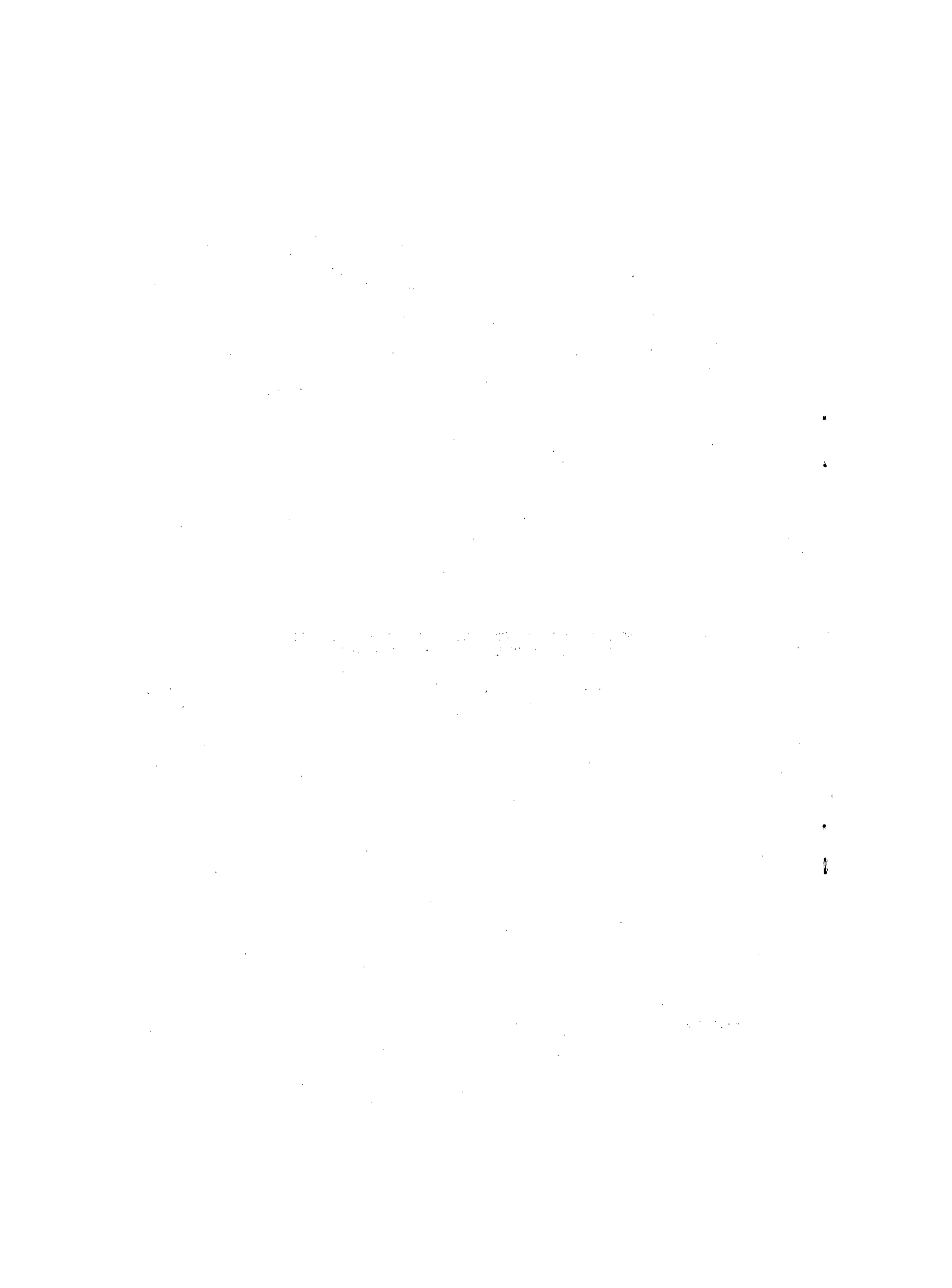


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THE ROLE OF EXTERNAL FINANCE IN THE EVOLUTION OF LATIN
AMERICA'S CAPACITY TO IMPORT: 1950-1975

77-1-0099



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INTRODUCTION

The purpose of this paper is to analyse the role of external finance in the evolution of Latin America's capacity to import during the last 25 years (1951-1975).^{1/} The paper, which is meant to complement a broader study being prepared by CEPAL on capacity to import and industrial growth, will focus on two basic sub-periods, 1951-1965 and 1966-1975, because of the distinct behaviour of key variables in these years. The scope of analysis has however, been seriously handicapped by the unavailability of deflated capital account data. Data for 19 Latin American countries ^{2/} as a group were deflated by hand calculations, a time consuming process that could not be repeated for individual countries or sub-groups. Thus, analysis will be limited to trends of 19 countries as a unit with little or no disaggregation to speak of. It is clear that analysis of trends in such an aggregated fashion has serious limitations. But however small, there nevertheless is some value to examining events for the region as a whole and it is just such a modest contribution that this paper proposes to attain.

As for the format of the paper, two basic sections will be presented. The first deals with the impact of various types of financial flows on the evolution of the region's capacity to import.

^{1/} CEPAL's traditional definition of capacity to import is: the amount of goods and services that can be purchased from annual net inflows of foreign exchange resources, excluding however, resources secured under the heading of compensatory finance. Thus capacity to import is derived by adding gross current account earnings of the balance of payments to gross inflows of autonomous capital; from this must be subtracted service payments (e.g. factor income, amortization payments, etc.) on foreign capital (including compensatory capital) and outflows of national capital (assets held by residents of Latin America). Account must also be taken of the net resource flow under the heading of "errors and omissions" of the balance of payments.

^{2/} Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela.

The second section deals with issues related to external finance such as the burden of debt service and the relatively new phenomenon of dependence on international commercial banks for a significant part of external resource flows.

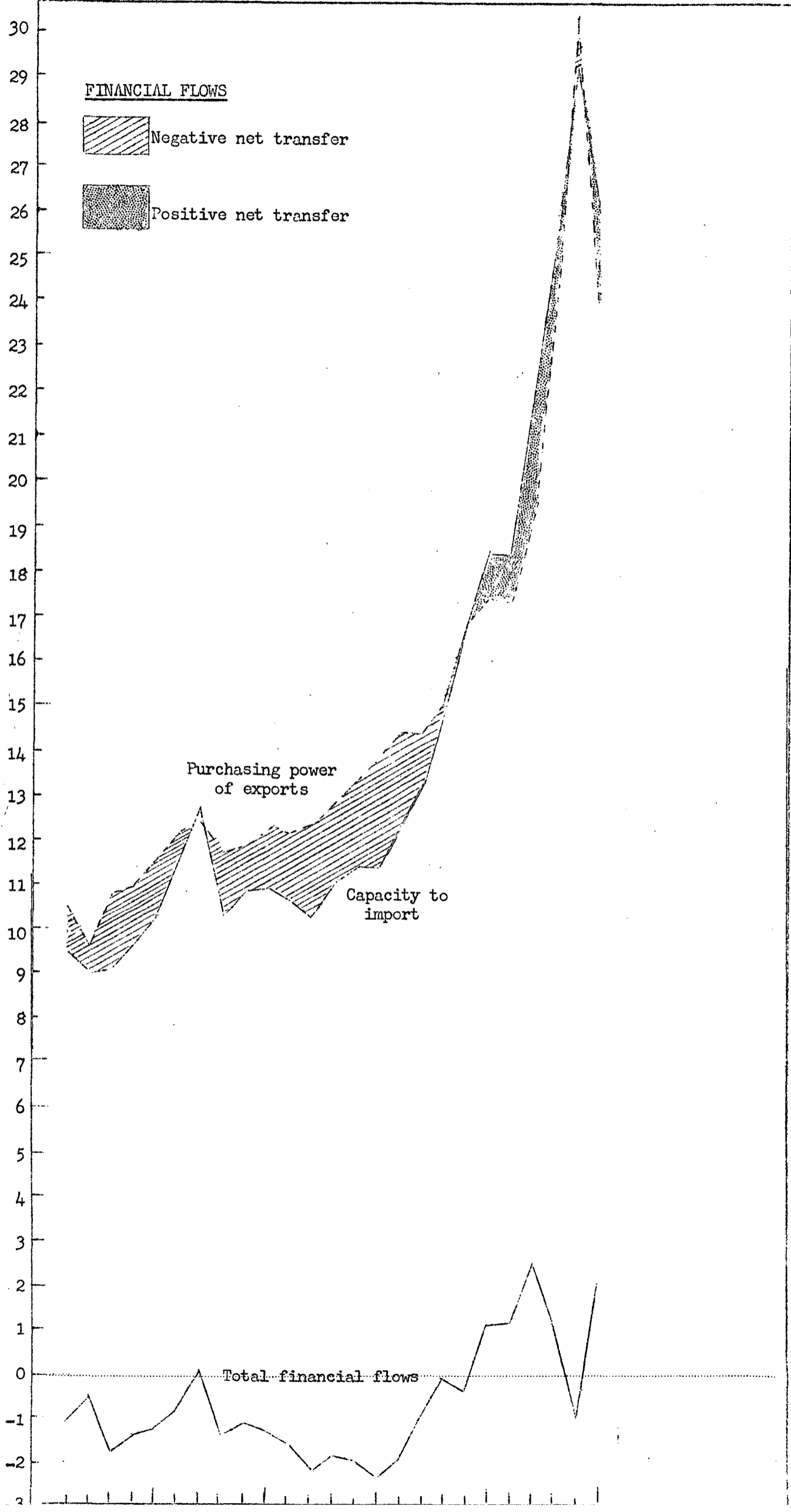
Finally, unless otherwise indicated, all data in the paper are in constant US dollars, using 1970 as a base.

