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UNITED NATIONS

27

# CEPAL

## Review

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UNITED NATIONS  
ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARIBBEAN  
SANTIAGO, CHILE, DECEMBER 1985

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LC/G.13.68
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December 1985
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#### Notes and explanation of symbols

The following symbols are used in tables in the *Review*:

Three dots (...) indicate that data are not available or are not separately reported.

A dash (—) indicates that the amount is nil or negligible.

A blank space in a table means that the item in question is not applicable.

A minus sign (–) indicates a deficit or decrease, unless otherwise specified.

A point (.) is used to indicate decimals.

A slash (/) indicates a crop year or fiscal year, e.g., 1970/1971.

Use of a hyphen (-) between years, e.g., 1971-1973, indicates reference to the complete number of calendar years involved, including the beginning and end years.

Reference to "tons" mean metric tons, and to "dollars", United States dollars, unless otherwise stated.

Unless otherwise stated, references to annual rates of growth or variation signify compound annual rates.

Individual figures and percentages in tables do not necessarily add up to corresponding totals, because of rounding.

UNITED NATIONS PUBLICATION
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ISSN 0251-2920 ISBN 92-1 121127-1
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# CEPAL

## Review

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Santiago, Chile

Number 27

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## Foreign policy and international financial negotiations: the external debt and the Cartagena Consensus

*Jorge E. Navarrete\**

The background, development and prospects of the concerted effort being made by the Latin American countries as expressed in the Cartagena Consensus and Mexico's role in this effort are discussed in this article from a foreign policy perspective. It is neither a quantitative technical analysis of the debt problem nor a systematic review of the renegotiations of recent years and those currently in progress. Instead, an attempt is made to explore those elements of international economic performance, trade and finance which led the Latin American countries to meet at Cartagena. It goes on to analyse the basic content of the proposals made at that meeting and at Mar del Plata and Santo Domingo, to discuss how the other parties to the negotiations (governments of developed countries, international banking authorities and multilateral financial bodies) have reacted to these proposals, and, finally, to describe what the outlook for the overall Cartagena process appears to be as of mid-1985.

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## I

### Towards Cartagena: the crisis and the external debt

In the three years which have passed since the problem of external indebtedness reached a crisis point in August 1982, international financial negotiations have been closely linked to foreign policy. In both debtor countries and advanced nations, issues such as interest rate levels and trends, the size of debt service and amortization payments, the possibility of an interruption in the servicing of the debt, negotiations with creditor banks, and the role of the International Monetary Fund have become leading topics of public debate and, what is more, focal points in the wider sphere of relations between the governments of these two categories of nations. The debt issue has thus been constantly at the forefront of international attention and concern.

International financial problems have, of course, been a foreign policy concern for a long time, but in the past these problems were never regarded as being of more than marginal importance. The recent change which has occurred in this regard may perhaps be characterized in the following terms: in the past, international financial affairs were primarily regarded as "technical" questions where the financial aspects were the predominant element, while their international aspects were only secondary; the task of dealing with these issues was therefore seen as being almost exclusively the responsibility of the financial authorities. Now, however, there is a growing awareness of the fact that these issues have an important political dimension, that their international aspects (i.e., their impact on the current status and future outlook of political relations between States) are just as important as their financial aspects, and that they are therefore of direct concern to the authorities responsible for foreign policy. This change in the way of international financial issues and particularly the problem of indebtedness are regarded and the participation of a broader spectrum of institutions in addressing these issues have given foreign policy a new and important field of activity.

The above observations are especially applicable to Latin America, which contains many of that "relatively small number of countries" which, as noted, by the Group of 24 in its latest document (1985, p. 48) "incurred the bulk of the debt" contracted during the late 1970s and early 1980s. When the foreign ministers and ministers responsible for financial affairs of eleven Latin American countries met at Cartagena in mid-1984, they opened up a new phase in the region's external financial relations. This initiative led to two other ministerial meetings (at Mar del Plata and Santo Domingo) where other statements and proposals were adopted. At the time of writing (September 1985), new proposals are being prepared with a view to a fourth ministerial meeting at Montevideo. This whole process, which bears the name of the historic city of Cartagena where the first meeting was held, is one of the most vivid and innovative manifestations of the international political action being taken by the Latin American countries.

Mexico played a decisive role in the design and preparations for the first meeting and took an active part in it. It was represented at the subsequent meetings and has been deeply involved in the process itself and in the effort to carry it forward and to heighten its political significance. The President of Mexico referred to the subject in his third annual report to the nation, when he said "In the Cartagena Consensus, Mexico has joined its political will with that of ten other Latin American countries... We have repeatedly stressed that the treatment of this issue [the external debt] must be tied in with the imperative need for a revival of international trade and the flow of financial resources for development. We have also reiterated the need for fresh financing which will simultaneously allow the countries to grow and to continue their payments" (de la Madrid, 1985, p. 21).

The "explosion" of the debt problem had been abundantly fuelled by the worldwide economic crisis which began in late 1979 (described as the worst since the Great Depression or, according to some, since the end of the Second World War) and which, in general, lasted until mid-1983 when the first signs of a recovery were glimpsed in a few developed countries. This recovery did not take hold, however, and did not lead to a steady expansion in the world economy

as a whole because the policies that had set off the crisis continued to be applied: "...In response to the decline in trade, there has been a proliferation of restrictive measures; in response to the drop in commodity prices, stabilization schemes have been dismantled; in response to widespread inflation, measures have been taken which, in many cases, have reduced countries' long-term growth potential; in response to the need for more funds, finance costs have been increased and lending terms made more stringent; in response to an insufficient level of multilateral economic co-operation, there has been a reluctance and, at times, even a refusal to undertake further negotiations" (Navarrete, 1984).

The crisis and its repercussions have had a profound impact on the international economy, trade and finance. More specifically:

- Within the broader realm of the international economy, interaction between the major industrialized countries was unstable and unbalanced. Each nation opted for short-term policy measures without regard for how they affected other countries. The "beggar-thy-neighbour" policies of the 1930s were once again in vogue. Hence, the lack of co-ordination with respect to economic policy, in conjunction with the combined effect of the expansionary fiscal policies and restrictive monetary policies adopted by some developed countries, introduced elements of instability which, in turn, paved the way for sharp imbalances. The United States' huge trade deficit added to the pressure for protectionist measures and trade restrictions and caused access to the United States market to be made contingent upon various demands for reciprocity. Its equally awesome fiscal deficit generated an enormous demand for resources, which decreased the amount of funds that were available for financing investment and development in the rest of the world economy and caused financing costs to soar in real terms. The moderate recovery in Western Europe was not great enough to produce any widespread decline in unemployment, and the prevailing mood of protectionism prevented exports from being used as a means of consolidating the recovery. Exports continued to be the fastest growing component of the Japanese economy, but Japan was increasingly obliged to limit its sales abroad, and its growth

rate was consequently held back. Thus, the recovery which had slowly and hesitantly begun to take shape in mid-1983 following the deep and widespread recession of the preceding 36 months proved to be both unstable and precarious. In fact, it died out before its effects could be felt in the world economy as a whole and, in particular, in the developing countries.

● In the developing countries, the wide variety of national situations notwithstanding, the overall picture continued to be one of stagnation and, in some cases, continued deterioration despite the uneven recovery in the North. Any hope of a steady recovery was virtually cut off by the continuing sharp decline in commodity prices, increasing trade restrictions, the heavy debt burden and the paralyzation of net flows of financial resources. The crisis caused the developing countries to lose a great deal of ground: the levels of per capita production, income and imports which most of them had achieved by the late 1970s will not be regained until the late 1980s. Because of this, it has been said that, particularly for Latin America, the 1980s will have been the "lost" decade of the crisis. The crisis destroyed part of the developing world's linkages with the world economy, and this damage will not easily be repaired.

● For the first time since the end of the Second World War international trade declined or completely stagnated for three years running; during this time, there was a progressive erosion of the open multilateral system of trade, and this trend was not reversed by the considerable expansion in trade that occurred in 1984. Protectionist trade barriers and restrictive measures increased; a growing number of sectors were withdrawn from the multilateral system and became subject to generally restrictive *ad hoc* arrangements characterized by the limitation of commerce, the fragmentation or division of markets and sanctions against competitiveness. The arsenal of protectionist and restrictive practices was diversified; the traditional measures of tariffs and quantitative restrictions were augmented by "orderly marketing" agreements, "voluntary" limits on exports, the restriction of market shares, the abuse of provisions designed to combat unfair trade practices (especially with respect to countervailing duties and anti-dumping measures), and the practice of tying the

terms for market access to issues unrelated to trade, such as the treatment given to direct foreign investment or national legislation on industrial property.

● To a large extent, trade restrictions were directed at those developing countries which had achieved a certain degree of progress and efficiency in their export activities. The principle of according preferential treatment to developing countries, which was one of the basic components of the postwar international system of trade, was abandoned in practice. Guidelines and policies relating to the concept of "graduation" were applied and increasing demands for reciprocity were made; the scope and force of the Generalized System of Preferences were progressively reduced, thereby infringing its basic principles of universality and non-reciprocity; and, as already noted, market access was made subject to certain conditions and was tied in with such issues as policies on foreign investment and industrial property.

● In the sphere of finance, during the early 1980s the world economy operated with unprecedentedly high interest rates (described by a former Chancellor of the Federal Republic of Germany as having reached the highest level in the entire Christian era). The effects of such high interest rates on the availability and cost of loans for investment and development and, particularly, on the level of the debt service were so severe that on some occasions the debtor countries were unable to cope with them and the entire world economy was placed in an untenable situation. Moreover, the debt crisis caused the flow of financial resources to debtor countries to be virtually suspended, thereby cutting off one of their major sources of development financing. The direction of international transfers of financial resources was thus reversed; the developed countries became the recipients of such transfers while the debtor countries, and particularly the Latin American nations, became net exporters of capital.

● As the world monetary system remained in disarray during these years (this situation being especially notable in the wild fluctuations of exchange rates and their persistent misalignment, especially as regards reserve currencies), the uncertainty involved in international transactions of goods and services increased, as did exchange



and financial risks. The various countries' ability to compete at the international level thus became subject to sudden and unpredictable changes.

So it was that, in August 1982, the crisis finally came to a head and the debt problem exploded. It was Mexico which set off this bombshell when it announced that it was unable to continue servicing its debt. Four months into the moratorium, the situation was described in the following terms: "Mexico suspended its external debt service payments in late 1982. The total amount involved was US\$ 87.4 billion, equivalent to nearly 53% of the gross domestic product. The due dates for debt payments were excessively concentrated in the short term: according to the terms and conditions of the loans, 46% of the debt was to be paid within not more than three years, and 27% was to be paid during 1983. Under these terms, the external debt was unpayable" (de la Madrid, p. 31).

The situation was also untenable in Latin America as a whole: the cumulative level of the external debt was equivalent to over half of the gross regional product and was three times as great as its annual exports; debt service payments were increasing twice as fast as exports, and the average annual outlays on debt service were over US\$ 29 billion, with each rise of one percentage point in interest rates adding US\$ 2.5 billion to the annual expenditure on debt service. In short, the region had become a net exporter of capital and was thus in a position that was incompatible with any hope for a resumption of sustained development.

In order to deal with the crisis and its attendant problems (especially their indebtedness), the debtor countries were compelled to embark upon adjustment programmes which were generally of a recessionary nature. It was imperative to re-establish the fiscal and external equilibrium of their economies; in order to do so, the countries resorted to cutbacks in spending and imports which resulted in stagnation or outright reductions in activity. In the years immediately following the debt crisis, many debtor countries managed to produce large surpluses on their current accounts as a result of their adjustment programmes, and they used these surpluses to pay the service on their debt. Nonetheless, the adjustment effort was made

within an international context which made it difficult and more costly than it would otherwise have been.

During the following twenty months (between August 1982 and April 1984), each of the debtor countries made a determined effort to cope with the resulting problems. No country considered the option of resorting to unilateral action, either individually or collectively, which might have entailed the risk of causing the collapse of the international financial system. This interest was shared by the governments of the developed countries, the international banking community and multilateral financial agencies. It was thus possible to organize the first round of negotiations and to provide emergency financing. These financial operations were, in general, very costly: high interest rates and unprecedented spreads (sometimes over two points); heavy commissions and other rescheduling charges; virtually punitive interest rates on the additional funds made available; and harrowingly short repayment periods which gave rise to untenable payment profiles.

The first round of renegotiations ran parallel to the sustained effort on the part of debtor countries to carry out a drastic adjustment. Indeed, the renegotiations and the granting of the fresh financing demanded by the situation were contingent upon such an effort being made. Despite the very high costs involved, this situation was endured throughout the period under discussion. The series of large increases in interest rates which occurred in early 1984, however, once again ushered in the danger of a collapse, and this situation brought a collective reaction from four Latin American governments.

On 19 May 1984, Presidents Raúl Alfonsín of Argentina, João Figueiredo of Brazil, Belisario Betancur of Colombia and Miguel de la Madrid of Mexico issued the following statement:

"We are greatly concerned by the fact that our peoples' hopes for development, the progress of democracy in the region and the economic security of the continent are jeopardized by situations not of our making and beyond our governments' power to control.

"Successive rises in interest rates, the prospect of additional increases, and the proliferation and intensity of protectionist measures have

made the outlook for our countries and for the region as a whole a dim one indeed.

"Our countries cannot continue to accept these risks indefinitely. We have affirmed our resolve to rectify the existing imbalances and to restore the conditions which will permit the resumption and consolidation of economic growth and progressive improvement in the living standards of our peoples.

"We have been the first to demonstrate our determination to meet our financial obligations on terms in keeping with the interests of the international community. We will not allow ourselves to be pushed headlong into forced insolvency and continued economic stagnation.

"We believe that it is imperative for the international community to make a concerted effort, without further delay, to agree upon cooperative action and measures aimed at resolving these problems, particularly in the related sectors of international trade and finance.

"We therefore propose the adoption of specific measures designed to bring about substantial changes in international financial and trade policy in order to afford greater access for our countries' products to the markets of the developed nations, to provide real and substantial debt relief, and to ensure the reinstatement of the flow of development financing. In particular, suitable amortization and grace periods must be established and interest rates, spreads, commissions and other finance charges must be reduced.

"In view of the foregoing, we intend to convene a meeting as speedily as possible of the Foreign Ministers and Finance Ministers of our countries. Ministers of other Latin American governments will also be invited to this meeting in order to define the most appropriate initiatives and courses of action with a view to finding satisfactory solutions for all the nations involved" (Ministry of Foreign Affairs of Mexico, 1984a)).

This statement, whose objectivity and restraint were widely acknowledged, was drafted within a remarkably short time thanks to direct consultations among the foreign ministries of the four countries.

The parties involved could not have reached agreement on this joint statement if one vital step

had not already been taken which paved the way for it: in early 1984, the President of Mexico visited a number of Latin American countries, among them the other three nations which signed the declaration. This visit provided an opportunity for an exchange of ideas concerning the debt problem and related trade and financial issues. Indeed, many of the basic proposals made in the declaration had already been outlined in the joint communiqués issued as a result of the visit.

The reactions came immediately. The most common one, which was expressed in both the European and United States press, conjured up the spectre of a "debtors' club"; this idea has since made the rounds of international financial circles and has given rise to all sorts of misinformed speculation. The reference to defining "initiatives and courses of action" was said to be an advance indication of the debtor countries' determination to take collective decisions with the intention of imposing them unilaterally upon the banking system and multilateral financial bodies. Those who called up this fearful vision overlooked the fact that the creditor banks had been guilty of manifest and open collusion when, several months before, they had created machinery for an exchange of information and the definition of collective actions *vis à vis* each of the debtor countries. They also overlooked the fact that at no time had the governments which signed the declaration announced or even implied the possibility of abandoning the idea of dealing with the problem on a case-by-case basis, inasmuch as they recognized the substantial differences between the various situations and specific prospects of each country, although they were also aware of those areas in which the debt's repercussions on their countries were similar.

