specific nature and relative importance of these factors has been very different in the different national experiences. Thus, in some of them -and especially in some Central American countries- the effects of the profound political changes and the long and painful civil strife which have marked the recent history of some countries of the region have been especially decisive, while in other cases the negative consequences of the shortcomings or excesses of the economic policies applied have played a more important role. Among the latter, two factors which have had a particularly strong impact were the policies of excessive spending, in some countries, and the monetarist-type policies, based on the principle of great openness to the exterior, in others. Paradoxically, however, the prolonged application of these two types of policies, based on very different theories and ideologies, had one major point in common: their dependence on a development strategy which relied excessively on external indebtedness.

1. Excesses in external indebtedness policy

In essence, this strategy was the domestic counterpart, on the one hand of the situation of abundant international liquidity which prevailed between 1974 and 1981, and on the other of the extremely expansive policy followed during that period by the private international banks in their relations with the semi-industrialized countries.

Strictly speaking, it was the interaction between this attitude on the part of the international banks and the external indebtedness strategy followed by many Latin American countries which to a large extent made it possible to mobilize the abundant financial surpluses generated in the international system from the time of the first oil crisis. That interaction also left its mark on the economic evolution of many countries of the region during that period. Finally, it was the abrupt change in the international banks' perception of the viability of development based on this strategy which constituted one of the main factors behind the present crisis.

The underlying foundation of the indebtedness strategy was the simple and not very novel idea of the desirability of supplementing domestic savings with resources from the exterior so as to increase investment and the rate of economic growth. However, the attraction and practical significance of this facet of the development process acquired radically different dimensions from around the mid-1970s onwards, when the volume of the external resources available in international capital markets increased and, in particular, when the real interest rates charged for the use of those resources actually became negative in those years.

The possibilities opened up by this new international financial context were initially exploited by many Latin American countries in order to relieve the adverse effects which the recession in the industrialized economies and the sudden and substantial rise in the international price of petroleum had had on the

/purchasing power

purchasing power of their exports. Thus, thanks partly to the procurement of a greater volume of external resources, in 1974 the region not only maintained a high rate of economic growth of close to 7% but also managed to increase its gross domestic product by close to 4% in 1975. This evolution of economic activity in Latin America was in marked contrast to that of the central countries, where, as already noted, economic activity was quite stagnant during that biennium.

Later on, in spite of the strong and sustained expansion of their exports, the majority of the economies of the region continued to make intensive use of the abundant financial resources offered by the private international banks, -with the result that the persistent accentuation of external indebtedness became both a salient characteristic and a basic requirement of their development processes.

The expansion of external indebtedness thus became a double-edged weapon. On the one hand, it made it possible to finance higher levels of imports and capital formation, thereby helping to maintain rates of economic growth in many countries that were higher than would have been possible otherwise. On the other hand -and to some extent this was a result of the very dynamism of the external debt as well as of its terms and forms- after a short time the expansion of external indebtedness made it necessary to pay increasingly huge amounts to the exterior in respect of interest and capital. Thus, the real transfer of resources represented by a given amount of new loans was rapidly diminishing, whereas there was a marked increase in the sensitiveness of the economy to possible declines in the amount of financing coming from abroad.

This new form of external vulnerability, the real implications of which were, as we have already seen, dramatically revealed in 1982, was not, however, the only negative effect of the exaggerated use of external indebtedness. An additional consequence, less direct but no less serious, was the decisive support given through the excessive use of external resources to the application and above all the prolongation of policies which had a strong influence on the generation of the present crisis, such as those which resulted in a very exaggerated expansion of domestic expenditure and a pronounced drop in the real exchange rate.

2. The over-expansion of domestic expenditure

Although the excessive increase of domestic expenditure played a paramount role in the inflationary and balance-of-payments crises suffered by many Latin American countries in the 1970s, its impact was especially significant in the events leading up to the current crisis in some of the oil-exporting nations of the region.

In these countries, the extraordinary increase in the value of exports caused by the rise in the price of petroleum and, in some cases, by the very marked expansion in the volume of external sales, was partly responsible for strengthening the balance of payments and at the same time enormously increasing the public-sector income. The export boom, also made for a considerable increase in the confidence of international banks in the growth prospects of the oil-exporting countries, with the result that financial institutions showed greater willingness to channel plentiful additional resources to the countries concerned.

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In this context of unprecedented abundance of public and external resources -and of favourable expectations with regard to future trends in the international price of petroleum-, development strategy succeeded in accelerating, likewise exceptionally, the economic growth rate and structural changes in the economy. The main instrument chosen for accomplishing this task was an expansion of public expenditure -both current expenditure and investment- which helped to strengthen the dynamic effects deriving from the external sector.

Stimulated by the buoyances of global demand, production also grew at an intensive rate. However, owing to the inevitable short-term rigidities in supply in some sectors, and especially because of the unusual rise in the level of production and domestic expenditure, the volume of imports increased even more rapidly. In fact, in spite of the notable upswing in external sales, the import coefficient rose higher than the export coefficient. Nevertheless, financing the trade deficit presented no difficulty, since at the same time the net inflow of capital increased. Thus, despite the steady enlargement of that deficit, international reserves continued to grow, and it was unnecessary to alter the exchange rate, whose real value was, however, declining since, owing to the boom in domestic demand, inflation was speeding up. Since, in addition, the exaggerated expansion of public expenditure was financed out of resources provided by foreign banks, the external debt also increased at a very rapid pace. In this way, the possibility that the economy could go on expanding without major inflation or balance-of-payments problems became closely dependent on the growth of external indebtedness.

Since the expansion of such indebtedness primarily depended, in its turn, on the policies of the banks, which were influenced both by the size of the financial surpluses they could attract and by their assessment of the debtor countries' prospects, the problems implicit in the development strategy chosen by borrower countries began to loom up in mid-1981 when the international price of petroleum ceased to follow a rising trend.

The threat represented by this situation was promptly grasped by many economic agents who opted for a transfer of their capital abroad in anticipation of an exchange-rate crisis. This attitude, besides causing international reserves to drop still further, helped to increase the doubts and reticence of the international private banks, with the result that it became even more obvious that an exchange-rate crisis was inevitable.

In these circumstances, the economic authorities were forced to make a drastic alteration in the parity of their currency, to take steps to renegotiate the payments on their external debt and to put strict adjustment programmes into practice. The immediate consequences of these measures were an abrupt acceleration of the inflationary process, a considerable rise in unemployment and a perceptible drop in the level of economic activity, and, in particular, in investment expenditure.

/3. Stabilization

3. Stabilization policies and the lag in exchange rates

Inflation -which up until the beginning of the past decade had been a serious problem only in a relatively small number of Latin American countries- showed a tendency during the period 1973-1975, to become general throughout the region for the first time, and began to worsen again in 1979. Faced with the need to control inflationary processes, which frequently owed much to external factors, many countries applied stabilization policies which, while successfully monerating price increases, were also partially responsible for slowing the pace of economic growth.

However, it was in the monetary experiments made by the Southern Cone countries -which at the same time applied strategies aimed at opening up their economies in the areas of trade and/or finance, and at shifting the emphasis placed on the roles of State and market, giving much more importance to the latter -that anti-inflationary policies had their most decisive effect on the gestation, depth and duration of the crisis.

Although the decision to apply these policies was based primarily on a theoretical conception of the way to reduce the rate of inflation, stabilize the balance of payments and manage economic policy, in economies which were wide open to the exterior in the fields of trade and finance, their maintenance over a long period was facilitated by the abundance of external financing which these countries were able to obtain up to 1981. The sizeable external loans they received made it not only possible to cover the increasingly heavy deficits in their balances of payment on current account but also easier to apply an exchange-rate policy whose central aim was to reduce the rate of inflation through its effect on expectations and, primarily, through the limiting of domestic price rises by freedom to import all categories of foreign goods.

In actual fact, in some cases it did prove possible, by virtue of these policies, to meet the objective of reducing the rate of domestic inflation to levels close or equal to that of international inflation. However, partly because this process of approximation took a much longer time than had initially been anticipated, and partly because inflation was already rampant when the exchange rate began to be used as an instrument of stabilization programmes, the policies in question brought about a considerable drop in the real exchange rate.

As was to be expected, this slump in the exchange rate had an unfavourable effect on activities relating to the production of tradeable goods. In the export sector, the fall in the real exchange rate, added to the high domestic rates of interest, reinforced the depressive effects of the international recession and the decline in commodity prices. Its impact was, however, much more adverse in the activities in competition with imports, where exchange-rate policy accentuated, instead of offsetting, the negative effects implied for them by the reduction of tariffs. Thus, at a time when the growth rate of exports was falling, there was an increase in the number and variety of domestic activities which stopped being "competitive" and whose role in meeting domestic demand was assumed by imports. As a result, many enterprises had to lower their level of activity, with the consequent negative impact on employment. Moreover, the heavy real cost of domestic credit adversely affected investment, since there were very few activities whose profits allowed them to pay such high rates of interest.

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Naturally, a principal result of those trends was the rapid and persistent enlargement of the deficit in the balance of trade in goods and services. However, since at that time there was still an abundant influx of external financing, this imbalance was not reflected in a loss of international reserves but was in fact accompanied by an increase in them. Another central and no less important consequence was the sustained growth of the external debt and hence of remittances of interest abroad.

Thus, in addition to the rise in the trade deficit, there was also a rapid increase in payments on foreign capital, which meant that balance of payments equilibrium came to depend even more on the constant expansion of the net inflow of loans and investment. A persistent increase in external financing also became the basic requisite for maintaining the exchange-rate policy and therefore for consolidating the progress achieved in controlling inflation.

In 1981-1982, when the evolution of external factors became more and more unfavourable, the use of the exchange-rate policy as an instrument of stabilization programmes was abandoned in one after another of the countries in which it had been applied. In face of new and sharp deteriorations in the terms of trade, an abrupt decrease in the net inflow of capital and a very marked drop in domestic production and employment levels, governments were forced to devalue their currencies severely.

Since this decision entailed a radical change in a policy which had repeatedly been presented as a fundamental element in the economic strategy adopted, its immediate consequences were devastating. The abrupt rise in exchange rates was promptly followed by a notable resurgence of acceleration of the rate of inflation. Moreover, it caused dramatic changes in the net wealth of many enterprises. The hardest hit were those which, in the belief that the exchange-rate policy would hold, had incurred substantial debts in foreign currency. The payments difficulties which such enterprises then experienced bore some of the responsibility for the deterioration in the portfolio of the banks and financial institutions. This situation was aggravated by the loss of confidence and the uncertainty caused both by the abandonment of the exchange-rate policy followed for so long and the lack of a clear definition of the new policy which was to begin to be applied in its stead.

In these circumstances, the inflow of foreign loans declined further, at a time when many enterprises owing foreign currency chose not to renew their credits abroad owing to the prevailing uncertainty concerning the future evolution of the exchange parity. This made international reserves fall even further, and thereby aggravated both the balance-of-payments crisis and the contraction in economic activity and employment.

/4. The

4. The liberalization of the financial system and the rise in real rates of interest

Another domestic event which was partially responsible for generating and strengthening the crisis was the sharp rise in real rates of interest which followed the financial market reforms introduced in various countries of the region during the second half of the past decade.

The main objectives of these reforms were to eliminate the existing distortions in the allocation of credit and to promote domestic savings by liberalizing interest rates and expanding and diversifying capital markets.

Up to that point the latter had developed relatively little in many countries, and interest rates, on both the debit and the credit side, were often set by government provisions at what were normally very low levels in real terms. As a result, the credit market was divided between those who had relatively easy access to loans granted at low (or even negative) real interest rates and those who were obliged to finance themselves or to obtain very expensive credits in the informal sector. The low interest rates on loans had a discouraging effect on personal saving and did much to limit the development of financial intermediaries.

In these circumstances, it was assumed that when the activities of the latter were liberalized and the market was left free to determine interest rates, financial institutions would obtain more resources and allocate them more efficiently than in the past. Although it was taken for granted that in order for this to occur, real interest rates would have to rise, it was hoped that they would not be much higher than international interest rates, especially if policies for domestic financial liberalization were accompanied by greater financial openness to the exterior.

In practice, however, after various kinds of "financial repression" had been eliminated, domestic real interest rates rose far above international rates.

This upswing was influenced by various factors, whose relative importance was, moreover, different in the different countries. Thus, in some cases, the liberalization of the financial market coincided with highly restrictive economic policies designed to slow down inflation. In these circumstances, many enterprises increased their demand for credit to avoid the liquidation of their inventories at the much lower real prices which the stabilization policies imposed. In this way, the rigidity in respect of a fall in the market prices of goods pushed up demand for credit, thereby helping to raise interest rates.

In other cases, demand for credit on the part of enterprises expanded because of optimistic expectations concerning the future of the economy -thus furthering a rise in interest rates- and it remained high in spite of the failure of those expectations to materialize, because the accumulated financial costs were so great that new credits were needed to avoid the heavy losses of capital which would have resulted if assets had been liquidated to pay off the debts contracted.

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Moreover, the exchange-rate risk necessarily created imbalances between domestic and external interest rates, and this difference tended to widen in so far as the drop in the exchange rate and the resulting decrease in the value of exports, plus the deterioration in the terms of trade, discouraged the entry of capital, thereby making a sharp devaluation more and more likely.

Whatever the causes of the rise in interest rates, the fact is that because of the liberalization of the financial system they did rise to a marked extent, in some countries reaching 2% to 3% a month in real terms. Naturally, interest rates of this magnitude were bound to discourage investment and also, in the long run, to endanger the solvency of enterprises, and therefore that of the financial system.

Nevertheless, the situation remained tenable while expectations concerning the global evolution of the economy were optimistic and net inflows of capital were high. Primarily as a result of those factors, the values of immovable assets and shares increased at almost the same rate as the debt, or even faster. However, in the end, the accentuation of the fall in the exchange rate, the deterioration in the terms of trade, the drop in the net inflow of capital and the pessimistic volte face in expectations undermined the foundations of the boom, demolishing the value of assets.

Partly on this account, many banks preferred to go on extending credit to companies which had become insolvent, since the new circumstances, recourse to the guarantees behind the loans meant that the banks would have recovered only part of the money lent. In a good many cases, this tendency was strengthened by the fact that the firms belonged to the very groups that controlled the banks. Thus, in order to postpone recognition of the loss, many banking institutions and firms kept up the fiction of renewing loans at very high rates of interest which were increasingly difficult to pay.

Finally, some banks became insolvent. To cope with this situation, the governments intervened in their support so as to avert a crisis in the financial system. But this made inflation and its consequences worse and necessitated the provision of a State guarantee for those debts which the banks held abroad.

Thus, essential though it was for the financial system to be in some measure liberalized for the sake of its growth and diversification, the actual methods by which the reforms were carried out sometimes led to exceedingly high rates of interest and disproportionate levels of internal and external indebtedness which in the end jeopardized the solvency of companies and banks. In this way, the measures designed to promote the development of the financial system paradoxically precipitated its crisis and aggravated the outflow of capital and the recession.

/II. THE

II. THE POLICIES AND PROCESS OF ADJUSTMENT

A. THE ADJUSTMENT PROCESS: ACHIEVEMENTS AND LIMITATIONS

As we have seen, from 1981 onwards, Latin America was faced with an extremely unfavourable external environment, as regards both trade and finance. On the one hand, the deterioration of the terms of trade -traditionally associated with recessions in the industrualized economies- was, on this occasion, unprecedented in magnitude and in duration; during the last three years, it more than offset the positive effect of the growth in the volume of exports, whose purchasing power therefore fell steadily. On the other hand, the real level of international interest rates also reached a record high. Partly because of this situation, partly because of the rapid and steady growth of the external debt up to 1981, and partly because a large proportion of the debt was contracted at variable interest rates, the increases in interest rates had a much more damaging effect than they had had in the past. Finally, to these changes, which naturally led to a considerable increase in the deficit on current account, was added, from 1982 onwards, a sharp drop in the net inflow of capital.

Under these circumstances, and because some countries had to slow down inflation and others had to correct the negative effect of inadequate exchange policies, many governments began to apply adjustment policies aimed at reducing the external disequilibrium and stabilization policies aimed at moderating the rate of inflation. Many also took steps to reschedule the service of their external debt.

The basic objective of the adjustment policies was to eliminate that part of the deficit on current account which could no longer be financed with the net inflow of external loans and investment or with international reserves. To this end, many governments applied -to different degrees and in different ways- two sets of economic policy which in theory are essential to the adjustment process and which, as is well known, include policies aimed at controlling the aggregate demand -e.g., the fiscal demand, the monetary demand and the demand for income- and others aimed at raising the relative price of internationally tradeable goods vis-à-vis the price of non-tradeable goods and services, e.g., exchange policies, tariff policies or export promotion policies.*/ In practice, these policies were often implemented within the framework of credit agreements entered into with the International Monetary Fund.

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*/ See the appendix to this document for a detailed analysis of how these two sets of policies contribute to the adjustment process, of the avoidable and unavoidable costs of this process and of its relationship with external financing and inflation.

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Thus, as may be seen in table 4, these agreements always included provisions imposing restrictions in monetary and fiscal matters, with limits being placed on the expansion of the Central Bank's net domestic assets and the external and internal indebtedness of the public sector, and established that the government should reduce its deficit by raising taxes, raising public utility rates and cutting down on current expenditures. At the same time, it was agreed that during the adjustment process, it would be necessary to raise the real exchange rate, reduce real wages and maintain positive interest rates in real terms.

There were differences in how strictly and consistently these policies were applied in the different countries and in the degree to which they achieved their basic objectives. In general, however, they were much less sucessful in controlling inflation than in reducing the external disequilibrium.

In 1982, merchandise trade balance had already changed considerably: after having generated a deficit of US$ 1.6 billion in 1981, it produced a surplus of over US$ 9.7 nillion. This trend was even more notable in 1983, when the region attained a spectacular trade surplus of around US$ 31 billion. As a result of this trend in the trade balance, the deficit on current account fell moderately in 1982 and dramatically in 1983, when it amounted to US$ 8.5 billion, only slightly over one-fifth of the high negative balance of only two years before (see table 1).

Because of the way in which it was achieved, however, this sharp reduction of the current-account deficit entailed a high cost in terms of the slowing down of economic activity and employment. Because of the sudden and radical drop in external financing, the adjustment had to be made over a short period of time. It was therefore basically incompatible with the process of reallocating resources from the production of non-tradeable goods to the production of export goods, which, as has been explained above, is a prerequisite for a dynamic and efficient adjustment. The growth of exports was also limited by the sharp drop in the international price of most of the main commodities exported by the region and by the drop in the volume of world trade caused by the prolonged recession in the industrialized countries, the increase in protectionist practices in many of them and the slowdown of the OPEC economies. Under such circumstances, and despite the substantial real increases in effective exchange rates that resulted from the devaluations implemented in many countries of the region, the value of exports of goods fell sharply in 1982 and slightly in 1983.

Consequently, the spectacular turnaround of about US$ 33 billion in the merchandise trade balance between 1981 and 1983 was due entirely to the no less dramatic fall of imports. As may be seen in table 5, the value of imports fell sharply from almost US$ 98.5 billion in 1981 to a little over US$ 56 billion in 1983, while their volume during this brief period fell by an almost incredible 41%. The volume of imports fell even more sharply in Argentina and Chile (where they were cut in half between 1981 and 1983), Venezuela (where the volume of imports fell by 60% in 1983 alone) and, above all, in Uruguay (which reduced its real imports by over 63% during the tirennium 1981-1983) and in Mexico (which reduced its imports by almost 62% from 1981 onwards).

/Table 4

Table 4

LATIN AMERICA: ECONOMIC POLICY ARRANGEMENTS MADE BETWEEN SOME COUNTRIES AND THE INTERNATIONAL MONETARY FUND a/

Country	Date of agreement	Execution criteria					Policy understandings									
		Quarterly				Annual										
		Net foreign assets	Payments arrears	Net domestic assets	Net domestic credit	External indebtedness	Exchange rate	Real wages	Real interest rate	Public sector deficit	Current income	Current expenditure	Current saving	Capital expenditure	Total expenditure	Rates charged by public sector enterprises
							Standby credit agreements									
Argentina	24-1-83	Central Bank	t	Central Bank	Public sector	Public sector	+			-	+	-	+		-	+
Barbados	1-10-82	Central Bank		Central Bank	Public sector	na		na		-	+	-	+	-	-	+
Chile	10-1-83	Central Bank		Central Bank	Public sector	Public sector	+	-	p	-	+	-	+		-	+
Costa Rica	20-12-82	Central Bank	t	Central Bank	Public sector	Public sector	+	-	p	-	+	-	+		-	+
Ecuador	25-7-83	Central Bank		Central Bank	Public sector	Public sector	+	-	p	-	+	-	+		-	+
Guatemala	31-8-83	Central Bank	t	Central Bank	Public sector	na		na	p	-	+	-	+		-	+
Haiti	7-11-83	Central Bank	t	Central Bank	Public sector	na		na		-	+	-	+	+	-	+
Honduras	5-11-82	Central Bank		Central Bank	Public sector	na		na	p	-	+	-	+	+	-	+
Panama	24-6-83			Central Bank	Public sector	na		na		-	+	-	+	-	-	+
Uruguay	22-4-83	Central Bank		Central Bank	Public sector	Public sector	+	-		-	+	-	+		-	+
							Expanded facility agreements									
Brazil	6-1-83	Central Bank-Banco Brasil	t	Central Bank-Banco Brasil	Public sector	Public sector	+	-		-	+	-	+		-	+
Dominica	6-2-81	Central Bank		Central Bank	Public sector	na		na		-	+	-	+	+	-	+
Grenada	24-8-83	Central Bank		Central Bank	Public sector	na		-		-	+	-	+	-	-	+
Jamaica	13-4-81	Central Bank		Central Bank	Public sector	na		na	na	-	+	na	na	na	-	+
Mexico	1-1-83	Central Bank		Central Bank	Public sector	Public sector	+	-	p	-	+	-	+	-	-	+
Peru	7-6-82	Central Bank-Banco de la Nación		Central Bank-Banco de la Nación	Public sector	Public sector	+	-	p	-	+	-	+	+	-	+
Dominican Republic	21-1-83	Central Bank	t	Central Bank	Public sector	Public sector			p	-	+	-	+	+	-	+

Source: ECLA, on the basis of official data and various national and international sources.

a/ The abbreviations appearing in the table are the following: t: Total elimination; na: Not available; (+): Increase in real terms; (-): Reduction in real terms; p: Positive in real terms.

/Table 5

Table 5

LATIN AMERICA: IMPORTS OF GOODS

Country	Value			Volume			
	Millions of dollars			Growth rates			
	1981	1982	1983	1981	1982	1983 a/	1982-1983 a/
Latin America	98 412	78 852	56 290	1.9	-17.8	-28.4	-41.1
Oil-exporting countries	44 753	36 006	20 670	10.8	-17.9	-42.4	-52.7
Bolivia	680	429	500	-1.9	-35.3	20.2	-22.2
Ecuador	2 362	2 181	1 630	-1.3	-7.4	-24.6	-30.2
Mexico	24 038	14 489	9 000	20.3	-40.5	-35.6	-61.7
Peru	3 802	3 787	2 830	15.1	-2.3	-27.3	-29.0
Trinidad and Tobago	1 748	1 954	1 370	-3.1	17.2	-27.8	-15.4
Venezuela	12 123	13 166	5 340	-0.4	15.2	-60.2	-54.2
Non-oil exporting countries	53 659	42 846	35 620	-6.9	-17.7	-13.2	-28.6
Argentina	8 432	4 873	3 900	-12.4	-39.1	-16.7	-49.3
Barbados	521	501	...	2.0	0.6	...	0.6
Brazil	22 091	19 395	16 000	-13.2	-8.9	-14.2	-21.8
Colombia	4 763	5 176	4 390	4.3	13.6	-14.4	-2.8
Costa Rica	1 090	780	840	-24.5	-32.0	8.9	-25.9
Chile	6 513	3 643	2 840	11.1	-39.3	-17.8	-50.1
El Salvador	898	822	880	-4.5	-13.4	9.4	-5.3
Guatemala	1 540	1 284	1 140	0.0	-21.5	-13.7	-32.3
Guyana	400	320	250	-0.4	-15.4	-18.7	-31.2
Haiti	358	278	290	8.8	-26.1	3.2	-23.7
Honduras	899	681	680	-10.9	-25.0	0.8	-24.4
Nicaragua	897	646	710	7.5	-31.4	6.8	-26.7
Panama	1 441	1 441	1 250	6.4	-4.6	-12.3	-16.3
Paraguay	772	711	570	10.8	-11.2	-19.9	-28.9
Dominican Republic	1 452	1 257	1 280	-7.8	-15.3	1.9	-13.7
Uruguay	1 592	1 038	600	-13.9	-29.8	-39.3	-57.4

Source: ECLA, on the basis of official figures.

a/ Preliminary estimates, subject to revision.

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Naturally, this dramatic reduction of imports affected not only external purchases of expendable consumer goods and of capital goods, but it also involved substantial reductions in imports of raw materials and intermediate products which are essential for maintaining the level of domestic economic activity. It was not surprising, therefore, that in 1982 the domestic product remained at a standstill or declined in many countries and that it fell again and more seriously in 1983.

In brief, as a result of the sharp drop in the net inflow of capital between 1981 and 1983, the region was obliged to embark on the difficult task of very quickly reducing a much greater external deficit than it would have had to eliminate had its external financial relations been more nearly normal. Because of this, and also because of the very unfavourable external environment which prevailed during this period as far as Latin American exports were concerned, the entire burden of correcting the external disequilibrium fell on imports, the violent contraction of which put a decidedly recessive stamp on the adjustment.