I. THE IMPACT OF EXTERNAL FINANCIAL FLOWS ON THE REGION'S CAPACITY TO IMPORT

Figure 1, in addition to displaying the evolution of the region's capacity to import, shows the behaviour of the major resource flows that determined this capacity, i.e., the purchasing power of the region's exports and the net flow of external financial funds. As is seen, a dramatic rise in the ability to purchase foreign goods and services took place in the period 1966-1975 as a result of highly favourable external conditions that manifested themselves in an unprecedented flow of external resources to the region. It is clear that the major thrust behind the phenomenal growth of capacity to import was the unprecedented rise in the purchasing power of exports. But it also is evident that the rise was attributable in part to a profound "shift" in the behaviour of net external financial flows. It is analysis of this shift to which the rest of this section of the paper will be devoted.^{1/}

^{1/} The role of exports and trade prices in the evolution of capacity to import has been analysed in a separate CEPAL document. For this reason analysis here will be limited to the contribution of financial flows to the capacity to import.

AND EXTERNAL FINANCIAL FLOWS TO CAPACITY TO IMPORT
Billions of dollars (Constant 1970 dollars)



1. External financial flows

As pictured in the bottom half of figure 1, in 1951-1965 Latin America was faced with a persistent net outflow of financial resources. Notwithstanding sharp short term fluctuations, the net flow of financial resources was negative in every year except 1957, when a marginal positive balance was recorded.^{1/} Moreover, the long term trend was towards ever larger outflows and by 1965 the net drain of resources reached US\$ 2.3 billion, more than double the outflow prevailing at the beginning of the period.

The deficit made for a very serious external bottleneck because not only did Latin America suffer from relatively sluggish growth of the purchasing power of its exports (an average 2 per cent per annum), but also from the fact that an increasing amount of resources derived from exports and trade prices leaked out of the region in the form of outflows of financial funds. The gravity of the problem is reflected in the upper portion of the figure by the widening gap between the purchasing power of exports and actual capacity to import; indeed, by the close of the period (1965) the drain of resources was such that capacity to import was 17 per cent less than the purchasing power of exportables.

The year 1966 marked the beginning of a remarkable "shift" in financial flows in the direction of a positive resource transfer, a phenomenon which naturally tended to enhance capacity to import. The favourable reversal started in 1966-1969 when there was a considerable reduction of the resource outflow - by 1969 the negative balance was only US\$ 0.4 billion, or roughly 80 per cent less than that recorded in 1965. In 1970 the resource flow reversed itself completely as the first positive balance (US\$ 1.1 billion) in 13 years was registered, causing capacity to import to actually exceed resources made available by exports and the terms of trade. (See again figure 1.)

^{1/} The positive balance is largely reflective of events in Venezuela.

/The net

The net transfer of financial resources into the region more than doubled in the next two years, reaching a record US\$ 2.6 billion in 1972. The transfer was reduced by 50 per cent the following year and turned negative again in 1974; however, at US\$ 0.9 billion the outflow of resources was considerably less than that experienced during most of 1951-1965. In 1975 the financial resource flow once again turned strongly positive, helping to cushion the impact of a sharp fall in the purchasing power of exports.

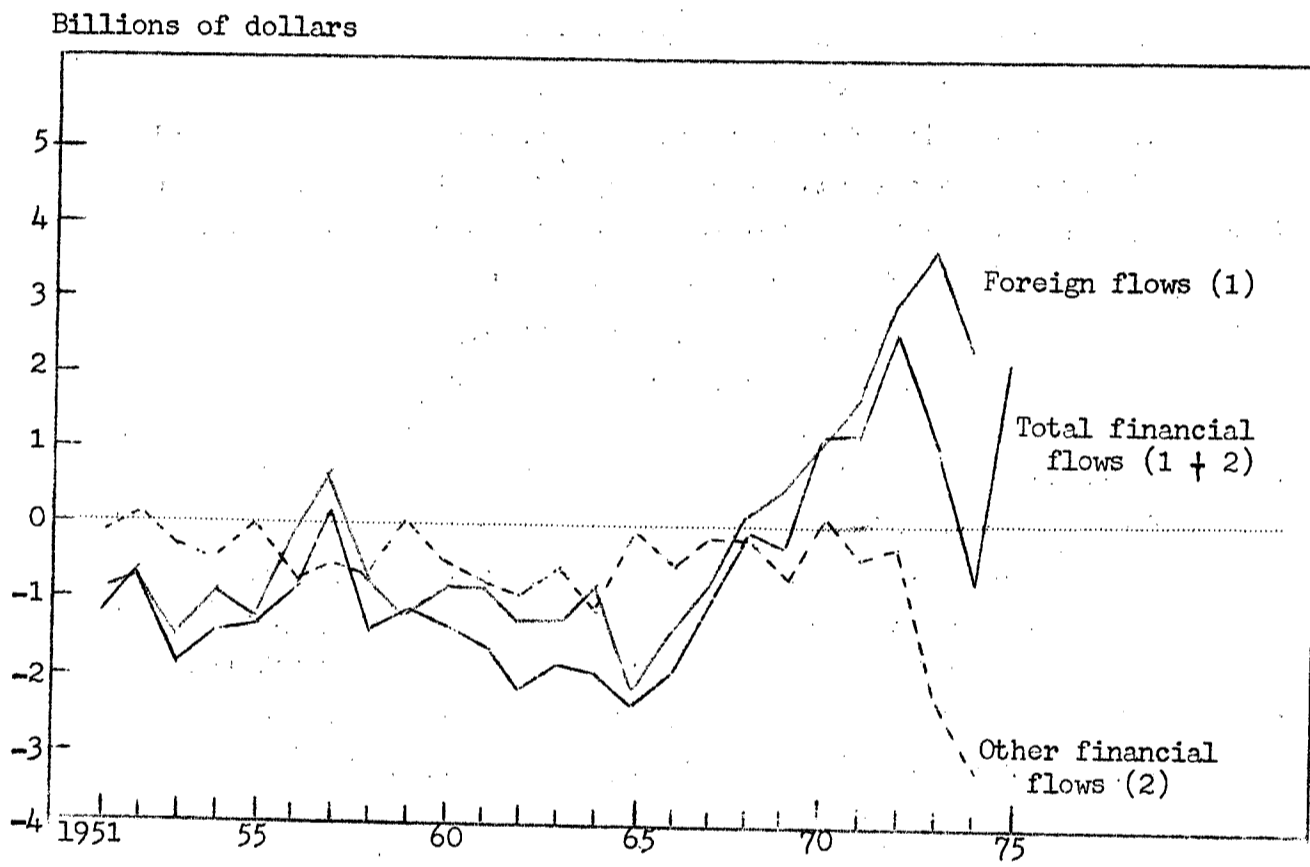
Figure 2 breaks external financial flows into its basic components: net foreign financial flows, net movement of national funds and the errors and omissions entry of the balance of payments. (The latter two flows being designated as "other" in the figure.^{1/}) It shows that the "shift" after 1965 was due basically to a favourable reversal of foreign financial flows. The foreign resource flow in 1951-1965 (except 1957) was persistently negative, and like the total resource flow, its long run tendency was towards enlargement, with US\$ 2.2 billion leaving the region by 1965. But in 1966-1967 the outflows began to diminish and by 1968 a small positive net transfer was recorded. Thereafter, the influx of foreign funds grew very rapidly, - at an extraordinary pace of roughly 140 per cent per annum - reaching US\$ 3.6 billion by 1973. In 1974 the net transfer was reduced by 37 per cent, but it nevertheless remained quite large vis-à-vis historical experience.^{2/}

^{1/} The errors and omissions entry is included in financial flow data because it is thought to be generally more reflective of unregistered flows of factor income and capital than of movements of tradeable goods.

^{2/} Disaggregated 1975 financial flow data were unavailable at the time of writing this paper.

Figure 2

LATIN AMERICA : EXTERNAL FINANCIAL FLOWS
(Constant 1970 dollars)



/As for

As for national funds and unregistered resources flows, their combined effect almost always was negative during the 25 years under consideration. (See again figure 2.) In 1951-1965 their joint behaviour tended to aggravate the drain of resources brought on by the outflow of foreign funds, while in 1966-1974 they tended to offset some of the favourable effects of the shift in behaviour of foreign financial flows. These "other" flows had their most profound impact however, in 1973 and 1974 when outflows were an unprecedented US\$ 2.3 and US\$ 3.2 billion, respectively; indeed, in 1974 the outflow was so large that it more than negated the sizeable positive foreign resource transfer realized that year. (The principal factor behind this enlarged outflow will be examined momentarily.)

The structural shift in the movement of financial flows can perhaps be better appreciated if averaged data for 1951-1965 and 1966-1975 are compared. Table 1 presents just such a comparison. It is noted that during the first period the region experienced an average drain of financial resources in the order of US\$ 1.4 billion per annum, which is equivalent to 12 per cent of average purchasing power of exports for the same period. This contrasts sharply with the behaviour in the succeeding 10 years as financial flows averaged a positive US\$ 0.4 billion, representing an increase in absolute terms of US\$ 1.8 billion with respect to 1951-1965; this would then mean that roughly 20 per cent of the increase in average capacity to import between the two periods was attributable to the more favourable behaviour of financial flows. Significantly, most of the rise occurred after 1970, with the average inflow being US\$ 1.2 billion in 1971-1975, compared to a negative US\$ 0.5 billion in 1966-1970.