Two weeks later (5 June), on the eve of the meeting of the Heads of State or Government of the seven major Western industrial countries in London, the same four Latin American presidents plus Presidents Osvaldo Hurtado of Ecuador, Fernando Belaúnde of Peru and Jaime Lusinchi of Venezuela decided to send communications to the political leaders of those countries. These messages (which were also drafted very speedily by means of consultations among the foreign ministries), in addition to reiterating the basic content of the declaration of

19 May, set forth some other fundamental concepts: "There is clearly an urgent need to take concerted action, especially with respect to the debt. It cannot be imagined that contacts with the banks or the participation of international financial bodies alone will be enough to resolve these problems. A constructive dialogue between creditor and debtor countries is needed in order to identify specific measures to ease the burden of the external debt while giving due consideration to the interests of all the parties involved... a set of integrated policies and actions in the fields of finance, the debt and trade must be defined. It is essential that a candid atmosphere of co-operation should be established on the basis of shared responsibility and consideration for the interests of the international community as a whole". In closing, it was emphasized that "a manifestation of the major industrial countries'

political willingness to work towards the achievement of these objectives would... be particularly opportune" (Ministry of Foreign Affairs of Mexico, 1984b)).

The statements issued on 15 May and 5 June 1984 laid the foundations for the meeting of the foreign ministers and finance ministers of eleven Latin American countries which was to be held in little over two weeks after the latter date in Cartagena. The attendance at Cartagena of the four countries which had signed the first declaration (Argentina, Brazil, Colombia and Mexico), the three other countries which had also signed the message sent to the London summit (Ecuador, Peru and Venezuela) and four other countries (Bolivia, Chile, Dominican Republic and Uruguay) provided incontrovertible evidence of the region's growing acceptance of the statements made in these declarations.

## II

### Cartagena: the basic platform

The platform decided upon by the countries participating in the Cartagena process found its first expression in the Cartagena Consensus, which was adopted at the first ministerial meeting of these eleven countries (21-22 June 1984) and was then further developed during two subsequent ministerial meetings in Mar del Plata (13-14 September 1984) and Santo Domingo (7-8 February 1985).

The platform adopted by these countries at Cartagena has three main components: political declarations, proposals for specific policy measures and action, and institutional considerations. The platform is addressed as a whole, without attaching too much importance to the specific forum where an idea was first expressed, inasmuch as the three basic documents in question (the Consensus and the statements issued at the meetings of Mar del Plata and

Santo Domingo) are clearly just three stages in a single ongoing process.

#### 1. *The main political pronouncements*

##### a) *The co-responsibility of debtors and creditors*

In view of the fact that the Latin American debt problem largely stems from "drastic changes in the terms under which the debts were originally contracted" in regard to interest rates, liquidity, the composition of the debt and the outlook for economic growth, and that these changes "originated in the industrial countries and lie beyond the reach of the region's decision-making capacity" (Cartagena Consensus, paragraph 7), it is evident that debtors and creditors are jointly responsible for its nature, scope and manifestations. This pronouncement was made

in response to the clearly biased approach which has been taken to the problem, whereby the burden of undertaking the necessary efforts and actions to deal with the problem has been shouldered by the debtor countries alone.

b) *The resolve to fulfill external payments commitments*

The countries concerned have consistently asserted and reiterated their "intention to comply with the commitments relating to their external indebtedness" (Cartagena Consensus, paragraph 8) and to carry forward adjustment processes with a view to re-establishing the necessary conditions for the resumption of the region's economic development and social progress. This statement was a refutation of the speculations which had circulated both on the eve of the Cartagena meeting and at the time of the subsequent conferences, according to which the countries involved were seeking ways to avoid fulfilling their commitments.

c) *A political dialogue on the debt problem*

The most controversial pronouncement to come out of the Cartagena process was without question the statement referring to a "political dialogue" concerning the debt problem and the related issues of financing and trade. This pronouncement was based on the recognition of the fact that, because its implications go far beyond the financial sphere and have "obvious political and social consequences", the debt problem clearly has a political side that makes its "political consideration... at international level" imperative, inasmuch as "only a meeting of minds of the governments of the debtor and creditor countries will bring about a change in present conditions, which are making it impossible to reach adequate and lasting solutions" (Cartagena Consensus, paragraph 9). The pronouncement also reflected the fact that such a dialogue would contribute to an understanding and that in the specific case of the debt, "a dialogue between creditors and debtors is essential if the problem is to be fully comprehended and an understanding is to be reached", since "failure to conduct such a dialogue would prevent the co-operation between the parties which is necessary in order to

resolve the crisis on a joint basis" (Mar del Plata Communiqué, paragraph 7).

d) *Dealing with the situation on a case-by-case basis*

In view of the particular circumstances of each individual nation and "the diversity of external indebtedness situations and of the measures needed to re-establish the conditions for growth", the countries involved in this process are of the opinion that "each country is responsible for the way in which its external debt is negotiated" but that, at the same time, "there is a need to define and agree to general policy approaches to restructuring and financing to serve as a frame of reference for the individual negotiations of each country" (Cartagena Consensus, paragraph 10). In this statement, the countries reconciled the obvious need to maintain national responsibility and control as regards the process of renegotiations with the desirability of defining a broad and generally applicable framework within which specific cases are to be handled. At the same time, they also rejected what would appear to be the main objective of a "debtors' club", i.e., collective renegotiation.

e) *An even-handed adjustment*

Recognizing the biased nature of the international adjustment effort, inasmuch as the debtor countries have been saddled with virtually the entire burden of making such an adjustment, the signatory countries enunciated "the concept of equity in the distribution of the cost of economic readjustment", stating (Cartagena Consensus, paragraph 12) that "the adjustment process should be symmetrical and equitable if it is to be effective" as regards re-establishing worldwide economic growth.

f) *The relatedness of the issues of the debt, financing and trade*

In view of the tendency to compartmentalize international economic problems, ignoring their obvious relationships, the countries stated that "debt, financing and trade problems are closely related, so that the region's payment capacity could be strengthened by stimulating economic

growth through an increase in exports, the re-opening of financial flows and the maintenance of adequate import capacity levels" (Cartagena Consensus, paragraph 13).

## *2. Proposals for specific action and policy measures*

### *a) The reduction of interest rates*

There is a need for the "adoption of measures leading immediately to a drastic reduction in nominal and real interest rates in international markets" (Cartagena Consensus, paragraph 18 A). Furthermore, the developed countries must rectify those aspects of their policy which tend to raise the cost of credit or to maintain it at levels "several times higher than historical averages" by taking "action to bring real interest rates back down to reasonable levels" (Mar del Plata Communiqué, paragraph 2).

### *b) Compensatory financing to help offset increases in interest rates*

The countries proposed "the putting into practice of temporary machinery to ease the impact of high interest rates" (Cartagena Consensus, paragraph 18 D), along the lines of the compensatory financing facility in the International Monetary Fund, or the extension of official concessionary loans for this purpose.

### *c) The postponement of interest payments*

In the case of countries "with extreme balance-of-payments difficulties", a proposal was made for "the deferment of the payment of some of the interest" (Cartagena Consensus, paragraph 18 F); such interest payments would be resumed once an increase in a country's exports allowed it to allocate a portion of its additional earnings for that purpose.

### *d) The introduction of new features into renegotiations*

A series of features which should be incorporated into the rescheduling of debts were set forth, including the following: i) applying interest rates "which should, in no case, exceed the real costs of securing the funds in the market or

be based on administered rates" (Cartagena Consensus, paragraph 18 B); ii) keeping "the margins of intermediation and other expenses" down to a minimum and "eliminating commissions" (Cartagena Consensus, paragraph 18 C); iii) establishing debt payment profiles that are in keeping with the country's "capacity for economic recovery" and substantially lengthening the "repayment and grace periods" of loans and extending the bases of renegotiation "to periods covering a number of years" (Cartagena Consensus, paragraph 18 E); iv) preventing rescheduled payments from involving the commitment of "income derived from exports... beyond reasonable percentages compatible with the maintenance of adequate levels of domestic production activity" in the debtor countries (Cartagena Consensus, paragraph 18 G); and v) in renegotiations undertaken with the governments and official export-credit institutions of industrialized countries, granting more favourable terms with respect to repayment periods and interest rates than those provided in renegotiations with commercial banks.

### *e) The generalization of the positive features of renegotiation operations*

Inasmuch as some of the rescheduling exercises carried out in the second half of 1984 adopted "some of the main principles set forth in the Consensus with respect to terms, costs and conditions" (Mar del Plata Communiqué, paragraph 6), the signatory countries drew attention to the need "to extend [such provisions] to include countries which are in the process of renegotiating their debts and [to make such provisions] a basic prerequisite for any future negotiations" (Santo Domingo Communiqué, paragraph 1).

### *f) Supplementary measures*

In reference to the clearly expressed belief of the developed countries and the international banking community that the renegotiations, especially those carried out since mid-1984, are a solution to the debt problem, the signatory countries stated that such operations are insufficient and proposed that they should be supplemented with a political dialogue: "rescheduling the debt is not enough and only defers the

problem, since negotiations with commercial banks, by their very nature, do not provide an opportunity for addressing broader issues such as the co-responsibility of debtors and creditors, the even-handedness of the adjustment, the implications for the debtor countries' development and the future course of the international economy, trade and finance, which would allow a permanent solution to the debt problem to be found" (Santo Domingo Communiqué, paragraph 2).

g) *The modification of banking regulations in creditor countries*

The countries proposed the elimination of "the regulatory inflexibility of some international financial centres which automatically castigate the credit portfolios of developing countries and prevent a concession of new financing" (Cartagena Consensus, paragraph 18 I) and the adaptation of such regulations to the characteristics of debtor countries and to their status as sovereign nations.

h) *Proposals relating to multilateral financial institutions*

The countries set forth a series of proposals relating to the policies and activities of the International Monetary Fund, the World Bank and the Inter-American Development Bank. These proposals included the following: a) "the allocation of a greater volume of resources and the strengthening of the lending capacity" (Cartagena Consensus, paragraph 18 K) of these bodies, along with the speedier and increased use of their resources; b) "a new allocation of Special Drawing Rights... compatible with the need of the developing countries for liquidity; the

lengthening of the duration of [the] adjustment programmes and increased access" (Cartagena Consensus, paragraph 18 L) to the resources of the IMF; and c) "a review of the conditionality criteria" of the Fund with a view to assigning "priority... to the growth of production and employment", excluding "the impact of the rise in international interest rates" from the assessment of the extent to which the fiscal and balance-of-payments goals of stabilization programmes have been achieved, and modifying "the monetary goals agreed upon" in order to "absorb unforeseen rises in the rate of inflation" (Cartagena Consensus, paragraph 18 M).

i) *Improving the international terms of trade*

The countries proposed courses of action for increasing their access to the markets of developed countries, including "the rapid elimination of tariff and non-tariff barriers", as well as the stabilization of commodity prices "at remunerative levels" in order to check the "sharp deterioration in their terms of trade" (Cartagena Consensus, paragraphs 18 P and Q).

3. *Proposals relating to institutional matters*

The countries decided to establish a "mechanism for consultation and regional follow-up... open to the participation of other countries of the region" in order to facilitate the exchange of information and experiences, to promote contacts with other developing countries and to "promote a dialogue with governments of creditor countries and, subject to appropriate arrangements, with multilateral financial institutions and the international banking system" (Cartagena Consensus, paragraphs 19 and 20).

### III

## The international response to Cartagena

The basic platform of pronouncements, proposals and lines of action which emerged from the Cartagena process had a major international impact. Initially (and in contrast to the impression given by the United States and European press, which conjured up the spectre of a "debtors' club" and attributed well-nigh apocalyptic intentions to its supposed members) the reaction was one of relief. The statements made by the 11 Latin American countries were recognized as being objective and reasonable and were regarded as highly feasible. In not a few cases, they were described as being moderate or even timid. There was speculation about the supposedly "radical" attitudes of some of the participants in the three ministerial meetings, which were believed to have been restrained by other "conservative" countries. In actual fact, the countries almost always took similar approaches to the issues dealt with in the debates and their proposals were formulated in a spirit of realism and objectivity. This does not mean, of course, that there was no controversy about such issues as the definition and content of a political dialogue and, above all, about the part to be played by rescheduling exercises in the search for an overall and permanent solution to the problem. Thanks to the understandings that were reached, it became clear that the Cartagena process constituted a new element in the international debt picture which, as was stated at the outset, opened up a new phase in the efforts to deal with this issue.

It is evident that many of the events which have occurred since mid-1984 with respect to the debt problem and the related issues of financing and trade have been influenced by the Cartagena process. It is equally clear, however, that many other factors, both actual situations and institutional elements, also influenced these events. It is therefore difficult to pinpoint any one factor as having been decisive in a given event. It can nonetheless be stated with certainty that the Cartagena process has had a major impact on the evolution of the debt problem and on the way the problem has been perceived by other debtor

countries in Latin America and elsewhere, by the developed countries, the international banking community and multilateral financial institutions, as well as by the broader forum of world public opinion. An analysis of the main events since mid-1984 relating to the debt problem or affecting the way in which it is perceived will shed light on the nature of the international reaction to the pronouncements of Cartagena.

One factor to be considered is the final statement issued by the Heads of State or Government of the seven major Western industrial countries who met in London from 7 to 9 June 1984. The participants in this summit had received communications directed to them by the Latin American presidents urging them to demonstrate their political willingness to address the pressing problem of the debt. The statement issued by the London summit devotes an unusual amount of attention to economic relations with developing countries (which had always received short shrift at these meetings) and to the debt problem in particular. It was stated in this document that, in the light of the concerns expressed by the developing countries and the economic and political difficulties confronting many of them, there was a willingness in the IMF/IBRD Development Committee to undertake a more thorough examination of the international financial problems affecting the developing countries in particular, and that this Committee was regarded as an appropriate and highly representative forum for the purpose. The summit participants also acknowledged that high (and even rising) international interest rates could exacerbate the problems of debtor countries and that this fact lent even greater importance to the measures which the developed countries should adopt in order to reduce interest rates. Finally, it was also announced that the participants had agreed, *inter alia*, to maintain and, if possible, to increase the flow of resources to developing countries; to uphold the strategy adopted to deal with debt problems and to continue implementing it and refining it in a flexible manner which would also involve the introduction of new elements, es-

pecially that of rescheduling commercial debts and debts contracted with States and State agencies for periods covering a number of years; and to increase the pace of present programmes aimed at easing restrictions on international trade (London Economic Declaration, 1984).

This was the initial response—incomplete, insufficient and laden with nuances—to the proposals set forth in the communications received from the Latin American presidents regarding a dialogue concerning the debt problem and the need to lower interest rates, improve market access, obtain better terms in the rescheduling of debts and provide additional resources for development.

As from the second half of 1984, a large number of debtor countries, including many Latin American nations, embarked on a second round of renegotiations which, in general, followed the guidelines laid down in the Cartagena Consensus. Argentina, Brazil, Mexico and Venezuela were among these countries, to name only some of the more prominent ones. At the time of writing, early in the fourth quarter of 1985, these negotiations either had been or were about to be concluded. To date, the introduction of the desirable rescheduling provisions set forth in the Consensus into the actual renegotiations carried out by various countries has been the most positive manifestation of the international response to Cartagena.

These important rescheduling exercises, successive decreases in nominal interest rates, the promising outlook for continued economic growth in the industrial countries observed during the second half of 1984 and the sharp upturn in world trade occurring at that time all combined to produce a feeling of relief and even complacency with respect to the debt problem which was seen as a much less pressing matter. This attitude was remarked upon in paragraph 1 of the Mar del Plata Communiqué.