In addition, the positive effect on the final balance of payments and hence on the level of international reserves that might have been expected from the trend in the trade of goods was to a large extent neutralized by the tremendous increase in payments for interest and profits and the sharp drop in the net inflow of capital. Thus, despite the remarkable reversal of the trade balance between 1981 and 1982 -from a deficit of US$ 1.6 billion to a surplus of over US$ 9.7 billion- the deficit on current account was only reduced by US$ 4 billion, and because of the sharp drop in the net inflow of loans and investment, the deficit on the balance of payments rose from US$ 2.3 billion to an unprecedented level of almost US$ 20 billion. This situation was only partially changed in 1983, when with a new and dramatic increase of over US$ 21 billion in the trade surplus the decline in the balance-of-payments deficit amounted to less than US$ 6 billion. Thus, largely because of the drastic deterioration in its external financial relations during 1982-1983, Latin America lost international reserves totalling almost US$ 24 billion, despite the fact that during the same period it had achieved a trade surplus of over US$ 40 billion (see table 1).

As has been mentioned before, in most cases progress towards achieving the other objective of the adjustment and stabilization programmes -i.e., to control inflation- was much slower. As a matter of fact, in practice the rate of increase of prices even tended to rise as the adjustment policies began to be applied. Essentially, this was mainly due to the effect of three measures which, as may be seen in table 4, were included in most of the agreements entered into with the International Monetary Fund: the rise in the exchange rate, the rise in public utility rates and the domestic price of fuels, and the maintenance of positive interest rates in real terms.

Indeed, because there was a considerable cumulative lag in the exchange rate in many countries and because many of them had kept public utility rates artificially low (especially fuel rates), they were obliged to implement substantial devaluations and readjust utility rates considerably. Consequently, the overall level of prices -and particularly those of tradeable goods- rose sharply during the initial phase of the adjustment policy and more than offset the stabilizing effect that might have been expected from the monetary and fiscal restrictions.

/Moreover, as

Moreover, as the slowdown of economic activity led to an acceleration of inflation and an increase in unemployment and underemployment, these factors led to a sharp fall in the real level of wages, with the resulting deterioration in the distribution of income.

B. TOWARDS A MORE EFFICIENT ADJUSTMENT

As indicated above, the adjustment made by the region thus far has had serious limitations and has been obtained at a high cost. Although the deficit on current account was reduced sharply and rapidly, this was only possible because imports were reduced brutally and this in turn was the main cause of the slowdown in economic activity and the drop in employment. Moreover, precisely because of the way in which Latin America achieved its substantial trade surplus during the period 1982-1983, should domestic production recover and grow, the external disequilibrium would tend to increase, although, with real exchange rates being much higher now, it would not reach the magnitude it did in 1981.

It is important to stress, however, that these unsatisfactory results were in large measure due to the extremely unfavourable external environment, as regards both trade and finance, in which the adjustment process had to be made. Hence, in order for a more efficient adjustment to be made in future, there must be some change in those external circumstances which have a decisive effect on the rate and nature of the growth of Latin America's trade and the net result of its financial relations with the rest of the world. It is also clear, however, that the characteristics of the domestic policies applied will play an important role in the achievement of an adjustment that is economically less costly and socially more equitable.

1. External factors

Essentially, there are four external factors that determine what kind of adjustment the region can make: the amount of net external financing, the level of international interest rates, the real rate of growth of world trade, and the international prices of the main Latin American exports.

The amount of financing is important because it determines not only the share of the current-account deficit that must be covered by the adjustment but also the time that is available for doing so. If, as happened recently, the net inflow of capital drops precisely when there is a cyclical deterioration in the terms of trade and an increase in interest rates, a greater proportion of the external disequilibrium will have to be eliminated by means of adjustment measures and there will be less time in which to do it. In that event, as has been explained before, the fundamental mechanism for reducing the deficit on current account would have to be that of sharply reducing imports. Because they are already at an extremely low level, this additional reduction would have an even more negative impact on economic activity and employment than it did during the period 1982-1983. If, on the other hand, a greater amount of external financing is available, the adjustment policies will be relatively less difficult to implement and can be carried out

/more gradually.

more gradually. In other words, it will not be necessary to reduce imports and there will be more time in which changes in relative prices can promote the necessary transfer of resources from the sectors producing non-tradeable goods towards export and import-substitution activities. It will thus not only be possible to avoid, to a large extent, the reduction of economic activity that is usually brought about by a sharp reduction in the volume of imports, but also to achieve a more lasting correction of the external disequilibrium, inasmuch as there will be a true restructuring of the apparatus of production.

Nevertheless, as the recent experience of the region has shown, what is important is not only how much external financing is received but also how much it costs. If interest rates remain at the high levels now prevailing or if substantial surcharges continue to be imposed under arrangements for the renewal or extension of loans, the deficit on current account will increase and so will the difference that has to be covered by the adjustment policies.

That is why the future trend of international interest rates, in the first place; the terms to be established in the new series of renegotiations of the external debt, in the second place, and the amount of new additional credit that can be obtained either from private commercial banks or, preferably, from public international financial bodies, in the third place, are all so important to the countries of Latin America. If basic interest rates fall, if the various surcharges imposed in the renegotiation of the external debt are also lower, and if the net inflow of loans and investment increases, the region will be able to carry out a less traumatic adjustment process with more definitive results than those attained in recent years and it will also be able to increase its imports, thus embarking upon a moderate process of economic recovery and growth without being faced with another unmanageable deficit in the balance-of-payments current account.

In the last analysis, however, if Latin America is to achieve a satisfactory degree of economic development and obtain an adequate amount of external financing to facilitate the adjustment process, it will have to increase and diversify its exports. As has been explained above, over the last three years, many of the countries of the region have taken measures -e.g., considerably increasing their real effective exchange rates- which are fundamental to the achievement of this objective. Nonetheless, as has also been pointed out, the effect of these measures has been considerably neutralized by the stagnation and decline of international trade and by the deterioration of the terms of trade. These trends must be reversed in order for a growth-oriented adjustment process -based on the rapid and steady growth of exports- to replace the heretofore recessive adjustment based on a radical and untenable contraction of imports. In order for this to be possible, however, there must be a consolidation and strengthening of the recovery of the economies of the industrialized countries, and these countries, as they recover their economic dynamism, must drastically cut down on the protectionist measures they have introduced in recent years.

/2. Internal

2. Internal policies

Although to a large extent determined by external factors, the success of an efficient adjustment also depends on certain internal circumstances and, above all, on the economic policies which are applied to reduce the deficit on current account. Thus, the possibilities of covering this deficit and at the same time maintaining or even increasing economic activity and employment are greater in an economic situation characterized by low or moderate inflation and by considerable and widespread underutilization of the production capacity. The task is, on the other hand, made more difficult if the implementation of the adjustment policies must be initiated when the inflationary process is very intensive and there is less underemployment of the labour force and underutilization of the installed capacity.

Thus, the best combination of internal policies from the point of view of decreasing the external imbalance is not necessarily the same in all countries or at all times in the economic evolution of any particular country. These policies may also differ depending on what have been the main causes of the external deficit. If the deficit has basically been caused by the excessive expansion of internal expenditure -as was true in certain Latin American countries-, policies such as fiscal, monetary and incomes policies which promote the adjustment by acting directly on the level of the aggregate demand will be more important. If, on the other hand, as happened in other countries of the region, the main cause of the imbalance on current account is the maintenance of a very low exchange rate or the structural deterioration of the terms of trade, adjustment policies in such fields as exchange rates, tariffs or export promotion, which alter the relative prices of tradeable and non-tradeable goods and in the end manage to correct the external imbalance by changing the composition of expenditure and the structure of production, will be called upon to play a more decisive role.

In spite of the fact that these various types of adjustment policy differ, and with good reason, as to the priority assigned to them and the importance of the role they play in different circumstances, there are certain general principles which should guide in their selection and in deciding on the extent to which they are actually applied. Thus, in the course of the adjustment, there should be a continual effort to abide by the principle that the social cost of saving on foreign currency by decreasing internal demand should be matched by measures to save or earn foreign currency by applying reallocation policies at the expenditure and production levels. This is especially important in the short term, since although policies which put a ceiling on the level of aggregate demand may rapidly result in a significant saving of foreign currency, due, in particular, to the depressive effect which they have on imports, this result is achieved at the expense of drops in production. Conversely, policies which change the relative prices correct the external imbalance more slowly, but they do not have a negative effect on the level of economic activity.*/ Precisely because of this difference in the speed with which the two categories of policy work in the short term, in many cases it will be advisable, in order to avoid drops in production, to apply "overswitching" measures during the initial phases of the adjustment process.

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*/ See sections 2 and 3 in the appendix.

/In addition,

In addition, in order also to keep the recessive and distributive problems associated with policies calling for a reduction in internal demand down to a minimum, cuts in expenditure should be made primarily in those categories with a high imported content and as little as possible in those which benefit labour-intensive activities. In particular, an attempt should be made to see that the decline in the production of non-tradeable goods which the adjustment policy calls for in a situation of near full-employment occurs, as far as possible, at the same time that the production of tradeable goods is increased, and not before.

a) Policies for controlling domestic demand

As has already been pointed out, the reduction of domestic expenditure plays an essential role in the adjustment process. Control of aggregate demand is also an indispensable element in stabilization programmes. This is the reason for the basic importance of restrictive fiscal and monetary policies both for redressing the external imbalance and for moderating the inflationary process.

However, if the adjustment is to be efficient and the stabilization effort is to have lasting and equitable effects, it is not enough merely to eliminate the fiscal deficit or to bring out a sharp reduction in monetary expansion. If those objectives are to be reached, the formats and mechanisms by which the balance in the fiscal accounts is restored, together with the relationship between the growth rate of the means of payment and the rate of change of other leading economic variables, are no less important.

i) Fiscal policy. In many countries of Latin America, the excessively rapid expansion of public expenditure and the equally notable increase in the magnitude of the fiscal deficit have undoubtedly been leading causes of the increase in the external imbalance and of the acceleration of the inflationary process. For that reason, in such countries the rapid and substantial reduction of the fiscal deficit is a sine qua non both for adjustment and for stabilization. Thus it is necessary either to reduce expenditure or to increase the income of the public sector or to take both those steps at once. However, the respective policies must be applied in such a way as to ensure that their contribution to the adjustment and stabilization effort is as great as possible and that their negative effects on production and employment are kept down to a minimum.

Thus, with regard to expenditure, preference should be given to reducing current outlays more than bringing down expenditure on investment, since a marked and, above all, indiscriminant decrease in the latter would not only affect future economic growth but would also limit the possibilities for setting an efficient adjustment process in motion. As indicated above, in the last analysis a positive and lasting adjustment calls for changes in the structures of production and employment of a kind which increase the absolute size and the relative participation of the production of exports and of import substitutes. In the short term, this increase in production should be achieved basically through more intensive use of the installed capacity of the activities producing tradeable goods, which is at present very much underutilized in many countries of the region. In the medium term, however, the reallocation of resources which the adjustment process

/necessarily involves

necessarily involves makes it necessary to expand the production capacity in these activities. This is why it is advisable to maintain, as far as possible, the real volume of public investment.

However, the strongest likelihood is that, owing to natural and legitimate social pressures applied for the purpose of avoiding sizeable cuts in public sector employment and remunerations as well as because of the size of the fiscal deficit which must be covered, public investment will decrease. If this happens, it is essential to adopt measures to change its composition. As the basic objectives of an efficient adjustment are to reduce the external imbalance and to maintain or increase levels of production and employment, investments which have a high imported content should be reduced and, on the other hand, those which require relatively few imported inputs and are highly labour-intensive should be favoured. In general this means reducing the investment in machinery and equipment and maintaining the amounts spent on construction. In the majority of Latin American countries, construction has a very low imported content but is directly or indirectly responsible for the employment of a considerable volume of labour. For this reason, the sudden curtailment of public works and housing programmes, frequently decided upon as one of the first steps to be taken under programmes aimed at reducing the fiscal deficit, yields very few benefits from the point of view of adjustment in that while resulting in hardly any reduction in imports, it has a high economic and social cost since it leaves many labourers out of work who cannot easily find short-term employment in export activities or import substitution. It is therefore advisable initially to maintain the level of expenditure on construction and to reduce it only gradually as the decisions adopted in respect of the exchange rate and tariffs and aimed at raising the levels of activity and employment of the sectors producing tradeable goods begin to have the desired effect.

For the purpose of achieving an adjustment which is more efficient and less costly in social terms, in addition to giving higher priority to investment in construction than to that which requires more machinery and imported inputs, governments should assign greater priority to investment projects which take less time to mature than to those which facilitate the increase in the production of tradeable goods and those for which external financing can be obtained.

So long as the net inflow of capital is not regained and it is necessary to apply a restrictive monetary policy, interest rates need be very high and consequently it will be a good idea to defer investment projects with very long gestation periods; such projects can be undertaken once the crisis in the external sector is over, when, financially speaking, there will be greater room to operate and a more abundant supply of foreign currency, so that projects taking a long time to mature and having a higher import content can be viewed in a more favourable light.

In selecting public works, it will also be necessary to show systematic preference for those which increase or promote the production of exports and import substitutes, such as, for example, irrigation canals, road construction, improvements in agricultural and mining areas, extension of ports, etc., over

/those which

those which only improve the living conditions of certain groups living in the larger and richer cities (such as the construction of underground railways, road works and urban modernization schemes, etc.).

During the adjustment process, finally, special priority should be assigned to those investments for which external financing can be obtained, particularly if it is long-term financing at interest rates lower than those charged by international commercial banks. In addition to their positive effects on production and employment, such investments have the advantage of increasing only that part of the public sector deficit which is not covered by external financing, and external financing is of direct help in reducing the imbalance in the current account, whose elimination is one of the raisons d'être of the adjustment process.*/

In most cases, in order to decrease the public sector deficit significantly, it would be necessary to reduce the current outlays, and obviously such a reduction would have to be higher if it were desired to maintain, or at least not to effect a sudden cut in, investment. This would present difficult problems of a political nature, since in the majority of the countries the main component of current expenditure is remunerations. Therefore, if it were necessary to reduce total government disbursements while at the same time maintaining the level of public investment, it would very probably be necessary to lower the remunerations of the public sector. So that this would not have a direct effect on employment, it would in turn be absolutely essential to effect some decrease in the wages paid in the public administration and in the State enterprises. It is likely that, although difficult from a political point of view, this decision would in many cases be preferable to its alternative -cutting employment in the public sector. The latter would not only be a very regressive measure in general from the point of view of distribution, but would almost inevitably affect the volume of the services supplied or of the goods produced in the public sector.**/

Subsidies constitute another large component of current expenditure, and in many cases they would have to be reduced in order to balance the fiscal budget. However, if such a decision is unavoidable, it should be put into practice in a way which maximizes its contribution to the re-establishment of the external

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*/ For this reason, and also because of the large external debt of many countries of the region, it is now advisable, from a purely economic angle, to raise the relative share of foreign investment in total external financing. Naturally, this decision must be assessed on the basis of political criteria of a more general nature.

**/ Of course the relative advantages of reducing wages or employment in the public sector depend on the prevailing circumstances in each country. Thus, if the global rate of unemployment is relatively low, there are a considerable number of redundant workers in the public sector and the average wages paid in it are very low, it may be preferable to reduce government expenditure on remunerations by decreasing the number of government employees rather than by lowering their wages. Of course these two ways of reducing the total remunerations paid in the public sector could also be combined in varying proportions and, moreover, not necessary in the same proportion in all the different branches of the civil service or in all the various State enterprises.

/balance and

balance and minimizes any possible negative effect it may have on the poorest groups. Although most subsidies tend to benefit such groups, only really progressive subsidies benefit the poor more than other sectors of the society. In this sense, the food subsidy is more progressive than the fuel subsidy, and therefore, the latter should be decreased much more than the former.*/

In order to keep the negative redistributive effect of the decrease in subsidies down to a minimum, those applied to prices, which lower the purchase cost of a subsidized good for everybody who buys it, whether he is rich or poor, should be replaced, as far as possible, by direct transfers to the most needy groups.**/ In this way, the effect of the price rise caused by the withdrawal of the subsidy would be neutralized for the poorest groups through the transfer of income to them; in addition, the price rise would provide a disincentive to the consumption of goods by the middle- and high-income sectors in addition to encouraging them to increase their production.

In addition to these considerations which relate to distribution, subsidy policies must take account of the effect they will have on domestic demand for tradeable and non-tradeable goods. In general, in order to facilitate an efficient adjustment process, it will be advisable to decrease the consumption of the former and increase that of the latter, since lower consumption of tradeable goods will reduce imports or increase the exportable surpluses, while an increase in the consumption of non-tradeable goods will tend to increase the domestic levels of production and employment. This differentiated subsidy policy may be applied even in the case of essential goods such as foodstuffs, with a distinction being drawn between imports and exports and foods produced exclusively for local consumption. The latter are usually produced by small farmers and, because of relatively high transport costs or reasons relating to different preference structures, are not exported. The former, on the other hand, are frequently produced in medium-sized or large agricultural units. Therefore, because of its effect on the external equilibrium as well as its social consequences, the reduction of food subsidies should be concentrated on products which can be traded on the international market.

Moreover, while changes of this kind in subsidy policy mechanisms may increase the redistributive effects which can result if the volume of resources remains constant (or even if it decreases), other changes in the structure and destination of the subsidies may also make a significant contribution to the adjustment process. Mention should be made, for example, of the possibility of reallocating the resources used to subsidize the domestic consumption of tradeable goods to an export subsidy programme or of using them as an incentive to increase production by raising the number of shifts worked in industry, particularly in industry with export potential.

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*/ In order to mitigate the impact had by the reduction of the fuel subsidy on the poor as much as possible, a direct subsidy can be applied to public transport, which would, in fact, benefit a greater proportion of the poor (especially in the big cities) than of the rest of the urban population.

**/ Although this principle of the efficiency of subsidy policies is always valid, it acquires special importance when it is necessary to reduce the total amount of the subsidies, as may become necessary during the adjustment process.

/The option

The option just mentioned is very important, especially in the short term, since if increases in production and employment had to depend on new investments, they would necessarily be slow. However, in view of the present wide margin of underutilization of production capacity which is the general rule in many Latin American economies, it is possible to effect a rapid increase in both production and employment by using the existing capital more intensively, and an expeditious way of achieving this is to increase the number of shifts. Studies carried out in six countries (Brazil, Colombia, Costa Rica, Chile, Peru and Venezuela) before the onset of the current crisis showed that in the manufacturing industry only slightly more than one and a half shifts a day were worked on average, and that, except in Brazil, close to two-thirds of the industrial enterprises worked only one shift.1/ Because of the severe contraction in industrial production in the majority of the countries of the region over the past three years, the number of shifts worked in the manufacturing sector is probably now considerably lower. There is therefore considerable potential for significantly raising employment in production and -more important- for doing so at a much lower cost in terms of new investment. However, in order to realize this potential it is necessary to solve two problems -that of how to sell the increased output and that of the larger amount of imported inputs required for that output. Both can be solved at the same time if the increase in production is sold in the exterior; it is therefore necessary to link the incentives for increasing the number of shifts worked to an export promotion and subsidy programme.

Finally, consideration should be given to a third way of decreasing total government expenditure which does not involve reducing current outlays or investment -namely, cutting defence spending. Although the decisions taken by governments in this aspect of national policy cannot be appraised solely or primarily from an economic point of view, it seems reasonable to assume that in many cases lowering such spending would result in appreciable progress towards redressing the balance of public finances and reducing the external deficit. The latter effect would be particularly significant if the contraction in defence spending were concentrated on armaments, which have a very high imported component in the majority of the Latin American countries.

However, to reduce the often sizeable deficit of the public sector, it is not enough to reduce expenditure, but it is also necessary to increase income, which in turn means increasing the tax levy and raising the prices and rates charged by State enterprises.

Of course, the mechanisms and procedures for achieving these objectives, as well as their relative importance, would be different in different countries. Nevertheless, there are two ways of increasing fiscal income which have proved to be particularly effective in the recent experience of some Latin American economies: the indexing of the tax system and the reduction of tax evasion.

In actual fact, in the presence of an inflationary process of any size (such as now exists in a much larger number of Latin American countries than approximately ten years ago), indexing is indispensable for maintaining the real level of tax earnings. In such cases, if the tax system is not indexed and there are lags between the time a tax is levied and the time it is paid, there will be a drop in real terms in tax earnings, and the more intensive the inflation and the longer

/the lag,

the lag, the greater the drop will be. In order to gain some idea of the magnitude of the impact which this phenomenon can have in the generation and expansion of the fiscal deficit, it should be borne in mind that with an annual rate of inflation of 40% and an average legal lag of three months, the real level of the taxes collected will fall by 10%.

Another negative effect of an unindexed tax system in a context of inflation is the incentive it provides for a deliberate delay in meeting tax obligations, which results in the extension of the real lag well beyond its legal limits. This occurs because if the fines and interest which are applied on account of the delay are not adjusted on the basis of the inflation, the taxpayer profits by postponing the payment of his taxes, thereby causing a de facto reduction in the real amount of the taxes he owes.

Therefore, the integral indexing of the tax system is one of the basic mechanisms used to reduce the fiscal deficit in countries facing a significant inflationary process and also helps to reduce the intensity of the inflation.

In addition, in many countries of Latin America there is known to be a considerable amount of tax evasion. In order to increase fiscal income, there is a greater need to control evasion than to raise the tax rates established by law, which are sometimes very high precisely because of the extent to which tax evasion is practiced. Recent experience in the region shows that this task is possible and that the basic requirements for carrying it out are not excessive. In addition to the essential requirement of the political determination to see that the tax legislation is respected, the following steps must be taken:

a) a drastic simplification of the tax system in respect both of the number and rates of the taxes and of special discriminatory exemptions and schedules. This will facilitate tax controls by traditional means tremendously and is indispensable for strengthening these controls by applying modern computer methods;

b) turning tax departments into divisions with special status within the public administration and providing them with the means of carrying out their controls and with a sufficient number of highly qualified and well-paid technical staff;

c) the establishment by law and the effective and rapid application of rigorous sanctions against tax offenders, and sanctions to be designed in such a way as to make tax controls more effective as well as to give taxpayers the general idea that it is economically more beneficial to meet their tax obligations than to run the risk of failing to do so.

For the purpose of reducing the public sector deficit, the amount collected by the central government in taxes should be supplemented by a rise in the prices and rates charged by State enterprises, some of which usually generate a considerable share of the total public deficit. In addition to having to strike a better balance between the income and the expenditure of the public sector, higher rates and prices have two further advantages. The first of these is that they cause State resources to increase much more rapidly than do changes in tax

/legislation, and

legislation, and the second is the adjustments they introduce in the price system, which have a direct positive impact on the adjustment process. In not a few cases, the artificially low prices charged by State enterprises encourage excessive domestic consumption of tradeable goods, such as fuels, which tends to increase the external imbalance, either by giving rise to more imports or by decreasing the exportable stocks.

ii) Monetary policy. Monitoring the expansion of the money supply and of credit is essential to any adjustment and stabilization policy, since if the means of payment continue to grow too quickly, domestic demand will also continue to expand at an exaggerated rate, and as a result the external imbalance and inflation will grow worse.

However, it is not enough simply to reduce the growth rate of the money supply. In order to avoid recessive effects on the real level of economic activity, deceleration is necessary not only in the case of monetary expansion but also in that of the growth rates of the nominal values of other key variables, such as prices, wages, the exchange rate and the rate of interest; it thus becomes necessary to bring the monetary policy into harmony with incomes policy, with the policy governing price controls and guidelines, and with expectations for the evolution of inflation. Monetary deceleration can in practice be either contractive or stabilizing, depending in the last analysis on the outlook for inflation. If producers continue to adjust their prices and labour contracts on the basis of the inflation in the past rather than the inflation targeted by the economic authority, reducing the growth rate of the monetary supply will have a contractive effect, since there will not be enough money available to purchase the goods produced at the new higher prices. As a result, and because prices are originally determined by the expectations regarding inflation, a monetary restriction will result in a drop in the product rather than in slower inflation, and the stabilization programme might well end in "stagflation", i.e., inflation accompanied by recession.

Naturally, inflation cannot be kept at the same level indefinitely only because of the expectations for it. If the line is to be held, the forecast must be borne out by the monetary policy. A problem which frequently arises is that pressures are exerted by the drop in production which tends to occur when the inflation targeted in the monetary policy is significantly lower than the inflationary expectations of the producers and trade unions; these pressures work at cross purposes since there is a tendency on the one hand to try to reduce the expectations for inflation, and on the other to relax the monetary policy so as to reduce its recessive aspects.

In the latter case, instead of its being the expectations which are adjusted in the monetary policy, it is the policy which is moulded to fit the expectations, so that in effect the economic authorities end by putting their stamp of approval on the inflation targeted by the producers and abandoning their own original forecasts. It is therefore important that they should try to influence the outlook for inflation so as to bring it into line with the stabilization programme.

/One consequence

One consequence of all this is that the monetary and credit targets agreed to with the International Monetary Fund should be set in conditional rather than in absolute terms, in particular with regard to a decrease in inflation. Thus, for example, if the inflation actually declines as originally forecast, the postulated reduction in the growth rate of the money supply should be maintained. If, on the other hand, the inflation falls more slowly than foreseen so that rigid adherence to the projected deceleration in the growth of the means-of-payment supply might result in a drop in production, a way should be left open for increasing the growth rate of the means-of-payment supply on the basis of a previously agreed criterion.