/Table 1

Table 1

LATIN AMERICA: NET CONTRIBUTIONS OF EXPORTS AND FINANCIAL FLOWS TO THE
CAPACITY TO IMPORT

(Billions of constant 1970 dollars)

Averages	Purchasing power of exports a/ (1)	External financial flows				Total (2+5) (6)	Capacity to import (1+6) (7)
		Foreign b/ (2)	Other		Total (3+4) (5)		
			National funds (3)	Errors and omissions (4)			
1951-1965	12.0	-0.9	-0.2	-0.3	-0.5	-1.4	10.6
1966-1975	19.2	...	...	...	...	0.4	19.6
1966-1974	18.7	1.1	-0.8	-0.1	-0.9	0.2	18.9
1966-1970	15.6	-0.2	-0.2	-0.1	-0.3	-0.5	15.1
1971-1975	22.9	...	...	...	...	1.2	24.1
1971-1974	22.6	2.6	-1.6	-	-1.6	1.0	23.6

Source: CEPAL on the basis of official statistics.

a/ Includes private transfers.

b/ Net effect of direct foreign investment (net) less profit remittances; short and long term non-compensatory loans less amortization and interest payments; net official transfers and amortization of obligations stemming from compensatory finance operations.

The turnaround in average financial flows was due, of course, to the noted shift in foreign resource flows. Whereas net flows on average were a negative US\$ 0.9 billion in 1951-1965 (equivalent to 8 per cent of average purchasing power of exports), they were a positive US\$ 1.1 billion in 1966-1974, representing an absolute increase of US\$ 2.0 billion. Most of the net transfer took place in the latter half of the decade as reflected by the fact that inflows averaged US\$ 2.6 billion per year in 1971-1974, while in 1966-1970 flows behaved in such a way that the average was still negative at US\$ 0.2 billion. (See again table 1.)

With regard to "other" financial funds, average flows were negative in both periods because annual deficits were generally experienced from the joint movement of national funds and errors and omissions of the balance of payments. However, the outflow in 1966-1974 was nearly double that experienced in the previous 15-year period.

The factor underlying this rise was a substantial expansion of the deficit on national funds: the average outflow rose 4-fold, from US\$ 0.2 billion in 1951-1965 to US\$ 0.8 billion in 1966-1974. The increase was however, largely reflective of the years 1972-1974 when the outflow averaged nearly US\$ 2.0 billion. Roughly half of the outflow in these three years was concentrated in one country (Panama);^{1/} but even so, this would still imply a noticeable rise in the movement of regional assets abroad in the latter half of the decade.

Average outflows under the rubric of errors and omissions declined by nearly two-thirds in 1966-1974, thus helping to offset some of the negative effects of increased placement of national funds abroad. Notably, in the latter half of the period the drain of resources was negligible in average terms.

^{1/} Panama is an international banking centre and outflows may have been the result of transactions carried out by these institutions.

/To summarize.

To summarize up to this point, there was a very distinct behaviour of financial flows during the two basic periods under consideration here. During 1951-1965 there was a large drain of financial resources from the region, which when coupled with the sluggish growth of purchasing power of exports, formed a very severe external bottleneck. In contrast, in the period 1966-1975 there was a large transfer of financial resources to the region which conveniently coincided with a sharp expansion of the purchasing power of exports, the result, of course, being a phenomenal rise in capacity to import. The key factor behind the favourable shift in behaviour of financial flows was foreign funds, which entered the region in unprecedented proportions after 1969.

2. Foreign resource flows

Given that foreign financial flows played such a key part in the rise in capacity to import during 1966-1975, it is useful to examine these flows in greater detail. But before proceeding it is wise to clarify what is meant by the net contribution of foreign funds to capacity to import.

Foreign financial flows have a direct and indirect impact on the region's capacity to import. The direct impact refers to the accounting of resource flows, i.e., the degree to which annual inflows of new foreign financial funds exceed outflows stemming from service payments (profit remittances, interest and amortization payments, etc.).

The indirect impact of foreign flows refers to any favourable effects that resources may have on a country's ability to generate foreign exchange, e.g., new foreign investment in an export industry would tend to boost export earnings. This paper will deal only with the direct effects of foreign flows on capacity to import. As will be seen soon, from this viewpoint foreign funds at times have had a negative impact on capacity to import. However, reference to negative net resource flows does not mean to imply that foreign funds have necessarily been detrimental to the region's interests; only analysis with a more ample perspective could make such a determination.

/(a) Foreign

(a) Foreign investment flows

Foreign direct investment includes capital contributions to private direct investment enterprises of non-residents and reinvested earnings from these investments. But foreign direct investment carries with it a reverse flow in the form of profit remittances. It is the net of these two flows which determines the direct impact on the region's capacity to import.

Figure 3 shows the evolution of new investment flows to the region and outflows stemming from payments of foreign income. It is clear that when Latin America is viewed in the aggregate, there has been a persistent and very large deficit associated with foreign investment operations. This, of course, has been detrimental to the region's capacity to import foreign goods and services.

A view of average flows in the two basic periods being considered is also presented in table 2. It shows that the average net outflow of funds related to foreign investment activities in 1966-1974 was nearly double what it was on 1951-1965, reflecting the fact that while average net inflows of new investment capital rose by one-third, remittances of foreign income rose by nearly two-thirds. Even if 1974 (a year in which payments skyrocketed because high petroleum prices generated record profits for foreign oil companies in Venezuela) is excluded from the period average, the net drain of resources remains considerable: average remittances become US\$ 2.0 billion and the deficit on foreign investment flows becomes US\$ 1.2 billion, still 50 per cent more than the deficit recorded for 1951-1965.

(b) Short and long terms loans ^{1/}

These flows include funds lent by private and official foreign sources to Latin American governments and private enterprises. Short term loans carry a maturity of one year or less, while long term loans are understood to carry more extended maturities. The net

^{1/} Includes portfolio investment.

Figure 3
 LATIN AMERICA : NET CONTRIBUTION OF DIRECT FOREIGN INVESTMENT
 TO CAPACITY TO IMPORT
 (Constant 1970 dollars)

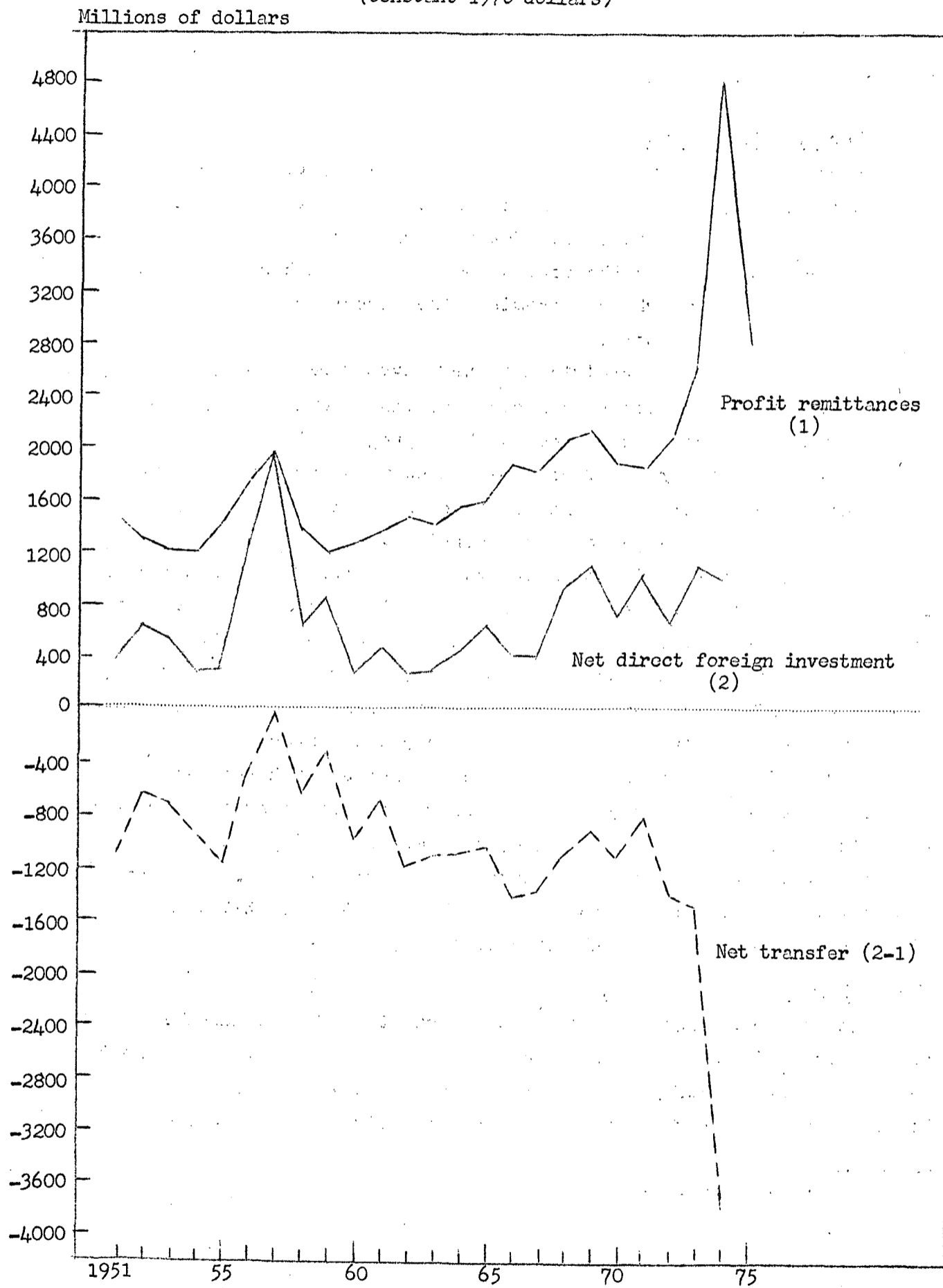


Table 2
LATIN AMERICA: NET FOREIGN FINANCIAL FLOWS
(Billions of 1970 US\$ dollars)

	Foreign Investment Net (1)	Foreign Investment Income (2)	Net Transfer (1-2) (3)	Non Compensatory Loans ^{a/}			Interest Payments (7)	Net Transfer (6-7) (8)	Other Flows (Net) ^{b/} (9)	Total (3+8+9) (10)
				L/T	S/T	Total (4+5) (6)				
				(4)	(5)	(6)				
<u>Averages</u>										
1951-1965	0.6	1.4	-0.8	0.5	0.2	0.7	0.3	0.4	-0.5	-0.9
1966-1974	0.8	2.3	-1.5	2.8	1.1	3.9	1.1	2.8	-0.2	1.1
1966-1970	0.7	1.9	-1.2	1.7	0.6	2.3	0.8	1.5	-0.5	-0.2
1971-1974	0.9	2.8	-1.9	4.2	1.7	5.9	1.4	4.5	-	2.6

Source: CEPAL on the bases of official data.

a/ Short and long term loans disbursements less amortization payments.

b/ The net balance of official transfers and compensatory capital outflows other than use of reserves.

impact of these funds on capacity to import is determined by the balance of net disbursements (gross disbursements less amortization) and interest payments on outstanding loan balances.