A few months later, however, beginning in the second quarter of 1985, international public opinion on the debt problem underwent an abrupt turnabout. The previously widespread complacency disappeared, and there was once again a sense of urgency. From the standpoint of the Cartagena proposals, this change in attitude was due to the fact that many of those proposals had not been heeded and that the international

economy, trade and finance took an unexpected turn in 1985. Thus:

i) Uncertainty about the trend of interest rates has grown. Although there have been considerable reductions in these rates, which have provided some degree of relief from debt service payments, the fact remains that if (as noted in the document of the Group of 24 cited previously) the spreads over the basic rates corresponding to the risk associated with each country and the decline in export prices are taken into consideration, it becomes clear that the real interest rates to be paid by debtor countries on bank loans are untenable in the long run because they are higher than the probable growth rates of real income and of the real value of exports (Group of 24, page 16). Moreover, many of the factors which have pushed up the cost of credit in the past have not been eliminated (e.g., the combination of expansionary fiscal policies and restrictive monetary policies in a number of developed countries, as well as the United States' huge fiscal deficit). The possibility of a renewed rise in interest rates, with all its adverse implications for the debtor countries, has not disappeared. In real terms, interest rates continue to be far higher than they were during the times of economic expansion registered since the war.

ii) Exchange rates have continued to be highly volatile in the short term and their misalignment has persisted, giving rise to sudden and uncontrollable changes in the relative prices of export products and services which alter the various countries' competitive positions at the international level. This has also increased the exchange risk involved in current transactions, thereby creating a greater need for reserves, while another effect is the greater uncertainty with regard to future foreign exchange earnings from exports of goods and services. All of these factors have cast a pall over the outlook for continued payment of the debt service.

iii) The prospects for sustained growth in the developed countries have rapidly deteriorated as a result of the sharp slowdown in the United States economy, thus rendering the outlook for the second half of the 1980s even more uncertain; the assumption that there will be "slow but steady growth" during the coming five years is now being questioned and another recession



is beginning to be regarded as more probable. This uncertain outlook affects debtor countries because of its impact on commodity prices, the demand for the exports of those countries, and the flows of direct investment to them.

iv) There has been a marked increase in protectionist trends and measures aimed at restricting international trade, which have a directly adverse effect on the debtor countries' export opportunities. The Group of 24 has noted that almost all the major debtor countries, after having achieved a sharp increase in their exports in 1984, are now experiencing a slowdown in the growth rate of foreign sales (page 16). World trade will probably not grow by even half as much in 1985 as it did in 1984, when the growth rate was estimated at 4.9%. Furthermore, there has been a proliferation of incipient trade wars involving a growing number of countries, sectors and products, such as, automobiles (Japan, the United States and Europe), electronic items (Europe and Japan), steel (United States, Europe, Japan and developing exporting countries), textiles and garments (the developed countries and developing exporters), foodstuffs (the United States and Europe) and footwear (the United States and developing exporting countries) —to name only a few of the more outstanding cases. In some of the above instances, bilateral or trilateral agreements have been reached which are generally of a restrictive nature, as in the case of the trade wars over steel between the United States and Europe or over automobiles between Japan and the United States. The restrictive agreements negotiated between two or three major parties are then expanded to include the other exporters. Sometimes, the restrictions are specifically directed at the developing countries which have won competitive export positions in various branches of manufactures. Despite the fact that the official line taken in developed countries is that they continue to favour an open multilateral system of trade, which has its institutional expression in GATT, in actual practice they are moving towards a restrictive and bilateralized "system" whose institutional expression takes the form of a wide variety of special arrangements that limit trade: "orderly marketing agreements", "voluntary" limitations on exports, the sharing-out of markets, the setting of quotas, etc., which are almost always established

outside the framework of GATT. The impact on debtor countries is obvious: a decrease in the growth opportunities for exports and other non-compensatory foreign exchange inflows.

v) Financial flows to debtor countries have continued to be much smaller than what is needed. The banking community has become more reluctant to channel fresh financing to them and has delayed the restoration of voluntary flows much longer than had been expected one or two years ago. Furthermore, the volume of loans from multilateral finance institutions has remained insufficient due to some developed countries' ongoing opposition to the authorization of substantial increases in these agencies' capital or to the modification of the ratio between capital and credits (the "gearing ratio") so as to bring about a significant increase in their lending capacity. Both these factors tend to perpetuate a situation in which debtor countries have become net capital exporters. According to estimates made by the Group of 24, in 1984 this net transfer from developing countries amounted to about US\$ 40 billion. The debt service payments made to banks by Latin American countries totalled US\$ 30 billion in 1983 and US\$ 27 billion in 1984, making it necessary for them to generate trade surpluses equivalent to around two-thirds of total imports and over 10% of the region's total GNP (Group of 24, pages 45-49). Obviously, this outflow of financial resources substantially reduces the debtor countries' future ability to pay, as well as virtually ruling out any prospect of long-term development for them.

vi) The obvious economic, social and political difficulties that would result from an indefinite prolongation of the recessionary adjustment processes put into effect by the major debtor countries have also been brought to the fore. A combination of internal circumstances —which vary enormously from one country to another— and of external factors such as those mentioned above has made it more costly and time-consuming than was originally thought to achieve the aim of the countries' adjustment programmes, i.e., the re-establishment of internal and external equilibria. It has thus become necessary to prolong these adjustment processes and to make them more severe, with the increasingly negative implications this has for the various spheres of life in debtor countries. This situa-

tion heightens the fears about the political stability and continuity of democratic systems in many of these nations.

During the first eight months of 1985, a number of important institutional events relating to the debt problem have also occurred which have done their part to increase the public's awareness of the proportions and scope of the problem and of the need to find permanent solutions. Directly or indirectly, these events represent part of the international response to Cartagena. Some of the most notable developments in this respect are as follows:

- The meetings held by the IMF Interim Committee and the IMF/IBRD Development Committee during the second quarter were in large measure devoted to the subject of the debt. The fact that these forums have embarked upon a discussion of this subject within the broad context of the developing countries' economic, commercial and financial prospects is a result of the "political dialogue" initiative of the Cartagena Consensus countries and constitutes a partial response to it. The meetings provided a first opportunity for exchanging opinions and viewpoints which revealed the great differences between the developing and industrialized nations' approaches to the debt problem and their points of view in this regard. Because of these differences, it was impossible even to decide upon definite follow-up steps aimed at establishing a procedure for a continued treatment of the subject, much less to agree upon specific policy measures. These bodies, together with their parent institutions, the International Monetary Fund and the World Bank, will surely continue to concern themselves with the subject of the debt and the related issues of financing and trade; nonetheless, it does not appear likely that at any time in the near future they will constitute appropriate forums for a political dialogue having the characteristics and objectives set out by the signatory countries of the Cartagena Consensus.

- When he became Head of State of Peru, Alan García announced that his country had decided, "in view of the need to move on from words to action, and in the spirit of the Cartagena Consensus" to enter into a dialogue with its creditors "without using the IMF as an intermediary" and, "during the next twelve months, and so long

as there is no change in the situation" to allocate no more than "10% of the total value of our exports to servicing the external debt" (García, 1985). This statement electrified public opinion on the debt service problem and opened up the possibility of each debtor determining what percentage of its export earnings it could reasonably devote to servicing its debt, in accordance with the tenets of the Quito Declaration and the Cartagena Consensus.

- On the initiative of Mexico and Panama, a meeting "of a clearly technical nature" was held at Oaxtepec, Mexico, under the auspices of El Colegio de México, and was attended by experts from ten of the Latin American countries that were parties to the Cartagena Consensus. It is expected that the conclusions and recommendations of this conference, which was held in July, will be reviewed at the formal meetings of the Cartagena participants at Montevideo in the fall of 1985 (Oaxtepec Communiqué, 1985).

- In the last few months, the President of the Councils of State and Government of Cuba, Fidel Castro, has been unusually active in matters relating to the debt issue. His statements and initiatives culminated in a large-scale meeting at Havana in August which provided an opportunity for a wide-ranging and pluralistic confrontation among representatives of different viewpoints, although it did not aspire to achieve the impossible task of reaching conclusions that would be acceptable to such a wide variety of participants. Castro has maintained that "the debt is unpayable" and has proposed that creditor countries should allocate a certain percentage of their military expenditures for reimbursing the banks for the amounts owed to them by developing countries. Despite this proposal's obvious unfeasibility, Castro's initiative has helped to revitalize, expand and enrich the debate on the debt and has given rise to a number of other proposals, many of which are quite valuable.

- As a result, *inter alia*, of the discussions held in the Interim and Development Committees, both the developed and the developing countries have directed their efforts towards formulating new proposals for the reform of the international monetary system. The propositions advanced by the Group of Ten make no explicit reference to the subject of indebtedness, nor do they contain

any concrete proposals in that respect, as if it were possible to deal with issues relating to the international monetary system without considering the debt issue or the related problem of the transfer of resources. In contrast, the report of the Group of 24 (1985, pages 48-54) includes a very useful analysis and some proposals concerning the problems of the debt and the transfer of resources. These proposals will be examined at the meetings to be held by both committees in Seoul during the third quarter of the year and at the annual meetings of the IMF and the World Bank.

With direct regard to the debt problem, all these factors have raised the possibility that the main positive aspect of the international response to Cartagena —i.e., the second series of restructuring operations begun during the second half of 1984, which many countries have not yet concluded— may have ceased to be viable. In other words, between late 1984 and mid-1985, there have been radical changes in the assumptions regarding the performance of the in-

ternational economy, trade and finance and the evolution of the debtor countries' economies on which this second round of rescheduling operations were based. As a result, there are pervasive doubts as to whether it will really be feasible for the countries to comply with the payment timetables provided for under these rescheduling agreements. There has also been a growing belief that their terms are not compatible with the resumption of growth because they do not include ceilings on transfers in the form of debt service payments. Since the second round of restructuring operations constituted the main grounds for the optimism and even complacency once felt with regard to the debt problem, the above-mentioned factors have clearly produced a radical change in attitudes and have brought back the former sense of urgency. It is for this reason that there is more and more talk of the need to begin a third round of rescheduling efforts on a different basis: an overall restatement of the debt problem through a political dialogue.

## IV

### The overall outlook for the Cartagena process

In the fifteen months which have passed since the first ministerial meeting, the Cartagena process has taken some major steps forward. One important advance is represented by the features included in the second round of restructuring operations; another is the contribution that this process has made to a better understanding on the part of the countries directly involved and the international community as a whole—including, of course, the public—of the nature, magnitude, scope and consequences of the debt problem. Nonetheless, a number of the political pronouncements and specific proposals made have not yet met with a positive response, while at the same time, the international economic, trade and financial situation has changed over the last few months in such a way that the debtor countries are now less likely to be able to cope with the problem on the terms resulting from the second round of rescheduling operations.

Hence there is now a need to update and revitalize the platform of the eleven Latin American countries participating in the Cartagena process in response to the changes that have occurred in the economic, trade and financial situation and the institutional events of recent months in order to go beyond the original proposals. The meetings of the Cartagena Consensus countries scheduled for the third quarter of 1985 in Montevideo, and especially the fourth ministerial meeting, provide an opportunity to do this. In order to update, revitalize and carry forward the ideas of the Cartagena process, the following issues and proposals might be considered.

#### *1. Initiating a political dialogue with the creditor countries*

There is an urgent need to define strategies and

procedures that will allow the political dialogue between debtors and creditors proposed by the Cartagena countries to be begun as soon as possible.

In principle, the concept should not seem in any way unusual to the advanced countries: indeed, the most highly developed example of a political dialogue concerning international economic, trade and financial issues is provided by the annual meetings of the political leaders of the seven major Western industrial countries, which have been held for the past eleven years running. The possible subject matter of such a debate should not seem unusual to them either: issues are addressed at this type of meeting which cannot be properly resolved at conventional forums for contact and negotiations among government representatives because far-reaching political decisions are required to do so. Nevertheless, the governments of the developed countries have not fully understood (or have not wanted to understand fully) the proposal of the Cartagena countries, and it is therefore necessary to clarify and refine it.

To this end, in September 1984 the Mexican Government issued a memorandum setting forth the main guidelines for such a political dialogue, stating that it should be a "direct [dialogue] between governments of industrialized and debtor countries". It went on to say that "... there must be an acknowledgement of the fact that the governments' direct participation is essential if they are to deal with the broadest aspects of the debt issue and reach definitive agreements which will allow this problem to be resolved...

"It is clear that this [the agenda for an intergovernmental dialogue] should include issues relating to relief of the debt service burden as well as subjects of a broader scope which concern financing and trade in addition to the debt, with a view to restoring the necessary conditions for the sustained economic growth of debtor countries. It should include, firstly, the definition of general criteria that will provide a frame of reference for [the third round of] national renegotiations and, secondly, the definition of criteria and guidelines concerning the adoption by multi-lateral financial institutions of new measures that are needed to deal with the debt problem within their sphere of operation (e.g., the extension of

the IMF's Compensatory Financing Facility to cover increases in interest rates). The agenda could also include issues relating to the regulation of the national banking systems of countries which act as financial centres in order to permit such steps as setting the interest on the accumulated debt at levels below market rates or the establishment of interest rate caps on loans to developing countries."

These statements in connection with the political dialogue proposed by the Cartagena countries should be reiterated to the developed countries. The strategy for initiating the dialogue should also be developed more fully. It is important, *inter alia*, to underscore the fact that it would be of an informal nature, to look into the possibility of initiating the dialogue with those developed countries that are most willing to pursue it; and to agree upon a plan for the gradual and progressive introduction of the issues to be considered. The essential point is to clarify and refine the proposal in order to avoid its rejection on the grounds that it is unclear and to find the appropriate channels to ensure that the proposal is heard and given positive consideration by the governments of the developed countries.

## 2. *Establishing the principle of "growth for payment"*

A common denominator in all the more intelligent proposals put forth with respect to the debt problem is that they stress that the debtor countries must be able to resume and sustain their economic growth at a satisfactory pace if they are capable of continuing to make debt service and amortization payments. This idea was expressed with particular clarity at Oaxtepec when it was said that the principle of "growth for payment" should replace the idea which has thus far prevailed in practice, namely, "payment and —maybe— growth" (page 3). The principle of the co-responsibility of debtors and creditors was laid down in the Cartagena Consensus and, no one has in fact rejected it; the next pronouncements to emerge from this process should set forth, just as vigorously, the idea that the debtor countries' resumption of sustained economic growth is a *sine qua non* for their continued fulfilment of their external payments obligations.

### 3. *Moving on from a "recessionary adjustment" to a "positive adjustment"*

In order to put the principle of "growth for payment" into practice, a substantive change must be made in the debtor countries' adjustment processes. A transition must be made from the recessionary adjustments that have been prevalent up until now to a positive type of adjustment which will permit and foster the resumption of sustained economic growth. Such a transition will obviously involve highly complex policy changes whose specific nature will vary from country to country, as well as the reform of the International Monetary Fund's standards and practices, including those relating to conditionality and other procedures mentioned in the Cartagena Consensus. In order to further this aspect of the process, the necessity of a transition to a positive type of adjustment might be set forth and an in-depth analysis of the domestic and international policy implications of such a transition might be suggested.

### 4. *Completing the second round of rescheduling operations*

It will be recalled that the main thrust of the original platform of the Cartagena Consensus concerned the definition of features which should be included in rescheduling exercises. Most of the provisions recommended in the Consensus have been incorporated into the second round of rescheduling operations, which some countries have completed and others are in the process of bringing to a conclusion. It is therefore important, as recommended in the Oaxtepec Communiqué (page 4), for the debtor countries "to proceed with and consolidate 'round II' in accordance with the principles of the Cartagena Consensus: rescheduling over a number of years, the elimination of managed interest rates, the reduction of spreads and the elimination of commissions on restructuring".

### 5. *Defining the characteristics of the third round of rescheduling operations*

As noted earlier, between late 1984 and mid-1985 the assumptions relating to trends in the international economy, trade and finance and in

the debtor countries' economies which had served as a basis for the second round of rescheduling operations underwent a radical change, and an effort must therefore be made to determine what characteristics would be desirable in the third round. Obviously, not all the debtor countries must undertake a third round of renegotiations, much less begin them simultaneously. Nonetheless, just as the desirable features of a second round were defined in the Cartagena Consensus despite the fact that at that point in time not all the countries planned to undertake such an exercise, the desirable features for a third round should now be defined. These features mainly relate to interest rates, repayment and grace periods, the availability of fresh financing, *ex post* rectifications in the transfers made in the form of service payments, and the ratio between payments of principal and interest on the debt.

*Interest rates.* In view of the persistence of international interest rates which are extremely high in real terms despite the nominal reductions made in recent months, purposeful action must be taken with respect to this variable in the third round of renegotiations. In other words, the attitude that the only applicable interest rates are those prevailing on the international financial markets must be abandoned, since it is inadmissible that interest rate fluctuations should directly affect the level of the service commitments on the renegotiated debt. A first step has already been taken in this direction with the elimination of "managed rates" (such as the prime rate) and the use of rates more closely related to the cost of obtaining resources (such as the LIBOR); this change was recommended in the Cartagena Consensus and was incorporated into many of the renegotiations that took place during the second round. Basically, what must now be done is to make further progress in the same direction. There are a number of possible ways of going about this.