To keep a restrictive monetary policy from generating too many recessive and redistributive effects, it is important also to bear in mind that its impact is not neutral, since it has a more than proportional effect on those sectors which are particularly sensitive to variations in the interest rate and to the availability of credit. Such sectors include construction and agriculture, whose use of working capital is relatively more intensive, so that they are affected more directly by credit restrictions and also medium-sized and small manufacturing firms, which would in all probability see their access to bank financing decrease markedly if the banks allocated credit directly on the basis of the guarantees which their clients could offer, instead of doing so by raising their interest rates. In addition, all three of these sectors are labour-intensive, so that a decline in their level of activity tends to produce a disproportionate drop in employment. For this reason, it is a good idea, in implementing a restrictive monetary policy, to set guidelines to ensure that the share of these activities in the total credit line remains the same and that, as far as possible, the real long-term interest rate is applied rather than the considerably higher rate which is usually applied during the adjustment period.

iii) Prices and incomes policy. As already noted, if a stabilization policy is not to give rise to recessive effects, it is indispensable for the nominal changes in the main macroeconomic variables to decelerate simultaneously and in line with the inflation target on which the monetary and fiscal restrictions posited in the policy are based.

Simultaneous deceleration is one very important way in which an incomes policy can constitute to stabilization. In addition, an incomes policy should strive to bring the values of the variables (exchange rate, wages, interest rate) close to the long-term equilibrium values, thereby avoiding destabilizing contractions of economic activity.

However, it makes no sense to control the nominal values of wages and interest and exchange rates if the prices of goods are not also controlled, since the aim is to affect the real levels of remunerations and of interest and exchange rates.

Guiding or controlling (rather than freezing) the prices of certain goods is all the more important when, in order to make progress towards external balance and internal stabilization, some relative prices must be adjusted, such as, typically, the exchange rate and public service prices. If no attempt is made to guide the rest of the prices towards a new point of equilibrium, it is likely that, at least

/at first,

at first, decisions to raise the real exchange rate and the relative prices of the public services will bring about considerable increases in the prices of the other goods, owing primarily to the tendency of their producers to resist the decline in earnings which they expect will result from the attempt to change relative prices through devaluation and by adjusting public service rates and to confuse this change with generalized inflationary pressure. On the other hand, the possibility of bringing about this kind of change in relative prices becomes greater if the producers can see that by monitoring prices, the economic authorities are able to limit price rises to those goods whose prices were primarily very low.

This is by no means the same thing as reducing inflationary pressures by the government's setting artificial prices or by creating complex bureaucratic price-control machinery. It needs relatively simple rules of price adjustment, which can be easily applied and whose effects are sufficiently generalized so that different sectors can be reached. These regulations should preferably be applied to industrial prices, since they are the most sensitive to the expectations for inflation and to oligopolistic controls; and to make matters easier, the effort should be focused on the control of the leading enterprises, since they usually enjoy a certain amount of oligopolistic power and can put pressure on the suppliers of their inputs to accept prices which are in line with those paid for the products they manufacture. They are also normally more capital-intensive, which makes them better able to absorb any temporary lowering of their operational income which may result from the price control policy by reducing their margins of profit.

Another sector in which prices can be guided or monitored is that in which certain basic inputs for construction are produced. As seen above, during the adjustment process the public works programme must play a basic role in maintaining the level of activity of the construction sector. The government may therefore negotiate the price of some basic inputs, such as cement, bricks and iron, taking the total publics works and housing programme into account.

For purposes of facilitating a stabilization process which avoids the risk of recession, the incomes policy must also attempt to establish certain general principles in connection with wage adjustments, taking into account the fact that wages are a component both of demand and of cost. When wages rise but stop below their level of equilibrium, the demand effect usually prevails; the wage increase promotes production, and therefore employment, more than higher wage costs discourage employment. It is for this reason that in such an economic situation real wages may rise without harming employment or putting greater pressure on prices, since other factors affect them more. On the other hand, when real wages are already close to their point of equilibrium, the cost effect predominates, and their rise tends to discourage the hiring of labour and production.

Once real wages are close to their point of equilibrium, their real increase should be brought into line with the growth of the national income per worker and not with the domestic product per worker. Adjustment programmes aimed at reducing external imbalances caused by deterioration in the terms of trade or by higher interest payments can therefore have a neutral effect from the point of view

/of distribution

of distribution only if wage variations are co-ordinated not with the domestic product per worker (which can be expected to rise) but with the national income per worker, which may drop even if the product grows, owing to drops in the terms of trade or to higher interest payments. For example, since 1977 the terms of trade of the non-oil-exporting Latin American countries have fallen by 20%, which means that this has been responsible for the transfer of close to 3% of the gross domestic product to the exterior (since international trade is equal to approximately 15% of the domestic product). As for the share of interest payments in the GDP in the same period, it rose from around 2.5% to 5%. In other words, during this period, these two factors were responsible for a total transfer of resources to the exterior of about 5 1/2% of the gross domestic product; this means that during these four years real wages should have grown by 1.4% a year less than the product per worker. Although this is a large figure, if the product per worker had grown at its normal postwar rate (3% a year), wages would in any case have grown at a rate of close to 1.5% a year. The really serious thing is that, due to the recessive nature of the adjustment, during this period the product per worker has fallen at an annual rate of approximately 1.5%, thereby exacerbating the wage contraction.

However, a more immediate problem which must be tackled by the remunerations policy in many countries of the region is that of setting rules which regulate wage readjustments in relation to inflation. In this respect, the ground rules for maintaining the real level of wages during a stabilization process are: a) that wage rises should be based not only on the rate of inflation in the past but also on that expected for the future and b) that the periodicity of wage adjustments should vary.

In periods when inflation decelerates, the indexing of the wage on the basis of the inflation in the past causes the real wage to rise, since the average annual wage (which is the relevant wage) increases when the rate of inflation decreases.*/ For this reason, tying wages to the past rate of inflation is one way of ensuring that either inflation in the future will be the same as in the past rate or that real wages will rise (which may or may not be good depending on the economic situation at the start). Conversely, if nominal wages are adjusted solely on the basis of the future inflation, real wages will fall even if the target is met and the more so if it turns out to be impossible to reduce inflation by the amount envisaged.**/

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*/ If the nominal wage is 100 during a year and inflation is 100%, the annual average real wage is approximately 75:100 on the first day of the year and 50:100 on the last day. Thus, if the nominal wage is doubled the following year (200), the real wage at the beginning of the year is 100 and, if the inflation decelerates to 50%, the real wage falls to 67 at the end of the year $(\frac{200}{300})$, in other words, the average wage is approximately 83, or 11% (83:75) higher than the preceding year.

**/ With this kind of adjustment, if an attempt is made to reduce the inflation to 50% in year 2 (after a situation of 100% inflation in year 1) and if the nominal wages are adjusted by 50%, at the beginning of the year they will rise from 100 to 150 in nominal terms and from 50 $(\frac{100}{200})$ to 75 $(\frac{150}{200})$ in real terms. If the inflation decelerates to 50%, at the end of year 2 the real wages will be 50 $(\frac{150}{300})$; i.e., in year 2 an average real wage of approximately 63, i.e., 16% less than that paid in year 1 (63:75), will have been paid.

/Therefore, if

Therefore, if it is desired to keep the real level of remunerations steady, they must be readjusted on the basis of the inflation in both the past and the future.*/ Even then there is the risk that if the inflation does not decrease as much as predicted, real wages will decline or that, if the inflation decelerates more than predicted, they will rise. Thus, a formula which is even more stable and less risky is the following: a) to readjust wages on the basis of both the past inflation and the projected inflation and b) to readjust them again when the inflation reaches the target level, whether that happens at the end of 12 months or sooner or later than that.**/ If this is done, the average real wage for the period covered by the readjustment is sure to be the constant real wage postulated as a target.

Finally, the stabilization policy must establish guidelines in respect of the level and growth of interest rates. This does not of course mean setting them in such a way that they are negative in real terms, as frequently happened in the past, because obviously not everybody can receive all the credit he wants at subsidized rates. In actual fact, a negative real interest rate is known to divide the market between those who have and those who lack access to credit whose cost has been artificially reduced by fixing the interest rate. In order to take advantage of this cheap credit, those who benefit from it tend to make their installations too large or to over-mechanize them or else to use the resources for the purchase of assets whose values are lowered by the fact that credit is tight, so that wealth also tends to be concentrated. In addition, the segmentation of the market discourages the expansion of activities with less access to the banks (usually the small and medium-sized enterprises, which use relatively more labour), forcing them to have recourse to credit in the informal sector at rates very much higher than the equilibrium rate. However, there are also problems when the real interest rate is higher than normal, at least when such a rate is maintained for a long time; it raises the financial cost sharply and therefore helps to reduce production. Moreover, as the recent experience of a number of countries of the region shows, it is obviously impossible for real interest rates of 25-30% to be paid over a very long period in economies whose growth rates of 5-6% a year without a financial crisis occurring.

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*/ In the case described earlier, if it is desired to keep the real wage equal to that paid in year 1 and inflation of 50% is anticipated, nominal wages should be adjusted by 80%, i.e., raised from 100 to 180, so that in real terms they rise to 90 (180:200) at the beginning of the year and then fall during the year until they reach 60 (180:300) at year end. Thus, the average real wage paid during the year will be equal to approximately 75 in year 2 -the same real value as in year 1.

**/ In the case already referred to, this example works out to an 80% readjustment, and another readjustment is made when the inflation reaches 50%. If it reaches 50% in 12 months, we have, as in the preceding case, an annual readjustment. If the inflation reaches 50% in 10 months, the readjustment is put forward, since the average wage for the ten months was already 75 (the real wage targeted); in contrast, the opposite occurs if prices take longer than 12 months to rise by 50%.

/As the

As the credit market is subject to rapid change in terms of price (i.e., the interest rate), imbalances in other markets (goods, foreign currency, assets) tend to be reflected in it not only in the form of sharp variations in the real interest rate but also in ridiculously high real rates, which are maintained for as long as these imbalances remain. In actual fact, a high interest rate reflects such imbalances but is unable to solve them. While they persist, a real interest rate slightly higher than the international rate must be maintained (or "suggested") since this is the price of obtaining additional capital for the economy.

A natural concomitant of this is that in such situations credit must needs be rationed in terms not only of quantity but also of price until the excess demand arising out of the imbalances existing in other markets disapperas. Meanwhile, it will be necessary to decide what part of the demand for credit is "legitimate" (i.e., based on a production potential which deserves to be realized) and what part is "illegitimate" (i.e., arising out of the desire of the applicant for credit to avoid liquidating his inventories or assets when their price is at its lowest). It is true that such a decision is not always easy to make or to put into practice, but it is better to be guided by it than to risk a crisis throughout the financial system because of real interest rates which can obviously not be paid except in rare cases or on a temporary basis.

b) Reallocation policies

As already noted, if the adjustment process is to be efficient, it is indispensable for the restrictive demand policies aimed at reducing the level of domestic expenditure to be accompanied by other policies which change the relative prices of non-tradeable and tradeable goods in such a way as to provide an incentive for the production of the latter and to discourage their consumption.*/ The reallocation policy with the most widespread effects is exchange rate policy. Unlike tariffs policies or export promotion policies, which stimulate the production of a group of tradeable commodities at the expense of another group, devaluation favours all such commodities.

It is because of this that it is important to set a high real exchange rate for any programme aimed at reducing the external imbalance. However, since export activities and those which produce goods in competition with imports or used as substitutes for them are sensitive not only to the real level of the exchange rate over a relatively short period of time but also to its stability, the exchange policy should not be open to sudden change but should be managed in such a way as to provide the producers with a clear indication of the real value of the currency in the long term. The application of a policy which eliminates sudden and frequent variations in the real exchange rate has the advantage of decreasing the uncertainty concerning the future level of the exchange parity and the risk of capital movements, which has destabilizing effects on the balance of payments, the economic activity and the level of prices.

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*/ For an analysis of this subject, see section 2 in the appendix.

/In order,

In order, then, to cope with a cyclical short-term deficit on current account for which financing is not available, it may be more appropriate to resort to the temporary application of selective tariff surcharges in the case of imports and special subsidies in the case of exports, using significant variations in the real exchange rate only to reduce external deficits related to more permanent factors or as a remedy for unmistakable cases of exchange rate lag. Such a policy has the additional advantage of not subjecting costs to inflationary pressures so generalized as to give rise to devaluation and, above all, is much less likely to give rise to galloping inflation or to increase the expectations of its occurring.

In the present circumstances in the majority of the Latin American countries, export incentives are likely to yield better results from the point of view of foreign currency earnings than tariff surcharges on imports. In general, export promotion is more productive in periods of recovery and growth of the international economy (as the period just beginning is hoped to be), while import substitution, on the other hand, is relatively more beneficial in periods of international recession, such as the period 1981-1983. In addition, in view of the tremendous reductions in the volume of imports in most Latin American countries over the past two years, it is reasonable to assume that the possibilities for producing a significant amount of additional import substitutes in the short term are limited. Finally, the existence of a considerable margin of idle capacity in manufacturing industry represents an export potential which could be put to use if sufficient incentives were given.*/

The special incentives for the production of tradeable goods should not only be applied on a temporary basis, but should also be selective and should favour activities with a highly elastic supply in the short term.**/ Such activities are likely to include a significant proportion of the industrial enterprises which are at present underutilizing a considerable share of their installed capacity. As for tariff surcharges, they should preferably be applied to non-essential imports, such as luxury goods and those for which substitutes can be produced relatively easily. They would be counterproductive if applied to imports of intermediate goods for which few substitutes were available locally.

In order to ensure that such special incentives are appropriately structured, it would be advisable as far as posible to abide by the basic principle of efficiency according to which the cost of earning a certain additional amount of foreign currency by expanding the export trade must equal the cost of saving the

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*/ In theory, this capacity could be used also for increasing production for the domestic market. This would make it necessary to import more intermediate inputs, which would be difficult to finance under present conditions, but there would be no obstacle if the additional output were sold in the exterior.

**/ In actual fact, if the application of special incentives were generalized and even, their effects would be the same as those of raising the foreign trade exchange rate, but their administrative cost would be higher.

/same amount

same amount of foreign currency through import substitution. This is why in theory an export incentive equal to the tariff protection provided for import substitution is justified. This means roughly that the subsidy given to exports of a certain commodity must be equal to the tariff rate which protects that commodity in the domestic market. If the tariff structure is differentiated (usually with higher tariffs for final products, lower tariffs for intermediate goods and minimum tariffs for raw materials), the export incentives should also be differentiated so as to equalize the incentives as between exports and import substitution and also among the various potential exports.

This policy of providing special temporary incentives for exports and for import substitution, which tends to reduce the trade imbalance, can be complemented by a policy which establishes a higher financial exchange rate than the commercial exchange rate for a limited period of time with a view to promoting the inflow of new capital and the return of some of the considerable amount of national capital which has flowed out in recent years. During this period, the financial exchange rate would be increased at a lower rate than the commercial exchange rate, so that at the end of the period in question, the two rates would be levelling out. If the commercial exchange rate were adjusted on the basis of the difference between the internal and the external inflation, this decision would make it more attractive to bring in capital from the exterior, since, as a result of the slower increase in the financial exchange rate by comparison with the commercial rate, anyone who brought in capital would obtain a very attractive interest rate.

In the last analysis, the temporarily higher financial exchange rate would, so far as capital flows are concerned, be the same as a tariff surtax on the more non-essential or easily substituted imports and as a special incentive for the more elastic exports. Thus, all highly elastic foreign currency flows, whether commercial or financial, would temporarily enjoy the equivalent of a higher exchange rate, while a lower exchange rate, similar to the equilibrium exchange rate in the long term would be applied to imports and exports of less elasticity.

It is true that in some cases it might be administratively easier to obtain the same result by setting a single exchange rate which was much higher than the long-term exchange rate and establishing a temporary tax for traditional exports and a very low tariff (or even a special subsidy) for essential imports, however, the basic principle would remain the same, i.e., the establishment of a higher real exchange rate, while the external crisis is being resolved, for those categories which in the short term respond rapidly to the price incentive, and a lower real exchange rate for those components with less elasticity.

/III. THE

III. THE RENEGOTIATION OF THE EXTERNAL DEBT

A. GROWTH, CHANGE AND CRISIS IN EXTERNAL INDEBTEDNESS

1. The growth and structural change of the external debt

According to preliminary estimates, at the end of 1983 the total external debt of Latin America amounted to approximately US$ 310 billion. Thus its growth rate for the year was 7%, which was substantially lower than the 12% rate of 1982 and, especially, much lower than the average of around 25% recorded during the period 1977-1981 (see table 6). The slackening of the rate of expansion of the debt, a result of the sudden drop in the net inflow of capital analysed earlier, was especially marked in the petroleum-exporting countries, whose debt as a whole increased less markedly than that of the rest of the countries of the region.

As a result of the extraordinary growth of the external debt in previous years, the persistence of high interest rates in the international financial markets, and the negative effect of the international recession on the Latin American economy, the various indicators of external indebtedness continued to be extremely negative.

This situation was reflected, for example, in the ratio of interest payments to exports, which to a certain extent is the best indicator of the burden represented by servicing the debt. During normal periods, amortization payments on the debt are refinanced more or less automatically by the creditors and, when circumstances deteriorate markedly, they tend to be rescheduled. However, this sort of guarantee of renewal does not exist for interest payments. In this connection, table 7 shows that these remittances by themselves are sufficient to create difficulties in servicing the debt. During the two-year period 1982-1983, Latin America assigned more than 35% of the value of its exports to interest payments, an unprecedented proportion which was three times that recorded barely five years before. That proportion was also well above the coefficient of 20% usually considered to be an acceptable maximum.

Of course, these regional averages conceal the significant differences which, in this aspect as in so many others, occur in the situations of each of the countries of Latin America. Thus, as can be noted in table 7, in 1982-1983 interest payments represented very low fractions of the exports of Haiti (2% to 4%) and Guatemala (8%), but their share was exceptionally high in economies as different as those of Argentina (51% to 55%), Brazil (44% to 57%), Chile (38% to 47%) and Costa Rica (33% to 44%).

However, it is obvious that the problem of Latin America's indebtedness has dimensions which go beyond those relating to the unusual rise in interest rates. At the beginning of the current decade, the region's external liabilities had attained such relatively high dimensions that it was unlikely they would be able to continue increasing at the rates at which they had been until then. This excessively rapid expansion of the indebtedness was reflected in the high level

/Table 6

Table 6

LATIN AMERICA: TOTAL EXTERNAL DEBT

(End-year balances, in millions of dollars)

Country	1977	1978	1979	1980	1981	1982	1983 a/
Latin America	105 650	132 992	166 420	205 153	258 756 b/	289 843	310 200
Oil-exporting countries	47 441	58 291	74 158	92 247	116 777 b/	128 948	134 500
Bolivia c/	1 633	2 052	2 585	2 439	2 450 b/	2 373	2 700
Ecuador d/	2 153	3 271	3 865	5 255	5 756	5 788	6 200
Mexico e/	26 583	29 783	37 450	50 134	72 007 b/	81 350	85 000
Peru d/	6 260	6 802	7 187	7 910	8 227	9 503	10 600
Venezuela d/	10 812	16 383	23 071	26 509	28 377	29 934	30 000
Non-oil-exporting countries	58 209	74 701	92 262	112 906	141 939 b/	160 895	175 700
Argentina e/	8 210	11 198	17 643	24 409	35 671 b/	38 907	42 000
Brazil d/	32 758	43 329	49 689	57 572	65 000	75 000	83 000
Colombia e/	3 892	4 444	5 931	7 260	8 160 b/	9 506	10 300
Costa Rica c/	1 030	1 290	1 742	2 223	2 345 b/	2 603	3 050
Chile e/	4 899	5 703	7 291	9 513	15 542 b/	17 153	17 600
El Salvador d/	539	791	798	847	980	917	1 200
Guatemala e/	603	780	983	1 140	1 133	1 053	1 200
Guyana d/	429	491	536	594	687	689	800
Haiti d/	158	185	232	266	326	765	800
Honduras c/	726	918	1 150	1 353	1 513	1 409	1 700
Nicaragua c/	1 300	1 425	1 361	1 687	2 163 b/	2 789	3 400
Panama c/	1 501	1 871	2 063	2 248	2 333 b/	2 733	3 100
Paraguay d/	329	503	659	918	1 120	1 195	1 300
Dominican Republic e/	862	951	1 152	1 549	1 837 b/	1 921	2 000
Uruguay e/	973	822	1 032	1 327	3 129 b/	4 255	4 250

Source: ECLA, on the basis of official data and publications of international financial organizations.

a/ Preliminary estimates, subject to revision.

b/ As from 1981, the statistical series includes broader coverage of the external debt.

c/ Corresponds to the public debt.

d/ Includes the public and State-guaranteed private debt, plus the long and short-term non-guaranteed debt with financial institutions which report to the Bank for International Settlements.

e/ Total external debt public and private.

/Table 7

Table 7

LATIN AMERICA: RATIO OF TOTAL INTEREST PAYMENTS TO EXPORTS OF GOODS AND SERVICES a/

(Percentages)

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

Source: 1977-1982: International Monetary Fund, Balance of Payments Yearbook; 1983: ECLA, on the basis of official data.

a/ Interest payments include those in respect of short-term debt.

b/ Preliminary estimates, subject to revision.

/and systematic

and systematic increase of the ratios between the debt and exports, on the one hand, and between the debt and the gross domestic product, on the other (see tables 8 and 9).

For the region as a whole, the latter coefficient rose persistently from 24% in 1977 to 36% in 1983, while the former ratio rose during that period just as steadily, from 191% to 282%. In comparative international terms, the value of the debt/product coefficient, although high, exceeded the comparable values for the semi-industrialized countries of other continents by much less than the debt/exports ratio. For example, taking the figures for 1980 -as a year that was not distorted by the prolonged world recession- the debt/product coefficient of South Korea, one of the Asian countries having the highest debt with the private banking system -was only slightly lower (29%) than the average coefficient for Latin America (30%). However, the value of the debt/exports coefficient of that country (72%) was equivalent to barely one-fourth that of Latin America. This enormous difference indicates that the relative over-indebtedness of Latin America has been much higher with respect to its degree of external openness than in relation to its productive capacity. In other words, the burden of the debt is much heavier as regards the region's possibility of changing income into foreign currency than as regards its capacity to generate income.

However, in this field, too, the differences among the various economies of the region are very marked. Thus, table 10, which contains a compound index taking account both of the debt/product ratio and the debt/exports ratio, shows that countries such as Argentina, Bolivia, Chile, Costa Rica and especially Nicaragua have relatively very high degrees of indebtedness in the region. Colombia, the Dominican Republic, El Salvador and Guatemala are in a very different situation, since their indebtedness indexes are the lowest in the region. However, it is important to note that among the latter group only Colombia had regular and substantial access to credit from the private banking system.

The rapid growth of the external debt which occurred during the past decade was also accompanied by a deep structural change. During that period there was a radical change in the relative importance of sources of external credit, as a result of which the private banks became Latin America's main creditors. Thus, the share of the banking system in capital flows towards the region increased from an average of 12% for the five-year period 1966-1970 to around 70% at the end of the 1970s.2/ Naturally, the counterpart to this change was a striking expansion of participation by private banking institutions in the structure of the external debt; at the beginning of the 1980s, the private banks already held around 8% of Latin America's pending external obligations.3/

Because of this higher participation by the commercial banking system, the region gained access to the Eurocurrency market, which was very dynamic and in full expansion at that time. As can be seen from table 11, Latin America was the developing region which made the most use of that market; thus at the end of 1982, 60% of the private banking system's portfolio in the third world was composed of credits granted to Latin America, and in net terms the share of the Latin American countries in total assets is even more striking.

/Table 8

Table 8

LATIN AMERICA: RATIO OF GLOBAL GROSS DISBURSED EXTERNAL DEBT TO GROSS DOMESTIC PRODUCT

(Percentages)

Country	1977	1978	1979	1980	1981	1982	1983 a/
Latin America	23.9	26.3	28.4	30.3	32.2	33.7	35.7
Oil-exporting countries	27.8	29.9	32.7	35.1	36.3	37.2	38.6
Bolivia	53.0	60.0	68.4	58.6	57.9	55.9	58.4
Ecuador	28.2	37.4	38.7	46.0	44.1	40.9	43.5
Mexico	23.4	22.6	24.0	27.1	30.2	31.5	33.0
Peru	36.9	37.5	35.0	33.9	31.0	33.6	40.8
Venezuela	36.4	49.8	63.9	68.0	66.1	65.3	61.8
Non-oil exporting countries	21.4	24.0	25.7	27.2	29.4	31.3	33.7
Argentina	14.7	19.4	26.2	32.7	38.4	39.7	41.1
Brazil	22.3	25.9	25.7	25.2	26.5	28.5	31.6
Colombia	14.1	13.8	16.1	17.3	17.8	18.4	17.4
Costa Rica	34.1	37.4	44.3	51.4	49.8	49.1	55.1
Chile	34.8	34.8	37.8	42.0	47.6	60.9	60.2
El Salvador	16.2	20.8	19.7	21.1	24.7	23.0	29.2
Guatemala	11.0	12.6	14.0	14.4	12.9	11.7	13.1
Haiti	13.9	14.5	16.0	16.0	18.5	40.6	40.9
Honduras	44.0	48.7	52.6	55.2	56.6	50.2	58.3
Nicaragua	68.4	75.2	88.8	91.5	92.6	93.3	123.3
Panama	53.7	58.5	55.5	52.8	48.9	46.7	49.0
Paraguay	14.7	18.8	20.5	23.5	24.1	24.7	26.1
Dominican Republic	19.1	19.2	20.4	23.8	24.6	21.6	24.4
Uruguay	18.2	13.4	14.0	16.0	20.0	28.8	29.5

Source: ECLA, on the basis of data from the World Bank (global gross disbursed external debt) and official data.

a/ Preliminary estimates.