Figure 4 shows that during the 25 years under consideration, transactions related to foreign borrowing operations generally resulted in a positive net transfer of resources to the region; indeed, only in two years (1959 and 1965) was the net flow negative. What is striking however, is that after 1965 the net transfer from loan operations reached unprecedented proportions and was able to more than offset the deficit associated with foreign investment activities.

The chief factor behind the phenomenal rise in the net transfer was a rapid and remarkably sustained rise (average growth of over 40 per cent per annum) in net loan disbursements, as loans were contracted at a much faster pace than they were repaid. Thus, net disbursements of foreign loan capital rose from US\$ 0.4 billion in 1965 to US\$ 7.8 billion by 1974.

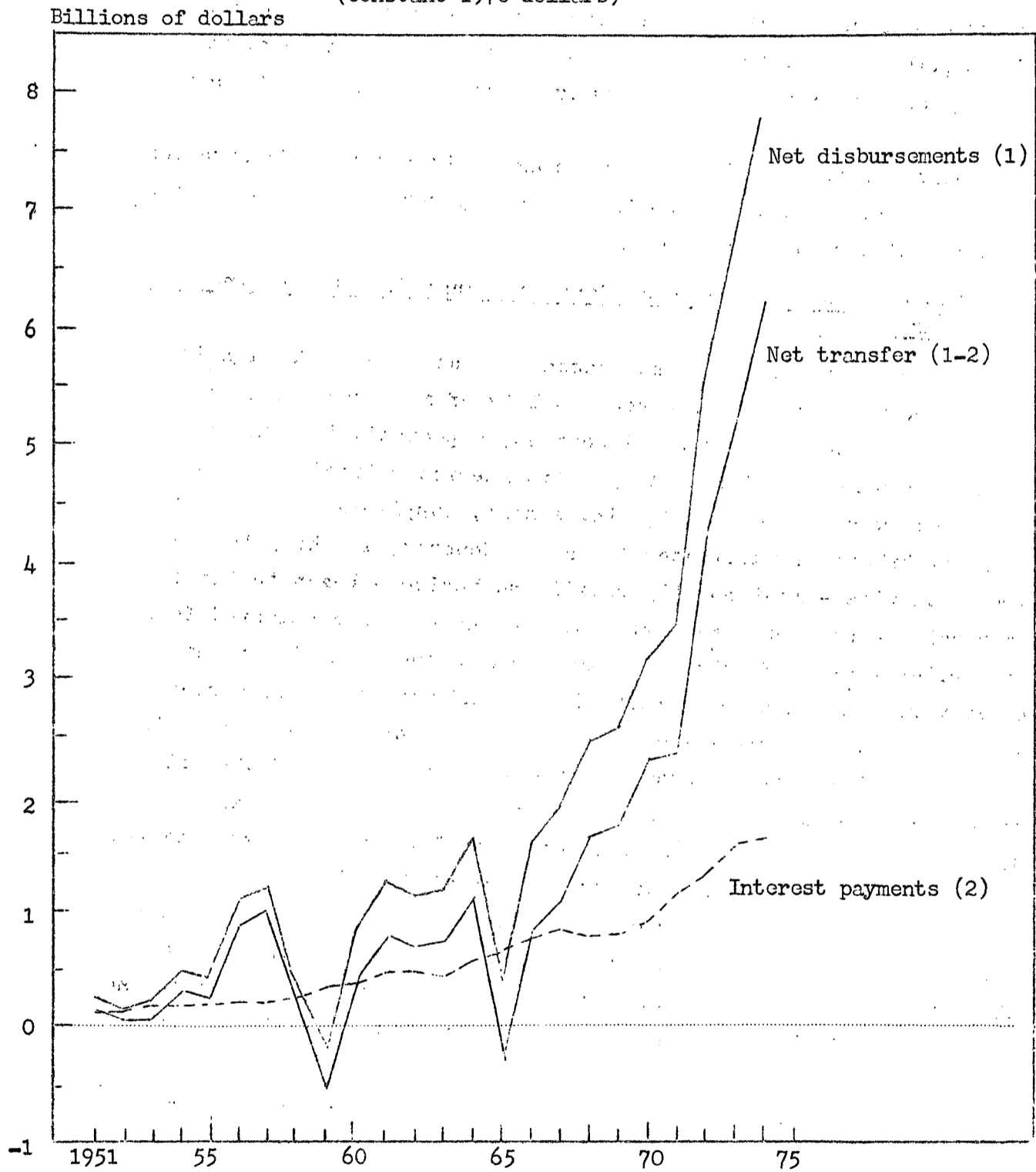
Notwithstanding sharply rising interest payments - the graph shows some acceleration after 1969 - the resource transfer to the region closely paralleled the rise in disbursements. By 1974 the net inflow reached US\$ 6.2 billion, or more than the cumulative net transfer for all of 1951-1965 (US\$ 5.8 billion).

The unprecedented inflows of loan capital after 1965 become all that more striking when averaged data are examined. It also can shed light on the relative importance of short and long term loans.

Returning to table 2, it is seen that the average net contribution of loans to the region's capacity to import rose from US\$ 0.4 billion in 1951-1965, to US\$ 2.8 billion in 1966-1974, an increase of 600 per cent. This reflects the fact that average net disbursements of loan capital rose by US\$ 3.2 billion (457 per cent), while average interest payments rose by US\$ 0.8 billion (266 per cent). Both the graph and the table make clear that it was after 1970 that the transfer was most significant: the average net flow in 1971-1974 was 3-times larger than the average for the previous 5 years and over 10-times larger than the average annual transfer in 1951-1965.

/Figure 4

Figure 4
LATIN AMERICA : NET CONTRIBUTION OF FOREIGN LOANS TO
CAPACITY TO IMPORT
(Constant 1970 dollars)



/It is

It is notable that the large influx of loan capital was attributable mostly to long term rather than short term funds as more than 70 per cent of the increase reflected loans with a maturity of more than one year. This is an important distinction since all things being equal longer maturities are more advantageous to development strategy because repayment is less burdensome on a country's cash flow.

Since loans played such a key role in transfer of foreign funds to the region, it might be useful to briefly comment on some of the factors that made this possible.

(c) Dynamics behind growth of foreign loans: Private international bank capital

Perhaps the most salient reason for the rise in foreign loans to Latin America was the enhanced ability of many countries in the region to tap private financial sources, especially international commercial banks. Prior to 1965 Latin America's traditional sources of finance were direct foreign investment, suppliers' credits and official bilateral/multilateral loans. However, in the late 1960s some countries - most notably Brazil and Mexico - began to tap foreign commercial banks for sums that would not have been considered feasible in earlier years. By the early 1970s these two countries became heavily reliant on private bank finance and many other countries - e.g., Peru, Colombia - were able to consistently secure sizeable loans from these banks as well. Then with the advent of the oil crisis in 1974, most countries experienced a severe external disequilibrium and it was private commercial banks that extended the bulk of the funds required to cover external deficits.

It appears that a number of special circumstances were behind the rise in bank loans to Latin America. Of major importance was the development of a new financial centre - known as the Eurocurrency market - in the late 1950s. At first the market catered primarily

/to industrialized

to industrialized countries, but by the late 1960s rapid growth of the market and competitive pressures pushed banks into a search for new customers in developing areas. Latin America - more specifically Brazil and Mexico - became a prime candidate because of the relatively higher level of economic growth and development to be found there. By the early 1970s the competitive rush for new markets reached such proportions that lending spilled over into other countries of the region, such that those traditionally accustomed to official sources of capital found the Eurocurrency market a more than willing supplier of funds.^{1/}

Other factors were clearly at play as well. The export boom experienced by many countries in the late 1960s and early 1970s greatly expanded foreign exchange earnings. This in turn made them appear more creditworthy, from the banks' point of view, precisely at the time when these institutions were vigorously competing for secondary markets in developing areas. Also, in the 1960s and early 1970s there was an enormous penetration of transnational corporations into the region (particularly Brazil and Mexico), and being intimately associated with private banks, these corporations naturally sought international bank capital to finance their expansion. Meanwhile, at the same time a number of governments had embarked on programmes of expanded public investment (some to complement and others to substitute foreign investment) and they found the Eurocurrency market a convenient source

^{1/} While most lending in absolute terms went to countries like Mexico and Brazil, Argentina, Colombia, Peru and Venezuela, as well as smaller countries such as Nicaragua, El Salvador, Panama and Bolivia were able to secure sizeable loans from Eurocurrency banks.

of finance.^{1/} Finally, the enormous rise in bank credits to the region in 1974-1975 was necessitated by the fact that oil producers deposited the bulk of their surplus oil receipts with private banks who then became financially, and perhaps politically, obligated to act as a recycling agent, channeling resources from surplus countries to deficit countries in both the industrialized and developing worlds.