The most innovative option would be to replace market interest rates with a different interest rate on the cumulative debt whose level would reflect, on the one hand, the average real interest rate prevailing during the postwar periods of economic expansion and, on the other hand, the projected rate of growth of debtor countries' real income and of the real value of their exports.

The difference between this rate and market rates would be absorbed by the creditor banks, which would take it out of their proceeds, or be financed by the monetary authorities of the creditor countries. In principle, the debtors should not have to bear any additional burden on account of this differential.

The Group of 24 (page 49) has recommended that urgent consideration be given to "progressive measures for rolling over a certain percentage of interest payments as, for example, that portion which is in excess of the long-term trend of real interest rates". This approach, which would be similar to the establishment of a cap on the interest rates applicable to the cumulative debt, would involve the establishment of some means of capitalizing interest.

A variation of this idea was proposed in the Oaxtepec Communiqué (page 4). In that document, it was recommended that, rather than setting interest rates at a given level, the essential point was to establish "ceilings on capital transfers which are in keeping with the minimum acceptable [economic] growth rate [of debtor countries]"; and that "this would open the way to systems for postponing interest payments... and, in extreme cases, systems for the partial cancellation of interest payments". A procedure for capitalizing interest is also implicit in this proposal.

There is also, of course, the proposal (which has been pending for quite some time now) for the establishment of machinery in the IMF to provide compensatory financing for increases in debt service caused by rising interest rates (i.e., an interest rate facility).

In short, regardless of the specific type of measure adopted, the important point is, within the context of the third round of rescheduling operations, to establish the need to insulate service payments on the restructured debt from increases in the interest rates on creditor countries' money markets. As a complementary measure, it would be desirable to establish the procedure that unpaid interest should not be capitalized, but rather absorbed by the banks or monetary authorities of creditor countries.

*Repayment periods.* The repayment periods provided for in the second round of restructuring operations were generally much longer than in the first round. This trend may well continue.

*Grace periods.* Another feature of the second round of rescheduling operations was the abandonment of the concept of grace periods and the establishment, in their stead, of a payment profile in keeping with the debtor country's ability to pay. An essential component of the third round would be the establishment of payment profiles in which a priority consideration is the need for such profiles to be compatible with the resumption of a sustained rate of economic growth in the debtor country.

*Supply of fresh resources.* Another point on which well-researched analyses of the debt problem are in agreement is that there is a pressing need to restore the debtor countries' access to external savings in order to put a speedy end to these countries' involuntary position as net exporters of capital. As noted in the Oaxtepec Communiqué (page 6), it is important for the third round of restructuring operations "to include commitments on the part of the banks to provide fresh financing as necessary during those years for which the corresponding due dates are being rescheduled". Furthermore, it is also important to incorporate an element of automaticity in the supply of fresh financing.

*Ex-post adjustment of debt service transfers.* Unlike the second round of rescheduling, where this element was absent, the third round must provide for the possibility of adjusting the total programmed amount of debt service transfers in the light of changes in international economic conditions affecting the debtor country's economic situation. Accordingly, as suggested in the Oaxtepec Communiqué (page 4), such phenomena as a sudden deterioration in the terms of trade, greater difficulties in gaining market access due to the establishment of new protectionist barriers or new restrictions on trade by developed countries, or a smaller supply of fresh financing in real terms than was expected or pledged in the renegotiations themselves would prompt a sufficient reduction in the debt service transfers to ensure that "the same volume of foreign exchange which had originally been allocated to finance imports for development would continue to be available" (page 5). The application of this principle would require accepting the practice of releasing debtors from interest payments or, alternatively, of capitalizing the interest

which, due to the above-mentioned changes, in not paid.

*Proportionality between payments of principal and interest.* The large resource transfers made by debtor countries in recent years have scarcely made a dent in the principal of the debt, because they have been applied almost entirely to interest payments. In the third round of restructuring, one possibility would be to establish an appropriate ratio between principal and service payments. If, as suggested in the Oaxtepec Communiqué (page 4), amounts are set that represent the "maximum... transfer of which the debtor countries are capable" on an annual basis or during the restructuring period, it is important that a significant percentage of these maximum amounts should be devoted to paying off the debt principal.

#### 6. *Securing real trade commitments: market access and essential imports*

The close link between debt-related and trade issues was made clear in the Cartagena Consensus. Debtor countries have found it necessary to generate large trade surpluses in order to be able to meet their external payment obligations. Thus far, these surpluses have been the result of a recessionary adjustment process and have been based more on the restriction of spending on imports (with serious implications in terms of both economic growth and an increasing technological lag in production) than on an increase in non-compensatory foreign exchange earnings from exports of goods and services. The latter earnings grew somewhat in 1984 but, as already noted, have unfortunately begun to lose ground once again in 1985. One of the reasons, of course, is the proliferation of protectionist trade barriers and of all sorts of other restrictive measures in developed markets which have had a particularly strong impact on the export position of debtor countries. There is hence a need for a real commitment to provide access to the markets of industrialized nations. This commitment can, of course, be negotiated in the appropriate forums (UNCTAD and GATT), but its extremely close connection with the possibility of continued servicing and amortization of the debt should not be lost from sight. It is also necessary to ensure that the debtor countries have the necessary foreign

exchange to finance the imports (especially inputs, capital goods and technology) they need to achieve and sustain an adequate rate of economic growth. In many cases, this means that they must have access to a sufficient volume of producer loans on acceptable terms.

#### 7. *Restoring access to external savings*

In addition to the necessity of including commitments to supply fresh financing on an automatic basis in the third round of rescheduling operations, the debtor countries' access to external savings must be restored and expanded. Since they are developing countries, it is evident that they need to supplement the resources used to finance development with external funds. The need to bring about a reversal as soon as possible in many of these countries' present position as net capital exporters, as has already been noted repeatedly, is equally indisputable. In this regard, it should be noted that the countries in question clearly have no wish to return to the levels of external borrowing seen between the late 1970s and early 1980s, inasmuch as domestic savings should in future play a more important role in providing development financing. This source will still not be able to provide all the necessary funds, however, and will have to be supplemented with credit and direct investment. The essential point is to obtain sufficient financing from a balanced combination of sources, which should include multilateral bodies, bank credit and direct investment. No single one of these sources can be expected to provide all or even the major proportion of the required funds; instead, a balanced contribution will be needed from each. As pointed out by the Group of 24, part of the current debt problem stems from the fact that bank loans became by far the largest source of credit, and such loans were extended under much harsher terms than the credits granted by multilateral bodies. If the latter are to resume their proper role, a sufficient expansion in the resource base of the World Bank (including, of course, the IDA, regional banks and the IMF) is urgently required. An earnest effort should be made to achieve the implementation of the proposals regarding this subject set forth in the Cartagena Consensus, which, of course, coincide with the positions taken by the Group of 24.

There must also be no further delay in restoring debtor countries' voluntary access to bank credits on more favourable terms. Finally, the re-establishment of economic stability and growth in debtor countries will provide incentives for direct foreign investment which will attract it back to these countries without there being any need for guarantees or other mechanisms of that sort.

#### 8. *Setting in motion effective machinery for the exchange of information*

Ever since the first meeting at Cartagena which gave rise to the Consensus, the eleven participating countries have agreed upon the need for a free-flowing exchange of information among them concerning the debt and particularly the characteristics of the renegotiations and related trade and financial issues (lending terms). For a number of reasons, it has not been possible to set up a mechanism that will ensure a speedy and automatic flow of information. An important step that should be taken at Montevideo is to design such a mechanism (at the technical meet-

ings) and to establish it officially (at the ministerial meetings), as well as to decide what information should be exchanged among the participating countries on a regular (e.g., monthly) basis through the interim Secretariat.

In assessing the longer-term outlook for the Cartagena process as a whole, the fact must be borne in mind that the debt problem is itself a long-term issue. The international community will have to continue dealing with its manifestations and consequences throughout the rest of this century. The vital need right now is to make it manageable. If this is to be achieved, the basic prerequisite is to take the appropriate steps to ensure that the continued fulfilment of international payments commitments is accompanied by the resumption of sustained economic growth by debtor countries. The contribution of the Cartagena process to this objective has been and should continue to be gradual and progressive. In the immediate future, the full implementation of the specific proposals made in the Consensus and of those which are made in the future as it is updated and revitalized will permit further progress to be made in this direction.

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## External debt: why don't our governments do the obvious?

*Guillermo O'Donnell\**

In spite of the occasional give and take, agreements and temporary advantages for some, the present balance of power and the deterrent effect of the debt trap in which the Latin American countries are confined involve extremely high costs for them. Nevertheless, the unpasses which are the consequence of continuing to pull on a rope which is strangling all of us correspond to a powerful logic which it is extremely difficult to break and replace with another more compatible with the essential interests of our countries. The author maintains, however, that this is not impossible: a prerequisite for achieving it involves facing up to the situation in which we find ourselves, as well as to the logic behind it and the strategies which derive from it for debtors and creditors. All the rest could depend on nothing more than the vision and audacity of our countries' political leadership and their capacity to set out the real choices before their people, as well as the costs and risks involved in each of them. It is a highly significant fact that in the present extremely harsh economic and social crisis most political leaderships, be they in government or in the opposition, are democratic. Among other things this provides a hitherto inexistent capacity for dialogue. Such a dialogue, based on the patriotic and carefully considered search for a way out of the dilemma in which we are all trapped, would represent an important first step.

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## I

### Where do we stand?

"Unity is strength." Although this proverb does not always prove to be true, it has always provided the underlying motive for the weak to band together, so as to at least make up for their weakness. The same is true today of debtor countries. Common sense dictates two reasons. First of all, presenting a common front to creditors would increase the bargaining capacity of each and every one of the debtors. Secondly, the creditors are well organized: they have formed their own "club" or "cartel", run by Committees managed by the major banks, they have their "general secretariat" and means of exerting pressure on the debtors in the form of the International Monetary Fund, and they can rely on determined support from their governments.

However, the much talked-of alliance between debtors, in which some of our governments placed high hopes when they assumed office, seems a long way off. In order to understand this, and to think out new possibilities, it may be useful to call on some elements which have been developed by political science in the field of game theory and coalitions. It should be mentioned in passing that there is every reason to believe that these elements are known and used by the creditors.

Let us start with the fact that what we are dealing with is a negotiation in which it is in our interest to pay as little as possible, over the longest possible period and with the smallest possible effects on the economic growth of our countries. Any negotiation involves agreements, and also more or less explicit threats as to what one of the parties could do against the interests of the other. Just as in poker, there is always an element of bluff; but in the long term it is impossible to win if one always holds the losing cards. In other words, in addition to a considerable element of skill and audacity, any negotiation takes place within the context of a balance of power.

If we assume that, whatever else may be claimed, debtors are in a weaker position than creditors, and the latter are organized while the former are disunited, there can be little doubt as to the outcome of negotiations on the external debt. Fortunately, however, it is not a question of just one negotiation whose effects will be felt for

ever, but rather (partly as a result of the exorbitant consequences for debtors of the balance of power affecting them) an ongoing process or series of renegotiations as to how and when the external debt is to be paid.

Within this process it is clearly in the creditors' interest to avoid modifications in the relative strength of the parties involved —i.e., to prevent the debtors from organizing themselves. In order to achieve this the creditors can take, and have taken, a number of steps. First of all, they can loudly protest against any attempts to organize "clubs" of debtors, quite naturally without being bothered (since it is not a question of logic but of power) by the incongruity of such protests in view of their own high degree of organization. Secondly, they can insist that it is a purely "technical" and "economic" question, as if it were "merely" a contract under private law —thus ruling out the "politicization" which would be implied by the debtors joining together in their capacity of national States with unavoidable responsibilities towards their populations. Thirdly, they may threaten to impose harsh sanctions on debtors who break the rules of the game by failing to pay or attempting to unilaterally redefine the terms of repayment.

All this is so obvious that, if we consider it in this light, it is most surprising that debtors have not yet set up their own alliance. Far less obvious, however, are the mechanisms through which the creditors are managing to prevent such an alliance from coming into being. The reasons correspond to the strict logic of game theory. What is involved is, firstly, the plausibility of the threats made by each side, and secondly the cost-benefit calculation made by each player regarding himself and his opponent, assuming that any of the threats is carried out. The most serious threat which the debtor can make is quite simply not to pay. The greatest threat which the creditor is capable of making, for his part, is to exclude the debtor from the "international community": to cut off import credits, ban exports by the debtor, and confiscate his property in other countries, among other sanctions. Carrying out this threat would involve the creditors in costs: not only would they cease to collect the amounts claimed but they would also suffer a loss of profits and earnings through ceasing to do business with this debtor; in addition, if the conflict

reached this extreme, it is quite likely that the debtor would confiscate the creditor's goods in his territory.

The problem revolves around the "dissuasive relationship" which tends to confine the debtor within the present balance of power. It is in this respect that the problem of the debtor's isolation is important, since if instead of simply not paying or unilaterally rescheduling his payments, he managed to form an alliance with others in a similar situation, this relationship would change radically. If the government of country X decides unilaterally not to pay or to redefine the way in which it would be prepared to pay, it is obliged with regard to its own population (at least if it is a democratic government) to first of all foresee which of the harsh sanctions mentioned earlier will be applied and, secondly, to explain these consequences to the population and in some way consult it. This holds true for extremely practical reasons: if the sanctions are applied and lead to serious economic shortages, and if (as must be expected) these sanctions and shortages considerably radicalize the domestic political process, the government could not fail to ignore, in the calculations made before taking that decision, the consequences which are extremely likely to follow: the social and economic upheavals which the sanctions would produce would, in spite of the foreseeable initial euphoria, imply its political suicide or set off a revolutionary process. None of the present Latin American governments show any such suicidal or revolutionary vocation, especially as these upheavals would come on top of the serious crises which our countries are already experiencing. In the face of such likelihoods it is quite reasonable for these governments to conclude that it is less costly to continue renegotiating, even from a position of extreme weakness, than to precipitate a rupture with creditors. I fear that the creditors are fully aware of this: in other words, the greatest threat which the debtors are capable of making is not plausible and, consequently, is of no use as a lever in negotiations.

On the other hand, is the threat of sanctions made by creditors plausible? It certainly is, and herein lies the fundamental disparity which reflects the existing balance of power. If country X ceases to pay, the creditors must weigh up the cost to them of applying these sanctions against

the cost of not doing so. In the calculation which the creditors must make, they must take account of all the debt owed by all debtors: if country X gets away with not paying (or unilaterally rescheduling), it considerably increases the likelihood of other debtors doing the same. In other words, however large the debt owed by country X may be and however high the cost of isolating it economically, this would be less than the losses suffered by the creditors if other countries took similar decisions. Furthermore, it would be in the creditors' interest not merely to apply sanctions to X but to apply the severest possible sanctions, so that X suffers the gravest possible consequences, since the graver they are, the more efficient they will prove in dissuading others from following suit. Thus, debtors cannot fail to be aware that it is probable that creditors really do hold the trump card they claim is in their hand. As we have seen, the same is not true of each debtor in isolation.

However, the costs and benefits to creditors involved in the dissuasive relationship would be changed if not just X but X...N countries jointly threatened to cease to pay or to unilaterally reschedule their payments. Since this joining of forces increases the debt involved, as well as the loss of profits and earnings which would affect creditors if they cut off relations with these countries, it also increases the cost of sanctioning them as against the benefits gained in the sense of dissuading the remaining countries. A fundamental change occurs in the balance of power at the point where both curves intersect: it becomes plausible that these debtors as a group—but, I insist, only as a group—really possess and may manage to play their highest card.

In the face of such a situation, game theory indicates that the principal target of the strategy pursued by rationally motivated creditors would not be—as is generally assumed—to continually optimize their capacity to obtain payments from the debtors. Instead, the principal target (or, at least, the limitation to which such an optimization is subject) would be to maintain the dissuasive relationship and, with it, the balance of power on which it is grounded. As we shall see, awareness of this fact may have considerable practical consequences.