/Table 9

Table 9

LATIN AMERICA: RATIO OF GLOBAL GROSS DISBURSED EXTERNAL DEBT TO EXPORTS OF GOODS AND SERVICES

(Percentages)

Country	1977	1978	1979	1980	1981	1982	1983 a/
Latin America	191	216	202	194	212	260	282
Oil-exporting countries	212	230	198	177	194	224	243
Bolivia	235	292	302	234	259	268	277
Ecuador	135	192	160	183	198	217	236
Mexico	341	277	248	213	232	253	270
Peru	294	283	175	170	205	234	238
Venezuela	106	167	154	133	137	172	134
Non-oil-exporting countries	177	206	207	211	231	300	322
Argentina	125	150	192	247	271	338	365
Brazil	252	317	297	263	255	341	345
Colombia	114	112	131	144	199	208	230
Costa Rica	107	128	159	186	132	204	260
Chile	188	194	158	159	226	289	317
El Salvador	50	82	59	76	105	102	133
Guatemala	45	60	68	65	78	81	100
Haiti	91	88	109	88	130	283	280
Honduras	125	134	135	144	171	183	216
Nicaragua	181	198	203	335	372	448	636
Panama	189	229	204	149	151	165	...
Paraguay	84	116	128	162	197	193	224
Dominican Republic	93	115	101	122	119	150	181
Uruguay	120	90	86	86	107	162	193

Source: ECLA, on the basis of official data.

a/ Provisional estimates by ECLA.

/Table 10

Table 10

LATIN AMERICA: INDICATORS OF MAGNITUDE OF INDEBTEDNESS WITH RESPECT TO GROSS DOMESTIC PRODUCT AND EXPORTS OF GOODS AND SERVICES, 1980 AND 1983

$\frac{D}{P}$			$\frac{D}{X}$			$\frac{D}{P}+\frac{D}{X}$		
Country	Rank index a/		Country	Rank index a/		Country	Compound rank index a/ b/	
	1980	1983 c/		1980	1983 c/		1980	1983 c/
Nicaragua	4.7	5.6	Nicaragua	4.9	5.7	Nicaragua	4.9	5.7
Venezuela	3.6	3.0	Argentina	3.6	3.3	Chile	2.3	3.0
Chile	2.3	3.0	Brazil	3.8	3.2	Bolivia	3.2	2.8
Bolivia	3.1	2.9	Chile	2.3	3.0	Argentina	2.8	2.8
Honduras	2.9	2.9	Bolivia	3.4	2.7	Costa Rica	2.8	2.6
Costa Rica	2.8	2.7	Peru	2.5	2.7	Honduras	2.5	2.5
Ecuador	2.5	2.3	Haiti	1.3	2.6	Brazil	2.7	2.5
Argentina	1.9	2.2	Mexico	3.1	2.5	Venezuela	2.8	2.4
Peru	1.9	2.1	Costa Rica	2.7	3.4	Haiti	1.2	2.4
Haiti	1.1	2.1	Ecuador	2.7	2.2	Ecuador	2.6	2.3
Mexico	1.6	1.8	Colombia	2.1	2.2	Peru	2.2	2.3
Brazil	1.5	1.8	Honduras	2.1	2.0	Mexico	2.4	2.2
El Salvador	1.3	1.7	Paraguay	2.4	2.1	Paraguay	2.0	1.8
Uruguay	1.1	1.7	Uruguay	1.8	1.8	Uruguay	1.9	1.8
Paraguay	1.5	1.5	Dominican Rep.	1.8	1.7	Colombia	1.2	1.8
Dominican Rep.	1.5	1.5	Venezuela	2.0	1.7	Dominican Rep.	1.8	1.6
Colombia	1.1	1.2	El Salvador	1.2	1.3	El Salvador	1.3	1.5
Guatemala	1.0	1.0	Guatemala	1.0	1.0	Guatemala	1.0	1.0

Source: ECLA, on the basis of official data.

a/ Calculated on the basis of the formula:

$$V = \frac{(x-\bar{x})}{s}$$

where V is a standardized rank variable in which :
x represents the coefficient D/P and/or D/X
$\bar{x}$ is the non-weighted mean of the coefficients of all the countries and
s is the standard deviation.
A constant was added to the values obtained according to the formula so that the minimum negative value was equal to 1.

b/ The index is a compound of D/P and D/X.

c/ Preliminary estimates.

Symbols: D = global gross disbursed debt; P = gross domestic product and
X = exports of goods and services.

/Table 11

Table 11

INDEBTEDNESS OF DEVELOPING COUNTRIES TO THE PRIVATE COMMERCIAL BANKS

(End-1982 balances in billions of dollars)

	Developing regions										
	Latin America a/		Middle East		Asia b/		Africa		Total		World
	Total	(%)	Total	(%)	Total	(%)	Total	(%)	Total	(%)	
Gross debt	202	59.9	43	12.8	39	11.6	53	15.7	337	100	1 687
Net debt c/	146	162.2	-93	-103.3	24	26.7	13	14.5	90	100	...

Source: Calculated on the basis of Bank for International Settlements (BIS), International Banking Developments: Fourth Quarter 1982, Basle, 20 April 1983, table 4.

a/ Includes the Caribbean, except for the Netherlands Antilles, Bahamas, Bermuda, Cayman Islands. Excludes Panama.

b/ Excludes Hong Kong and Singapore.

c/ Gross debt, less deposits in international private banks.

/2. Limitations

2. Limitations on financing by the private banks

The private banking system's interest in granting loans to Latin America provided an important opportunity to make development financing more dynamic -following two decades of restrictions in this sphere- and was certainly a vital mechanism in lessening the effect of the sharp rises in oil prices by OPEC. However, it also increased the external vulnerability of Latin America. In fact, with the private banks' growing domination of capital flows to the Latin American countries, a structural asymmetry arose in the region's external liabilities, which raised potential problems concerning the debt service.

In the first place, the private banks operate on the basis of a commercial interest rate which is substantially higher than that of the credits granted by the international public financing entities, such as the IDB, the World Bank, etc.*/ Due to their high cost, credits from the international private banks are strictly compatible only with activities which yield a commercial profit. Therefore, if the major portion of external financing is provided by the private banking system, a potential imbalance arises, since the State, which is the economic agent that contracts the highest external debt in Latin America must, as part of its responsibility to promote development, finance activities which have a high social return but do not necessarily also generate a high commercial profit. It is difficult to finance these activities, in which there are often considerable differences between private and social yield, through loans from the private banks.

In the second place, variable interest rates are applied to the loans granted by the international commercial banks. This means that if the interest rate rises in the international markets, there is an increase not only in the cost of the new loans, but also in that of the entire debt previously contracted at variable rates.**/ Such debt currently represents more than 75% of the total external debt of Latin America. Under these circumstances, sharp rises in the nominal rate, similar to those which, as indicated in figure 2, occurred in 1973-1974 and at the beginning of the current decade, cause big conjunctural fluctuations in the balance-of-payments current account, and make the debt service much costlier, thus leading the banks to restrict the granting of new credits. Furthermore, the fact that the rate is variable means that the countries -except for very brief periods- lose their traditional debt relief mechanism: real devaluation of the debt through inflation. Thus, in practice the benefits obtained by debtors in the last decade, during which the interest rate was negative in real terms -which made indebtedness attractive- have been more than offset in the current decade by the persistence of real interest rates of the order of 6% to 8%.

In the third place, the repayment periods of the loans granted by the commercial banks are considerably shorter than those of other credit sources. In fact, the average period is generally shorter than the maturing period of many

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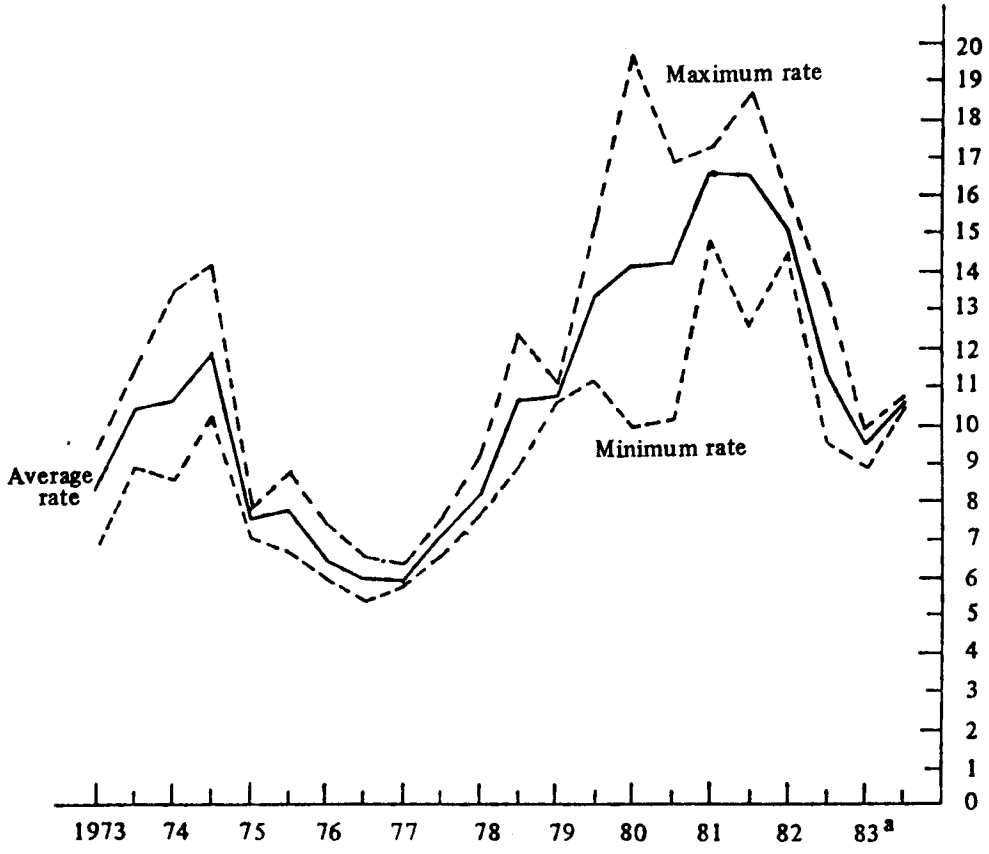
*/ In nominal terms, the margin of difference is almost 50%.

**/ Of course, this mechanism also means that a drop in the nominal interest rate tends to benefit the debtors, since it reduces the interest which must be paid on the entire debt contracted at variable interest rates.

/Figure 2

Figure 2

SIX-MONTH LIBOR RATE



Source: Morgan Guaranty Trust Company of New York, *World Financial Markets,* various issues.

[a]July and August.

/investments, so

investments, so that the financing of the latter requires a periodic renewal of the initial credits. Naturally, the considerable increase of participation by commercial banks in the external financing of Latin America brought with it a shortening of the average period of amortization of the debt. Thus, in recent years the amortization rate -that is, the ratio between the total amounts payable each year and the total indebtedness at the beginning of the year- has been around 15% in the case of the debt contracted with public financing entities; in contrast, the debt with the commercial banks has involved an amortization rate of around 50%.4/ As a result, in recent years around 40% of the region's total debt has had to be amortized or renewed annually, in contrast with figures of the order of 10% in the 1960s. In these conditions, Latin America has had to seek more and more loans simply in order to pay its debt. Furthermore, this much greater need to obtain new credits, which is inherent in the structure of current indebtedness, makes the debtor countries very vulnerable to the banks' willingness or reluctance to finance the commitments which fall due periodically.

A fourth problem -closely connected to the foregoing- is that the private banks are lenders whose willingness to lend may be characterized as procyclical. That is to say, they tend to reinforce the fluctuations of the economic cycle since their perception of the risk makes them very expansive during favourable economic situations (national and/or international) and very restrictive when the economic situation is tending to worsen. Thus, during the favourable phase of the economic cycle, credit supply is abundant and there is little or no pressure by the banks for payment of the debt; in fact, they usually grant a volume of new loans which amply exceeds the amount of resources they receive as amortization and interest payments.5/ In this permissive atmosphere, a borrower who is not careful can easily accumulate a debt that is much higher than a careful appraisal of his payment capacity would advise. As a result, his possibility of servicing the debt normally comes to depend to a large extent on the continuation of the favourable economic conditions and the somewhat euphoric attitude of the banks. Under these circumstances, a significant reversal of the expansive trends of the economy (national and/or international) tends to alter the conditions which made it possible to service old debts easily and contract new ones, thus producing a credit crisis for the borrower. What is more, if the borrowers with problems are borrowers of great significance to the creditors, the conditions of uncertainty can extend to the entire credit market and cause a deterioration in the terms of indebtedness for the remaining debtors, a stagnation in financing, and even a widespread economic crisis.

These four characteristics of bank credit, that is to say, its high cost, the variability of the interest rate, its relatively short terms, and its procyclical tendency, helped to create marked instability in the external financing of Latin America. This instability was added to the well-known traditional instability of demand for the region's exports, which is transmitted to the countries through changes in the terms of trade and in the volume of exports. What is worse, due to the nature of the risk and profit criteria which guide the conduct of the private commercial banks and to the dominant role which they have acquired in external financing, there tends to be a lack of synchronization between the fluctuations of external trade and the credit flows, and this intensifies the region's external vulnerability.

/3. The

3. The special circumstances of external financing in the 1970s and the crisis of 1982-1983

During the 1970s, this potential danger did not come into effect for several special reasons, which are unlikely to occur again. The main reason was the fact that the international private banking system began the stage of expansion of its loans to the periphery at a very low level and under conditions of great liquidity, which were initially caused by the expansive monetary and fiscal policies followed by many OECD governments at that time, and subsequently because of the substantial financial surpluses which it received from some of the OPEC countries. In more technical terms at the beginning of the 1970s the banking system began "taking stock" of its portfolio, raising the relative importance it gave to the developing countries, to which the international private banks had lent little or nothing in previous decades.

Under these circumstances, the credits granted by the banks to Latin America increased spectacularly. They are estimated to have risen at an annual rate of more than 30%, which was well above the also very high rate (around 20%) of Latin American exports for that period, and also well above the annual 15% to 20% increase of the banks' capital.

This exceptionally marked expansion of the financing supplied by the international private banking system concealed, to a large extent, the risks implicit in contracting debts with the system. In the first place, the excess liquidity and unexpected inflation of the period 1973-1975 made the interest rates negative in real terms. In the second place, during the initial stage of expansion, the banks usually offered relatively long repayment periods (from 10 to 15 years). Finally, the banks' procyclical tendency was to some extent neutralized by the succesive incorporation of new banking institutions which were interested in broadening their portfolio of loans to Latin America. Because of this, if a bank opted to withdraw partially from the Latin American market because it felt that it had overexpanded its credits, there were others -with a very small or even non-existent portfolio of loans in the region- which were more than willing to take its place.6/

But such behaviour, based as it was on a transient adjustment of the financial market, could not continue. Eventually, at the end of the last decade, the banks as a system drew close to the limits of prudence as regards exposure and perhaps even surpasses them in the final phase of heavy indebtedness which took place immediately after the second round of oil price rises.

This new situation caused a worsening of the conditions of indebtedness at the beginning of the current decade. In addition, the exceptional seriousness and duration of the international recession made the problem of exposure of the banking system even more obvious and helped to produce an extraordinarily restrictive reaction on the part of the banks. This reaction, in turn, was one of the basic causes of the unleashing of Latin America's current economic crisis.

Under these circumstances, the main mechanism which had facilitated the smooth servicing of Latin America's debt for many years -the obtaining of new loans which more than covered the interest and amortization payments- ceased to operate. The inevitable payment difficulties which this radical change necessarily created were intensified by the fact that the change coincided with the most acute international recession in the last 50 years.

/B. THE

B. THE PROCESS OF RENEGOTIATION OF THE EXTERNAL DEBT

1. The first round of reschedulings

For the developing countries, 1982 marked the beginning of both delays in the payment of their external debt and attempts to renegotiate the terms of payment. At the end of that year and the beginning of the next, more than 25 countries of the periphery and Eastern Europe had begun negotiations to reschedule debts which amounted to nearly half of the portfolio of loans in foreign currency granted by the international private banks in those areas.7/

As indicated in table 12, 13 Latin American countries reached preliminary or final agreements for rescheduling their commitments falling due in 1983 or during the period 1983-1984, and they accounted for around 80% of the international bank debt to be rescheduled.*/ It may also be noted in table 13 that several Latin American countries also requested a rescheduling of their debt with official financial entities, through the so-called Paris Club.

The wave of reschedulings began in Latin America in August 1982, when the Government of Mexico formally declared a 90-day moratorium on payments of capital on the public sector debt, although it kept up interest payments. Payment problems had already arisen in Mexico during the first half of the year, but they had not become obvious to all creditors because the country was able to obtain short-term credits to meet its medium-term obligations. However, when petroleum prices dropped and the debt service rose, the situation became unmanageable and the Government was forced to request a rescheduling of the debt.

By mid-1982 there were already other countries, such as Bolivia and Costa Rica,**/ that were behind in their payments to the private banks, but so far only relatively small debtors had been involved. Mexico, on the other hand, was the banking system's second most important client in the Third World, with a net indebtedness of US$ 49 billion, a figure only slightly lower than that of Brazil.8/

Mexico's problems, therefore, caused great concern in banking circles, since a possible failure to meet its obligations could seriously destabilize the international financial system.9/

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*/ Jamaica and Guyana were also able to reschedule their debt with the banks; however, data on this process are not available.

**/ Bolivia rescheduled its debt with the banks in 1981 after having experienced more than two years of difficulties in servicing its obligations. But the country signed an agreement with burdensome conditions and this, together with a series of internal economic problems, quickly brought about new delays in the payment of the debt. Costa Rica, for its part, entered into a de facto moratorium in August 1981 and only managed to reach a rescheduling agreement with the bankers in 1983.

/Table 12

Table 12

LATIN AMERICA: PRELIMINARY DATA ON THE RENEGOTIATION OF THE EXTERNAL DEBT OF SOME LATIN AMERICAN COUNTRIES WITH THE PRIVATE BANKING SYSTEM. FIRST ROUND OF NEGOTIATIONS, 1982/1983 a/

(Billions of dollars)

Country	Gross bank debt b/ at end of:		Renegotiation of debt with private banks					Credits approved in 1982 and 1983			
			Beginning of negotiations	Amount			Due dates of service payments reschedules	IMF	BIS c/d/	U.S.A. d/	New credits e/
	1982	June 1983		Total	Public	Private					
Argentina	22.2	23.0	Sept. 1982	13.00 f/	6.00	7.00	Sept. 1982-1983	2.20	0.50 g/	-	1.10 d/ 1.50
Brazil	56.0	57.1	Dec. 1982	4.70 h/	...	...	1983	6.00	1.20	1.50	4.40
Costa Rica	0.7	0.7	Sept. 1981	0.70 i/	...	...	1982-1983	0.10	-	-	...
Cuba	1.0	0.9	Sept. 1982	0.34 j/	0.34	-	Sept. 1982-1983	-	-	-	-
Chile	10.4	9.8	Jan. 1983	3.46 k/	1.10	2.36	1983-1984	0.88	0.30	-	1.30
Ecuador	4.1	4.1	Oct. 1982	2.70 l/	1.10	1.60	Nov. 1982-1983	0.17	-	-	0.43
Honduras	0.2	0.3	July 1982	0.12 m/	0.12	-	...	0.11	-	-	-
Mexico	58.9	60.5	Aug. 1982	23.0 n/	23.0	-	Aug. 1982-1984	3.97	1.85	1.60	5.00
Nicaragua	0.6	0.6	... 1982	0.55 o/	0.55	-	...	-	-	-	-
Panama	...	1.6 p/	...	0.28	0.28	-	...	...	...	...	0.1
Peru	5.2	4.8	Mar. 1983	2.40 q/	...	...	1983	0.94	-	-	0.45
Dominican Republic	0.3	0.3	... 1982	0.15	0.15	-	...	0.46	-	-	-
Uruguay	1.2	1.2	Feb. 1983	0.71 r/	...	...	1983-1984	0.46	-	-	0.24

Source: ECLA, on the basis of official data from the countries and various national and international sources.

a/ Includes the countries which signed final or preliminary agreements to renegotiate their external debt with the private banking system during 1983.

b/ Refers exclusively to the short, medium and long-term public and private debt of each country with private commercial banks which report to the Bank for International Settlements. It therefore does not include debt with governments and official agencies, with suppliers, or with commercial banks which do not report to the Bank for International Settlements.

c/ Bank for International Settlements.

d/ Short-term bridging loans.

e/ Loans granted by the international banking system as part of an external debt renegotiation "package".

f/ Corresponds to maturities of amortization payments on the external public debt for the period September 1982 to December 1983 (US$ 6 billion), those in respect of external private debt convered by Central Bank exchange insurance which fall due as from November 1982 (US$ 5.5 billion), and maturities in respect of "swaps" (US$ 1.5 billion). It should be noted that Argentina did not sign any final agreement with regard to the renegotiation of its external public debt during 1983. In December 1983, the new government stated that it would renegotiate a new agreement.

g/ Credits requested.

h/ At the end of 1982, an application was made to foreign banks to grant: 1) US$ 4.4 billion in new loans; 2) refinancing of US$ 4.7 billion of amortization payments on the public private debt; 3) the maintenance of short-term loans to finance foreign trade operations ("roll-overs") for US$ 9.6 billion, and 4) the restoration of inter-bank lines of credit to the levels at which they stood on 30 June 1982 (US$ 10 billion). Points 1 and 2 were accepted in February 1983, and subsequently point 3 also.

i/ At the end of April 1983 it was reported that a preliminary agreement had been signed with the main creditor banks.

j/ In August 1982 a request was made to defer the external debt service payments falling due between September 1982 and December 1983.

k/ Includes amortization payments which should have been made during 1983 and 1984 (US$ 2 158 million) and the restructuring of short-term financial credits (US$ 1.3 billion). At the end of April 1983, a preliminary agreement was reached with the 12 main creditor banks regarding the renegotiation of the debt. In July 1983, contracts were signed to obtain the new credits. Until the renegotiation process is completed, the banks have extended up to January 1984 the three-month postponement of payments granted on 1 February 1983.

l/ In September 1983, the decrees were signed which authorize the signing of contracts to refinance US$ 2.7 billion of amortization payments in respect of the public and private debt falling due in the period November 1982 to December 1983. By agreement with the creditors, no payments were made in respect of the public debt between October 1982 and January 1983.

m/ In February 1983, a memorandum of understanding was signed between the Government and the committee of creditor banks, but this agreement did not enter into force because of the refusal of the banks to provide fresh financing equivalent to double the six-monthly interest payments due. Up to the end of 1983, the Government was up to date with regard to the payment of interest, but not with regard to payments of capital.

n/ In August 1982, the international banking system authorized the postponement of amortization payments in respect of the external public debt for three months, subsequently extending this to March 1983 and then to August 1983. In the latter month and in September 1983, contracts were signed for the refinancing of a total of US$ 19 830 million of amortization payments in respect of the external public debt. Subsequently, the amount restructured under the agreement rose to a total of US$ 23 billion.

o/ Renegotiation in respect of this sum was completed in 1982. The terms of the renegotiation are similar to those originally contracted in a renegotiation of the debt carried out by the Government in 1980 (see table 17).

p/ Corresponds only to the public sector.

q/ In June 1983, preliminary agreement was reached regarding the refinancing of US$ 2 billion of amortization payments on the short-term debt and US$ 408 million in respect of the medium and long-term public debt (US$ 317 million in 1983 and 91 million in 1984).

r/ Corresponds to 90% of the amortization payments in respect of short and medium-term loans which should have been made during 1983 and 1984. In early March 1983, the payments had been postponed for 90 days under an agreement with the creditor banks. In July 1983, an agreement was signed with 80 creditor banks.