It is important to add here that up through mid-1974 international commercial bank loans to Latin America were accompanied by relatively long maturities. Commercial banks typically prefer short maturities, and indeed to the extent that banks became involved in the region's external finance during 1951-1965 it was more often than not for shorter term loans. But in the early 1970s a combination of high liquidity and competitive pressures caused a noticeable lengthening of maturities and by 1972-1973 some countries like Brazil were able to consistently secure loans with maturities of 10 years or more.^{2/} Thus, the dramatic rise in net loan disbursements to the region in the last decade was not only because of an increased ability to

^{1/} Governments found banks a convenient source of funds not only because banks appeared eager to extend loans, but also because they were prepared to apply little or no conditionality for disbursement. Thus, loans could be effected quickly (helpful for budgetary planning) and with few strings attached as to how funds were to be employed. This was a sharp contrast to the behavior of international lending institutions which have traditionally applied a high degree of conditionality to loans. This has often tended to delay disbursement and has sometimes even provoked irritation on the part of governments because of real or imagined threats to national sovereignty.

^{2/} In fact, in mid-1973 Brazil was able to establish a minimum term requirement of 12 years on foreign financial credits and still experience a large influx of bank loan capital. See study on Brazil in CEPAL. Economic Survey of Latin America 1975.

/borrow abroad,

borrow abroad, but also because amortization payments were restrained somewhat by a lengthening of maturities.^{1/}

As might be expected, with the greater reliance on private bank credits came the additional cost associated with hard loans. Thus, sharply rising interest payments could be attributable to not only the increased volume of loans, but also to the fact that many countries were slowly being "weaned" of concessionary finance.

(d) Other foreign financial flows

This last classification includes the net effect of official transfers, and debt service payments stemming from compensatory finance operations. Although the combined impact of these flows on capacity to import was negative in both major periods being considered here (see again table 2), the average net outflow declined by 40 per cent between 1951-1965 and this in itself tended to enhance capacity to import.

The reduction for the most part reflects the behaviour of amortization payments on obligations related compensatory finance (since the impact of these flows tends to dominate the group). During 1951-1965 Latin America's balance of payments was generally in disequilibrium, necessitating relatively active use of compensatory instruments. This generated a sizeable reverse flow because of the need to amortize obligations. But after 1965 the inflow of autonomous capital was more than sufficient to meet requirements for external finance, thus permitting Latin America to take less recourse to compensatory finance, which in turn eventually reflected itself in reduced service payments.

It is clear from the above analysis that the radical change in the behaviour of financial flows after 1965 was due to the region's increased ability to contract foreign loans. In 1951-1965, loan

^{1/} It should be noted that beginning in mid-1974 market conditions deteriorated and there was a sharp contraction of maturities being offered by banks. This development will be examined in greater detail later on in the paper.

/capital was

capital was not available in sufficient amounts to offset outflows associated with foreign investment activity, resulting in a net transfer of resources abroad. But in the late 1960s and especially in the 1970s, Latin America was able to mobilize massive amounts of loan capital that more than offset the growing deficit on foreign investment flows and allowed for a favourable net transfer of foreign resources into the region. Moreover, the influx of loan capital in this latter period was largely attributable to a relatively new phenomenon, i.e., extensive participation of international commercial banks in regional external finance.

/II. SOME

II. SOME IMPLICATIONS OF THE ENLARGED INFLUX OF FOREIGN FINANCIAL FLOWS TO LATIN AMERICA

While the greatly enlarged flow of capital resources into the region during 1966-1975 made an important contribution to capacity to import, it also was accompanied by several side effects. First, it meant that an ever larger portion of foreign capital was required to sustain a given level of imports. Second, with the enlarged flow of foreign capital came a very sharp rise in debt service payments. And third, external financial operations of many countries were deeply penetrated by international commercial banks, a development that, as will be seen later, presents a number of potential problems for the region. It is these issues to which the rest of the paper will be devoted.

1. Reliance on foreign capital

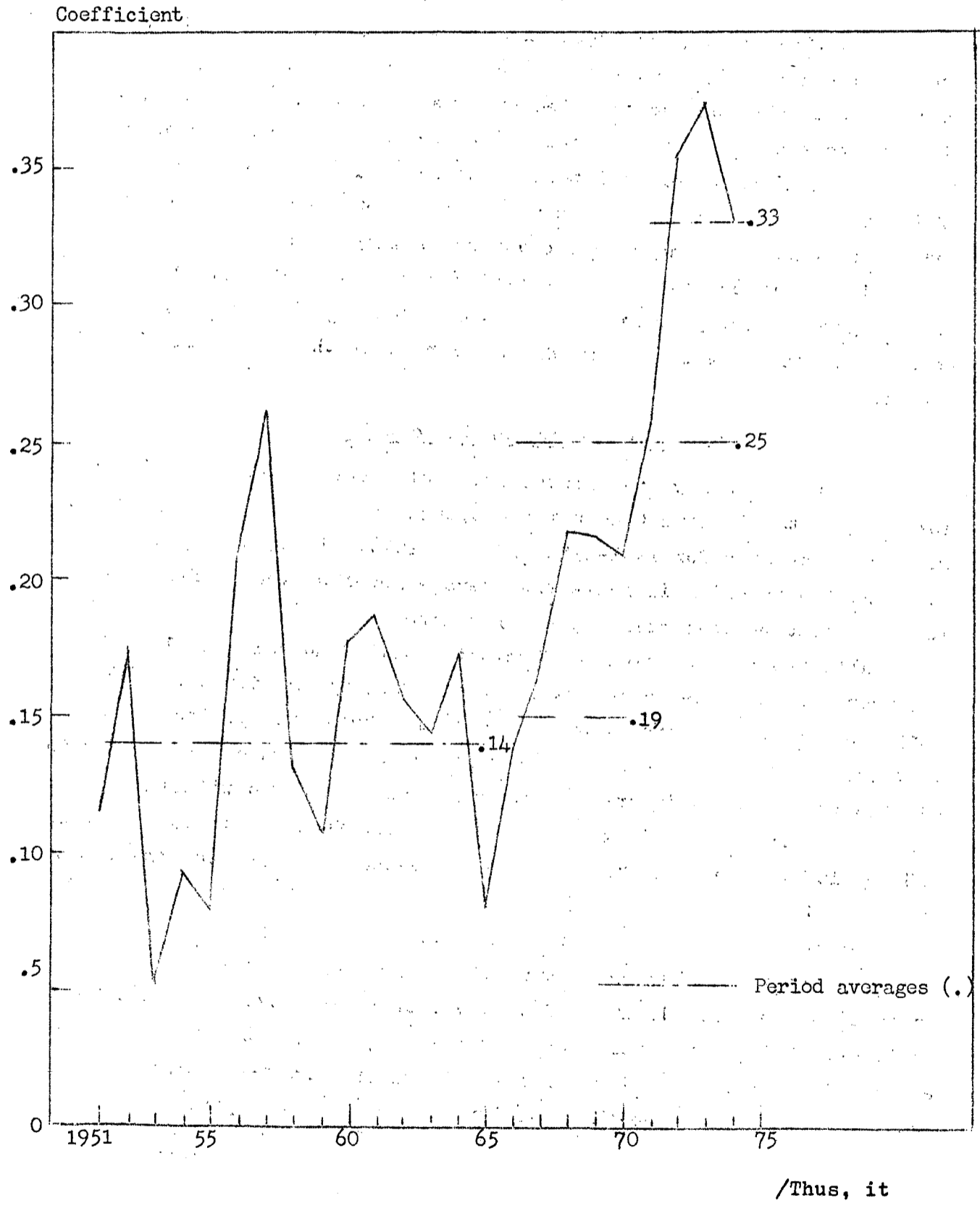
Figure 5 displays the annual level of a coefficient relating net foreign capital inflows (including compensatory capital) to imports of goods and services for 1951-1965 and 1966-1974. It also displays horizontal bars which indicate the average level of the coefficient for the basic periods being considered here.

Although the coefficient fluctuated quite radically in 1951-1965, an upward drift is nevertheless evident. This upward drift turned into a sharp and relatively sustained climb during the period 1966-1974 however, indicating a much greater reliance on foreign capital flows to sustain the region's imports of goods and services. Notwithstanding a brief pause in 1969-1970, the coefficient rose from 0.8 in 1965 to over 0.37 by 1973. The coefficient slipped somewhat in 1974, but indications are that it probably rose again quite sharply in 1975.

Given the number of fluctuations in the coefficient, averaged data may provide a clearer picture of the pronounced rise in dependence on foreign capital. In 1951-1965, the coefficient averaged 0.14, but in 1966-1974 it was 76 per cent higher at 0.25. The coefficient was especially high in 1971-1974 as net inflows of foreign capital were equivalent to nearly one-third of imports for the same period.

/Figure 5

Figure 5
LATIN AMERICA : NET FOREIGN CAPITAL FLOWS /IMPORTS
OF GOOD AND SERVICES
(Coefficient)



Thus, it is clear that in the last decade Latin America dramatically increased its reliance on foreign capital for maintenance of imports. This reliance, not surprisingly, was accompanied by sharply rising debt service payments.

2. Debt service

In its broadest sense debt service could include remittances on foreign investment and amortization and interest payments on foreign loans. But it is more customary when analysing the burden debt service to apply a narrower concept that involves only service on foreign loans.

Loans display characteristics that clearly place them in the framework of debt. When they are secured, the borrower is under a contractual obligation to repay the loan in a specified period. This usually involves a precise repayment schedule - often based on semi-annual or annual quotas - that the borrower agrees to meet. Traditionally, repayment schedules are considered binding and foreign creditors normally take a very dim view of attempts to modify the schedule; indeed, failure to meet installments or even indications that difficulty is being encountered can jeopardize a country's "credit worthiness" and make it difficult to secure new loans. Thus, if a country is undergoing a foreign exchange crisis and is unwilling to face the rather traumatic consequences of a default on payments, its only other option often is to "compress" imports.