In order to reach their goal, the creditors must meet two conditions. The first is related to themselves, and concerns their own organization

in a club or cartel. It is crucial that they exercise self-discipline, ensuring that no single one of them attempts to optimize its short-term debt collection position, or—which amounts to the same thing—ensuring that the dominant concern not to cause a change in the dissuasive relationship remains paramount in the relationship with debtors. It is no accident that the Committees which deal with each of the debtor countries are directed by the main creditor banks, and that the IMF plays a pivotal role: both are virtually obliged to take a medium and long-term view, in contrast with small creditors whose credit involves a small part of their wealth. If this were not so, pressure from the latter could lead a large enough number of debtors to such a degree of despair that they might be prepared to pay any price in order to avoid paying. It should be pointed out, in addition, that by acting concertedly and thus maximizing their capacity to exert pressure to maintain the existing balance of power, the creditor banks and other sectors of transnational capital are able to considerably increase their profits in activities which are apparently unconnected with the external debt. This is the consequence of their capacity to put heavy pressure on the debtor governments to consent, for example, to give such transnational capital access to domestic markets or activities which these governments would not otherwise have authorized. This is the “good behaviour” pledge which creditors demand in order to accept postponements of debt payments which in any case, as we have seen, it is not in their best interest to maximize in the short term. Consequently, our countries are probably paying a heavy tribute whose origin in fact lies in the external debt, but which, as this relationship is obscure, is not attributed to the debt and consequently does not subject creditors to the risk that the balance of power from which this very same tribute originates will be questioned.

As far as the debtors are concerned, the interests of the creditors make it necessary that they be kept in the so-called “debt trap”, whose structure I shall set out below, in so far as it directly concerns our subject. To begin with, it must be pointed out that in view of the serious damage which would be caused to them by the formation of a sufficiently “weighty” alliance of debtors capable of intersecting the above-mentioned cost/benefit calculation, it is rational

for creditors to be prepared to make relatively high "payments" to certain debtors to prevent the formation of such an alliance. From the point of view of the debtors, these are known as "side payments": individual benefits which some countries receive as compensation for acting in accordance with the strategy of the creditors—in other words, bribes not to act in accordance with the interests of the debtors as a group.

To sum up, from the creditor's point of view it is rational to make side payments to prevent an alliance of debtors. This is even more true as, in general, it is not real payments that are involved but rather agreements to postpone the recovery of sums which the creditors are fully aware it would be extremely difficult to collect at term and which, if they attempted to do so, might provoke desperate debtors into running the risk of forming their alliance. As far as each debtor is concerned (or, more precisely, the government of each debtor), we have seen that the maximum threat of not paying or of unilaterally rescheduling the debt is highly implausible. However, a debtor can make another threat: that of helping to form a debtors' "club". For this threat in turn to be plausible, the debtor must satisfy the following conditions: a) he must join with other debtors who as a group are important enough to intersect the cost/benefit curve drawn by the creditors, since it is beyond this point of intersection that it would no longer be rational for the latter to act with maximum severity towards these debtors; b) he must be fully confident that these other debtors will follow him down the same path; and c) he must have given clear indications (although not necessarily public ones) that he is serious in his intention and that other debtors may respond to it.

Behind these statements there are a number of problems of which the creditors may take advantage. The first of these is that it is rational to offer side payments to precisely those debtors who seem to be moving towards an alliance (such payments need not be made to all of them; it is sufficient to offer them to a large enough number so that the importance of the alliance will be reduced). Each of these debtors sees the situation as follows: if it accepts these payments it will be in a better position than before it seemed prepared to promote or to take part in the alliance of debtors; in other words, the plausibility of this threat proved, or was from the beginning, an

excellent tool in negotiation. However, the price paid is the persistence of the balance of power and consequently of the dissuasive relationship which existed before. Moreover, the debtor must weigh the immediate and tangible advantages of receiving side payments against the medium-term benefits of forming the alliance, and the net balance of these benefits will depend upon something which it is not possible to foresee in full—the reactions of the creditors.

If, on the contrary, the debtor rejects the side payment and remains firm in his intentions, he cannot fail to be aware that the tactic followed by the creditors will be to offer side payments to other debtors. Moreover, the nearer the debtor came to achieving his goal, the bigger those payments would be. As these payments could become quite important for some debtors, none of them could be sure, right up to the last moment, that he would be able to form a sufficiently powerful alliance. If desertions took place, those debtors who remained linked to too weak an alliance would suffer the serious sanctions mentioned at the beginning, leaving them in the worst possible position. As far as the deserters are concerned, their situation would have improved but, as already pointed out, at the cost of ratifying a balance of power which is extremely unfavourable to them. In relation to the external debt, this is the "debt trap" in which we find ourselves and in which it is the best interests of the creditors to keep us.

It is impossible for this dilemma to be broken by means of sequential decisions: if country X "sticks its head out" in the hope that Y and Z will follow to form a sufficiently strong alliance, it must be aware that in this case, the side payments which creditors are prepared to make to Y and Z would increase even more. In this case, X could be leaping into the abyss to no effect but to force up the side payments received by the deserters; the repeated, and unsuccessful exhortations along the lines of "we're all in this together, but you go first" reflect this situation. Game theory confirms that the knot can only be severed firstly by setting up extremely reliable communications between the potential members of the club, and secondly, by all of the members taking a simultaneous decision. In the second part of this paper we shall see whether this path is capable of leading us to somewhat more encouraging conclusions.

## II

### Can anything be done?

In the first part of this paper we saw that as far as the external debt is concerned, our countries are in a "debt trap", and that the predominant strategy of the creditors is, quite rationally, to keep us in this dilemma. We also saw that if there is any way out, it is to be found through setting up convincing communications between debtors, in order to simultaneously announce and formalize their alliance and the principal decisions which it has taken with regard to their debt. In order to explore this path it is worthwhile pursuing the development of a remark made in the first part of this paper. Given the serious damage which would be caused to creditors by the formation of a sufficiently important alliance for it to be too costly to apply harsh sanctions against all its members, the side payments which creditors are prepared to make in order to prevent such a joining of forces grow rapidly the more probable and imminent the formation of such an alliance seems.

Apart from the fact that it is always possible that someone will "betray" his fellows at the last moment and leave them in an insufficiently powerful alliance, this raises the problem of the process by which the alliance could be formalized. If, for example, the governments of countries X ... N agreed to jointly declare a five-year moratorium and then to repay the debt over periods and at rates of interest which they also jointly decide without the prior agreement of the creditors, it is clearly in their interest for the negotiations between them, as well as the domestic preparatory work done by each of them, to be carried out in the strictest secrecy. If the creditors learn of these steps they are likely to redouble their efforts to attract deserters, as well as to mobilize domestic sectors in each debtor country which, for a variety of reasons, might oppose this alliance. It must also be foreseen that the creditors and their governments would apply a number of "preventive sanctions" to dissuade the debtors. This all implies that—above all if it is revealed—the process of forming the alliance would be far from free of political and economic costs. However, if we consider that the negotia-

tions will require journeys and international communications involving important personalities from the debtor countries, we see that it is unlikely that this process will remain unnoticed by the intelligence services of the creditor countries. Furthermore—and above all—the secrecy of the negotiations and the consequent inevitable lack of any consultation over a decision such as the formation of an alliance of debtors, which cannot fail to involve considerable risks and uncertainty (and possibly costs) for the population, would hardly be in line with the democratic nature of many of the governments which could form such an alliance in Latin America.

This raises the problem of how the representatives of each of these governments could assure the others that they are fully authorized to bind their government (and country) in the alliance; failing this, each of them would tend to decide that the risk of desertion is too great, and this in itself increases this risk. Could ministers of the economy or of foreign affairs claim this authority? Obviously not, as they may be dismissed or disavowed tomorrow. What about the presidents? The present presidents of our countries could hardly be expected to feel they possess such Caesar-like duties and powers as to assume these responsibilities alone. What about parliament, which is the body that initiates legislation or ratifies presidential initiatives? This would be closer to the spirit and the letter of constitutional democracy, but it would be difficult, if not to forecast the result of parliamentary decisions, at least to ensure the essential simultaneity of decisions in all the countries which would make up the "Club". What about a popular referendum? This would probably be the most appropriate means (if there are no constitutional impediments to this, as there are in certain countries), particularly as it could be held simultaneously in all the countries. It must be pointed out, however, that the most suitable arrangements for taking such a great decision (some combination of presidential and parliamentary authority, perhaps together with a referendum) take a considerable length of time

to implement. This heightens the vulnerability to attempts at bribery and various other forms of pressure from the creditors, especially if we consider that, as we have seen, each government begins to incur considerable costs for itself and for its country from the moment it starts on this decision process, before having any assurance that the alliance will come into existence. If for any reason whatsoever it became necessary to back down (for example, because some countries which were essential to the alliance had deserted during this period), those costs would have been incurred in vain: they would have served merely to sharpen domestic conflicts, demoralize those who supported the governments in question, and benefit the deserter countries through the high side payments they would receive in this case. Naturally, this risk is lower in the case of secret negotiations whose results are announced unexpectedly—but we have already seen that it is unlikely that they could be hidden from the creditors and, in addition, such secrecy is hard to reconcile with the operation of a democratic régime.

These are not the only hurdles which would have to be overcome. Supposing this “club” or debtors’ alliance came into being, it is necessary to start from the assumption that it would be subject to the centrifugal forces characteristic of any cartel or oligopoly. In order to reach the desired goals it is far from sufficient to simply create the alliance. It is equally important that the alliance should hold together for the whole of the period involved in the decision to declare a moratorium and the subsequent rescheduling of external debt payments (which must of necessity cover a relatively long period, if this alliance is to have any significance for the debtors). To come back to the first part of this paper, let us consider the most favourable hypothesis. A number *N* of debtor countries have managed to form an alliance of such weight that, as they have correctly calculated, the creditors (including the IMF and its member governments) consider that even though this alliance may cause them extremely serious damage, the costs they themselves would have to bear as a result of applying the harshest sanctions to these debtors (and which, as we have seen, the creditors would probably not hesitate to apply if that alliance were not sufficiently weighty) would be even greater.

In other words, by means of their alliance the debtors would have managed to escape from the debt trap. However, for this very same reason, the rational tactic for the creditors to follow would be to attempt to return them to the trap. They would possess an important capacity for doing this, so that it is highly likely that, although they might not make maximum use of their reprisal capacity, they would not fail to apply certain sanctions to these countries. These sanctions would have differential consequences for the debtor countries, depending on their economic structure, degree and type of industrialization and the characteristics of their principal exports, among other factors. In addition, depending upon the balance of political and ideological forces in each country, such consequences could be differently interpreted and evaluated. Furthermore, it would be rational for the creditors to attempt to accentuate these differences as far as possible; they would thus be able to develop feelings of injustice regarding the consequences of the alliance between the member countries. Following this, the creditors would again aim, although in a less favourable context than at the present time, to foment sufficient desertions of member countries to ensure that the alliance was no longer sufficiently important. If they managed to do so, the situation would return to what it was before, although probably with even higher costs for those debtors who remained within an insufficiently weighty alliance.

A typical way of diminishing the above-mentioned risk (but not of eliminating it) is for the “members” to become hostages of each other, so to speak. This could be done, for example, by setting up a supranational body to which they would transfer, for the period required by the moratorium and the subsequent payment plan, the decision-making power and the resources necessary for the alliance to function. This is the point where creative thinking, in which specialists from various disciplines would have to participate, could make its principal contribution. In addition, it would be essential to do this right now, as the prospect of a viable institutional system which is in principle acceptable to the potential “members” would undoubtedly give a strong impetus in this direction.

Strictly speaking, however, the preceding two paragraphs go beyond the limits of what it is

reasonable to propose, according to the lines of game and coalition theories. If an important enough coalition came into being and if this at least gave the impression of being capable of lasting over the medium term, it would enormously increase the number of variables which would have to be taken into account. In particular, it would be highly likely that other debtor countries which did not initially belong to the alliance would wish to join it, or that they would unilaterally declare their adherence to the conditions of the moratorium and the payment plan set up by the alliance (since it would no longer be rational for creditors to severely sanction debtors taking a unilateral decision after the creation of that alliance). The convergence of these interlopers with the original members of the alliance would so deeply transform at least the set of international financial relations involved that the game in which the parties were engaged would no longer be the same as that outlined in this paper.





## External debt and crisis: the decline of the orthodox strategy

*Robert Devlin\**

This article presents a general view of the reschedulings of Latin American debts with the private banking system during the period 1982-1985. The marked worsening of the conditions of indebtedness experienced by the debtors in the first round of negotiations in 1982-1983 has gradually given way to more favourable terms, above all in the most recent rescheduling (1984-1985). The creditors use market concepts to explain this phenomenon: the better terms represent a reward for good behaviour and the consequent lessening of risk.

The present analysis propounds another conceptual framework for interpreting the facts, based on the notion of bilateral monopoly. According to this view, the favourable trend of the terms of rescheduling was due not so much to some objective fundamental change in the image of creditworthiness of the borrowers as to their increased bargaining power, which enabled them to capture the monopoly rents obtained by the banks in the initial rounds of negotiation. The study goes on to analyse the North-South debate on the heavy transfer of resources from the region to the creditor banks, concluding that this cannot be justified by the conventional criteria of economic theory. Finally, within the framework of the bilateral monopoly, the study suggests various options that would permit the countries to reduce the transfer to the banks and thus give greater support to their own growth and development.

\*Staff member of the ECLAC Economic Development Division. A more extensive version of this study was prepared for the Latin American Economic Research Corporation (CLEPLAN) during the author's tour of duty as a Visiting Researcher in the Research Programme on the Economy and International Relations of that corporation, which enjoys the support of the Ford Foundation. The author wishes to express his gratitude for the comments offered by José De Gregorio, Enrique de la Piedra, Ricardo Ffrench-Davis, Adolfo Gurrieri, Manuel Marfán, Oscar Muñoz and Joseph Ramos. Guillermo Mundt provided valuable statistical assistance.

## I

### Rescheduling the debt: the first three rounds

The multiple reschedulings of the debt in Latin America in recent years have followed a well-defined course. In the first round, which began in August 1982, the debtor countries rescheduled obligations maturing in a term of 12 to 36 months. At the same time, in the case of a great many countries, the banks agreed to grant new credits for 1983, which represented an *ex ante* expansion of around 7% of the creditors' loan portfolio<sup>1</sup> (see table 1). The negotiated cost of this exercise—defined in broad terms as including the spread over LIBOR, the amortization period and the commissions—was extremely high. In general, the countries had to pay a spread of over 2%, obtaining amortization periods of only six to eight years and facing fixed commissions of 1.25% or more (see table 2). In comparison with the credit terms negotiated by the same countries in the Eurocurrency market before the onset of the crisis, the rescheduling conditions represented a serious reverse. In effect, using a combined index based on the spreads over LIBOR, the amortization period and the commissions, it is estimated that most of the debtors suffered a deterioration in the negotiated cost of credit of between 100% and 250% (see table 3).

The first round of reschedulings was followed almost at once by another in 1983-1984, to reprogramme the 1984 maturities of some countries and to determine the amount of new resources that the banks would lend for that year. Although the terms imposed in the transactions remained relatively severe, they were somewhat better than those negotiated in the reschedulings of the first round. In general, the spreads were 0.3 to 0.5 percentage points lower, the amortization periods were lengthened by one or two years and the commissions dropped to under 1% (see table 2). The volume of new credits granted by the banks for 1984, however, was in general lower in value than the loans authorized for the previous year<sup>2</sup> (see table 1).

<sup>1</sup>The figure of 7% was reached by general agreement with the IMF (ECLAC, 1984a, p. 56).

<sup>2</sup>The new set of loans for Brazil was bigger than in 1983, but this rise was intended to compensate the country for the loss of short-term credit lines during 1982 and 1983.