/Table 13

Table 13

LATIN AMERICA: PROVISIONAL DATA ON THE RENEGOTIATION OF THE EXTERNAL DEBT OF CERTAIN COUNTRIES IN THE PARIS CLUB, 1982-1983 a/

(Millions of dollars)

Country	Beginning of negotiations	Amount	Maturities rescheduled	Term	Period of grace
Brazil	July 1983	3 800 b/	Sept.1983-1984	9	5
Costa Rica	... 1982	215 c/	1982-1983	8.1 c/	3.1 c/
Cuba	Sept.1982	413 d/	Sept.1982-1984	8.5	3.5
Ecuador	... 1983	250	June1983-May 1984	8.0	3.0
Mexico	... 1983	1 550 e/	...	...	...
Peru	June 1983	1 037 f/	May 1983-Feb.1985	8.0	3.0

Source: ECLA, on the basis of official data and information from various national and international sources.

a/ The "Paris Club" is a forum in which countries negotiate the restructuring of their public sector debt with 17 member governments of the Development Assistance Committee (DAC) of the Organization for Economic Co-operation and Development (OECD). Under the rules of the "Paris Club", a government which requests refinancing can suspend payments on its debt before an agreement is reached.

b/ In November 1983, an agreement was reached whereby the creditors will extend the term in respect of 85% of the debt for four years, with payments beginning in 1989.

c/ Weighted average of two portions. In January 1983, an agreement was reached which provides for payment over a term of nine years, with four years' grace, in respect of 80% of the payments of capital and interest due between July 1982 and December 1983, amounting to US$ 121 million, and payment over seven years, with two years' grace, in respect of 85% of the arrears of US$ 94 million accumulated up to 30 June 1982. The remainder will be paid off in quotas in amounts set forth in the agreement, beginning on 30 June 1983.

d/ In February 1983, the President of the National Bank of Cuba announced that amortization payments for US$ 413 million had been reprogrammed. Of this amount, 5% will be paid during 1985 and the remainder reprogrammed over 8.5 years with 3.5 years' grace.

e/ In June 1983, Mexico agreed to renegotiate this amount with the official export credit agencies of 16 Western countries.

f/ This sum includes US$ 333 million of commitments to governments and official agencies, US$ 420 million in commercial bank credits backed up by export credit guarantees, and US$ 283 million of debts to suppliers with export credit guarantees.

/Under these

Under these circumstances, the banks' restriction of credit was quickly extended to the other Latin American countries and led to a virtual stagnation of the flow of loans to the region. According to figures from the Bank for International Settlements, new net loans granted by the private banking system to Latin America (excluding Venezuela and Ecuador) fell dramatically from US$ 21 billion in the second half of 1982 to US$ 12 billion in the first half of 1982 and to barely US$ 300 million in the second half of that year.10/ The terms of indebtedness also deteriorated seriously.

Naturally, the contraction of the credit market made debt servicing more complicated for the rest of the borrowers, who were already confronting difficulties in their balances of payments due chiefly to the worsening of the terms of trade and the unusually high interest rates prevailing in the international financial markets. Some countries, such as Chile and Peru, announced that they would not reschedule their debts. However, the burdensome debt service payments and the severe restrictions in the financial market eventually compelled their economic authorities to seek agreements with their private creditors. Thus, by the beginning of 1983 the banks' only important Latin American client to avoid rescheduling was Colombia, a country whose credit strategy has traditionally been cautious as regards debts with the private banks.

a) Mechanisms

The rescheduling process has been extremely laborious and slow, both for the banks and the economic authorities of the borrower countries. To a great extent, this is because the dynamism of the capital market during the 1970s made the number of private banks which were Latin America's creditors extremely high. Thus, a major debtor such as Brazil has more than 1 200 private banks as creditors, and even a relatively small borrower like Bolivia has loans pending with more than 100 credit institutions. Although some of these banks are very large, with a long tradition in the international sphere, most of them are smaller and their experience in the area of international loans is relatively slight. These latter banks began to loan to Latin America when regional prospects were more favourable. The negative developments of recent years led them to withdraw towards their national markets and to attempt to reduce their net commitments in the international sphere, a situation which has created a conflict of interest within the banking system itself and has prolonged the renegotiation process, creating considerable uncertainty.

The banks as a whole have shown great concern to avoid a situation in which their debtors may be declared in default */ -a state of affairs in which they would be legally compelled to record the corresponding losses in their account books.

Of course, default by a small borrower would not have great repercussions for a bank with a varied portfolio. Nevertheless, however, creditors obviously prefer not to create a precedent in this area, since this could "set a bad example" for other debtors. Thus the banks have been very tolerant in this respect.

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*/ Given the prevalence of "mutual default" clauses in loan contracts, a declaration of default made by one bank with respect to a country is legally equivalent to a similar declaration made by all the creditors.

/Costa Rica,

Costa Rica, for example, maintained a de facto moratorium for nearly two years without bringing on a declaration of default.

Generally, when a borrowing country has made known its inability to meet its obligations in time, the large banks with major investments in that country have formed special committees for negotiating with the public authorities. The composition of these committees, which enable the banks to co-ordinate their action with respect to each debtor country, reflect the geographic distribution of the net commitments of these institutions in Latin America: they are predominantly made up of United States banks, with one or two banks from other principal credit zones -Japan, Europe and Canada- representing the minority.

The members of the bank committee negotiate a tentative agreement with the country -a process which usually takes several months, even under favourable circumstances- and then present the agreement to the other banks for approval. Among the latter, the smaller banks especially have not always shown themselves to be well-disposed towards the agreements, and in many cases the larger banks have had to pressure them to participate in the agreement and thus avoid the declaration of default. On some occasions the main banks of the committee have been supported by the Central Bank authorities of their countries of origin, who have also pressured the smaller institutions to participate in the rescheduling agreement.

The support of these smaller institutions has been more difficult to obtain because of a special dimension of the renegotiation agreements: they not only reschedule the amortization payments on the outstanding debt but also grant new loans. This is a result of the fact that, due to the extraordinarily high interest rates prevailing during the period 1980-1983 and the very high amount of the external debt, interest payments have come to represent such a heavy burden for Latin America that they themselves are sufficient to create problems in servicing the debt.

Traditionally, rescheduling does not reduce interest payments. The banks are not interested in rescheduling these payments, partly because if they did so they would run the risk of having their loans classified as unprofitable assets by the national regulatory authorities. As a result, the banks have been compelled to seek other forms of reducing the burden of interest payments for the debtor countries. The main form has been the granting of new loans to refinance a portion of the outstanding interest commitments; in this way, the banks have introduced a de facto rescheduling of interest payments, since they are capitalizing a portion of their income under this heading until the countries are able to recover their external payment capacity.

This formula has been developed in close contact with the International Monetary Fund (IMF). With the sole exception of Nicaragua and Cuba,*/ the signing of a stand-by credit agreement with IMF has been a necessary pre-condition for the rescheduling of the debt by the banks. The IMF, for its part, has maintained that

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*/ Nicaragua refused IMF involvement in its agreement, while Cuba is not a member of the Fund.

/the set

the set of measures taken by the banks to correct the situation should be consistent with the overall objectives of the respective stand-by credit agreement. In the cases of Argentina, Brazil, Chile, Costa Rica, Ecuador, Mexico, Panama, Peru and Uruguay, this had made it necessary to grant new credits for refinancing a portion of the interest owed (see table 12).

In general, there has been an informal agreement between the big banks and the IMF to grant commercial loans for refinancing interest in amounts corresponding to an increase of around 7% of the banks' net commitments, although some countries such as Chile have obtained a relatively higher amount.*/ The capitalization of a portion of the interest payments, however, has been a very delicate point in negotiations with the small banks, which have attempted to lessen and not increase their net commitments.

Another obstacle to rapid renegotiation of the debt -which is related to the foregoing- concerns the short-term lines of credit. Both the IMF and the principal banks of the committee have attempted to maintain short-term bank loans at levels similar to those which existed before the crisis. Many credit institutions, on the other hand, feel that the easiest and most rapid way to reduce their net commitments in countries with problems consists of not renewing the short-term loans. As a result, it has been difficult to maintain those lines of credit -which are vital to the proper functioning of trade- at the projected levels.

Another stumbling block for the rescheduling of the debt has been the problem of State guarantees for the rescheduled private debt. In some countries, the private sector has been a very important client of the banks. Credits granted to that sector often had no State guarantee, for which reason their cost was higher, since the banks collected an extra fee because of the greater risk involved in granting loans to the private sector under these conditions. Subsequently, however, when payment difficulties began to arise, the banks attempted to obtain State guarantees for the rescheduled private debt.

In any event, the above-mentioned factors have made a rapid solution to the crisis of indebtedness practically impossible. These delays and uncertainties have given rise to a series of emergency measures designed to overcome the lack of financing and avoid default. In the first place, resources have been obtained under the stand-by credit agreements of the International Monetary Fund and financing from that institution's compensatory facilities. In the second place, the big international banks which form the creditor committees have often granted short-term bridging loans as a provisional financing measure until an agreement is reached with the smaller institutions. In the third place, the Bank for International Settlments has broken its tradition and, at the request of the OECD governments, has provided several countries with bridging loans. Finally, the United States Treasury has intervened directly and granted short-term loans to Brazil and Mexico, two countries in which the United States banks have heavy commitments (see table 12). Unfortunately, there have been such long delays in the final agreements that in many cases the bridging loans have run out before

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*/ In the case of this country, the new loans represented an increase of approximately 11% in the net commitments.

/the definitive

the definitive funds have become available, making it necessary to carry out negotiations to renew the former.

The effect of the foregoing has been that the banks have found a formula for avoiding the disastrous losses which could result from a declaration of default, although some countries have built up considerable arrears on several occasions.

b) Terms

Table 14 contains a breakdown of the main terms granted in the first series of external debt rescheduling exercises of nine Latin American countries. In practice, the banks and borrowers must reach agreement on the spread over LIBOR, the commissions, and the amortization period both for the rescheduled debt and the new loans. These three aspects taken together determine the "negotiated cost" of the credit. The LIBOR rate is established by forces of supply and demand in respect of funds in the Eurocurrency market. The banks' profits, for their part, are determined by the negotiated portion of the price of the credit, since for the most part they pay a rate quite close to LIBOR for the money deposited with them. For the countries, on the other hand, the major portion of the cost of the credit is represented by the LIBOR, although, with the increase of the debt, both the cost represented by the spreads and commissions and the amortization period also become extremely important.

The first noteworthy aspect presented by the rescheduling exercises carried out during the first round is the similarity of the terms agreed upon with the various borrowers (see table 15). If the terms established for the amortization and the new loans are weighted by the amount of the transactions, it may be noted that the spread over LIBOR went from a minimum of 1.95% (Mexico) to a maximum of 2.32% (Brazil); that the amortization periods varied from 6 years (Uruguay, Dominican Republic and Panama) to 8.5 years (Costa Rica), and that the commissions fluctuated between 1.05% (Mexico) and 1.5% (Brazil). In quantitative terms, most of the countries accepted terms that were closer to the higher end of the scale.

The similarity of terms is partially explained by the way in which the process of negotiation with the banks began. This process began and took place most rapidly in Mexico, due to the urgency of solving the problems of such an important borrower. That country also had the tradition of being one of the banks' best clients. Since the banks contend that rescheduling terms are determined on a risk basis, the agreement reached with Mexico established a sort of "floor", or lower limit, for the terms of other rescheduling exercises. These "floor" terms were similar to the least favourable terms of the 1970s.*/ As a result, the latter, which at one time were an exception affecting only a few countries, ended up by extending to practically all of Latin America. Thus a second characteristic of the agreements was the deterioration of the terms of indebtedness.

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*/ During the 1970s, it was not common for countries to pay spreads that were higher than 2% over LIBOR, and such spreads practically never exceeded 2.25%. The very high rates were generally reserved for new borrowers with little experience in international capital markets, or for older borrowers who were totally incapable of servicing their external debt.

/Table 14

Table 14

LATIN AMERICA: PROVISIONAL DATA ON THE TERMS OF RESCHEDULING OF THE EXTERNAL DEBT IN THE FIRST ROUND OF NEGOTIATIONS, 1982/1983 a/

Country	Spread over LIBOR (%)		Total term (years)		Period of grace (years)		Commissions b/	
	R	AC	R	AC	R	AC	R	AC
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Argentina c/	2.13	2.5	7.0	5.0	3.0	3.0	...	1.25
Brazil	2.50	2.13	8.0	8.0	2.5	2.5	1.50	1.50
Chile	2.13	2.25	8.0	7.0	4.0	4.0	1.25	1.25
Costa Rica	2.25	1.75	8.5	3.0	3.0	...	...	...
Cuba	2.25	-	8.0	-	3.2d/	-	1.25	-
Ecuador	2.25	-	9.0	-	2.0	-	1.25	-
Mexico	1.88	2.25	8.0	6.0	4.0	3.0	1.0	1.25
Panama	2.25	2.25	6.0	6.0	...	...	...	...
Peru	2.25	2.25	8.0	8.0	3.0	3.0	1.25	1.25
Dominican Republic	2.25	-	6.0	-	...	-	...	-
Uruguay	2.25	2.25	6.0	6.0	2.0	2.0	...	...

Source: ECLA, on the basis of official data and information from various national and international sources.

a/ These data are provisional and subject to revision. Column R refers to the portion of the due payments rescheduled, while column AC refers to the terms for additional credits.

b/ Calculated as a percentage of the total amount of the transaction and paid as a lump sum on signing the loan contracts. It has been noted that some commissions were not made public, so that the figures given could represent an underestimation of this item.

c/ At the end of 1983 the new Argentine Government announced that it would negotiate a new agreement for rescheduling the external debt.

d/ Weighted average of two portions.

/Table 15

Table 15

LATIN AMERICA: PRELIMINARY DATA ON THE DETERIORATION IN TERMS OF INDEBTEDNESS IN THE FIRST ROUND OF RENEGOTIATIONS, 1982/1983 a/

Country	Spread over LIBOR (%)		Total term (years)		Commissions		Deterioration in terms (%)	Real cost of credit c/		
	1980/1981	R*AC	1980/1981	R*AC	1980/1981	R*AC		1980/1981	R*AC	Increase
	(1)	(2)	(3)	(4)	(5)	(6)	(7) b/	(8)	(9)	(10)
Argentina	0.67	2.16	7.5	6.8	1.09	...	...	5.82	...	...
Brazil	1.62	2.32	8.5	8.0	2.01	1.50	44	6.86	7.50	9.3
Chile	0.91	2.16	7.6	7.7	0.81	1.25	125	6.02	7.32	21.6
Costa Rica	1.13	2.25	6.0	8.5	1.23	...	...	6.34	...	...
Cuba	1.00	2.25	5.0	8.0	0.88	1.25	28	6.18	7.41	19.9
Ecuador	0.74	2.25	8.0	9.0	0.97	1.25	146	5.86	7.43	26.8
Mexico	0.65	1.95	7.6	7.6	0.70	1.05	181	5.74	7.09	23.5
Panama	1.09	2.25	8.0	6.0	1.0	...	...	...	...	...
Peru	1.12	2.25	8.2	8.0	1.07	1.25	97	6.25	7.41	18.6
Dominican Republic	1.30	2.25	8.1	6.0	0.91	...	...	...	...	...
Uruguay	0.98	2.25	9.1	6.0	...	...	...	...	...	...

Source: ECLA, on the basis of official data and information from various national and international sources.

a/ The symbol R*AC represents a weighted average of the rescheduled loans and additional credits.

b/ Based on an index of the credit cost elements subject to renegotiation. The formula used is as follows:

$$\left[\frac{\dfrac{\dfrac{C_1}{T_1} + S_1}{T_1}}{\dfrac{\dfrac{C_0}{T_0} + S_0}{T_0}} - 1\right]$$

where: C = commissions; T = term, and S = spread over LIBOR, the subscript 1 refers to the conditions prevailing in 1983 and the subscript 0 refers to those prevailing on average in 1980-1981.
All the components of the formula are weighted by the amount of the credit. It should be noted that the deterioration is not in itself an indicator of the quality of the negotiation of a country, since it is highly influenced by the initial position of the borrower.

c/ A real LIBOR of 5% is assumed, to which is added C/T + S.

/This deterioration

This deterioration may be examined in two ways. The first takes into account the evolution of the terms subject to negotiation, that is to say, the spread over LIBOR, the amortization period and the commissions. Table 15 illustrates the marked deterioration in the conditions of indebtedness. The biggest relative deterioration in terms affected Mexico, since the negotiated cost of the credits represented an increase of more than 180% over the terms prevailing during the period 1980-1981. The relative deterioration for the rest of the countries was lower, inasmuch as the terms they accepted are compared with previous credit terms that were considerably less favourable than those of Mexico. For example, in 1980-1981 Brazil negotiated loans with relatively high spreads and commissions, partly because it was requesting longer payback periods; as a result, although the rescheduling terms of that country were the most burdensome, the relative deterioration was considerably more modest: 44%. Cuba is another case of a country whose credit terms before the rescheduling were relatively unfavourable (which was reflected in its short payback periods) and therefore the relative deterioration in its case was also more modest (28%).

The second way of examining the rescheduling terms relates to the financial cost, that is to say, the basic LIBOR plus spreads and commissions. This measure is qualitatively different from the previous one since it incorporates LIBOR but takes practically no account of amortization periods. In any event, this indicator too suggests that rescheduling agreements have been burdensome for the borrowers. Taking a basic LIBOR rate of 5% in real terms (the rate in force for creditors in 1981-1982), all the countries appearing in table 15, with the exception of Brazil, experienced an increase of 20% or more in the real financial cost of credit. The most marked increases were those of Ecuador and Mexico (26% and 24%, respectively). In the case of Brazil, since its credit terms in 1980-1981 were already burdensome, the rise of the financial cost of indebtedness in the set of measures relating to the rescheduling amounted to only 9%.

2. The second round of rescheduling exercises

Almost immediately after the first one, a second round of renegotiations was begun (see table 16). This was brought about by several factors. On the one hand, some countries had renegotiated only the payment of amounts falling due in 1983 -to which, in some cases, they added arrears from 1982. Since the external sector continued to be sluggish, these countries opted to request a rescheduling of amortizations payable in 1984. On the other hand, there were countries which, despite having begun negotiations to reschedule their debt during the first round, for some reason or other had not managed to sign a final agreement.

This was the case, for example, of Argentina, whose authorities reached agreement with the bank committee on the renegotiation of the public debt in 1983, on terms summarized in table 14. For its part, Venezuela, which had requested the rescheduling of its bank debt in October 1982, did not succeed in reaching an agreement with its private creditors. In the first place, the Government refused to accept the adjustment measures required by the IMF for approval of a stand-by credit programme, since it believed that those measures were exceptionally harsh and would have a high political and social cost. The private banking system, for its part, was not prepared to agree on rescheduling without a prior agreement

/Table 16

Table 16

LATIN AMERICA: PROVISIONAL DATA ON THE RENEGOTIATION OF THE EXTERNAL DEBT OF CERTAIN LATIN AMERICAN COUNTRIES WITH THE PRIVATE BANKING SYSTEM. SECOND ROUND OF RENEGOTIATIONS, 1983/1984 a/

Country	Gross bank debt b/ at end of:		Renegotiation of debt with private banks					Credits approved	
			Beginning of negotiations	Amount			Due dates of service payments rescheduled		
	1982	June 1983		Total	Public	Private		IMF	New c/
Argentina	22.2	23.0	Dec. 1983	22.0 d/	22.0	-	Sept. 1982-1984	-	-
Bolivia	0.7	0.6	Oct. 1982	... e/	...	...	...	0.3 f/	-
Brazil	56.0	57.1	June 1983	4.5 g/	...	...	1984	-	6.5 h/
Chile	10.4	9.8	Jan. 1984	-	-	-	-	-	0.8 f/
Ecuador	4.1	4.1	Nov. 1983	0.6	...	...	1984	-	0.5 f/
Mexico	58.9	60.5	Mar. 1983	15.0	-	15.0	...	-	3.8
Nicaragua	0.6	0.6	June 1983	...	...	...	j/		
Peru	5.2	4.8	Dec. 1983	...	...	...	...	...	...
Venezuela	22.7	22.2	Oct. 1982	18.4 j/	18.4	-	1983-1984	-	-

Source: ECLA, on the basis of official data from the countries and from various national and international sources.

a/ Includes the countries which did not conclude any formal renegotiation agreements in respect of their external debt with private banks during 1983; those which signed final or preliminary agreements during 1983 only in respect of amounts falling due during that year and which began a second round of renegotiations in respect of those falling due in 1984; and countries which requested new credits to refinance interest payments in 1984.

b/ Refers exclusively to the short, medium and long-term public and private debt of each country with the private commercial banks which report to the Bank for International Settlements. Consequently does not include debt with governments and official agencies, debts to suppliers, or debts with commercial banks which do not report to the Bank for International Settlements.

c/ Refers to credits granted by the international banking system as part of a renegotiation "package".

d/ Corresponds to US$ 14 billion of amortization payments in respect of the public debt corresponding to 1982-1984, US$ 6 billion of interest payments, and US$ 2 billion of bridging loans. The total amount includes the renegotiated external public debt mentioned in table 12, since the authorities never managed to reach a final agreement with the private banking system. In mid-December 1983, the new Argentine Government asked the international banking system for a postponement of all payments of capital and interest until 30 June 1984.

e/ At the end of March 1983, the international banking system agreed to postpone the receipt of payments of capital and interest amounting to US$ 460 million. The Government continued negotiations to reschedule the external debt.

f/ Credits requested.

g/ Includes US$ 4.5 billion of payments of capital falling due in 1984.

h/ In November 1983 final agreement was reached on a financing "package" which includes US$ 6.5 billion provided by the commercial banks, US$ 1.2 billion refinanced in the "Paris Club", and US$ 2.5 billion of financing from State agencies of the industrialized countries.

i/ As from June 1983, Nicaragua ceased for the first time to fulfil the payments of interest on its bank debt. In December agreement was reached on the refinancing of the arrears of interest. In addition the agreement provided that the amortization of the capitalized interest commitments would begin in the second half of 1984.

j/ Correspond to amortization payments in respect of the public debt in 1983 and 1984. At the end of March 1983, the international banking system authorized the postponement of payments for three months, subsequently extending this arrangement on two occasions. In October 1983 a fourth postponement was granted, to January 1984. In January 1984 there were indications that the Government would request a fifth negotiated moratorium of a further 2-3 months.

/between Venezuela

between Venezuela and the IMF. A second obstacle was raised by the terms offered by the private banking system for rescheduling the debt. In these circumstances, and also considering the fact that there had been a Presidential election in December 1983, the authorities requested several postponements of payment of the debt. The postponements were approved by the banks, and so the de facto moratorium period was extended to January 1984.

Bolivia did not reach a final agreement with its creditor banks either. The country had signed an agreement for rescheduling the debt in 1981 (see table 17), but the burdensome terms of that agreement and other difficulties of a domestic nature rapidly led to a new outbreak of problems with the private banking system. Despite this, it was not possible either in 1982 or 1983 to reach a new agreement with the banks for rescheduling the debts and in fact there were some delays in payment of those obligations.

The situation was different in Nicaragua, which achieved a significant rescheduling of its debt in 1980 (see table 17). Since then that country has not made any capital repayments on the debt but has paid interest on its commitments at a nominal rate of 7%. These payments ceased in June 1983, but nevertheless, in an agreement signed later that year, the banking system decided to refinance the payments in arrears, which are to be repaid in the second half of 1984.

Another country which has carried out a second round of negotiations is Mexico. As already noted, the Mexican Government renegotiated the payments of the public debt falling due in the period 1983-1984 and obtained a new credit of US$ 5 billion intended to refinance a portion of the interest payable in 1983. Subsequently, it began a second series of negotiations to reschedule US$ 15 billion of the country's private debt, in which it also requested a new credit of more than US$ 3 800 million for its 1984 financial plan. The banks agreed to grant this new loan in 1984, and its terms are much more favourable than those of US$ 5 billion loan which they granted in 1982. Thus, instead of the spread of 2.25% over LIBOR required in respect of the 1983 loan, the spread on the new credit will be 1.5% and the new terms -a five-year grace period and a ten-year amortization period- are substantially longer than the three- and six-year periods set for the previous loan.

Brazil also appears to have obtained some softening of the terms of indebtedness in its second series of negotiations. According to some preliminary data, the renegotiation for 1984 will probably mean a reduction of the spread over LIBOR to 2%, a lengthening of the grace period to five years and a decrease of the fixed commissions to 1%.

/Table 17

Table 17

LATIN AMERICA: BANK DEBT RENEGOTIATION AGREEMENTS WHICH ANTEDATE THE MEXICAN CRISIS a/

	Maturities rescheduled (years)	Amount (millions of dollars)	Terms			
			Total term (years)	Period of grace (years)	Spread over basic interest rates b/ (%)	Commissions c/
1978						
Peru	0.5	186	...	...	...	...
Peru	2.0	200	5.0-6.0	2.0	1.88 d/	0.5
Peru	1.0	63	5.0	2.0	2.00	...
1979						
Jamaica	2.0	149	5.0	2.0	2.00	...
1980						
Peru e/	1.0	340	5.0	2.0	1.25	...
Nicaragua	2.0	240	12.0	5.0	1.00-1.75 f/	-
1981						
Jamaica	2.0	89	5.0	2.0	2.00	1.5
Bolivia	2.0	244	5.0-6.0	2.0	2.25	1.125
Nicaragua	1.7	180	10.0	5.0	1.00-1.75 f/	-
1982						
Nicaragua	1.0	55	10.0	5.0	1.00-1.75 f/	-
Guyana	1.0	14	...	0.6	2.5	...

Source: ECLA, on the basis of official data.

a/ Includes agreements signed between 1978 and August 1982, but excludes agreements in respect of arrears of payments. The table includes both cases of forced refinancing of the debt and those of normal rescheduling.
b/ Over LIBOR.
c/ Expressed as a percentage of the total debt rescheduled.
d/ Corresponds to payments due in 1979.
e/ Peru paid the debt service commitments rescheduled for 1979 in advance and renegotiated the terms of rescheduling of the payments due in 1980.
f/ The surcharge rises gradually from 1% to 1.75% over the period covered by the agreement, ending up with an average of less than 1.5%. Nicaragua pays a maximum rate of 7%; the difference between the prevailing interest rate and the 7% ceiling will be capitalized and paid between 1986 and 1990.