Foreign investment does not display the binding repayment characteristics of loans. Profit remittances are determined by earnings on investments and thus cannot be established on a predetermined and fixed schedule. Although controls on remittances are generally frowned upon by industrialized countries and can even provoke retaliation, it appears that latitude exists for governments to alter the outflow of remittances on any given level of investment. For instance, governments can introduce incentives for foreign companies to reinvest their earnings in the country instead of remitting them abroad. In the event of a short term foreign exchange crisis, a
/government can

government can often successfully exert "moral suasion" on foreign enterprises to delay or restrict their remittances; and in extreme circumstances governments have sometimes been able to introduce legal measures to temporarily restrict payments without doing unrepairable damage to the so-called "foreign investment climate".

It is the greater degree of flexibility associated with foreign investment income that causes it to be excluded from considerations of debt service. Remittances do however, represent a charge against export earnings and reduce resources available for debt service. As will be seen later, this factor will be taken into account when considering the burden of these payments.

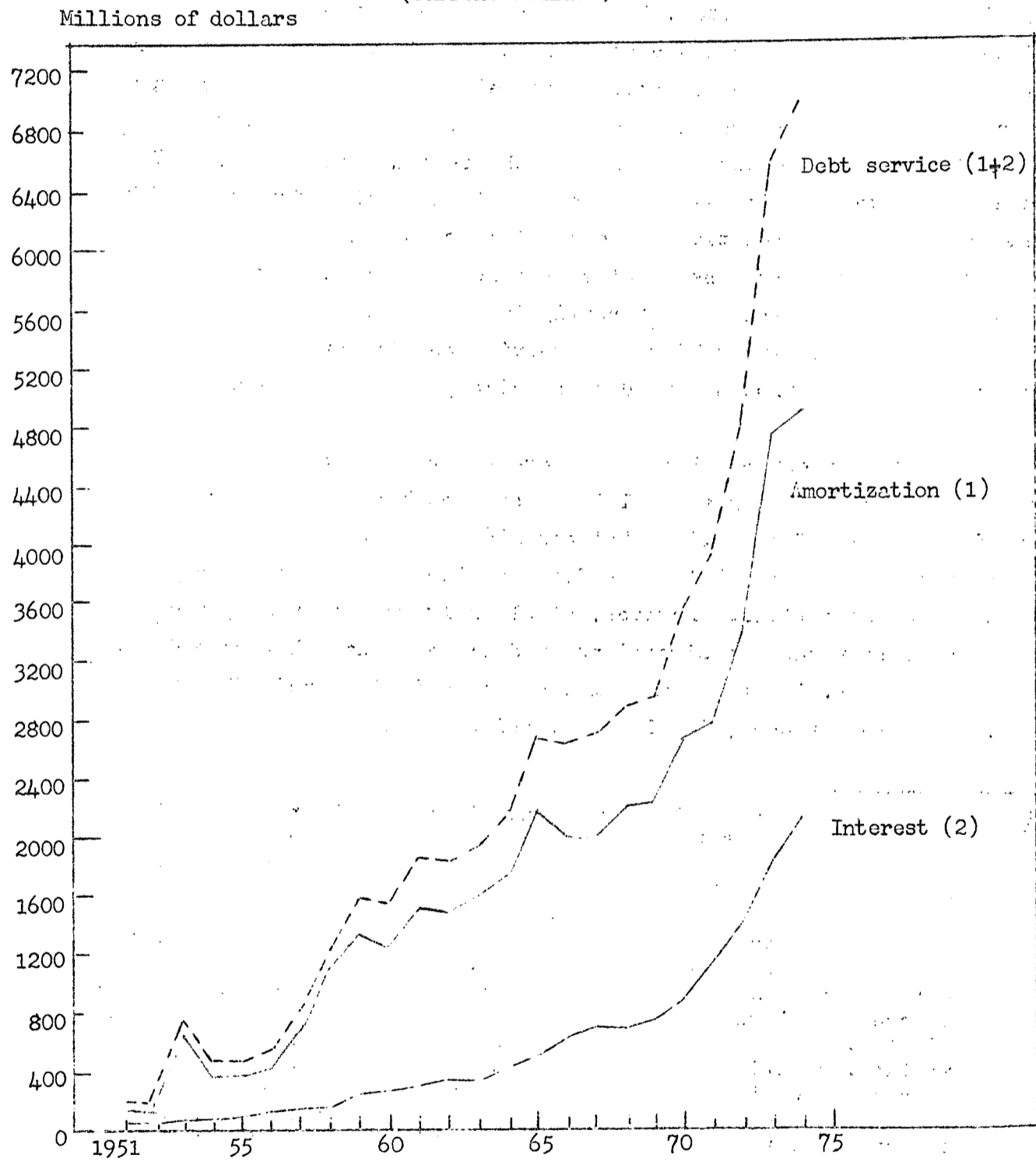
(a) Payments

Figure 6 displays the evolution of the region's debt service payments in current dollars.^{1/} Reflecting a growing recourse to foreign loans, service payments show an almost unbroken path of expansion during the 25 years being examined here. Average rates of growth are 15.1 per cent and 11.3 per cent for 1951-1965 and 1966-1974, respectively. There is however, a noticeable acceleration of growth after 1969. The region's debt payments rose from nearly US\$ 3.0 billion in 1969 to US\$ 7.0 in 1974; in other words, they more than doubled in 5 years, representing an average growth of nearly 19 per cent per annum.

The sharp growth of payments reflects the increased level of borrowing that began to take place in the latter half of the 1960s. Another factor contributing to the expansion was the increased recourse to commercial bank loans (noted earlier). As Latin America shifted from reliance on relatively soft to hard commercial loans, interest costs increased accordingly.

^{1/} Current dollars are presented in order to support subsequent analysis about the burden of debt service.

Figure 6
LATIN AMERICA : DEBT SERVICE PAYMENTS
(Current dollars)



/(b) Burden

(b) Burden of payments

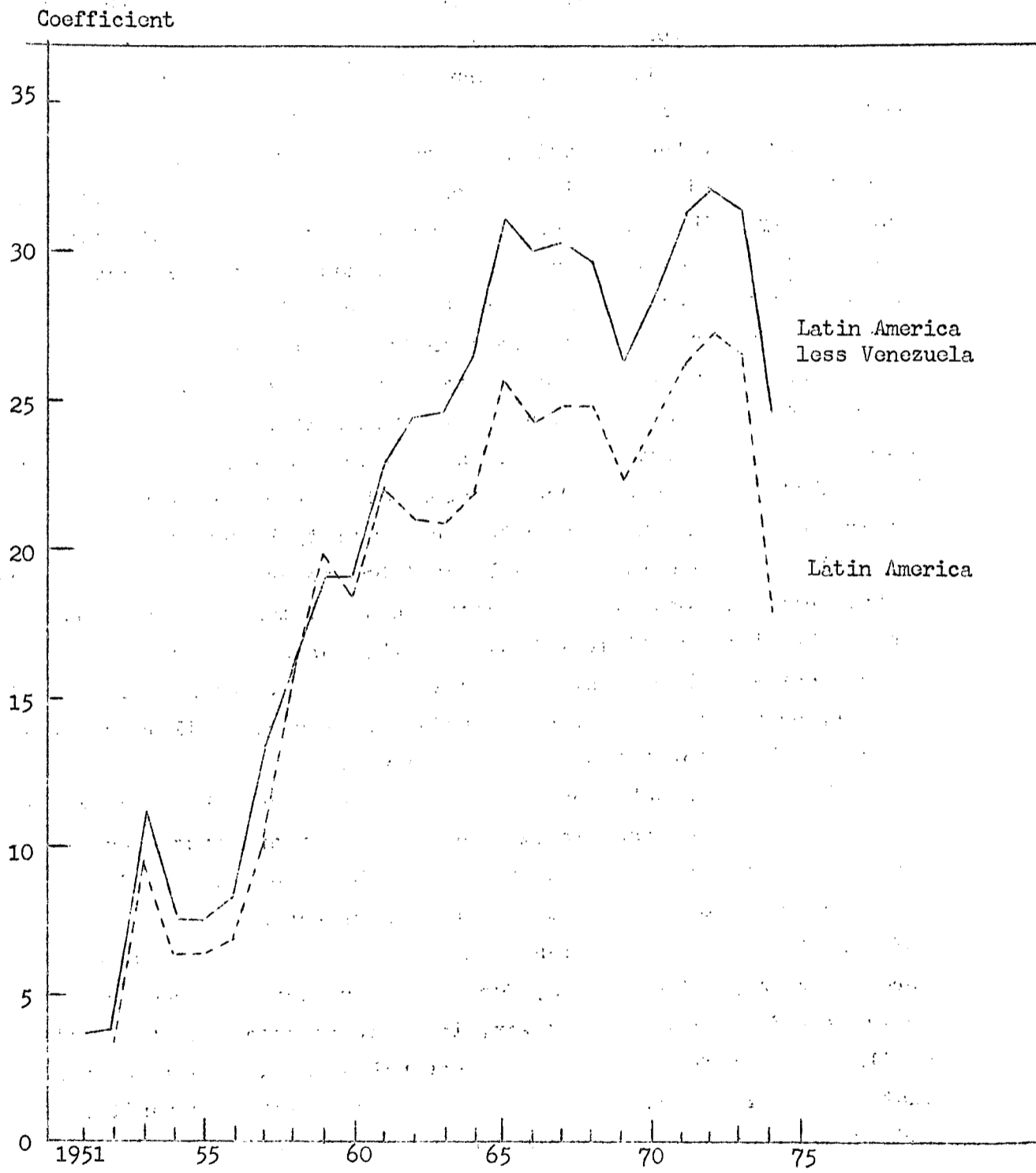
The burden of debt service payments is not so much determined by their absolute magnitude, but rather by their size vis-à-vis ability to generate foreign exchange. A traditional measure of burden is the debt service coefficient, which relates debt service to export earnings, net of foreign investment income remitted abroad.^{1/}

Figure 7 shows the evolution of the region's debt service ratio over the 25 years being examined here. It shows that from 1951-1957 the ratio remained relatively modest at less than 10 per cent. But in the next few years a new plateau was reached: by 1959 the ratio was nearly 20 per cent and by 1965 nearly 26 per cent. Thus, Latin America already had a relatively high debt service coefficient prior to the massive rise in borrowing and debt service payments that occurred in 1966-1975.