Table 1  
LATIN AMERICA: RESCHEDULING OF THE BANK DEBT 1982-1985<sup>a</sup>  
(Millions of dollars)

Countries	First round 1982/1983			Second round 1983/1984			Third round 1984/1985		
	Maturities		New credits	Maturities		New credits	Maturities <sup>b</sup>		New credits
	Amount	Years	Amount	Amount	Years	Amount	Amount	Years	Amount
Argentina	13 000 <sup>c</sup>	Sept. 82-83 <sup>c</sup>	1 500 <sup>c</sup>	—	—	—	13 400	82-85	4 200
Brazil	4 800	83	4 400	5 400	84	6 500	...	...	...
Costa Rica	650	82-84	225	—	84	—	280	85-86	75
Cuba	130	Sept. 82-83	—	103	84	—	94	85	—
Chile	3 424	83-84	1 300	—	—	780	5 932	85-87	714; 371 <sup>d</sup>
Ecuador	1 970	Nov. 82-83	431	900	84	—	4 811	85-89	200
Honduras	121	82-84	—	—	—	—	220	85-86	—
Mexico	23 700	Aug. 82-84	5 000	12 000 <sup>c</sup>	82-84	3 800	48 700	85-90	—
Panama	180	83	100	—	—	—	603	85-86	60
Peru	400	83	450	662	84-Jul.85	—	...	...	...
Dominican Republic	568 <sup>c</sup>	82-83 <sup>c</sup>	—	—	—	—	868	82-85	—
Uruguay	630	83-84	240	—	—	—	...	...	...
Venezuela	—	—	—	—	—	—	21 200	83-88	—

Source: ECLAC, Economic Development Division.

<sup>a</sup> Refers to the value of the rescheduled amortization commitments and the years to which they correspond, plus the new credits granted by the banks as an integral part of this restructuring. The table does not include information on the maintenance of short-term credit lines and the bridging credits authorized by the United States Treasury, the Bank for International Settlements, etc.

<sup>b</sup> In some cases these incorporate maturities already rescheduled in 1982/1983.

<sup>c</sup> The agreement was never signed and the maturities were incorporated into the new agreement of 1984/1985.

<sup>d</sup> The values correspond to 1985 and 1986 respectively. They include US\$ 150 million guaranteed by the World Bank.

<sup>e</sup> Private sector Commitments.

Table 2  
LATIN AMERICA: CONDITIONS FOR RESCHEDULING BANK DEBT<sup>a</sup>

Countries	First round 1982/1983			Second round 1983/1984			Third round 1984/1985		
	M	P	C	M	P	C	M	P	C
Argentina	2.16 <sup>b</sup>	6.8 <sup>b</sup>	1.25 <sup>b</sup>	—	—	—	1.44	11.5	0.15
Brazil	2.32	8.0	1.50	2.00	9.0	1.00	...	...	...
Costa Rica	2.25	8.0	1.00	—	—	—	1.65	9.5	1.0
Cuba	2.25	7.0	1.25	1.88	9.0	0.88	...	...	...
Chile	2.16	7.0	1.25	1.75	9.0	0.63	1.42	12.0	0.08
Ecuador	2.28	6.7	1.25	1.75	9.0	0.88	1.39	11.9	—
Honduras	2.38	7.0	1.38	—	—	—	1.58	11.0	0.88
Mexico	1.95	7.6	1.05	1.50	10.0	0.63	1.13	14.0	—
Panama	2.25	6.0	1.50	—	—	—	1.40	11.7	0.50
Peru	2.25	8.0	1.25	1.75 <sup>c</sup>	9.0 <sup>c</sup>	0.75 <sup>c</sup>	...	...	...
Dominican Republic	2.25 <sup>b</sup>	6.0 <sup>b</sup>	1.25 <sup>b</sup>	—	—	—	...	...	...
Uruguay	2.25	6.0	1.41	—	—	—	...	...	...
Venezuela	—	—	—	—	—	—	1.13	12.5	—

Source: ECLAC, Economic Development Division.

<sup>a</sup> Short-term credits are not considered. The symbols are:

M = spread over LIBOR;

P = total period (in years) of amortization; and

C = fixed commissions expressed as a percentage of the total value of the credit.

Each column shows the conditions agreed with the banks for the reprogrammed maturities and the new credits. In cases where a country negotiated in a round both a reprogramming of maturities and the granting of new resources, the figure represents a weighted average of the two transactions. For more detailed information on these credit exercises, see ECLAC (1984b), tables 15 and 16, and ECLAC (1985), pp. 67 to 72.

<sup>b</sup> This agreement never came into force. The corresponding maturities were incorporated in the agreement which formed part of the third round.

<sup>c</sup> This agreement is in suspense.

Shortly after the end of the second round of reschedulings, the countries met again to discuss the restructuring of the maturities falling due from 1985 onwards. In this third round, which continued during 1985, a new improvement was observable—very marked this time—in the negotiated cost of credit. The spreads over LIBOR continued to display the declining trend noted in the second round; the amortization periods were extended (10 to 14 years) and the commissions were sharply reduced, falling even to zero in the cases of Ecuador, Mexico and Venezuela (see table 2). In fact, it is evident that the credit terms achieved in the third round, taken as a whole, were somewhat better than those obtained in the Eurocurrency market prior to the crisis (see table 3). This result was also facilitated by the willingness of the creditors to extend the matur-

ity rescheduling horizon from a maximum of two or three years to between three and six years<sup>3</sup>. On the other hand, the banks have obviously become more restrictive with the new credits, since these were much scarcer in the third round<sup>4</sup> (see table 1).

In these three rounds of reprogramming, the private banking system has carried out the most massive restructuring of debts in the history

<sup>3</sup>Other innovations were the option offered to the borrowing country to transfer its loans from the Prime rate to the lower LIBOR rate, and to incorporate the debt reprogrammed in the first round into the more favourable conditions of the third.

<sup>4</sup>Some countries did not ask for new credits, partly because they wished to improve their image of creditworthiness with a view to returning to the autonomous credit market.

Table 3  
LATIN AMERICA: CONDITIONS OF INDEBTEDNESS WITH THE PRIVATE BANKS<sup>ab</sup>  
(Index: 1980-1981 = 100)

Country	Autonomous credit market		Rescheduling of the debt		
	1980-June	1981	First round 1982/1983	Second round 1983/1984	Third round 1984/1985
Argentina	100		317	—	166
Brazil	100		144	108	...
Costa Rica	100		133	—	83 <sup>c</sup>
Cuba	100		148	93 <sup>c</sup>	...
Chile	100		250	151	89 <sup>c</sup>
Ecuador	100		342	191	109
Honduras	100		153	—	63 <sup>c</sup>
Mexico	100		281	160	83 <sup>c</sup>
Panama	100		274	—	81 <sup>c</sup>
Peru	100		197	133	...
Dominican Republic	100		235	—	...
Uruguay	100		349	—	...
Venezuela	100		—	—	68 <sup>c</sup>

Source: Devlin (1983), p. 108; ECLAC (1985), pp. 67 to 69; and data provided by the Economic Development Division of ECLAC.

<sup>a</sup> Based on an index of the elements of credit cost subject to rescheduling. The formula used is the following:

$$\frac{\frac{C_1}{P_1} + M_1}{\frac{C_0}{P_0} + M_0} \times 100$$

where: C = commissions; P = period of amortization and M = spread over LIBOR, and where the subscript 1 refers to the terms existing in the respective rounds of reschedulings and the subscript 0 to those which existed in the normal credit market of 1980-June 1981. All the elements of the formula refer to the reprogrammed debt and to the new credits and are weighted by the amount of credit. Note that the relative deterioration is strongly influenced by the initial position of the borrower as regards the spreads, amortization periods and commissions contracted in the market between 1980 and June 1981.

<sup>b</sup> In the reschedulings the State frequently had to give its guarantee in respect of the private sector's debt which previously did not carry this guarantee. This deterioration is not incorporated in the index.

<sup>c</sup> Improvement.

of modern international finance. Besides this, the banks took great care to watch over their own interests in incorporating new credits into the rescheduling exercises, a procedure to which they had traditionally been opposed<sup>5</sup>. Nevertheless, even with the alleviation of the debt, the borrower countries have not succeeded in avoiding serious obstacles to their economic growth and development. Perhaps the statistic which best sums up the difficult situation besetting the region is the per capita income: in 1984 it was 9%

<sup>5</sup>The subject of the new credits in the reprogramming arrangements is dealt with in more detail further on.

lower than that recorded in 1980, and this regional average conceals even worse conditions for some countries (ECLAC, 1984, table 1). At the same time, despite the obvious softening of the terms negotiated in the third round of rescheduling, the growth prospects of the region are far from good. In fact, even the most optimistic observers acknowledge that the 1980s will be a lost decade for Latin America, and project a per capita income in 1990 which in the best of cases will be only slightly higher than that of 1980 (Cline, 1984a, p. 195). Using less favourable assumptions, it is estimated that even the 1980 level of income might not be regained.

Table 4  
LATIN AMERICA: NET CAPITAL INFLOW AND TRANSFER OF RESOURCES  
(Billions of dollars and percentages)

	Net effective inflow of capital <sup>a</sup>	Non-registered transactions <sup>b</sup>	Net inflow of capital	Net payments of profits and interest	Transfers of resources		Transfers, as a percentage of exports (x)	
	(1)	(2)	(3)	(4)	(1-4) (5)	(3-4) (6)	5/x (7)	6/x (8)
1970	3.8	0.1	3.9	2.8	1.0	1.1	5.9	6.5
1971	4.5	-0.2	4.7	3.0	1.5	1.7	8.5	9.6
1972	6.0	1.0	7.0	3.1	2.9	3.9	14.1	19.0
1973	8.5	-0.7	7.8	4.2	4.3	3.6	14.9	12.5
1974	12.7	-1.3	11.4	5.0	7.7	6.4	17.7	14.7
1975	16.0	-1.8	14.2	5.5	10.5	8.7	25.5	21.2
1976	18.9	-0.7	18.2	6.8	12.1	11.4	25.6	24.1
1977	15.4	1.6	17.0	8.2	7.2	8.8	12.9	15.7
1978	24.4	1.7	26.1	10.2	14.2	15.9	23.1	25.9
1979	26.9	1.7	28.6	13.6	13.3	15.0	16.2	18.3
1980	35.5	-5.5	30.0	18.0	17.5	12.0	16.5	11.3
1981	48.3	-10.6	37.7	27.7	20.6	10.0	18.1	8.8
1982	30.0	-10.8	19.2	37.6	-7.6	-18.4	-7.5	-18.1
1983	11.1	-6.7	4.4	34.5	-23.4	-30.1	-23.3	-30.0
1984 <sup>c</sup>	...	...	10.6	37.3	...	-26.7	...	-23.8

Source: ECLAC (1984a), p. 11; ECLAC (1984b), table 12, and data supplied by the ECLAC Division of Statistics and Quantitative Analysis.

<sup>a</sup>Equals the net capital inflow less non-registered transactions.

<sup>b</sup>Corresponds to the item "errors and omissions" in the balance of payments.

<sup>c</sup>Preliminary figures.

The nub of the matter lies in the fact that, even after this relief of the debt burden (including the new credits), Latin America will continue making enormous transfers of financial resources to the creditor countries. Table 4 shows that the net balance between the entry of new capital and the outflow of resources in respect of factor services (which represent almost entirely interest payments) was very negative in 1982-1984, with a transfer to the exterior which fluctuated between the equivalent of 18% and 30% of the region's exports of goods and services. Such a transfer of resources was possible thanks to the rapid transformation, in the debtor countries, of a trade deficit into substantial surpluses. Nonetheless, the latter were almost entirely achieved through the contraction of Latin America's imports, whose value fell by close on 40% in the course of those three years. With this abrupt reduction of foreign purchases, there was an inevitable collapse of economic activity and a fall in the gross domestic product in absolute terms.

What was the reason for the large transfer which unleashed this adverse sequence of events? It was due to unprecedented world interest rates, with an average LIBOR rate of between 10% and 13%; unprecedented negotiated costs (spreads, amortization periods, commissions) on the rescheduled debts and the new loans; and a massive drop in the net inflow of capital, which during the 1970s had been more than sufficient to cover the deficit on factor services. This latter phenomenon was caused by the reluctance of the private banks to grant new loans to the Latin American countries after 1982 and to the considerable flight of capital belonging to private economic agents<sup>6</sup>.

The debt and the problems of the transfer of resources will certainly affect Latin America's development policy in the coming years. In the

<sup>6</sup>A rough idea of the effect of the flight of capital is given in column 2 of table 4, derived from the item "errors and omissions" of the balance of payments.

absence of international public action to alleviate the financial burden of these countries,<sup>7</sup> the region will have to continue its ceaseless negotiations with the private banks, while the countries seek new formulas that will enable them to minimize

the payments and free resources for investment and growth. In these circumstances it is important to examine the options which are open to the debtors, establishing in the first place the framework for the negotiation process.

## II

### The framework for negotiations between creditors and debtors<sup>8</sup>

#### 1. *Are market forces at work?*

In evaluating their own policies regarding the debt reschedulings, bankers frequently recur to market concepts. This is most evident in their arguments concerning the pricing of the rescheduling exercises. For instance, in the first round of reschedulings the creditors used one or more of the following to justify the sharp rise in the negotiated price of credit.

*Price elasticities.* It was argued that the higher price would induce the refinancing of amortization and the extension of net credit. As Gasser and Roberts (1982, p. 28) argued, "Clearly the more attractive the terms of the 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".

*Risk.* Another argument frequently used to explain the higher price of credit was the greater risk involved in extending maturities beyond the dates originally agreed to in the loan contract: i.e., the greater price compensated for the greater risk.

*Moral hazard.* Drawing from the literature on health insurance, some argued that the higher price was needed in order to provide the borrowers with a disincentive for pursuing policies

which might lead to the need for rescheduling<sup>9</sup>. In other words, debtors had to be penalized, for otherwise they would be tempted to behave in ways which would lead to repeated repayment problems.

All of the above arguments are market-oriented and in one way or another imply that the supply curve was shifting upward and to the left in the first round of reschedulings, making credit more expensive. The improvement of the terms in the second round of the reschedulings was justified by the bankers on the ground that the debtors behaved well in the adjustment process, reducing risks and moral hazard; in other words, the supply curve began to shift down and to the right again. The third round represented another downward shift in the supply curve. Thus, all developments are explained in terms of the "magic of the marketplace". But one must be suspicious of "ad hocery" when three arguments are employed simultaneously to explain a single phenomenon. Indeed, none of the arguments hold up under scrutiny.

With regard to price elasticities, there is no empirical evidence to support the notion that a bank's willingness to reschedule debt is linked to a higher negotiated price of credit. It is almost

<sup>7</sup>For an analytical summary of the different proposals for solving the debt crisis, see Guerguil (1984).

<sup>8</sup>This section is a synthesis of a more extensive and theoretical analysis found in Devlin (1985). The same article contains the related supporting documentation and bibliographical material. The 1985 article represents a further development of Devlin (1984 and 1983a).

<sup>9</sup>In the health insurance literature it is pointed out that the way a client behaves influences the need for services. After a premium is paid, the cost of health care is zero. This could induce an economic agent to behave in ways which would consume more health services than if there were positive marginal costs. Thus, to avoid moral hazard, most insurance companies require insured customers to pay a deductible amount on each claim.

self-evident that banks reschedule not to make profits, but to avoid the large capital losses that would result if the borrower fell into open default. As for net credit, studies have shown that the reaction of banks to a rescheduling—even when the negotiated price has risen sharply—is to cut back exposure, not expand it.

It is true that during the current series of reschedulings banks have extended new credits. But these new credits are really a disguised rescheduling of interest payments. In effect, borrowers have faced unsustainable interest payments equivalent to 30% or more of their export earnings. If banks had not extended the new loans, most borrowers would have ceased to pay interest, negating the commercial viability of the whole rescheduling exercise. In sum, the new credits are simply part of the overall administration of old debt and their appearance is due to the need to avoid capital losses rather than to the attractiveness of the price of the operation.

There are of course many banks which were latecomers in the expansive phase of Latin America's credit cycle. These banks have a relatively smaller exposure in the region and perhaps were tempted to resist new lending even in the face of potential default. But their participation in the new credit packages was not due to the higher price; indeed, these banks were at their maximum point of credit rationing, at which no price would voluntarily elicit a supply. Their willingness to lend was basically due to coercion from the bigger banks, Central Bank authorities, the IMF, etc. This is confirmed by the fact that the smaller lenders took any opportunity they could to sneak out of the new loan packages even though the negotiated price of credit was at record levels.