/C. PRINCIPLES

C. PRINCIPLES UNDERLYING THE ORTHODOX RESCHEDULING OF THE EXTERNAL DEBT

1. The banks' position

a) Refinancing and rescheduling

Whereas the rescheduling of the official debt -i.e., the debt contracted with the governments of the OECD countries- has been a quite common occurrence during the postwar period,11/ the renegotiation of debts with private banks is a relatively new phenomenon in Latin America. Nonetheless, on the basis of the experiences of the Latin American countries which were having difficulties paying their bank debt prior to the Mexican crisis (see table 17), current instances of rescheduling and some of the economic literature on the subject, the basic principles guiding the actions of the banks in renegotiation exercises may be outlined.

Essentially, the position of the banks is based on three main principles:12/

i) There is a fundamental difference between the official debt which is contracted with governments and multilateral institutions and bank debt;
ii) The highest priority must be assigned to the servicing of the bank debt;
iii) The servicing of private commitments must not be modified as regards the schedule of amortization and interest payments.

These rules are based on the assumption that the future availability of credit is closely dependent upon the past conduct of debtors as regards complying with original payment schedules, i.e., one of the banks' fundamental positions is that reprogramming the debt will inevitably do harm to a country's image of creditworthiness and will hamper its access to private credit in the future.13/

Hence, in the past, banks have traditionally been able to exert influence in order to refinance debts which have fallen due 14/ rather than rescheduling them. Although, in essence, there is no major difference between these two operations, in a formal sense rescheduling is a clear sign that problems exist; it is interpreted as an operation which is out of the ordinary which indicates some degree of failure on the part of the banks to assess correctly the risk involved in the loans they grant. In contrast, refinancing, i.e., the extension of additional credit to finance debt payments which would otherwise not be paid, allows the maintenance of a degree of normality in banking operations.15/

Nevertheless, since the late 1970s private banks have been more willing to reschedule the debt on a formal basis; this occurred in such cases as that of Peru (1978), Nicaragua (1980) and Bolivia (1981). One of the reasons why the banks opted for the renegotiation of payments rather than refinancing them was that the latter arrangement's lack of formality ceased to be advantageous for them. As will be discussed further on in this document, the banks perceived a need to

/carry out

carry out negotiations in a more controlled context and with the participation of the IMF; on the one hand, this showed up more clearly the exceptional magnitude of the emergency and, on the other hand, ensured stricter compliance with the adjustment measures deemed necessary to overcome it.

b) The purpose of rescheduling

The exercise of rescheduling is seen by the banks as an exceptional policy demanded by circumstances under which the only alternative would be default by the debtors.16/ Moreover, the banks tend to believe that payment difficulties are the result of shortcomings in the economic policy of the borrower country rather than of defects in the granting of loans themselves and in the assessment of the risks they involve.17/

This attitude on the part of the private banks has a great influence on the characteristics of reprogramming; since the banks start from the assumption that the problems are due solely to the mistaken policies applied by the country, rescheduling is aimed at providing the minimum relief necessary to allow the country to recommence the normal servicing of the debt as soon as possible. Thus, in evaluating a country's ability to pay and, ultimately, the amount of relief which they should provide, the banks usually regard the servicing of the debt as having just as high a priority as the purchase of essential goods.18/

c) The terms and characteristics of rescheduling

Although the banks frequently argue that the terms of the renegotiation of a debt should be individually formulated for each country, rescheduling exercises have a number of characteristics in common which merit discussion.

Firstly, banks usually operate in a very short time frame. Thus, the usual practice is to reschedule loans falling due over a period of only two years and to provide that they should be paid off within five to eight years. This practice, in turn, originates from various principles. In the first place, the banks feel that the short-term structure of their resources prevents them from rescheduling loans for medium or long periods. In addition, as mentioned above, the banks attempt to impose a certain measure of discipline on the borrower; in the opinion of the banks, rescheduling over a medium or long term makes it more difficult to regulate that discipline. Moreover, a short-term plan is the preferred solution because bankers generally believe that payment difficulties are basically related to transitory factors. Lastly, their concern and perception of risk lead the banks to keep both the magnitude of the rescheduled maturities and the newly-established amortization periods down to the minimum.

A second characteristic is that rescheduling involves only the payments of capital on the debt. The banks insist that the country should keep its interest payments current or, in the event that it does fall into arrears in this regard, that it should settle them before the debt is renegotiated. This scheme

/functions normally

functions normally when the debt burden originates out of an excessive accumulation of maturities over a short period. However, as noted above, in recent years interest payments themselves have come to represent a considerable burden for the Latin American countries. Consequently, the private banks have had to seek an additional relief formula; in 1983 this took the form of the more or less compulsory granting of new loans in order to refinance between 40% and 50% of the interest payments.

A third characteristic of rescheduling terms is an increase in borrowing costs. As already noted, in virtually all the debt renegotiation exercises the banks have imposed a sharp increase in the price of credit, in the form of higher spreads and commissions on the rescheduled commitments and on the new credits extended in order to refinance a portion of the interest payments (see table 15).

The banks advance various arguments in order to justify this practice. One of them is that rescheduling a debt involves a greater risk for the bank, since it is extending the payment period beyond the terms originally agreed upon at the time the loans were granted. The higher costs of borrowing are therefore supposed to offset the greater risk assumed by the creditors and to be in accordance with the lowered credit standing of the borrower.

Another argument is related to the idea that a rescheduling agreement on favourable terms for private banking is the best way to ensure an adequate flow of loans in the future. In other words, if they treat the banks well today, the creditors will treat the borrowers well tomorrow.19/

A third justification which is often used in banking circles is based on the idea of fairness, the assumption being that in the past the spreads over LIBOR and the commissions charged have not been enough to cover the risks. In turn, this insufficiency is often attributed to the "fierce competition" which existed among the banks during the 1970s. Thus it is argued that the current increase in the cost of credit when a debt is rescheduled is nothing more than an "adjustment" of the insufficient price charged for credit during the competitive phase in the international capital market.

A fourth characteristic which the banks have managed to impart to rescheduling processes has been the extension of a State guarantee to private debts which were originally contracted without that backing.

In the initial phase of the expansion of bank lending in Latin America, the vast majority of the loans were contracted by public entities of the region or by private companies whose commitments were guaranteed by governments. Under these circumstances, if payment difficulties arose and there was a need to reschedule or refinance a debt, the banks required the State to continue to guarantee the renegotiated debt. However, in the late 1970s some countries -especially those of the Southern Cone- encouraged their private sectors to borrow abroad without State guarantees. In general, the private banks accepted this new modality, but they charged a higher price for the credits they granted on the assumption that they entailed a higher risk.

/When the

When the countries in which the non-guaranteed private sector debt was a significant percentage of the total debt faced payments difficulties, the banks demanded a change in the rules of the game. They insisted that the reprogramming of the private debt should be accompanied by an ex post facto State guarantee. The banks used various forms of pressure in response to the resistance which the governments initially showed to this arrangement; one particularly effective form of pressure was the reduction or cut-off of short-term credits. In many cases, the banks achieved their objective, and a significant portion of the private sector debt thus became directly or indirectly guaranteed by the State.

An argument frequently used by the banks to justify this policy was that the private sector's ability to pay had been eroded by the abrupt changes in the economic policy of the State -for example, the "maxi-devaluations"- which were introduced in order to deal with the crisis in the external sector. Another argument used by the banks was that the private sector's ability to pay had been impaired as a result of the economic policies required to carry out the adjustment process.

2. The position of the International Monetary Fund

As has been seen in the preceding section, the IMF has played a decisive role in the management of the debt crisis. Firstly, before approving the tentative debt rescheduling programmes, the bank committees have generally required a "green light" from the IMF. In other words, in order to receive the support of the big lending banks, the borrower country has had to comply with an adjustment programme agreed upon in detail with the IMF. Given the lengthiness of the renegotiation process and the fact that the loans from banks and from the Fund are disbursed in installments, the borrowers have been under strong pressure to meet the various economic targets established by the Fund, since if they did not, this would endanger the negotiations with the banks to reach a rescheduling agreement and/or the disbursement of one or more of the loan installments forming part of that agreement.

Secondly, the Fund has intervened directly in the actual drafting of the reprogramming agreements. It has already been noted that the banks granted new credits to some countries in order to refinance part of the interest payments due because the Fund insisted that the rescheduling agreements should be consistent with the targets of the adjustment programme sponsored by it.

This attitude reflects an interesting and positive trend in IMF policy in recent years, since the role of the Fund as a world financial institution during the 1970s was relatively marginal. In fact, it was the private banks which mobilized the bulk of liquidity at the international level, and at some points they even attempted openly to take the place of the IMF in the financing of the adjustment process. This attitude on the banks' part was manifested in its

/purest form

purest form in the case of Peru in 1976. On that occasion the banks attempted not only to finance but also to monitor a stabilization programme for that country without the involvement of the Fund.20/

After this frustrating experience, the banks fell back to more traditional ground, once again accepting that debt rescheduling or refinancing should be contingent upon an IMF stand-by credit programme. A qualitative change, however, took place in the relationship between private banks and the Fund. Traditionally, that relationship had been of an ad hoc nature; after 1976, however, certain informal but relatively well-known rules of the game were laid down which were observed by all parties. These rules included the acceptance of the role of the IMF as the economic advisor of the country, the negotiator of the stabilization programme, and as a channel of information for the private banks concerning the progress of the adjustment process; another rule was that the countries must sign an agreement with the Fund in order for there to be any rescheduling or refinancing of their debt by the commercial banks.21/ Thus, even though the banks stress the fact that they and the Fund assess the situation of a country independently and that their opinions may not coincide, in practice the approval of the Fund is actually a "green light" for private creditors.

During the current crisis the International Monetary Fund has evolved towards a third phase in its relations with the private banking system. Its passive role perhaps functioned adequately when payment problems existed in only one or a few countries. However, after the generalization of payment difficulties in Latin America beginning in 1982, a mere IMF stand-by credit programme would no longer be sufficient to ensure an adequate flow of bank credit to the many countries faced with troubled economic situations. Because of this, the Fund assumed a new role as an active catalyst of bank funds, exerting direct pressure on the banks. This new position introduced major changes in both the nature and scope of the Fund's operations and in its responsibilities as an important intermediary between the economic interests of the rich and poor countries.

As pointed out by De la Rosiere, in its new role the Fund attempts to achieve two basic objectives: on the one hand, it tries to assure the international financial community that the debtor country will undertake a sustained internal adjustment effort; on the other hand, it also tries to assure the debtor country that external financial assistance will be made available to it on a sufficiently large scale to help it with the task.22/

Indeed, during the recent crisis the strategy of the IMF was manifested in the design and monitoring of stringent adjustment programmes in most of the Latin American countries and in the concerted effort which it made in the first round of renegotiations to ensure the active participation of the banking system in the renegotiation of the debt and in the refinancing of some of the interest payments. This step -which was taken during a time of great uncertainty in international financial markets- was an extraordinary one and was outside the traditional scope of the IMF. It is therefore not surprising that this institution subsequently looked with a certain satisfaction upon the role which it had played in dealing with a financial crisis which, in the opinion of its Executive Director, "represented a very serious threat to the world system of finance and trade".23/

/D. THE

D. THE ORTHODOX VIEW OF DEBT RENEGOTIATION: AN ASSESSMENT

1. The banks' policy

a) Financial discipline and economic development

To begin with, the prevailing idea in financial circles that the servicing of the bank debt is sacrosanct and that changes in payment schedules should be discouraged and accepted only under exceptional circumstances, is both too simplified and relatively ahistoric. Actually, the emergence of serious difficulties with respect to the servicing of the external debt has been a frequent occurrence in development history.24/ Moreover, in situations where there was no opportunity to reprogramme their debts, the countries experiencing payments problems generally gave priority to the importation of essential goods.*/ Thus, from an historical perspective, the possibility of reprogramming the debt is actually a "big asset" currently enjoyed by the private banks and one that points up the sense of responsibility with which Latin America has been facing up to its financial commitments. This option was not available to bond holders during the nineteenth century or in the 1930s, and they suffered great losses on this account.**/

Of course, it is both correct and necessary to show concern with the stability of the international financial system. However, it is also essential that the interests of international financial discipline should be made compatible with the demands of the economic growth and even the socio-political stability of the developing countries. As the Quito Declaration points out quite clearly:

> "The attitude of the governments of Latin America and the Caribbean in acknowledging and assuming their obligations calls for a matching attitude of shared responsibility on the part of the governments of the creditor countries, international financial agencies and the private international banking system with respect to solving the problem of the external debt, while also bearing in mind its political and social implications. Consequently, flexible and realistic criteria must be used in renegotiating the debt, including loan periods, grace periods and interest rates which

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*/ The industrialized countries have also reacted in a similar manner. For example, during the 1930s the governments of England and France did not service their debt with the United States, on the grounds that their commitments to their own peoples were more important than their commitments to foreign creditors. See Hardy, op.cit.

**/ Unlike bank loans, bonds are a borrowing instrument involving numerous, anonymous and widely-scattered creditors. Consequently, it is difficult to reach an agreement among them in order to redraft the payment schedule. Faced with the incapacity of the borrower countries to service the debts, bondholders had no other alternative than to accept the losses determined by the market in the form of a reduction in the price of the bonds.

/are in

are in keeping with the recovery of economic growth. Only in this way can it be guaranteed that the debt service will continue to be met.

We wish to declare that it is neither just nor rational that the countries of the region have become net capital exporters: a state of affairs which further exacerbates their precarious economic situation and ultimately runs counter to the interests of the industrialized countries and the world community".25/

The private banks might conceivably expect preferential treatment with regard to their assets if those assets represented only a very small part of Latin America's external commitments. However, at present over 80% of the region's external liabilities are with private banks and, therefore, these banks should not expect to elude the effects of the negative economic situation which exists in these countries, regardless of whether this is caused by internal or external factors or a combination of the two. In other words, debt rescheduling should be regarded as a mechanism which is an integral part of the global process of international lending and borrowing. Normally, this process provides benefits to both lender and to the debtor country but, precisely because of this, the costs which it involves during periods of recession or crisis should also be shared by both parties, rather than being shifted on to only one of them.

In this regard, it should be noted that recently the United States Congress has explicitly acknowledged this interdependence and the need that financial discipline should be in keeping with the economic development needs of the debtor countries. The new Public Law 98/181,26/ concerning the increase in the United States quota for the International Monetary Fund states, inter alia:

- That economic adjustment programmes should aim to safeguard to the fullest possible extent international economic growth, world trade, employment and the long-term solvency of the banking system, while seeking to minimize the likelihood of civil disturbances in countries requiring economic adjustment programmes.

- That economic adjustment programmes should convert bank debts with short terms and high interest rates into long-term debts at substantially lower rates than those prevailing in the restructuring of bank debts negotiated between August 1982 and August 1983 for countries receiving aid from the Fund to finance economic adjustment programmes, in order to minimize the burden of adjustment on the debtor countries, provided such ranges of interest are consistent with the country's need to obtain an adequate amount of private external financing.

- That the annual service on the external debt demanded of the country in question should represent a prudent and reasonable percentage of the projected annual export income of that country.

/b) The

b) The "short leash" principle and external constraints */

As already discussed, one of the banking system's fundamental assumptions is that a debtor country's difficulties are transitory and that they basically stem from the application of mistaken policies by its economic authorities. Consequently, the banks deem it fitting to pressure the debtor to adjust its economy as rapidly as possible in order to restore its ability to pay.

Up to a certain point, this attitude on the part of the banks is helpful to their public image and especially to their image with the national institutions which supervise them and with their shareholders. There are circumstances, however, under which this strategy gives rise to more disadvantages than solutions.

Firstly, the "short leash" policy inhibits the re-establishment of a normal credit situation for the debtor country. The short time frame which it imposes upon debt rescheduling distorts the credit decisions of the creditors, thus making the future prospects of credit flows needlessly uncertain. This is due to the fact that when only those loans falling due over a period of one or two years are rescheduled and when it is provided that the payments must be made over a period of approximately five years, the country's ability to pay continues to appear doubtful. Beyond the one- or two-year period in which payments have been consolidated, bankers can visualize a considerable accumulation of debts which are soon to fall due, composed of the amortizations which originally would fall due during that period, plus those whose payment was deferred under the rescheduling agreement. Therefore, unless the countreis make very sweeping adjustments, which would be difficult to achieve politically, and/or the terms of trade undergo a drastic change, it is likely that very soon the banks will be faced with the need to renegotiate the debt once again. This uncertainty, naturally enough, raises an obstacle to the reinitiation of normal financing for the debtor country by the banks.

The situation is also aggravated by the slowness of the debt renegotiation process, as discussed above. The relief from one or two years of payments which is provided by the banks is actually quite ephemeral. The negotiations and, therefore, the uncertainty associated with the availability of financing, its terms, the nature of the guarantees, etc., in practice stretch over a good part of the first year during which the reprogramming agreement is supposedly in full force. Furthermore, the credits extended to finance interest payments are negotiated only on an annual basis. Therefore, even when the rescheduling agreement is for a period of two years, the country is faced with the need to enter into new negotiations at the end of the first year covered by the agreement, in order to determine the amount and terms of the loans to cover interest payment during the second year.

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*/ The "short leash" principle is that which imposes a very short time frame for the rescheduling of the debt.

/Secondly, the

Secondly, the application of the "short leash" principle makes it likely that both the authorities of the country and the bankers will devote a disproportionate amount of their time to travel, meetings and communications, with all the expense, time and trouble that this entails for both parties.

A third effect of the "short leash" principle which guides the actions of the banks is that it permits them to sidestep any of the responsibility which might be theirs in the generation of the indebtedness problems and that it tends to oversimplify the causes and solutions of those problems. As mentioned above, the banks are inclined to believe that problems in servicing the debt always stem from the application of mistaken economic policies by the governments. Nevertheless, it is evident that, in many cases, they are partly due to exogenous factors related to the frequent and abrupt swings in the terms of trade or to the no less sharp fluctuations in interest rates in international markets. Moreover, in view of the extreme permissiveness of the international banks during the 1970s -which is now acknowledged even by the authorities of the central countries- these banks cannot elude the share of responsibility corresponding to them because of their own excesses in the original generation of the present difficulties.

c) Bank committees

The bank committees which the creditors customarily set up when they begin to renegotiate a loan are undoubtedly an effective mechanism for co-ordinating the actions of the vast number of financial institutions which, as previously noted, have lent money to Latin America in the recent past. However, another dimension of them should not be lost from sight: the possibility that they permit the creditors to act as a monopoly or as members of a cartel.

It must be remembered that in a truly competititve financial market, the creditors would not have an opportunity to organize themselves so well. Indeed, if debtors had payments problems in such a market, the banks would either have to take the corresponding losses or would have to compete with one another to find formulas which would allow them to recommence the servicing of the debt and to rescue at least a part of their loan portfolio. It is well known that during the financial crises of the nineteenth century, as well as in the Great Depression, creditors tried to organize at the national level in order to recover their loans but without much success.27/ Now, in contrast, private banks enjoy special circumstances which allow them to co-ordinate their actions effectively and to exercise a great deal of bargaining power vis-à-vis their debtors.

Firstly, as mentioned above, all the private banks are closely linked on a legal basis at an international level by the so-called reciprocal default clauses which are a part of almost all loan agreements.*/ Secondly, the structure of the world financial markets is such that they operate at two levels, since on the

*/ In passing, it may be noted that this clause is not in keeping with the classic spirit of free competition which is frequently attributed to the international capital market.

/one hand

one hand there are a few large institutions which dominate the market, while on the other hand there is a large number of medium-sized and small banks. Thirdly, the private international banks currently dominate the external financing of the region; this gives them a great deal of power since, in practice, the countries have no meaningful external financing alternative. Thus, the pyramidal structure of the market,28/ together with the links represented by the reciprocal default clauses, facilitates the organization of bank committees considerably. In addition, the banks' preponderant share in the total capital flows to the region gives the bank committees a great deal of power.

The capacity to organize themselves in a bloc has obvious potential advantages for the banks, and furthermore, their insistence on tackling indebtedness problems exclusively on a "case by case" basis reinforces those advantages. Of course, the banks are right when they emphasize the differences between countries: for example, a reasonable criterion for drawing a distinction between different debtors would be to differentiate between those countries which have used their debt efficiently, and which therefore have good prospects of restoring their ability to pay, and those whose resource allocation has been questionable and which, therefore, have little prospect of recovering their creditworthiness in the immediate future. Nevertheless, in a situation where creditors have the opportunity to negotiate as a bloc, another potential result which is implicit in a strategy of negotiating on a "case by case" basis is that the common interest of the debtors can be kept apart from one another; this makes it easier for the banks, which act as a group to segment the market and impose conditions which are more favourable to the creditors.

The latter effect seems to have predominated in the current rescheduling exercises. As has already been demonstrated, despite the countries' varying debt service capacity, their individual treatment by the banks during the first round of negotiations resulted, paradoxically, in the imposition of almost identical lending terms for all the countries, What is more, the terms of the first round of reschedulings were as onerous as the hardest of lending terms established during the expansive phase of banking in the 1970s.

These adverse effects were perhaps further exacerbated by the actions of the debtor countries. Faced with the united front of the banks, they acted as if they were competitors with respect to the servicing of the bank debt, and so there was little co-operation among the debtor countries in the negotiations themselves.

2. The cost of rescheduling: Can the Latin American countries negotiate better terms?

As noted earlier, the bankers have a number of arguments to defend the commissions and fees which they have charged in the process of debt renegotiations.

One argument used to justify these charges is that by paying a high price for debt rescheduling, the countries will have easier access to credit in the future. Thus far, however, expereince does not bear out this thesis. Indeed the

/evidence suggests

evidence suggests that the banks' most frequent reaction after reprogramming has not been a restoration of the flow of credit but rather a sharp reduction in their net commitments. In reality, experience indicates that access to credit depends largely on whether the balance of payments has been put back on a sound footing. An important factor in really restoring the external sector's credit standing -in addition to sound economic policies, whose decisive importance should certainly not be underestimated- continues to be a renegotiation of the debt which significantly reduces the burden of the debt service. Obviously, rescheduling processes based on the "short leash" principle, which provide insufficient relief as regards interest payments, which load down debtors with high spreads and commissions, and which set very short amortization and grace periods, can only help to restore the countries to solvency if external demand is very dynamic. If it is not, then orthodox forms of reprogramming will tend to create a situation marked by a continuing shortage of autonomous financing, negative transfers of real resources to the benefit of the creditors, multiple renegotiations and the economic stagnation of the debtor countries.

As has already been seen, due to the actions of the IMF the banks increased their net commitments in the region on the occasion of the first round of renegotiations. This, of course, represents a much more rational situation than that which existed at the worldwide level during previous reprogramming exercises. The new attitude of the banks is in their own interest, in that it helps to avoid the collapse of the banking system. Indeed, the so-called new credits granted by the banks are part of a process in which money leaves the banks through one door and immediately re-enters through another.

Strictly speaking, the new loans constitute a kind of forced administration of previously-granted but not immediately recoverable credits. In point of fact, if they did not grant new loans, the banks could be faced with a situation in which the debtor countries would fall behind with their interest payments, which would give the national supervisory institutions sufficient grounds for classifying the existing loans as "unprofitable". Moreover, debtor countries receive loans only for an amount equivalent to the interest which they would have ceased to pay if those loans had not been granted; since these credits cover only a portion of the accrued interest, the debtor countries continue to make net resource transfers to the banks.

Another argument employed by the banks is that the supposedly higher risk which they incur by rescheduling the debt justifies its compensation by means of additional spreads and commissions. It should be remembered, however, that when an efficient bank grants a loan in a competitive financial market, the corresponding risk should be covered by the diversification of its portfolio and by the levying of a spread over the basic interest rate. This is how an efficient bank takes into account and covers the possibility that it might not recover a loan. If it proceeds in this manner, then in the event that the borrower country cannot service the loan, the bank would already be in a position to absorb the loss by drawing upon the premiums charged to cover the risk of non-payment.

/This is

This is precisely the solution which would obtain in a competitive market. Thus, in its classic form the competitive model incorporates a sense of justice. The borrower country pays premiums for the right to borrow which compensate the bank for the opportunity cost and the risk. If the country later finds itself in a position which prevents payment in the form originally agreed upon, the creditor assumes the corresponding losses and the country, in turn, receives relief in the form of a devaluation of its debt.

However, by reprogramming the debt all together, the banks are in fact able to avoid the effects which the operation of competitive mechanisms would have. They argue that by rescheduling debt payments they incur an additional risk. However, strictly speaking, this does not involve an additional risk but rather the materialization of the risk which has already been paid for by the debtor country at the time the original loan was contracted. Moreover, in reprogramming exercises the banks usually obtain other guarantees which also reduce the risk such as, for example, the presence of the IMF to supervise the adjustment programme and the State guarantee for the private sector debt which had previously lacked that backing. It therefore appears difficult to justify the increased cost of borrowing with the argument that there is greater uncertainty.

Another argument which has been used refers to the need to charge higher premiums now in order to compensate the banks for the low premiums which were charged in the 1970s and which are supposed to be the result of the intense competitition that existed among the banks during the expansive phase of the credit cycle. Actually, this argument does come somewhat closer to the truth of the matter and provides a means of better understanding the strategy of the banks.

Thus, it is in fact possible that the risk premiums were too low in the 1970s, so that the banks really are unable to resort to them now in order to overcome their loan portfolio crisis. This state of affairs, however, is not the result of the intensity of competition, but rather is solely a consequence of faulty risk assessment by the banks.