It is interesting that the apparent burden of debt service did not change dramatically after 1965, even though payments grew quite rapidly. True, after falling between 1965-1969, the ratio did rise sharply again up through 1972, reflecting the surge in service payments that was noted earlier. However, at slightly more than 27 per cent, the coefficient was not significantly different than that recorded in 1965. Moreover, the ratio actually declined in 1973 and 1974 (when it reached 18 per cent, its lowest level since 1958).

^{1/} It is necessary to plant some caveats about the nature of the debt service coefficient. First, no single indicator or group of indicators can provide adequate information about the burden of service payments because many of the key components of a debt problem are not easily quantifiable. For instance, it is often difficult to ascertain at what point development objectives are becoming compromised by requirements to meet debt service obligations. Another crucial element that is difficult to assess is creditors' willingness to "rollover" payments with new loans. Finally, indicators cannot forecast future events such as bad weather, political upheavals, etc., that can quickly convert manageable debt service into a severe problem. For all these reasons the debt service coefficient must be used with caution and can be considered only a rough and ready indicator of debt service burden.

Figure 7
DEBT SERVICE RATIO



/The movement

The movement of the debt service coefficient remained relatively restrained despite sharply accelerating service payments largely because export earnings also expanded very rapidly during the period; indeed the expansion of export earnings in 1973-1974 was so strong that it more than offset the sharp rise in payments and permitted a significant fall in the apparent burden of debt service obligations. In 1975 however, the situation changed radically as export earnings stagnated while debt service payments are known to have again increased considerably. This leads one to conclude that the coefficient must have shown a marked rise in 1975. If export growth were not to recover in subsequent years, the apparent burden of debt service would probably become considerably more severe than the recent past.

Given Venezuela's special status as a major producer of petroleum, it is useful to look at Latin America minus this country. As can be seen in figure 7, such an approach does not substantially alter the trend of the coefficient, but it does make the apparent burden of service uniformly higher, with the disparity being the greatest from the early 1960s onward. As early as 1965, an annual debt service ratio in the neighbourhood of 30 per cent became common, and even after the plunge that the coefficient took in 1974, burden measured out at nearly 25 per cent - high by most standards. Moreover, the coefficient also probably showed a marked rise in 1975 for reasons similar to those described above for Latin America as a whole.

The region's debt service problem can perhaps be even better appreciated if the issue is examined from another, less traditional, angle i.e., the manner in which payments have been effected.

In order to repay debt, Latin America has had to generate sufficient amounts of foreign exchange. The principal sources of foreign exchange are exports, foreign investment and transfers (private and official). However, in order to determine the real availability of foreign exchange, net balances must be accounted for, that is, exports less imports, foreign investment less remittances, and transfers net of similar flows going abroad.

/Table 3

Table 3 displays the current annual values of the region's trade balance, net foreign investment flows and net donations for 1966-1975, the period in which foreign borrowing operations showed a marked acceleration. It is seen that when the net flows are taken together there was a deficit resource flow in every year except 1974, when a marginal surplus was recorded. In other words, foreign exchange income consistently fell short of general payment obligations.

If there was a chronic shortfall of income, it might be asked how then did Latin America manage to meet its debt service obligations? The answer is that repayment was effected by securing new loans to cover obligations falling due on older loans, a process that is commonly referred to as a "rollover". Indeed, during the period under discussion Latin America secured loans in quantities sufficient not only to roll-over debt payments, but also to cover the noted deficit on other payments and to accumulate foreign exchange reserves. The latter phenomenon would lead one to conclude that the notable accumulation of foreign exchange reserves after 1966 (see table 4) was not generated by a surplus of real income, but rather by foreign borrowing.

The practice of paying off old loans with new ones is not uncommon in development or commercial finance. However, pursuit of a permanent or continuous roll-over process, such as has been practiced in Latin America, has its counterpart in a spiraling external debt, because as interest on foreign debt is effectively capitalized, ever larger amounts of loan capital must be secured to achieve a roll-over. The severity of the spiral will depend on the terms and conditions of new loans. Since the primary source of new loan capital for many Latin American countries is private commercial banks, whose terms traditionally involve short maturities and market interest rates, there is growing concern that the region is now caught in a vicious debt spiral that could create serious problems in the near future.

/Table 3

Table 3

LATIN AMERICA: NET FOREIGN EXCHANGE EARNINGS
(Millions of current US\$)

	Trade Balance	Direct Foreign Investment	Donations	Balance
1966	975	-1 179	157	-47
1967	652	-1 202	174	-376
1968	165	-988	121	-702
1969	634	-899	130	-135
1970	-189	-1 180	241	-1 128
1971	-1 159	-873	222	-1 810
1972	-627	-1 557	246	-1 938
1973	1 553	-1 716	355	192
1974	1 971	-4 688	285	-2 432
1975	-5 936	...	...	...

Source: CEPAL, on the basis of official statistics.

Table 4

LATIN AMERICA: ANNUAL NET ACCUMULATION OF FOREIGN EXCHANGE RESERVES
(Millions of current US\$)

1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	Total
3	329	393	537	1 312	483	3 224	4 565	3 381	44	14 271

Source: CEPAL, on the basis of official statistics.

3. Vulnerability to international commercial banks

Potential difficulties of a rapidly expanding foreign debt extend beyond the mere quantitative problem of burdensome debt service payments. The ever growing domination of international commercial banks in regional external finance also awakens concern about excessive vulnerability to these institutions. More specifically, there is an apparent asymmetry between the exigencies of development (in developing countries) and those associated with international commercial banking, such that serious questions arise about the appropriateness of large scale participation of these institutions in external finance.

Some of the characteristics of international bank finance which may come into conflict with the development aspirations of Latin America are outlined below. But before touching on them it is important to point out that many of these same characteristics are also encountered by industrial countries as well. However, with high income levels and sophisticated export machinery they are much better equipped to cope with international financial markets than developing countries whom by and large are primary commodity producers facing volatile world prices and whose peoples bear income levels and social conditions that would not be tolerated in the developed Centre. Moreover, Latin America's position would appear particularly difficult in this regard, because by being the "middle class" of the world economy, its access to alternative sources of concessionary finance has been severely limited.

(i) Unstable. Ideally, external finance for developing countries should display a degree of stability with regard to amounts and terms. Indeed, the value of official bilateral/multilateral credit flows is that they generally are not subject to sharp short-term fluctuations and in some cases even display an element of programming through the mechanism of prior commitments. As for terms, maturities tend to be of a long term nature, while interest rates are relatively stable and remain fixed over the life of a loan.

/Credit flows

Credit flows from international banks however, have opposite characteristics. Lending often displays a procyclical behaviour, euphoric when world and/or country economic conditions are favourable and restrictive when conditions deteriorate.^{1/} The procyclical behaviour can reflect itself in the volume of lending, terms, or both.

With regard to loan volume, in favourable times, say when exports are booming and/or bank liquidity is high, a country may find credits very easy to secure - this was typically the case in the early 1970s. But should country conditions turn sour and/or uneasiness develop in money markets, officials may find new loans that are needed to "roll-over" debt service on previous borrowing more difficult to secure - such has been the case for many developing countries since mid-1974.

If loans can be obtained during unfavourable times, they are more often than not carrying rather onerous terms. This indeed has been typical of behaviour in the last couple of years as banks have maintained a high volume of lending to a number of non-oil-developing countries with rather precarious external positions - but on terms that are relatively severe. Maturities have contracted considerably, e.g., in 1975 only 23 per cent of publicized eurocurrency credits to developing countries had maturities in excess of 6 years, compared to 77 per cent in 1974 and 84 per cent in 1973,^{2/} while so-called "spreads" over the London interbank offer rate (LIBOR) have risen to levels more than double

^{1/} As a point of clarification, bank behaviour can be looked at from two levels: (i) as a reaction to general world conditions, especially as reflected in developments in money markets; and (ii) as a reaction to the specific economic situation of a prospective borrowing country. These two factors interact to jointly determine lending behaviour; moreover, given the large degree of interdependence in the world economy, global and country conditions may often parallel each other.

^{2/} IBRD, Borrowing in International Capital Markets (Supplement EC-181), August 1976, p.21.

/those prevailing

those prevailing in 1973 and 1974.^{1/} Furthermore, the more severe a country's external position, the greater likelihood it will receive the low end of the prevailing maturity spectrum and the high end of the prevailing spreads.

Another element of uncertainty is that interest rates on loans are variable and adjusted periodically, usually at 6-month intervals, according to the LIBOR or similar interbank rate. This seriously complicates debt management as interest payments are subject to the vagaries of financial markets and can rise suddenly without warning, as was the case in 1974-1975 when uncertainties over the oil crisis, inflation, and jitters derived from a series of bank failures all caused the LIBOR, and therefore interest payments, to skyrocket.^{2/}

The thrust of all this is that borrowing countries in the developed world are often faced with the paradox of having a surplus availability of commercial credit on favourable terms when external conditions are buoyant and internal liquidity high, and tight credit with rather onerous terms when the external situation is difficult and ample credit on lenient terms would seem more appropriate.