With regard to risk, there was no increase of this upon rescheduling debt. What the lenders faced in 1982 was the materialization of the risk that they had evaluated in the 1970s and for which they had charged a risk premium. In fact, the reschedulings actually lowered risk because without them the original default risk and consequent losses would have appeared on the banks' balance sheets. Moreover, risk was further reduced by the monitoring of the economies by the IMF and by the ability of the banks to force governments to guarantee the debts of the debtor country's private sector.

The moral hazard argument also is spurious. In a fair environment premiums for moral hazard are determined in a competitive framework and economic agents are aware of costs upon signing a contract. To charge a premium for this concept during a rescheduling exercise is arbitrary and equivalent to informing a patient of his health insurance premium after he is sick. Furthermore, in the economic literature it is well known that jacking up the price of credit—especially when borrowers are under stress—can increase moral hazard, not reduce it. On the one hand, borrowers must undertake more risky behaviour to meet the higher service payments. On the other, if the borrower is dishonest, the higher price of credit raises the benefits of open default.

Indeed, the price of credit is not the true incentive to good behaviour. No country wants to enter into a rescheduling, because it means the interruption of its credits flows and external savings, which have a high rate of return. And as mentioned, if the borrower is inclined to default, the higher price just raises incentives for this type of action. In fact, the behaviour of economic agents cannot be controlled by economic incentives alone. The sign of a successful economic system is a sufficient trust between the principal economic agent and the subordinate so that the former assumes that the latter will not act in bad faith even if it were rational to do so. In other words, an integrated and efficient economic system cannot be based on a *homo economicus* assumption, where all behaviour is based on a pure cost-benefit calculus.

It is in this light that one can interpret the great responsibility with which most Latin American countries have confronted their debt obligations, even when to do so has involved tremendous social costs and political risks. In effect, Latin American countries are integrated into the world capitalist system and largely share its values. Yet the enormous burden of the debt is working contrary to the continued economic integration of the region and threatens to underpin political forces which wish to close the economies and reduce commitments to the international capitalist system. It is precisely for this reason that there is an urgent need for new and more equitable ways of managing the debt problem.



## 2. The monopoly power of the banks

We have seen that the banks' interpretation of the three rounds of reschedulings was conceptually related to the market mechanism. But in reality there was no competitive market; indeed, if the market had been functioning debtor countries would have received relief via the classic market risk sharing device—default and devaluation of the banks' assets—much as they did in the 1930s. But in fact, in the first round of the reschedulings the banks avoided competition and losses by joining together to negotiate *en bloc* and by using the resulting monopoly power to pass the costs of their faulty risk evaluation of the 1970s onto the borrowers.

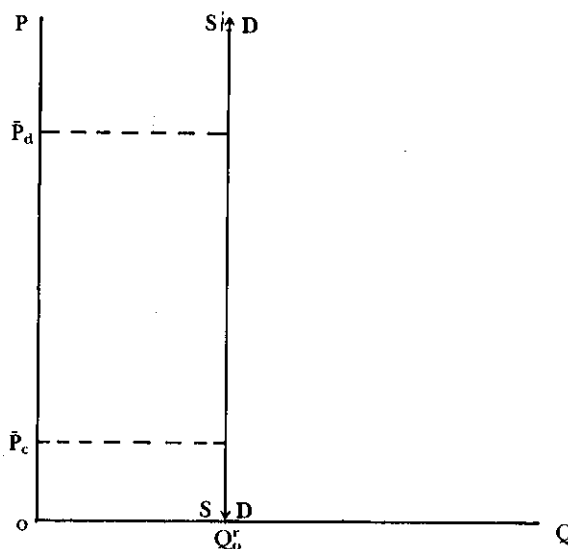
At the same time, the *ex-post* rise in the cost of debt that was imposed by the banks in the first round of reschedulings was a monopoly rent, or superprofit. A rent is a payment above that which is required for an economic agent to do what it does. In this case, the banks charged more for an administrative operation (the rescheduling of amortization and refinancing of interest) which was in any event necessary to avoid large capital losses. Moreover, the nearly uniform reduction in credit terms in the second round of the reschedulings is a good empirical indicator of the rents obtained in the first round. In effect, many countries won concessions without any objective improvement in their underlying economic situation and indeed some were accumulating arrears which the new credits were in part designed to eliminate. The fact that most countries are paying terms in the third round which are *better* than those they contracted during the normal credit market of 1980/1981 is another good indication that monopoly rents were won by the banks during their management of the crisis.

The rescheduling of debt and refinancing of interest payments in fact cannot be evaluated as a market transaction where there is a price for a determinate flow. The exercise takes place in the framework of a bilateral monopoly. The outcome is theoretically imprecise and depends on the bargaining strength of the two parties. To the extent that the banks manage to impose rescheduling terms that permit them to elude the devaluation of their assets and losses that would come about from the free play of market forces, they are earning rents. These rents can be cap-

tured by the borrowers and are in fact now being captured by them.

The situation can be illustrated in the manner shown in figure I, which assumes that there is only rescheduling of capital that otherwise would be in default. It also excludes externalities, or demonstration effects.

Figure I



- $\bar{P}_a$  = Maximum price accepted by the debtor to avoid default.
- $\bar{P}_c$  = Minimum price accepted by the creditor to avoid default.
- $Q_0^f$  = Credit to refinance/reschedule unpayable amortizations.
- S = Supply.
- D = Demand.

It can be seen from the figure that in a bilateral monopoly the supply and demand curves are superimposed upon one another over the amount of debt subject to reschedulings ( $Q_0^f$ ). The demand curve DD is perfectly inelastic because the debtor is insensitive to the price of credit in order to gain loans ( $Q_0^f$ ) sufficient to avoid default. Likewise, the creditor too is not precise about the price of a rescheduling because of the need to avoid default and the losses that would be confronted in the absence of a restructuring. For this reason the creditor also has a wide range of prices that are acceptable for lending  $Q_0^f$ .

Nevertheless, the debtor will have a max-

imum price for credit  $\bar{P}_d$  above which it will be preferable to default. The creditor also will have a minimum price  $\bar{P}_c$  below which it would be inclined to call a default. Thus there is a range of prices  $\bar{P}_c - \bar{P}_d$  for which an acceptable agreement can be reached. The result does not depend on the forces of supply and demand, but rather on the relative bargaining strength of the parties.

In the first round of reschedulings the borrowers unwittingly accepted the banks' conceptual framework and the price of credit approached  $\bar{P}_d$ , providing the banks with large monopoly rents.  $\bar{P}_d$  and the rents fell in the second and above all in the third round of the reschedulings. This had to do with the gradual improvement of the borrowers' joint bargaining power. On the one hand, there was consternation in many circles of the North and South owing to the exorbitant cost of the reschedulings; indeed, even the United States Congress called for a softening of terms in a public law it passed concerning increased quotas for the IMF. On the other hand, debtor countries began to mobilize themselves, first in regional meetings, such as the Latin American Economic Conference in Quito in January 1984, followed by the joint declaration of the presidents of Argentina, Brazil, Colombia and Mexico in May 1984, which condemned the high level of world interest rates. This last initiative eventually gave rise to a meeting of 11 Latin American ministers in Cartagena, Colombia, in June 1984.

While the debtor countries vigorously denied any intention of forming a Debtors' Club, the banks became concerned about the growing solidarity among the borrowers and its potential for the formation of such a cartel. They therefore attempted to neutralize the new movement and offered to Mexico and later Brazil—the two most powerful debtors in the group—the significantly better terms that formed part of the third round of reschedulings<sup>10</sup>. Later, other debtors received roughly similar treatment.

The strategy of the creditors temporarily paid off, as subsequent meetings of the 11 ministers (now denominated the Cartagena Consensus) in Santo Domingo and Mar del Plata were ex-

tremely dull affairs. However, in mid-1985 the creditors appear once again to be under pressure to reduce their rents. The slowdown of the United States economy has damaged prospects of relief via world recovery and turned off the light, faint though it was, that some debtors had perceived at the end of the debt crisis tunnel. Moreover, the Government of Cuba has taken the initiative on the debt problem, promoting in the region the idea that the debt cannot be paid and should therefore be forgiven by the North as one component in the restoration of a New International Economic Order. Also, new democratic governments, such as those in Brazil and Peru, have been displaying their profound displeasures with the orthodox management of the debt problem.

In any event, is it possible to be somewhat more precise about  $\bar{P}_c$  in figure I the limit below which a declaration of default becomes the preferred alternative of the bank? In the absence of externalities, it would be the price that brought losses just below those which would be incurred in the event of an open default. The determination of this price is quite difficult because of the reluctance of banks to enter into secondary trading of loan paper and because of the strong influence of bank regulatory authorities in the valuation of assets. But it is evident that  $\bar{P}_c$  is well below the price agreed to in the first three rounds of reschedulings and indeed could even be negative<sup>11</sup>.

The introduction of externalities greatly complicates the analysis. Without considering

<sup>11</sup>For example, suppose a bank had to call a default on loans worth US\$ 100 million. It could enter a small secondary market to sell the paper. At the beginning of the crisis, Latin American paper experienced discounts of up to 20%. With a cost of funds of 10%, the loss to the bank would be 20% of principal (\$ 20 million) plus 10% (\$ 10 million). The return therefore is -30% [ $100(1 + X) = 70$ ]. In this case any agreement which offered a loss of less than 30% would be attractive to the creditor. A return higher than the market valuation would be a rent. One can arrive at similar conclusions by making assumptions about the behaviour of banking supervisors regarding their valuation of the bank's assets. In all probability the supervisors would spread the losses over time. Finally, it is worth mentioning that in early 1985 the discounts registered in secondary trading of Latin American paper were as follows: Argentina (30%); Brazil (20%); Bolivia (80%); Chile (35%); Mexico (15%); Nicaragua (90%); Peru (50%) and Venezuela (10%).

<sup>10</sup>Brazil never signed its rescheduling agreement and continues negotiating with the banks and the IMF.

the action of other debtors, the creditors would perhaps accept a price for rescheduling debt that was well below a commercial rate. But the creditor knows that if debts are rescheduled at less than a commercial rate, other debtors might demand similar treatment. So the effective loss registered on *one* rescheduling could in fact be multiplied many times by the action of other debtors. In the light of this  $P_c$  would be considerably higher than that outlined in the example contained in the last footnote. Whether it is below the price registered in the third round of reschedulings is a matter of conjecture. But one suspects there is further room to reduce the rents; indeed, some countries such as Peru, Bolivia and Nicaragua have in fact so far managed to drive the effective price down below that of the third rescheduling exercise by accumulating arrears.

The same framework of a bilateral monopoly can be used to evaluate the possibility of forcing new credits from the banks. In effect, the new credits are indistinguishable from the old debt because they keep interest payments current and avoid a writedown of the portfolio. I have a

shown elsewhere (Devlin, 1985) that a borrower is more likely to be able to force new credits from the banks, the bigger its debt with them and the greater the reduction in the probability of default after the loan is extended. Thus new forced lending is easiest to achieve in a context of illiquidity and much more difficult to realize in a state of insolvency<sup>12</sup>. Moreover, an illiquid borrower which is co-operative and inclined to compress its imports as much as is necessary to pay the debt is, ironically, less likely to obtain new credits than an illiquid borrower which is tough and threatens default if a high percentage of interest payments are not covered by new loans.

Finally, the readiness to lend greatly depends on the collective action of the banks, since no institution would have incentives to grant credits in isolation. It is precisely in its role of coordinator that the Bank Steering Committee is a "public good". Unfortunately, it has been noted that this group also has had its collusive aspect: it enabled the banks to act *en bloc* against isolated debtors in order to transfer to them the greater part of the costs of the crisis.

### III

## Strategies for shielding development from the burden of the debt

It has already been observed that the financial crisis has had a devastating impact on Latin America's economic activity and per capita product. A central factor in the situation was the transfer of financial resources from the debtor countries, which has resulted in a dramatic reduction in imports. This outflow is mainly due to two phenomena; i) the procyclical behaviour of the banks; and ii) the flight of capital. But, as will be seen further on, the second phenomenon cannot be entirely disassociated from the first.

#### 1. Transfers of resources to the private banks

##### a) Good or bad?

The Mexican financial crisis in August 1982 brought with it a paralysation of bank credit to

Latin America, which in the 1970s had been expanding at an annual rate of 30% or more<sup>13</sup>. In the face of the collapse of the autonomous credit supply, the creditor banks came to an agreement among themselves to provide new loans to the debtors as an integral part of the rescheduling of the debt.

In the first round, the general formula of the

<sup>12</sup>Strictly speaking, the terms illiquidity and insolvency are commercial concepts not applicable to countries. Here the terms are used loosely to distinguish between debtors which have prospects of adjusting in a medium-term period and those which must undergo long-term restructuring of their economies in order to regain their creditworthiness.

<sup>13</sup>Morgan Guaranty Trust Co. (1983, p. 6) and Ffrench-Davis (1985, p. 2).

creditors was to expand the loans by around 7%. Nevertheless, the interest rates at that time were on average somewhere in the region of 12% (including the spreads), which meant a programmed transfer to the banks equal to 5% of the existing obligations. This had a serious adverse effect on the debtors, since just before the crisis they were receiving a positive contribution from the banks equivalent to close on 6% of these obligations, so that there was in fact a total programmed turnaround of 11% in credit flows<sup>14</sup>.

The transfer of financial resources to the banks was and continues to be a very controversial topic. Latin American analysts—for example ECLAC (1983 and 1984a); Prebisch (1985), p. 50; Ffrench-Davis and Molina (1985), pp. III 10 to 13; and Ferrer (1984), pp. 309 to 311—have vigorously criticized the process. On one occasion ECLAC (1983, p. 9) even called it “perverse”, in that it was premature in relation to the level of the region’s development.

On the other hand, many analysts from the North are accustomed to defend the negative transfers as the only way of “solving” the financial crisis of the region. By way of example, Cline (1984a, p. 175)—one of the most influential researchers in this field—recently criticized ECLAC’s concern over the net outflow of resources. According to him, the substantial net payments to creditors are not “perverse” but a healthy sign, since they promote the reduction of the debt in relative terms and speed up the arrival of the day on which the Latin American countries will recover their image of creditworthiness and their normal access to credit. It is also argued that the anxiety about the negative transfers and the contraction of imports is misplaced, since the adjustment policies will promote the production of tradeable goods and especially of exports. In their turn the growth of the latter will increase the capacity to import, even with the transfer of resources to creditors.

This argument has some validity in the

<sup>14</sup>Indeed, the figure was close to 14%. According to Ffrench-Davis (1985, p. 10) the positive transfer of the banks to Latin America in 1981 was US\$ 10.5 billion, which is equivalent to 6% of the total bank debt in 1980. The same author estimated the negative flow in 1983 at US\$ 18.8 billion, which equals 8% of the total commitments at the beginning of that year.

medium term, but it falls down through its deficient consideration of the time factor in the adjustment process. In fact, in the short run the price-elasticities of exports and imports are frequently low, because of rigidities in the reallocation of resources to tradeable goods<sup>15</sup>. Thus, a debtor country tackling the adjustment without adequate external financing will be forced to generate a trade surplus by a disproportionate compression of its imports and a reduction of its economic activity. This negative adjustment is magnified in so far as the world economy is in recession and there is no dynamic external demand. The foregoing well describes what happened to Latin America in 1982-1983: there was an overestimation of the effects of resource reallocation and an underestimation of the need for credit, which resulted in an abrupt fall in imports and per capita income. It is precisely in this context that the negative transfers and the adjustment they required were “perverse” and socially inefficient.

If the debtors’ payment problem had been characterized by a lack of liquidity, as the proponents of negative transfers affirmed, the logical prescription would have been very different from what was actually experienced in Latin America. It is well known that the classic process of efficient adjustment based on the reallocation of resources suffers from time-lags which make it evolve in the form of the famous J-curve. To maintain the symmetry, a socially efficient adjustment should include new credit in the form of an inverted J. In other words, there was a logical reason to expect that during the initial phase of the adjustment the transfer from the creditors should have been nil or slightly positive, but not negative. And the coefficient of debt to exports should have tended to rise temporarily and not fall. Only when it had been confirmed that the reallocation of resources obtained the anticipated effect on the overall growth of exports and on the substitution of imports should there have been a commencement of substantial transfers to the creditors and the sustained reduction of the coefficient of debt to exports.