In turn, from a more technical standpoint, this ex post facto increase in the cost of borrowing is tantamount to a monopolistic income, i.e., it represents an income above and beyond the economic costs (including a normal rate of return) that is generated as a result of the bargaining power acquired by the large banks which, through the bank committee, control the access to credit of a country facing payment difficulties.*/

Lastly, mention must be made of the banks' practice of demanding ex post facto guarantees for the private sector's bank debt. To a certain extent, it is valid to link the outlook for the private sector to changes in government policy. However, this argument operates in relation to all economic agents, not only with

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*/ The softening of the financing terms granted by the banks to Brazil in the second round of rescheduling is empirical evidence of the monopolistic income attained by the banks in the first round. The banks accepted softer loan terms despite the exacerbation of the Brazilian crisis and the accumulation of US$ 3 billion in debt service arrears.

/respect to

respect to the international banks. Moreover, it can be argued that the risks involved are an integral part of the risk for which the banks charged when they originally granted the loan. Hence, demanding ex post facto guarantees becomes one more way of passing on the cost of an erroneous risk assessment to the debtor.

3. The policy of the International Monetary Fund

The Fund has played a very valuable role in the debt rescheduling exercises, above all as regards the demand that the banks should grant "new" credits.

It has already been observed that the Fund had two basic objectives with respect to the reschedulings: i) to assure the creditors that the debtor country would make the necessary adjustments, and ii) to assure the debtor country that it would have an adequate amount of financing. Although the Fund has evidently achieved the first objective, it still has a long way to go before completely achieving the second.

Firstly, recent experience suggests that in many cases the financing needs of the debtor countries were substantially underestimated. Even with the "new" credits granted by the banks, most of the countries continued to encounter severe external constraints which had a strong influence on the decline of economic activity. In this regard, it is possible that the Fund may have been the victim of its own paradigm, which was overly reliant on the power of external demand to boost the growth of the debtor countries. In view of the fact that, in practice, not only did this expansion not take place, but economic activity continued to decline in many countries of the region, the Fund should call for the refinancing of a greater proportion of interest payments until such time as there is clear evidence of a significant external stimulus for the debtor countries.

Secondly, now that the initial stages of the economic emergency which gave rise to the first rescheduling exercises have been surmounted, it is time to take more effective action with respect to the terms of debt renegotiations, for it is clear that the cost to the debtors was excessive and, in a sense. was counterproductive with respect to securing an efficient adjustment. Just as financial support was obtained from the banks on the basis of the argument that this was necessary for the implementation of an adjustment programme in the debtor countries, it appears necessary to employ the same logic in order to convince the banks to charge lower rates and spreads in the rescheduling exercises. Ever since the report of the Pearson Commission in 1969, the economic literature has stressed the need to replace the "short leash" with a criterion based on development and growth, to avoid burdening debtors in an economically difficult situation with higher interest rates, and to replace rigid payment schedules with flexible schemes that take into account the various situations in which debtors may find themselves.29/

These principles have not been taken into consideration by the creditors, with resulting higher costs for the debtor countries. Given the growing influence of the Fund in the debt rescheduling process, it would be advisable to take these principles into account in the new rescheduling exercises which are beginning, since by facilitating the growth process and the debtor countries' ability to pay, this would not only benefit those countries but would also, ultimately, benefit their creditors too.

/E. TOWARDS

E. TOWARDS MORE EQUITABLE RENEGOTIATION

1. Overview

The current debt crisis in Latin America clearly requires quick remedial action because without this efficient adjustment becomes all but impossible. Actions to alleviate the crisis can be taken at three different levels: a) national; b) international and c) regional. In considering formulas one must also take into account an additional dimension: that of time. In other words, in sorting out the possible solutions to the problem it is important to distinguish between actions that can provide immediate relief and those that are more of a medium or long-term proposition.

This latter type of distinction becomes necessary because in Latin America the debt problem has ceased to be a theoretical problem and is now of the highest practical urgency. Latin America needs relief from the crisis today, since socio-economic tensions in the borrowing countries are at unprecedented levels. To quote President Hurtado of Ecuador in his opening address at the January 1984 Latin American Economic Conference in Quito, "if the economic crisis of our nations is not solved, it could give rise to a new cause of serious and unsettling social and political conflicts which will inevitably upset the shaky world equilibrium".

The countries of the region have taken extraordinary measures to adjust and make payments to their creditors. But as already pointed out, the adjustment has been undertaken in a depressive world economic environment. It has been made more difficult by conditions in which an unblanced international financial system has been unable to provide adequate amounts of anti-cyclical finance. With simultaneous depressive trends in both trade and finance, it is not surprising that the adjustment process carried out so far can best be characterized as having been perverse: it was achieved basically via a brutal compression of imports and unprecedented falls in per capita income.

In at least one important sense the adjustment in Latin America is probably complete: after a 41% fall in the value of imported goods in 1982-1983 it is difficult to believe that there is any "fat" left in the region's import structure. For this reason alone it is of paramount importance that Latin America avoid further reductions in imports.

But the problem is not only to detain the further squeezing of vital imports. One suspects that the rapid adjustment in Latin America has been somewhat artificial; it has been motivated by desperation and has been negative in character inasmuch as it was won largely by greatly weakening the productive capacity of the region. In contrast, a positive, efficient adjustment is one that comes about by strengthening productive capacity, and this in turn requires, among other things, economic restructuring, investment, reactivation and a greater capacity to import.

/Unfortunately, the

Unfortunately, the weight of Latin America's debt service -even after the first round of reschedulings- provides little or no margin for economic growth and recovery of international reserve positions. Thus, any type of economic recovery cum restructuring will require new and direct remedies to relieve the burden of the debt.

The theoretically most appropriate measures to tackle the debt crisis are at the international and regional levels; but because of political and economic obstacles such solutions cannot be sufficiently timely and provide the immediate relief that Latin America so urgently needs in 1984 and 1985. In view of this, borrowing countries must explore other solutions which could involve much higher costs for the international community.

2. The best solution: a multilateral settlement involving the banks, their governments and debtor countries

a) The public nature of the debt crisis

The current debt crisis in Latin America must be viewed as a public problem, the cost of which is not borne by those responsible for it, but by others: in other words, the costs are externalized.

From the standpoint of the debtors, servicing problems for a major borrower, i.e., Mexico in mid-1982, created a panic in financial markets and were perceived by bankers as a "Latin American problem", so that the ensuing general restriction of new loans quickly sucked almost all other Latin American debtors into the crisis. The importance of this negative externality in the development of the crisis comes to light when one remembers that in normal market conditions debtors invariably are permitted to repay loans with the contracting of new ones.30/ With the spilling over of the Mexican crisis to all of Latin America, the countries of that region lost the very resources (new loans) that had been permitting the smooth servicing of private bank debt for more than 15 years.

From the standpoint of the banks, the negative externalities surrounding the crisis are just as impressive and tend to intensify the problem. For instance, a bank could not possibly agree to extend new credit to a borrowing country without knowing that all other creditors would do the same; otherwise, that bank's new loans would just be used to repay loans to other institutions which were retrenching from the market, with no net benefit from the borrower and considerably increased risk for the bank.

Negative externalities are also present in the so-called "market solution" to the debt problem. For example, losses on a portfolio derived from poor risk assessment by an individual lending institution could very well set off a panic in financial markets that would adversely affect the viability of other institutions which technically had not erred in the evaluation of their own risks.

/But the

But the externalities also abound when one seeks to pinpoint just who is to blame for the problem, and hence where the costs of the problem should lie. Again, in the purely competitive framework outlined earlier, where all decisions by the economic actors are made independently, the costs should be fully borne by the inefficient lenders because they charged premiums on the basis of their assessment of risk, and recourse to those premiums should be taken when the risks materialize. The real world, however, is not so simple. It has already been pointed out that externalities will prevent the incidence of losses from being limited to banks which pursued poor lending criteria. But more importantly, risk evaluation by creditors in the 1970s was not formulated independently. Banks, in fact, were strongly encouraged by their governments, as members of OECD, to lend to LDCs, both through direct exhortations that banks must recycle petrodollars and, indirectly, by i) expansionary fiscal and monetary policy which produced excess liquidity in the banking system; ii) the asymmetry between tight regulation of the home financial market and unregulated international markets; and iii) the failure to support international lenders such as the IBRD, IDB, IMF, etc., which could have been a more appropriate alternative for recycling.

Additional externalities were generated by the structure of financial markets itself. As already noted, the banking system has two tiers: the big international banks that search out markets and evaluate risk, and medium and small banks which provide the bulk of the funds and lend on the basis of the assessments of the big banks. Furthermore, the big international banks themselves are locked into an oligopolistic structure and do not make lending decisions independently of what they expect their competitors to do.

Finally, examining the problem from the standpoint of the debtors, it must be remembered that while during the 1970s Latin American countries borrowed on the basis of their own needs and decisions, they were also encouraged to do so by a form of conventional wisdom prevalent in important international circles that argued that bank credits were "cheap" in real terms and that foreign indebtedness was "good business".

In sum then, what one is confronting is a big "public problem". Both in terms of the causes of the crisis as well as its nature, one can perceive that the banks, their governments, and the LDC borrowers are subject to important interdependencies that condition all solutions to the crisis and suggest that a sharing of the costs is appropriate.

b) A public problem demands a public solution

A sine qua non for efficient adjustment in Latin America and a lasting solution to the crisis is a co-ordinated effort on the part of the OECD governments to reactivate their own economies and bring interest rates down to historical levels. Indeed, if Latin America's terms of trade had been similar to those prevailing in 1980 (25% higher than at present), and if at the same time real interest rates mirrored those in force at the time when the bulk of the debt was contracted (4 points less), the region would have available to it US$ 25 billion

/of additional

of additional resources, enough to meet debt services without a dramatic compression of imports and hence of growth. It also must be remembered that this a terrain where debtors, creditors and their governments have strong mutual interests: economic recovery would reduce unemployment and social tensions in both the North and South, while lower interest rates would promote recovery and restore the repayment of loans by debtors without threatening the profits of the lending institutions.

In the absence of a strong and sustained recovery of the OECD countries, debt service will depress Latin America's growth prospects and, in the context of "short leash" reschedulings, continue to occupy a disproportionate share of bankers' and developing country authorities' time.

Nevertheless, proposals abound to alleviate the problem by joint multilateral public action. A summary of the contents of some of the proposals is presented in table 18. In addition to these global ideas, specific measures have frequently been suggested concerning reform of the international financial structure. These include:31/

a) increasing available long-term finance from the World Bank via a change in the gearing ratio of this institution;

b) authorization of direct access by the IMF to private capital markets;

c) cofinancing between the World Bank and private banks;

d) elimination of the concept of graduation for middle-income countries;

e) modification of IMF conditionality; and

f) increasing the importance of programme loans in the World Bank.

On the regional front there are similarly many proposals to help Latin America overcome the crisis. To mention just a few of them here:32/

a) a freeze on protectionism, together with efforts to promote the expansion of regional trade and preference schemes;

b) the expansion and interconnection of the various interregional financial programmes already in existence such as multilateral payments mechanisms,33/ schemes for balance-of-payments support,34/ import credit insurance plans 35/ and the establishment of institutions dedicated to the financing of projects;36/

c) the enlargement of the role of the Inter-American Development Bank; and

d) effective, direct and confidential exchange of information on the conditions on which the external debt of the countries of the region is being refinanced and reprogrammed.37/

/Table 18

Table 18

SUMMARY OF SELECTED PROPOSALS TO ALLEVIATE THE DEBT CRISIS

Government of Mexico a/	A new window at the IMF that would provide lightly conditional finance to countries facing interest payments in excess of 2% real. This represents an expansion of the concept underlying the Fund's current Compensatory Finance Facility.
Kenen b/	In this scheme private banks trade their LDC loans for 10-15 years bonds to be emitted by a newly created OECD supported international organization. The loans would be traded at a 10% discount and the devaluation of the banks' assets would allow the new institution to reschedule LDC loans on more favourable terms.
Weinert c/	Private banks would trade their LDC loans for bonds to be emitted by the World Bank and the Bank in turn would reschedule the loans on better terms. The trade would be at face value, but the bonds would carry a reduced interest rate; this would distribute losses over a longer period than would occur in the Kenen plan with its immediate 10% devaluation of assets.
Zombanakis d/	The IMF would extend its adjustment programme to 10-15 years. The private banks would then reschedule their loans in a way that is compatible with the longer adjustment programme and in turn would receive an IMF guarantee for the latter maturities of the rescheduling.
Bolin and Del Canto e/	Propose the establishment of a new public institution to provide loans that bridge the short-term maturities of private banks and the longer-term maturities of multilateral lenders. They also envision a bigger financing role for OECD export credit agencies. As for the fluctuation in interest rates, it is suggested that the World Bank provide residual finance that would effectively guarantee a maximum interest rate for debtor countries.
Lever f/	On the basis of an evaluation of what constitutes a reasonable current account deficit, countries should have made available to them a maximum amount of finance. This evaluation will be made in conjunction with the IMF. Bank loans in this programme also should enjoy OECD government guarantees.

/Table 18 (Concl.)

Table 18 (Concl.)

Avramovic g/ Massad h/	Both propose increases in LDC liquidity via new emissions of SDRs.

Source: Developed from data in M. Guerguil, "La Crisis Financiera Internacional: Diagnósticos y Prescripciones" (mimeo), ECLA, Economic Development Division, November 1983.

a/ "Facilidad para el financiamiento del déficit de balanza de pagos provocado por las altas tasas de interés" (mimeo), August 1983.
b/ P. Kenen, "A Bailout for the Banks", New York Times, 6 March 1983.
c/ R. Weinert, "Banks and Bankruptcy", Foreign Policy, No. 50, Spring 1983, pp. 138-149.
d/ M. Zombanakis, "The International Debt Threat: A Way to Avoid a Crash", The Economist, 30 April 1983, pp. 11-14.
e/ W. Bolin and J. Del Canto, "LDC Debt: Beyond Crisis Management", Foreign Affairs, Summer 1983, pp. 1099-1112.
f/ H. Lever, "The International Debt Threat: A Concerted Way Out", The Economist, 9 July 1983, pp. 18-20.
g/ D. Avramovic, "The Debt Problem of Developing Countries at End-1982", Aussenwirtschaft, March 1983, pp. 65-86.
h/ C. Massad, "The external debt and the financial problems of Latin America", CEPAL Review, No. 20, August 1983, pp. 149-164.

/The spirit

The spirit and intent of all these proposals is correct: public problems require public solutions. However, their efficacy is conditioned by the aforementioned element of time: most of the proposals are at best a medium-term proposition. It must be remembered that an economic system based on private markets tends to underproduce public solutions (i.e., public goods). Furthermore, pressures for a public solution are usually minimal until the externalized costs of a problem become internalized vis-à-vis the major economic agents of the system.

So far, the ability of the banks to successfully reschedule debts on terms highly favourable to them has allowed the capital exporting countries to keep the costs of the debt crisis externalized, i.e., the debtor countries have borne them and what benefits there are have been largely accrued to the creditors.*/

Solutions at the regional level also encounter similar obstacles. The major difference, however, is that the costs of the crisis have already been internalized for the most important economic actors of the region, thus giving greater impulse to regional solutions. But in any event, time remains a factor and regional accords cannot be expected to provide immediate relief from the debt crisis.

3. An alternative solution: bilateral agreements compatible with positive adjustment

A public solution to the crisis, while entirely desirable and urgently needed, does not seem feasible in the near future. This reduces the field of action to the national level, where the response could be a bilateral agreement between the borrowing country and its creditor banks involving a rescheduling suitable for positive adjustment.

It has already been observed that Latin America must reduce its external vulnerability by restructuring its relations with foreign creditors and adopting more efficient strategies of indebtedness and growth. Nevertheless, the region presumably will want and need future external financing. The value of a bilateral settlement involving a rescheduling on terms suitable for a positive adjustment process is that it is less conflictive than unilateral action and thereby may avoid serious negative repercussions with respect to the future access to credit. Such a settlement should be in keeping with the terms and conditions agreed at the January 1984 Quito Latin American Economic Conference already referred to.

a) The terms of an agreement in line with the criteria of the Quito Plan

Assuming that the effects on Latin America of the present world economic upturn will be more gradual than has been the case in past recoveries since World War II, and assuming that in the near future nominal and real interest rates will remain unusually high, rough and ready estimates would suggest that for Latin America to grow by 5% per annum in the triennium 1984-1986 and to begin a modest recuperation of its international reserves, it will need to reschedule all its amortization payments, and on average have 80% of its interest payments rescheduled or refinanced.

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*/ A recent study by A. Fishlow notes that the nine biggest United States banks obtained extraordinary profits totalling between US$ 70 million and US$ 130 million in 1983 from renegotiation of debts with the Third World. See El Mercurio (Chile), 16 January 1984.

/In this

In this light, bankers and debtor countries should arrive at a rescheduling package that at a minimum covers the triennium 1984-1986, although ideally the two should pursue a restructuring of the entire stock of debt owed to the banks. It is absolutely essential to eliminate the traumatic yearly rescheduling exercises which consume so much time of government authorities and bankers, raise uncertainties, and inhibit restoration of a normal credit environment for Latin America. Thus, a debt relief package providing a once-and-for-all definitive breathing space on upcoming payments is called for. Such a new debt relief package could coincide with the IMF's extended adjustment programmes, thus providing bankers with the security of the Fund's conditionality.

Amortization of debt, however, is really not the problem as bankers have shown a disposition to reschedule. The real bottleneck to recovery in Latin America, and the issue on which the focus of attention must lie, is the problem of interest payments. As has been seen, banks have been refinancing about 40-50% of interest payments. Even so, the GDP continues to fall as countries must generate large trade surpluses (in the face of external constraints on export performance) to cover the remaining interest payments, which come to a very large sum due to the extraordinary level of nominal interest rates. Ceteris paribus, then, formulas must be found to reduce these interest payments not financed with fresh loans.

Therefore, as an integral part of the rescheduling agreement, creditors should provide an ex ante guarantee of 80% refinancing of interest payments */ during the period 1984-1986. This could very well involve a sliding scale, e.g., 90% in 1984; 80% in 1985, and 70% in 1986, to take into account the possibility of a gradual improvement in the world economy and somewhat lower world interest rates. An historically useful instrument called a "bisque clause" could also be inserted into the agreement to provide for less automatic refinancing of interest payments in the event of a dramatic and unforeseen favourable change in the world economic situation and/or a sudden drop in interest rates.**/

The rescheduled amortization payments and refinanced interest should bear a repayment schedule that pushes against the limit of what could be considered a commercial transaction. It is already known that this schedule should be at least 10-12 years (with a 6 year grace period) since a 10-year amortization period (6 of grace) was agreed to in the second round of the Mexican rescheduling and 12 years were aworded to Nicaragua in 1980, all with no negative repercussions

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*/ The guarantee, of course, would be tied to compliance with IMF adjustment programmes, which presumably could be less severe due to the greater available financing derived from the greater roll-over of interest payments.

**/ Bisque clauses were employed by the United States Government on some of its postwar loans. For example, in 1945 the Government made a US$ 4 billion loan to the United Kingdom, to be repaid over 50 years, in which a bisque clause allowed the repayment schedule to adjust to the economic conditions of the borrower. See G. Abbott, "The case for cancellation", Inter-Economics, No. 7, July 1975, pp. 217-221.

/or sanctions

or sanctions from the creditors' local banking authorities. But an even more acceptable goal would be 15 years (6 of grace): a maturity plan that banks extended with some frequency on loans during the 1970s.*/ On the other hand, the 20-year repayment plan often proposed in Latin American forums risks going beyond the threshold of tolerance of local banking supervisors, since it represents a period that traditionally is outside a bankers' business horizon and enters into the terrain of an institutional investor. While OECD government guarantees on the tail end maturities could overcome this latter problem, such a scheme is outside the self-imposed constraint of a bilateral agreement.

As for the margins over LIBOR -another of the elements determining the negotiated cost of credit- charged on rescheduled debt and refinanced interest payments, they must be as low as possible, yet satisfy the requirements of a commercial framework. This would involve spreads well below those charged in the first round of reschedulings and in most cases below those originally contracted on the debt to be rescheduled. These spreads cannot really be specified theoretically, since the relationship between the banks and the debtor country is in the nature of a bilateral monopoly, so that the rate finally fixed will depend on the relative bargaining power of the banks on the one hand and the country on the other.

But even within the banking community itself there have appeared proposals to the effect that while the banks could not accept a spread below their (marginal) cost of funds (which is the LIBOR), a 1% margin would be feasible as a temporary measure.38/ An even better arrangement, however, would be one providing for a 1% spread, or the margin originally contracted on the debt to be rescheduled/ refinanced, whichever be lower. This would allow countries like Mexico, with traditionally excellent images of creditworthiness, to approach their normal negotiated cost of credit (which is below 1%); most other countries on the other hand would enjoy a spread somewhat lower than that originally contracted on the debt. There is moreover a precedent for this type of treatment inasmuch as the successful bank restructuring of United States and Canadian corporate debt involved special "soft" market rates of interest. Indeed, respected experts in the OECD area have recommended that this strategy for problem debtors in domestic markets be extended to the international plane.39/

As for commissions, they in principle should not be charged in the rescheduling/refinancing package, since one is dealing with an administration of existing debt in which commissions were already originally paid. However, following normal banking practices there is no reason why payment of commissions could not be agreed to in exchange for an interest spread somewhat lower than that proposed here.

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*/ The 15-year loans most often appeared in the early phase of the bankers' expansion into LDCs, that is, in the first half of the 1970s. See the annexes of the World Bank study, Borrowing in International Capital Markets, Washington D.C., Supplement EC 181, August 1976.

/b) Co-operation

b) Co-operation among debtor countries

Achieving the above rescheduling conditions is a question of bargaining power. As noted earlier, the banks' bargaining power and ability to impose conditions may have been somewhat eroded by negative reactions in certain influential circles of the centre and periphery concerning what appear to be excessive charges on reschedulings. The Latin American countries could further increase the pressure, however.

The simplest and least controversial way of doing this would be an exchange of information among the countries concerning the bargaining tactics of the banks. This idea, which was proposed by the Executive Secretaries of ECLA and SELA in the Plan of Action presented to President Hurtado of Ecuador in 1983,40/ would help to counterbalance the advantages enjoyed by the banks, which exchange information through their committees as well as through a new institute recently organized by them in Washington D.C. In the first round of reschedulings, the borrower countries negotiated in relative secrecy and to little advantage, as witnessed by the fact that the terms of the agreements are practically identical for all the countries. The establishment of a credit information system within an existing regional institution would seem to be an easy way to enhance the bargaining power of the Latin American countries.

c) Interest rate ceilings

The refinancing of an average of 80% of interest payments means that current cash payments to the banks would be only a low percentage of debt outstanding. This is quite reasonable because even cash payments equivalent to a "normal" 2% real interest rate would be very burdensome in the current abnormal world economic conditions. Thus, if it is sought to achieve even moderate economic growth, it is reasonable to assume that interest payments on a cash basis must be well below 2% real. Nevertheless, as a proposal for the future, if and when the world economy returns to a degree of stability, it would be constructive to try to stabilize interest payments around a "normal" rate -say 2% real- with the balance over this being capitalized with interest by creditors.*/ This would provide debtors with a degree of stability in interest payments. Moreover, the international financial markets would then have an "automatic" mechanism to roll over interest payments and thereby avoid the trauma and uncertainties that excessively high interest rates generate in financial markets via their negative and transitory effect on the debt servicing capacity of borrowers.

4. Other action

Two unilateral solutions to the debt problem have recently been put forward and discussed in political and academic circles: a moratorium, and unilateral conversion of the debt into long-term bonds. In fact both solutions are very similar, since proponents of a moratorium are not suggesting repudiation of the

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*/ In the 1960s the banks frequently set floor and ceiling interest rates for loans with floating interest, but there was no machinery for capitalization and finally the system ceased to be attractive for the banks.

/debt, but

debt, but rather a temporary halt in current commercial repayment schedules and their eventual replacement by very long-term service calendars. In this context there also would be no need to submit to an IMF adjustment programme.

While the precise terms of repayment differ among the various proponents of these schemes, they are similar in principle. Payments of interest and principal would be halted for a period of 2-5 years, with reimbursement of principal being affected over a 20-30 year period. Interest rate proposals vary from less than market rates to a 2% real rate.*/

The proponents of these plans argue that they would: i) provide considerable and immediate relief from the burden of debt; ii) offer a repayment scheme that is much more compatible with development than any commercial scheme that would conceivably be acceptable to the banks; and iii) eliminate the need for endless multiple reschedulings with their ensuing costs of time and resources.

Another potential benefit, often cited by proponents of unilateral debt conversions into bonds, is that such an emission would help to create a secondary market for Latin American debt paper. On the one hand, this would allow the banks to free themselves of unwanted assets by selling them off in such a market. On the other hand, countries would gain valuable information on their creditworthiness via the fluctuations in the market value of their paper. Also, any sharp devaluation of the assets in the market could provide potential debt relief via the opportunity to repurchase the obligations at their new lower values.

The proponents of these solutions must be aware, however, that they also involve some important costs.

The first cost is related to what would happen to the bonds and future access to credit. A generalized debt conversion into bonds, or moratorium, would force the banks to write off a considerable part of the value of their loans to LDCs. This would imply large accounting losses for the banks. Moreover, the losses would be disproportionately assumed by the big United States lending institutions which are the least diversified with respect to Latin American debt.41/

These losses would probably prejudice future access to credit. On the one hand, the losses would seriously threaten the solvency of many of the world's largest financial institutions. The resulting uncertainty would paralyse credit markets and spark a major rise in interest rates from their already excessively high levels. According to some analysts, this in turn could cause the debt crisis to spread to Northern markets, stifle the economic recovery of the OECD countries,42/ and hence make even more problematical the recovery of Latin America's creditworthiness.