(ii) Hard terms. Generally speaking, the costs of bank credits are greater than what are normally available from official institutions. Even in the realm of commercial rates, developing

^{1/} Most commercial bank loans are contracted with an interest rate based on a fixed margin or spread over an interbank deposit rate (commonly the LIBOR) that is supposed to reflect a bank's cost of money. Whereas a country like Brazil often received a spread of 3/4 - 1.0 per cent in 1973, in 1975 spreads were typically in the neighbourhood of 1.3/4 - 2.0 per cent, (Ibid., pp. 24-149).

^{2/} Available data show that London bank's bid rates for 6-month Eurodollar deposits - which represent a conservative approximation of the LIBOR - rose from a monthly average of 8.3 per cent in the first half of 1973 to 10.6 per cent in the first half of 1974, for an increase of 28 per cent. An even more telling example of the degree of variation that can be encountered is a comparison of the low bid in 1973 versus the high bid in 1974: in the beginning of the former year the rate was as low as 6.8 per cent, while towards the end of the latter it had reached as high as 14.1 per cent. Ibid., p. 11.

/countries must

countries must agree to accept considerably larger "spreads" than commonly granted developed countries on the grounds that greater risk is involved. When Latin American countries borrow with spreads as high as recent times (often 2 per cent or more), they lock themselves into a rate structure which - given the variable nature of interest rates - can result in astronomical interest payments. Moreover, spreads can often understate effective costs since recent trends have shown banks willing to disguise margins in the form of banker's fees.^{1/}

As for maturities, banks traditionally prefer shorter maturities in the neighbourhood of 5 years or less in contrast to the longer maturities normally available from official institutions. All things being equal, these short maturities make a developing country's debt servicing more difficult to manage.

It is true that in the early 1970s terms were considerably more favourable as it was not uncommon for developing countries to receive margins of $3/4$ per cent and maturities of 10-15 years. However, some market experts have expressed the opinion that this phenomenon was a novelty stemming from "exceptional" circumstances and that bankers will undoubtedly be reluctant to depart again from their traditionally conservative lending practices.^{2/}

(iii) Short term lending criteria. In formulating their attitude on borrowers' creditworthiness, international banks tend to focus on short-term financial indicators rather than those associated with development per se. Thus, if a country becomes heavily dependent on private bank credit, it may find itself in a situation whereby it must sacrifice development objectives in order to create an environment conducive to private bank lending. Development strategies can then

^{1/} Given that spreads are supposed to correlate with bankers' perception of risk (creditworthiness), countries are reluctant to have unusually large spreads publicized. To accommodate this concern, bankers often hide margins in a myraid of fees that customarily accompany syndication of a loan.

^{2/} Financial Times, September 20, 1976.

become biased and narrowly defined in terms of external solvency, even though severe social and economic costs may be involved in such an approach.^{1/}

(iv) Alien institutional environment. International banks differ from development institutions in that while the latter are non-profit organizations with a perspective for the development problem, the former are profit-oriented institutions primarily linked to commercial markets of the developed countries. In other words, the institutional environment is only tangential to developing areas.

The alien institutional environment can cause banks to behave in ways not particularly favourable to borrowers in developing areas. First, it means that developing countries are largely secondary markets for banks, with the consequence that they can be "squeezed out" of the market when loan demand in primary markets (the industrialized countries) becomes heavy. Second, banks can have a low threshold with regard to creditworthiness considerations because of a lack of clear understanding of development issues, in particular, differentiating between short term financial problems and long term development trends. Third, bankers' decisions are likely to be honed on a value system more relevant to the countries of the industrial Centre than to Latin America and other developing areas; in other words, banks' professional bias is likely to be in the direction of "free movement of human, physical and financial resources" for purposes of global trade liberation, an objective which may be beneficial to their profits, but not always compatible with development objectives.

(v) A high degree of concentration. Even given a narrow perspective with regard to the issue of development, banks may be ill-prepared to assess country conditions on their own criteria. Except

^{1/} Short term criteria has also hurt banks, the most clear case being that of Zaire, an African country with a per capita income of only US\$ 140 (1973). In the period 1972-1974 banks lent this relatively poor country resources (exclusive of export credits) in the neighbourhood of US\$ 500 million, based seemingly on financial indicators inflated by cyclically high copper prices. When copper prices subsequently plummeted, the country found itself unable to meet debt service payments.

/for very

for very large international banks, research staffs are generally quite thin or non-existent. Thus it is a handful of large banks that organize syndicated loans and perform the necessary evaluation of country creditworthiness. This often can contribute to a "bandwagon" effect, i.e., one or more of the larger banks considers a country creditworthy and immediately on its heels are a herd of smaller banks that enter the market on the basis of the leader's assessment. Similarly, banks can desert a country in droves when the leader's assessment turns sour. This characteristic can not only contribute to cyclical and sometimes irrational lending behaviour, but also can make the international bank lending market highly competitive when conditions are favourable (in the eyes of the leaders) and highly uncompetitive when conditions are deemed to be unfavourable.

(vi) Regulatory limbo. Operations of international banks transcend national boundaries 1/ and as a result there often is no clear lender of last resort to bolster banks weakened by bad loans and investment. Given that there is a high degree of interdependence among international banks, a serious loss on assets held by one or several banks can easily create jitters in financial markets. This in turn can be harmful to Latin American countries dependent on private financing because a nervous market often reflects itself in a contraction of lending and/or terms, especially for secondary and more risky borrowers like those in developing countries.

1/ Indeed, the Eurocurrency market was spawned to a large degree by attempts of commercial banks to escape capital restrictions imposed by their national governments. By moving operations to "offshore" locations banks found that they could avoid these restrictions as well as other regulations - such as reserve requirements - that are normally imposed by national banking authorities. As a result of successful efforts to elude national public policy, there presently is little information on or official control of transnational banking operations. This at times has created severe problems even for governments of industrialized nations as billions of dollars have sloshed around world markets, often contributing to radical fluctuations in balance of payments, exchange rates, inflation, etc.

/Recent events

Recent events are reflective of the problem. The tightening of world financial markets in 1974-1975 was to a significant degree a reflection of bankers' uneasiness over a series of major bank failures brought on by losses from foreign exchange speculation and problems at other major banks because of bad loans to real estate enterprises in the United States. Thus, borrowers in Latin America encountered restrictive financial markets for reasons that were largely exogenous to the region.

(vii) Leverage. The final consideration concerns the fact that for some countries in the region (e.g., Brazil, Mexico, Peru) international bank finance now dwarfs multilateral finance to such an extent that private banks can begin to assume roles traditionally filled by international institutions such as the World Bank and IMF. More specifically, indebtedness to private banks has in many cases reached the point where leverage is such that banks can insist on a much more direct role in the formulation of government policy, e.g., in the form of advisory missions, the tying of balance of payments loans to adoption of specific policy measures, etc. The banks themselves have discovered that they carry increased leverage in the third world and have made their intentions quite clear in this regard, as exemplified in the following extract from a publication of a major international bank:

"... it is incumbent on banks to improve further their competence in appraising borrowing countries' economic and financial policies. The Fund (IMF) generally will be involved only in the critical cases where the necessity for internal adjustment is clearcut. But, in the less than critical cases, bank credit decisions also involve a judgement on the way an economy is managed and on the prospects for the balance of payments. In deciding whether to extend credits, and in setting the terms and conditions for loans, banks can influence the nature and timing of borrowing countries policies. This is a heavy responsibility and admittedly one which is difficult to carry out, particularly in the face of competitive pressures. However,

/from the

from the viewpoint of the borrower, the discipline of the marketplace can have an important bearing on whether sound economic and financial policies are taken on a timely basis."^{1/} Given characteristics (iii) (short term lending criteria) and (iv) (alien institutional environment) increased bank involvement in policy formation may not be a wholly desirable development in the region. More pointedly, there are serious doubts about the appropriateness of having institutions, whose primary motivation is generation of profits, guiding the development policies of Latin American countries - obviously, the possibilities for conflicts of interest loom quite large.

The preceding is not meant to be an indictment against international banking as financial markets have long played a very important role in the expansion of the world economy. Moreover, the behaviour of banks is generally a legitimate response to the exigencies of profitability - the traditional standard by which the performance of private enterprise is measured. What the preceding has attempted to show however, is that international banks have been thrust into a role for which they appear to be neither prepared nor well suited to play, and if left unchecked, Latin America's development aspirations could suffer as a result.

If problems are to be avoided, the international community must begin to seek measures to put a break on present trends. This might involve a restructuring of the region's external debt by substituting some bank capital by other types that are more appropriate for development finance. Such a process would require substantial co-operation from the industrialized countries who would have to provide access to their capital markets as well as channel substantially more funds into official lending institutions. Official institutions themselves would have to be reformed to eliminate what often appears

^{1/} Morgan Guaranty Trust Company of New York, World Financial Markets, May 1976, p. 9.

to be excessive conditionality; furthermore, recent trends towards a hardening of terms would have to be reversed.^{1/} Also, efforts might be made to further promote participation of private banks in credit operations of multilateral agencies, which might serve to both stabilize terms and make them more suitable for development programmes. Finally, and perhaps most importantly, Latin American countries themselves perhaps should re-evaluate their development strategy of the last 10 years, which has involved heavy recourse to external debt finance, to see if similar objectives cannot be achieved through greater reliance on national resources and ingenuity.

^{1/} Recently, pressures have been put on the World Bank and similar institutions to harden their interest rates (even to the extent of charging floating rates) and reduce efforts to accelerate the growth in the volume of lending. Meanwhile, official export credit agencies of the industrialized countries have sought to "reduce competition" on terms offered to borrowers by establishing minimum interest rates and maximum maturities on transactions.