On the other hand, creditors have long memories with regard to accounting losses, as witnessed by the reluctance of institutional investors to re-enter the LDC bond market after their disastrous experience in the earlier half of this

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*/ What has not been mentioned, and would be even more appropriate, is a real interest rate calculated not on the basis of international inflation, but rather the borrower's terms of trade.

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century. These negative repercussions are intensified in a modern banking system. First, there are the aforementioned negative externalities that make the crisis permeate the entire financial network. Second, the losses would be disproportionately concentrated in the big banks, which are the most internationally oriented and to a large extent are responsible for mobilizing credit from the hundreds of smaller domestically-oriented banks that provide the bulk of loanable funds in the market. Furthermore, the big banks also have some control over bond markets, since they frequently underwrite such instruments.*/

As for the benefits of developing a secondary market, these too are problematical. First there is the question of who would purchase the paper. Second, a unilateral bond emission by one or several small borrowers would involve values that are too low to support efficient secondary market operation. Furthermore, although such action by a big borrower and/or smaller borrowers would create values sufficient to form a secondary market, the losses imposed on the banking system could be so large and immediate that the primary market would probably be in disarray for a considerable length of time, while the secondary market would not emerge, thus adversely affecting both access to new credits and conversion of old debt.

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*/ There is of course the theoretical possibility of emitting bonds in respect of debts to banks that find such an arrangement acceptable, such as smaller United States banks and European institutions which are relatively less exposed in Latin America. But this theoretical possibility is stifled by the legal requirements of cross-default clauses, which put all banks into the same boat. Moreover, this boat is piloted by the big United States institutions.

/Notes

Notes

1/ See Daniel M. Schydlowsky, Capital utilization, growth, employment and balance of payments and price stabilization, Center for Latin American Development Studies, Boston University, December 1976.

2/ See C. Massad and R. Zahler, "Dos estudios sobre endeudamiento externo", Cuadernos de la CEPAL, United Nations, Santiago, 1977; R. Ffrench-Davis, "El problema de la deuda externa en América Latina: tendencias y perspectivas en 1983", Integración latinoamericana, September 1983, and R. Devlin, "External finance and commercial banks. Their role in Latin America's capacity to import between 1951 and 1975", CEPAL Review, No. 5, First half of 1978, pp. 63-98.

3/ Ffrench-Davis, ibid.

4/ See Ffrench-Davis, ibid., and Morgan Guaranty Trust Co., World Financial Markets, August 1982, p. 10.

5/ See Devlin, op. cit.

6/ The first banks substantially to increase their credit to Latin America were the big United States banks. They were followed by that country's so-called regional banks and later by the European, Canadian and Japanese banks. On the expansion of the banking system, see S. Robinson, Multinational Banking, London, H.E. Sijthoff, 1974; R. Weinert, "Eurodollar Lending to Developing Countries", Columbia Journal of World Business, Winter 1973; P.A. Wellons, Borrowing by Developing Countries in the Eurocurrency Market, Paris, OECD, 1977; and Devlin, op. cit.

7/ Morgan Guaranty Trust Co., World Financial Markets, February 1983.

8/ Bank for International Settlements, International Banking Developments: Third Quarter, 1982, Basle, 19 January 1983.

9/ The nine largest banks of the United States have lent Mexico the equivalent of 50% of its capital and reserves and the largest banks of Japan have well over 50% of their capital at stake in that country. See "Bottomless debt", The Economist, 11 December 1982 and "The Mexican Shokku", Euromoney, November 1982.

10/ Bank for International Settlements, International Banking Developments: Second Quarter, 1983, Basle, 19 October 1983.

11/ See World Bank, Multilateral Debt Renegotiations, 1956-1965, Washington D.C., 1969, and Chandra Hardy, Rescheduling Developing Country Debts, 1956-1981: lessons and recommendations, Washington D.C., Overseas Development Council, 1982. The multilateral debt of the IDB and the World Bank traditionally does not enter into rescheduling operations.

12/ See Irving Friedman, The Emerging Role of Private Banks in the Developing World, New York, Citicorp, 1977.

13/ See Irving Friedman, op.cit., and W. Glasser and D. Roberts, "Bank lending to developing countries", Federal Reserve Bank of New York, Quarterly Review, Fall 1982.

14/ This was the method used to deal with the debt crisis in Peru in 1968-1970 and 1976; in Argentina in 1976 and in Jamaica in 1978. See D. Beim, "Rescuing the LDC's", Foreign Affairs, July 1977; R. Devlin, op.cit., and I. Friedman, "The role of private banks in stabilization programs", in W. Cline and S. Weintraub (eds.), Economic Stabilization in Developing Countries, Washington D.C., Brookings Institution, 1981.

15/ See Beim, op.cit., and C. Carvounis, "The LDC debt problem: trends in country risk analysis and rescheduling exercises", Columbia Journal of World Business, Spring 1982, pp. 15-19.

16/ See Friedman (1981), op.cit.

17/ See Hardy, op.cit.

18/ See I. Friedman, "A Contrarian View of Country Risk", Bank of Boston, New York, 1980.

19/ To quote Glasser and Roberts, "Clearly the more attractive the terms of restructured or rescheduled debt, the more willing will be the participation of all banks, and a reasonably early resumption of lending will be more likely". See Glasser and Roberts, op.cit.

20/ This case is analysed in detail in R. Devlin, Los bancos transnacionales y el financiamiento de América Latina: la experiencia de Perú, 1965-1976, Santiago, Chile, ECLA, 1980. Also see D. Duff and I. Peacock, "Refinancing of Sovereign Debt", The Banker, January 1978, pp. 69-75.

21/ See Irving Friedman (1981), op.cit., p. 254.

22/ See International Monetary Fund, "Fund policy on adjustment and financing clarified in address by Managing Director", IMF Survey, Washington, D.C., 9 January 1984. Also see M. Guitian, "Crisis financiera internacional o la revuelta contra la interdependencia económica" (mimeograph), International Monetary Fund, Washington, D.C., 1983.

23/ IMF Survey, ibid.

24/ See D. North, "International capital movements in historical perspective", in R. Micksell (ed.), U.S. Private and Government Investment Abroad, University of Oregon Books, Oregon, 1962 and ECLA, El financiamiento externo de América Latina, New York, United Nations, Sales No. S.65.II.G.4, 1965.

25/ Latin American Economic Conference, "Quito Declaration and Plan of Action", Quito, Ecuador, 13 January 1984.

26/ See Organization of American States, "Extracto de la Ley Pública 98-181 del Congreso de los Estados Unidos titulado: Ley de Viviendas Nacionales y de Recuperación Internacional y Estabilidad Financiera", OEA/Ser H/XIV/CEFYC/4, 10 January 1984.

27/ This was the experience of the Corporation of Foreign Bondholders of London in the last century and of the Foreign Bondholders Protective Council of New York in the 1930s. See ECLA (1965), op.cit.

28/ It is worth stressing the fact that the big banks which lead the market, which are United States banks, are also closely linked by interlocking directorates and by mutual participation in each other's equity. See U.S. Senate Committee on Government Operations, Disclosure of Corporate Ownership, U.S. Government Printing Office, Washington, D.C., 1974, and U.S. Senate Committee on Governmental Affairs, Interlocking Directorates Among Major U.S. Corporations, U.S. Government Printing Office, Washington, D.C., 1978.

29/ See Pearson Commission, Partners in Development, Praeger Publishers, New York, 1969; G. Corea, "The debt problems of developing countries", Journal of Development Planning, No. 9, 1976; Brandt Commission, North-South: a programme for survival, MIT Press, Cambridge, Mass., 1980.

30/ See Pierre Dhonte, Clockwork Debt, Lexington Books, Lexington, Mass., 1979; W.A. Lewis, The Evolution of the International Economic Order, Princeton University Press, New Jersey, 1977, and R. Devlin (1978), op.cit.

31/ See also the Brandt Commission, North-South: a programme for survival, Cambridge, Mass.; the MIT Press, 1980.

32/ For a complete review of regional schemes see C. Alzamora and E. Iglesias, "Bases for a Latin American response to the international economic crisis", CEPAL Review, No. 20, August 1983, pp. 17-46.

33/ Central American Clearing House, Caribbean Multilateral Payments Clearing System, and the ALADI System for Clearing Mutual Balances and Credits.

34/ Santo Domingo Agreement, Central American Fund for Monetary Stabilization, and Fund for Financing Debit Balances of the Central American Clearing House.

35/ Latin American Export Bank, Andean Trade Financing System, and Latin American Association of Export Credit Guarantee Organizations.

36/ Central American Bank for Economic Integration, Caribbean Development Bank, Andean Development Corporation, and Financial Fund of the River Plate Basin.

37/ See the "Quito Declaration and Plan of Action" adopted at the Latin American Economic Conference, Quito, 9-13 January 1984.

38/ See P.P. Kuczynski, "Latin American Debt: Act Two", Foreign Affairs, Autumn 1983. On the other hand, Robert Roosa, a former Under-Secretary of the Treasury of the United States and now a partner in the investment bank of Brown Brothers Harriman, has declared that interest rates should be close to LIBOR. See "Robert Roosa Delivers Sture Memorial Lecture Emphasizing a Broader Role for the Fund and Bank", IMF Survey, 15 December 1983.

39/ See R. Roosa, op.cit., and R. Weinert, "Banks and Bankruptcy", Foreign Policy, Spring 1983.

40/ See Alzamora and Iglesias, op.cit.

41/ See D. Wyss and R. Napier, "The World Debt Crisis and the US Economy", Data Resources US Review, September 1983, pp. 1.24-1.29.

42/ Ibid.

/Appendix

Appendix

CONCEPTUAL ASPECTS OF THE ADJUSTMENT POLICIES

1. Adjustment and financing

The need to initiate an adjustment process arises when an economy is faced with a deficit on its balance-of-payments current account which it cannot finance in a regular fashion. In other words, an adjustment is inevitable when the difference between domestic expenditure and income -which, by definition, is the deficit on current account- exceeds the maximum amount which the economy is able to finance, either by attracting a net amount in foreign loans and investment or by using its international reserves. Under such circumstances, the adjustment process becomes inevitable because, in the last analysis, there is a fundamental budgetary restriction, i.e., the economy simply cannot spend ("absorb") more resources than it has, including its own and borrowed resources.

The origin of the external disequilibrium which the adjustment policies must correct may be found in internal factors -such as an excessive growth of aggregate demand or the maintenance of an excessively low real rate of exchange- or in external factors. The latter may be of a temporary nature -e.g., a temporary increase in international interest rates or a cyclical drop in the terms of trade- or of a permanent nature -e.g., a deterioration in the purchasing power of exports caused by the partial or total displacement of an export product on the world market by more efficient and less expensive substitutes.

These distinctions are important because, in principle, an adjustment policy should be limited to correcting the deficits arising from internal causes and those which arise from external causes of a permanent nature. Negative balances on the current account that are caused by temporary external factors should not be eliminated through adjustments in the economy but rather they should be financed with international reserves or external indebtedness. In practice, of course, if international reserves are inadequate or if the necessary external financing is not available, adjustment policies will also have to be applied to cover at least part of the negative balance arising from temporary external factors.

2. Basic adjustment policies

Essentially, there are two types of adjustment policies: those which reduce the level (or growth rate) of domestic demand and those which raise the relative prices of internationally tradeable goods (i.e., exports or exportable goods, imported goods and goods which replace imports) vis-à-vis the prices of non-tradeable goods.

As will be seen, both groups of policies are necessary in order for the adjustment process not only to achieve its basic objective of reducing the external disequilibrium to a level where it can be financed, but also to achieve this result in a more efficient fashion.

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Policies for controlling the aggregate demand -typically, fiscal, monetary and income policies- help restore the external equilibrium through three basic mechanisms. Firstly, by limiting domestic expenditure, they directly reduce imprts and make available for export goods which had previously been absorbed by domestic consumption or investment demand. Secondly, by also reducing domestic expenditure for non-tradeable goods, they free real resources (in activities which produce them) which can then be used to increase the production of exports and imports substitutes. Lastly, by raising domestic interest rates, restrictive monetary policies tend to attract a greater amount of external financing and thus reduce the amount of the external disequilibrium that must be eliminated.

Policies such as those pertaining to the exchange rate, export subsidies and promotion and tariff increases, which raise the relative prices of all or some tradeable goods, supplement the effect of policies aimed at controlling the aggregate demand by generating changes in the composition of domestic expenditure and in the structure of production.

Thus, for example, by raising the national-currency value of exports, imports and import substitutes, a devaluation tends, first of all, to reduce domestic demand for all these goods, thus helping to increase exports and decrease imports by virtue of the decline in domestic expenditure deriving from policies aimed at restricting the aggrgate demand. Moreover, as a devaluation raises the relative price of tradeable goods, this in turn increases the profitability of the industries producing them, thus fostering an increase in the production of exports and of goods that compete with imports. Naturally, the devaluation has exactly the opposite effect on the demand and supply in respect of non-tradeable goods, i.e., by reducing their relative price, it stimulates their consumption, on the one hand, and, on the other, it discourages their production. The latter change reinforces the change brought about by the decline of total domestic expenditure deriving from policies aimed at controlling demand and therefore tends to facilitate the reallocation of resources from the production of non-tradeable goods to the production of exports and import substitutes. The other change, i.e., the reduction of the relative price of non-tradeable goods, tends to neutralize the effect of the decline in total domestic demand and thus helps attenuate the resulting decline in levels of activity and employment of the sectors which produce non-tradeable goods and services.

In brief, it is possible, by simultaneously applying policies aimed at controlling demand and policies aimed at changing relative prices, to reduce the extent of the external disequilibrium by reducing total domestic demand through an adjustment in the composition of expenditure (from tradeable to non-tradeable goods) and through adjustments in the structure of production (from the production of non-tradeable goods to the production of tradeable goods). In theory, moreover, this combination of policies should make it possible to restore the external equilibrium while maintaining the overall level of employment.

In order for the latter to occur, of course, resources must be reallocated from the production of non-tradeable goods to the production of exports and import substitutes. Because such resources, particularly over the short term, are relatively specific in nature, and because it is necessary to expand the installed

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capacity of the sectors producing tradeable goods, this process of reallocation takes time and requires additional investment. In practice, therefore, adjustment can only succeed in a dynamic context of economic growth. To achieve this, policies aimed at restricting demand and at changing relative prices must be complemented by others aimed at promoting investment in export and import-substitution activities and facilitating the movement and readaptation of labour.

3. The cost of the adjustment

As has been indicated above, when a current-account deficit can no longer be financed, an adjustment is inevitable. When this happens, the difference between domestic expenditure and income must be reduced to an amount that is compatible with the actual flow of external financing. The central concern, therefore, is not how to avoid going through an adjustment, for when international reserves fall below the minimum level required to allow for a smooth operation of international trade and no additional external financing is available, there is no question but that an equilibrium must be brought to the balance of payments; rather, the main concern is how to minimize the cost of the adjustment. Consequently, the two fundamental objectives of an adjustment process are to reduce the current-account deficit to an amount that can be financed and to achieve this at the lowest possible cost.

Strictly speaking, the greater or lesser efficiency of an adjustment process depends on the extent to which it achieves the second objective. Indeed, the achievement of the first objective -to reduce the external disequilibrium- necessarily entails a cost to society, at least in relative terms, i.e., it means that exports must be increased, imports decreased or both.

The three alternatives have one fundamental effect in common that must be stressed, i.e., they cause a reduction in the volume of goods that remain available on the domestic market to meet consumption and investment expenditure. From the social standpoint, the inevitable cost of making an adjustment to an external disequilibrium lies precisely in this real reduction of available goods (or of their rate of growth). The more external financing is available, the more this cost can be distributed in different ways over time; as will be noted later on, this aspect may be a crucial one, particularly from the viewpoint of the political and social viability of adjustment programmes. Sooner or later, at any rate, the price must be paid.

A clear distinction should be made, however, between the cost that is inherent in the process of correcting an external disequilibrium and another social cost that, in practice, often goes hand in hand with adjustment policies, namely, the decline of the domestic product. Contrary to what happens when there is a decrease in domestic expenditure -and its counterpart, available goods- the contraction of domestic production is not an inevitable consequence of adjustment policies. As explained above, adjustment policies require a reduction of the ratio of expenditure to income and this objective -to the extent that expenditure is restricted- can be achieved more easily when domestic production increases, while it is more difficult when domestic production goes down.

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This becomes even more evident when it is borne in mind that in order to reduce the external disequilibrium, in addition to reducing imports, it is normally necessary to increase exports. The efficient way to achieve both results would be to increase production, both of exports and of import substitutes. Depending on the extent to which existing resources are utilized and the ease and speed with which they can be moved from one sector to another, such increases in production may require a decrease in the production of non-tradeable goods. Even in this case, there is no reason for overall economic activity to slow down, since, in theory, a decrease in the production of non-tradeable goods could and should be offset by the increase in the production of exports and import substitutes.

Consequently, an adjustment policy causes a decline not only in domestic expenditure but also in domestic production entails an excessive social sacrifice and must be qualified as inefficient because, to the inevitable drop in the volume of available goods that is required to correct the external disequilibrium, it adds an unnecessary and definitely counterproductive drop in the production of tradeable goods.

The ideal adjustment to an external disequilibrium, therefore, is characterized by an increase in exports, the replacement of some imports of intermediate goods by domestic products and the elimination of non-essential imports or their replacement by local products whenever possible. A less desirable adjustment, on the other hand, would be one which would lead to the reduction but not the replacement of imports of necessary intermediate goods; in that case, the external disequilibrium is corrected at the expense of a slowdown in economic activity and a drop in employment.

The advantage of the latter type of adjustment is the speed with which it works. Indeed, it is possible, under such an adjustment policy, to bring about a short-term and very drastic contraction of imports, provided there is a willingness to incur the recessive cost this entails. The ideal adjustment, on the other hand, works more slowly because, as explained above, it calls for structural changes to be made in the supply and, in order for this to happen, changes must also be made in the spheres of production and marketing.

It is true that, in principle, if there is an idle capacity or if the only concern is to divert abroad that part of production that is freed through the restriction of domestic expenditure, the response in terms of production must be speedy. In practice, however, this is likely to be limited by the need to fit the quality and type of goods produced to the requirements of the external market, and by the fact that relatively long time periods are required for introducing them on those markets. In fact, even when goods that are internationally competitive in terms of price, quality and financing are available, it takes time and effort to sell them on the external markets, because buyers must be assured of a stable and constant supply. Obviously, this penetration of new markets is even more difficult when the international economy is at a standstill or going through a decline, as it then becomes necessary to displace from the markets in question other competitors who also probably have no better alternative for selling their production.

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Consequently, the more time is available to make these changes, the greater will be the likelihood of the adjustment and correction of the external disequilibrium being implemented through changes in the structure of supply and, more specifically, through an increase in the production of tradeable goods rather than through excessive reductions in demand, with the resulting negative effect on overall economic activity.

Hence, also, it is important that there be a more abundant flow of external financing, since that allows time for resources to be reallocated towards the production of tradeable goods, a step that is essential to an efficient adjustment process.

In this regard, the recent experience of the region provides a clear illustration of the negative effect which the lack of adequate external financing has on the adjustment process. As indicated above, during the period 1982-1983, the net inflow of capital fell dramatically. Partly because of this, and partly because international trade fell at the same time, the adjustment process was necessarily very abrupt and led to a tremendous reduction of imports and a very small increase in exports. Since the reduction of imports affected not only purchases of non-essential final goods but also those of intermediate goods that are essential for maintaining adequate levels of domestic activity, it was partly responsible for bringing about a considerable decline in the gross domestic product.

4. Adjustment and inflation

External disequilibrium often goes hand in hand with inflation. This happens particularly when the main cause of the disequilibrium is the excessive expansion of domestic expenditure. When domestic expenditure grows too fast, prices and imports also tend to rise rapidly. Under such circumstances, economic policy is faced with a complex double challenge, i.e., to correct the external disequilibrium by means of adjustment processes and to reduce or eliminate a form of domestic disequilibrium -inflation- by means of stabilization policies.

Although the two problems and the policies designed to solve them are closely interrelated, it is advisable initially to separate them, since there are also significant analytical and practical differences between them.

One important difference is that which has to do with the possibility of delaying a solution to the external disequilibrium, on the one hand, and to inflation, on the other. For the reasons mentioned above, when the deficit on the balance-of-payments current account reaches a level where it cannot be financed through the net inflow of capital or the reduction of reserves, the application of adjustment measures is inevitable. On the other hand -and as the Latin American experience clearly shows- countries are able to live -although not very well- with inflationary processes of some magnitude for relatively long periods of time.

Another significant difference is the difference between the social cost of stabilization policies and that of adjustment processes. As indicated above, the latter necessarily entails a real cost, inasmuch as in order to correct the external disequilibrium, it is necessary to reduce the volume (or the growth rate) of the

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goods that remain available on the domestic market to meet consumption and investment demands. On the other hand, at least from a theoretical point of view, policies aimed at controlling inflation do not entail an inevitable real cost.

In theory, there is no reason why the reduction of inflation should entail a reduction of economic activity. This is so because, essentially, what an efficient stabilization policy should achieve is the simultaneous deceleration of the rates of change of the nominal values of several key variables, such as the money supply, the exchange rate, wages, profits, and interest rates, and this, in principle, can be achieved without affecting the real sphere of the economy.

It is well known, nonetheless, that in practice, stabilization policies often go hand in hand with a decline in economic activity and employment. One fundamental reason for this is precisely the fact that the rates of increase of the aforementioned variables are not synchronized. If, as is often the case, the deceleration of the increase in wages and in the money supply precedes or is more intense than the deceleration of the increase in interest rates and prices, the stabilization policy will tend to bring about a contraction of real economic activity.

A third important difference between adjustment and stabilization processes has to do with the speed or intensity with which they can be implemented. In the case of an adjustment process, it is clearly preferable for it to be carried out gradually because, as mentioned before, the ideal way to correct an external disequilibrium is to change the structure of production, and this requires a reallocation of resources. All of this takes time. On the other hand, in order to control inflation, it is essential to make adjustments on the demand side. Although this calls for a co-ordinated policy that allows for a simultaneous deceleration of nominal changes in a series of key variables, it does not entail any significant modification in the structure of production. In principle, therefore, the goal of reducing inflation can be achieved rapidly.

In practice, however, stabilization processes frequently move at a slow pace. The fundamental reason for this is that the progress of a stabilization programme is determined by the speed at which the inflationary expectations of economic agents can be changed. Strictly speaking, it is because such expectations are relatively rigid that it is preferable to apply stabilization policies that can be implemented gradually. That is why if, in an effort to reduce inflation abruptly, economic policy sets goals with respect to price increases that are much lower than the inflationary expectations of the main economic agents, the level of production will fall along with the rate of inflation. It is therefore important that the stabilization policy establish goals that seem credible, given the prevailing inflationary expectations. Similarly, because such expectations tend to change slowly, a gradual type of stabilization policy is often advisable.

However, if the "spontaneously" credible reduction of inflation is small and, above all, if the existing rate of inflation is very high, a gradual reduction may take so long that, in practice, what may not be credible is precisely that the government should continue with its gradual policy for as long as necessary.

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Under such circumstances, it may be preferable to apply a "shock" treatment based on an income policy calling for a simultaneous and drastic adjustment of prices, wages, interest rates, exchange rates, rents, etc., and accompanied by substantial reductions in the fiscal deficit and in monetary expansion. In this case, however, it is of vital importance that such measures be adopted simultaneously with respect to all the aforementioned variables. If, as has happened in the past, the "shock" treatment consists of abruptly halting increases in some variables -typically, the money supply and wages- while leaving the others free, the result will be a tendency to generate undesirable and unnecessary distributive effects and equally undesirable and avoidable decreases in the level of production.

5. Adjustment, stabilization and reactivation

As mentioned above, it is much more difficult to apply adjustment policies -aimed at reducing the external disequilibrium- and stabilization policies -aimed at reducing the rate of inflation- simultaneously than it is to deal with only one or the other of these situations. When it is necessary to attenuate both the current-account deficit and the intensity of the inflationary process, it is more likely that economic policy will involuntarily cause drops in production and employment instead of only reducing domestic expenditure and the rate of price increases.

Nonetheless, if there is a second significant internal disequilibrium consisting of a substantial idle capacity for production in practically every sector there will be a greater chance of applying a growth-oriented adjustment and stabilization policy. This option also depends on the potential for increasing the volume of imports, particularly of intermediate goods, since under circumstances such as those described above, the scarcity of imported inputs is the main obstacle preventing an increase in the level of economic activity.

To a large extent, this hypothetical scenario reflects the current situation of quite a few Latin American economies. That is why it is so important to the region that the recovery of the world economy be strengthened, since this would have a positive effect on the volume and prices of exports, thus making it possible to finance a greater amount of imports. If this happened and if, in addition, coherent economic policies were applied, it would be possible at the same time to achieve a moderate rate of economic growth and to reduce the magnitude of the external disequilibrium and the intensity of the inflationary process. Naturally, much more progress could be made in these three fundamental areas if, as a result of negotiations with the international banks, less burdensome terms were granted for the service of the external debt and if interest rates on the main world financial markets went down. This would allow for a more rapid increase in the volume of imports -which, as already indicated, is the main obstacle to the achievement of greater economic growth- without such an increase bringing about an untenable increase in the deficit on current account.