<sup>15</sup>The bottlenecks are of an economic, social and political nature. Of course, the seriousness and nature of the obstacles vary considerably among the countries.

The root of the problem lies in the fact that during the 1970s the anticyclical components of the international financial system (the international public lenders) shrank excessively, while the procyclical elements (the private banks) expanded far too much. When the crisis broke out in 1982 the system was highly unbalanced and could only tackle the problem in an *ad hoc* manner with makeshift measures. Although the crisis was well handled in the sense that it rescued the international financial system, the result was achieved at the expense of Latin American development<sup>16</sup>.

The dilemma was evident from the start. In the face of the massive procyclical withdrawal of the banks, the IMF—whose relative international position had declined—<sup>17</sup> was in no condition even to begin to fill the gap. In these circumstances it decided to transform itself rapidly into a catalyst for the mobilization of private funds; acting in conjunction with the large banks, it made many of its stand-by programmes conditional on the aforesaid 7% formula for the expansion of credit. But it has been seen that in face of the rigidity of resource reallocation and the depressive effects of the world recession, the expansion of 7% was not enough to promote a socially efficient adjustment. Furthermore, it is by no means evident that the recent initiatives of the creditors to reduce the new obligations still further have been expedient, since so far there has been no trustworthy evidence that Latin American exports are responding favourably to the adjustment prescribed by the Fund.

Still more disturbing, however, is the utopian view of these events held by many analysts of the North. The contraction of imports and the fall in economic activity (which implied a reduction in the investment required to reinforce future payment capacity) are assessed positively as an "overperformance" in the process of adjustment (Wallich, 1985, p. 1; Cline, 1984b, p. 15). At the

<sup>16</sup>It is interesting to recall that Marxist theory predicts that in a financial crisis the capitalist system will always tend to sacrifice the value of productive capital on the altar of financial capital (Weeks, 1981, pp. 123 to 217). This interpretation seems to have some affinity with the handling of the present crisis in Latin America.

<sup>17</sup>Up to 1970 IMF quotas were approximately equivalent to 10% of the annual value of world trade; when the crisis arose, they had fallen to 4% (Cline, 1984a, p. 124).

same time there are repeated expressions of "confidence in the appropriateness of the current strategy" (de Larosière, 1985, p. 200). Meanwhile, those who put forward more equitable ways of solving the debt problem—which would imply carrying out fundamental reforms—are considered as mere wet blankets by the supporters of the orthodox strategy.

It is really difficult for an economist concerned with economic development to understand this complacent attitude. The only reason for optimism that there could be in the face of an adjustment which has so ruthlessly violated the most fundamental principles of a social market economy is that, to speak quite frankly, there is in some circles the implied assumption that Latin Americans are irresponsible and that the International Monetary Fund is unable to control them. This would create a need to impose a forced and onerous adjustment. Unfortunately this seems to be the assumption that has guided a large part of the policy of the creditor countries<sup>18</sup>.

b) *How can the transfers to the banks be reduced?*

Only economic growth will allow the servicing of the debt. Payment cannot be sustained in circumstances in which the per capita product is falling or stagnant, and in any case it would be counterproductive. On the one hand, without growth the servicing of the debt rapidly ceases to be a technical matter and is converted into a political problem in which, in the last resort, even the authorities most committed to the international system have to take steps in favour of the national public interest<sup>19</sup>. On the other hand,

<sup>18</sup>The new economic analyses of the debt are often led astray by an exaggerated Benthamism as regards rationality and the calculation of costs and benefits. In other words, according to this theory, if the cost of bad behaviour of a debtor is less than its benefit, the rational debtor will always opt for the former without considering the general welfare. There can be no doubt that this represents a development of the concept of *homo economicus* to a level which undermines its usefulness for diagnosis and subscription.

<sup>19</sup>The industrial countries have reacted in a similar way. For example, during the 1930s the Governments of England and France suspended the servicing of their debt with the United States on the grounds that their obligations to their peoples were more important than their commitments to their foreign creditors (Hardy, 1982, p. 40).

the sacrifice of investment and human capital to pay the debt today only reduces the capacity to pay tomorrow.

The recent reduction in world interest rates has given some relief to the debtors. But the decisive factor for restoring the capacity for payment is an exogenous stimulus which would be achieved with the so deeply desired sustained expansion of the OECD economies and the consequent improvement in the terms of trade for Latin America. However, the possibility of a substantial recovery remains elusive and the outlook is very uncertain. Without a greater advance in this field, the dynamics of economic development and the servicing of the debt will continue in open conflict. In the short term, with a view to increasing domestic economic activity, many of the debtor countries must reduce their transfers to the foreign banks.

Naturally, to reduce the amount of the transfer implies a cost for the creditors. If this cost could not be completely covered by the financial institutions it would have to be shared with the OECD governments, by the application of some type of systematic public intervention in order to mitigate the burden of the debt. This should not be viewed primarily as a bailout of the debtors and the banks, but should be regarded as "sound economic policy"<sup>20</sup>. It should be remembered that the great crises of indebtedness invariably arise in a context of major negative externalities which induce market failure. During the crisis, new negative externalities arise which tend to prolong it. Hence it has been customary for governments to intervene with a view to re-

establishing order and confidence in the market. Unfortunately, in economic systems based on private markets, public solutions are scarce goods and frequently do not appear until the costs of the problem have been internalized by the main economic agents. As long as the banks and their governments can externalize the costs of the crisis, passing them on to the debtors, there will be less incentive to apply a public solution. This explains in part why the numerous proposals for public intervention in the crisis have not borne fruit<sup>21</sup>.

In view of the obstacles to public solutions, in the immediate future the debtor countries will have to tackle the banks directly on the subject of the transfer of resources. How the countries do this will depend, *inter alia*, on their importance as debtors, on their bargaining power and on their ability to adjust themselves to the debt servicing required.

i) *The cases of illiquidity*. It would still be reasonable to believe that some of the more important debtor countries (for example, Brazil and Mexico) face temporary liquidity problems. Their economies tend to be more closed and industrialized and their markets are relatively better organized and are capable of exporting—and in fact are exporting—manufactured goods with some success. Hence their capacity for adjustment is apparently quite good, even when confronted with a sluggish world economy. Moreover, the authorities of these countries have acted as if they had a problem of liquidity, accepting without serious objections the orthodox programme of commercial rescheduling offered by the creditors as the best way of rapidly recovering the image of creditworthiness required to re-enter the Eurocurrency market. This, of course, has meant giving up the idea of obtaining new credits in the third round of rescheduling<sup>22</sup>.

<sup>20</sup>Cline (1984a, pp. 133 to 135) criticizes the numerous proposals demanding reforms and international public action to give relief to debtors and creditors, because *inter alia* 1) the problem of the debt, according to him, is one of liquidity and not solvency; and 2) the proposals frequently imply losses for the banks and would prejudice future access to credit by the debtors. He forgets, however, that the solution even of liquidity problems may be long delayed, so that the maintenance of the *status quo* will turn out to be a very burdensome and socially inefficient policy. On the other hand, it is not inevitable that public measures to alleviate the crisis will involve losses for the banks; all depends on how this is arranged. Finally, the question of future access to credit is a false dilemma, since even the most optimistic projections of the Latin American balance of payments do not open up prospects of a positive transfer from the creditors for many years.

<sup>21</sup>The only major public solution introduced in the crisis is the participation of the IMF in the adjustment programmes and in the organization of the new credits. Nevertheless, this "public good" has been of much more benefit to the creditors than to the debtors. A more detailed analysis of the role of the Fund appears in Devlin, 1984 (pp. 55 to 57, 66 and 67). Ground (1984) has made a critical assessment of the Fund's adjustment programmes.

<sup>22</sup>Mexico did not request new credits in the third round. In 1984 Brazil likewise announced that it would not request new loans. However, the civil government which recently

This good behaviour has been socially very burdensome, since during the period of rescheduling both countries have suffered severe economic depressions. But this cost has been in some degree voluntary, since both borrowers have gigantic debts and a geopolitical importance which gives them considerable bargaining power with the creditors and their governments. In fact, each country in itself alone practically constitutes a debtor carter, which would presumably make them tough contenders in the game of bilateral monopoly described above. Nonetheless, they have exercised this power very selectively, obtaining only marginal advantage in their quest for reincorporation into the autonomous credit market. Their position as quasi-cartels and the hope of achieving a rapid adjustment to restore their image of creditworthiness also help to explain why these countries have been very cautious as to regional co-operation in relation to the debt and above all in regard to the formation of a Debtors' Club.

If these major debtors come to consider that the promised return to the Eurocurrency market is being too long delayed, it is possible that, in the face of prolonged economic stagnation, they may exert greater pressure on the banks to obtain a reduction of the negative transfer. Unless the authorities change their views on the nature of the problem (that is, lack of liquidity), it is improbable that these countries will use their bargaining power to capture a larger amount of the monopoly rents obtained at present by the banks. They will rather tend to be co-operative and will try to negotiate agreements which maintain the commercial character of the rescue arrangements, avoiding manifest losses for the creditors. This might lead to a greater compression of the negotiated cost of credit, which can fall a little more and still appear as commercial. But the real objective will be the procurement of new loans to refinance interest payments.

There seem to be sufficient space for negotiating new involuntary credits. The forced loans to Brazil and Mexico in 1983-1984 were more or less equivalent to *ex ante* expansions of 18% and 13%, respectively, of the outstanding

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took office has hinted that the country might possibly now need to have recourse to new credits.

commitments in the biennium; *ex post* they resulted in lower increases (8% and 12%)<sup>23</sup>.

Cline's analysis (1984a, pp. 71 to 75) shows that with a firm bargaining position and very little probability of default after obtaining new credit, it is profitable for the banks to grant an expansion of up to 40% in their loan portfolio<sup>24</sup>. Krugman's model (1984, p. 21) is even more explicit in respect of the capacity to obtain new forced loans. According to him, in conditions of lack of liquidity a bank will always have a motive for lending enough to avoid default, provided that the new loans do not exceed the amount of the servicing of the debt<sup>25</sup>.

To sum up, the more powerful borrowers, faced with what they consider to be problems of lack of liquidity, could probably reduce transfers to the banks if they were disposed to exercise their bargaining power, by hinting that the alternative to the granting of new loans could be default. According to the analyses of Cline and Krugman, in not requesting these loans they are in fact virtually paying a subsidy to the banks. Hitherto the major debtors have apparently felt that it is worth while to pay the subsidy with a view to achieving their reincorporations into the voluntary credit market—the benefit of which would be, presumably, the positive transfer of resources from the banks, although at a much lower level than that recorded in the 1970s.

ii) *The cases of insolvency*. There are debtors in the region—generally small and medium-sized countries—which present problems that begin to look very like those of insolvency<sup>26</sup>. Without a

<sup>23</sup>Bank for International Settlements (1983 and 1985). For the *ex ante* expansion, the new loans for 1983 and 1984 were calculated as a percentage of the pending commitments at the end of 1982 and 1983 respectively. The *ex post* increase simply equals the effective commitments for 1984 divided by those for 1982.

<sup>24</sup>Cline ignores the time factor. It is assumed that the amount of new loans in any year could not exceed the value of the interest payments.

<sup>25</sup>This is expedient for the bank, because in this way it at least receives some return.

<sup>26</sup>There are others, obviously, which fall in a gray area between lack of liquidity and insolvency. It is possible that Argentina is one of these. Its debt is the third largest in the region and it has the greatest burden of interest, with payments equal to more than 50% of its exports (ECLAC, 1984b, table 14). Nevertheless, it is a relatively rich and industrialized

relatively vigorous economic expansion in the OECD area, they could only adjust themselves to debt servicing on commercial terms if they agreed to subject themselves to a profound and politically unacceptable economic depression. (Indeed, some of these borrowers might find the servicing of the debt intolerable even in more favourable external economic conditions.) The growing realization that the problems are persisting strengthens the creditors' reluctance to provide relief by granting new loans. In reality, with the passing of time the banks will be more disposed to risk losses because most of the debtors are not large and because, since 1982, these institutions have been strengthening their balances with a view to coping with such contingencies.

These debtor countries have every incentive to try to capture more fully the monopoly rents of the banks and achieve a greater alleviation of the debt, since their possibilities of returning to the voluntary credit market in the foreseeable future are remote. Ironically, however, it is difficult for them to capture these rents because their individual negotiating power is small and their open economies are relatively vulnerable to reprisals. Nonetheless, something can be done.

The safest way for a debtor country to avoid confrontation with the banks is to informally fall into arrears. The banks can threaten a declaration of default, but it is very improbable that they will do so as long as the country continues to express its good faith, the desire to fulfil its obligations, and a wish to negotiate. To begin with, declarations of default are legally onerous and imply a great loss of time for the banks, with meagre tangible benefits (Kaletsky, 1985). Secondly, the creditors do not wish to create a "martyr", since this might damage their own public image, perhaps provoking reactions of solidarity among the borrowers. Moreover, if the bank supervisors insist on reclassifying the loans, the banks will be in a position to absorb the loss of

income which this would imply. In short, unless they are directly provoked, it is most probable that the creditors will turn a blind eye and treat the borrower as another special case. In this way no one comes off too badly.

Under this strategy, the borrower must amortize the short-term credit lines in a normal way so as to minimize the incentive to withdraw them. Some lines will inevitably be lost, but it will always be possible to obtain the essential financing through the mediation of various creditors who foresee possibilities of profit in relatively risk-free trade finance. The selective deposit of international reserves is another way of obtaining commercial credit from the banks. In addition, the borrower must be willing to make periodic nominal payments to the creditors on its medium-term debts to demonstrate his good faith. These payments, however, can be maintained at levels as low as 1% or 2% of the outstanding obligations. At an interest rate of 10% there is a saving of eight to nine points on the remittance of foreign exchange<sup>27</sup>. Although this does not represent a bonanza—especially for countries which have less than 50% of their debt with the banks—it does provide a worthwhile margin of relief which, together with other measures, will help recovery.

The debtor must also be prepared to face possible reprisals. The international reserves will need to be deposited in safe institutions. A firm of lawyers will have to be retained in New York or London to formulate a contingency plan to protect the country's trade from possible legal action and to defend its interests in foreign courts if necessary.

This strategy has proved its feasibility: there are already some borrower countries in a *de facto* situation of default which have managed to avoid reprisals. There are two main disadvantages. First, if many borrowers use the same strategy, the losses of the banks may reach critical levels. Nonetheless, this might turn out to be beneficial, because it would gradually demonstrate that the costs of the crisis were being internalized in the

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country, possessing a highly skilled labour force, and it has the ability to generate trade surpluses rapidly. Its heavy debt with the banks (US\$ 46 billion) gives it considerable negotiating power. It attempted to make use of this power in 1984 to escape from the orthodox pattern of rescheduling; it failed, however, partly because at that time it had no convincing economic programme to legitimize its bargaining position.

<sup>27</sup>The net saving would be rather less if, in the face of arrears, the interest rate for the credit lines rises. At the same time, this saving should be compared with the possibility (if it exists) of obtaining new credits.



centre, which might stimulate a quest for an integral international public solution to the problem of indebtedness. Second, the borrower will have to be ready to cope with a precarious situation and one of increasing tension with the banks as the arrears accumulate. The uncertainty which this situation implies can in itself be prejudicial to the efforts for economic recovery.

Owing to this second problem, it would certainly be preferable to work out a definite plan of debt relief on non-commercial conditions. The problem is that the banks do not wish to adopt rescheduling projects of this kind through fear of the demonstration effects: if they rescheduled a borrower's debt on non-commercial terms, others might demand the same treatment. The fear of precedent makes it a risky business for small and medium-sized debtors to try to impose a unilateral plan of non-commercial payments on the banks (for example, the issue of long-term bonds at low interest rates). Indeed the banks and their governments might feel sufficiently provoked to face the cost of starting reprisals.

At all events, the feasibility of a unilateral course is greater if it is proposed in very serious and conciliatory terms and is also associated with a serious economic programme which offers some prospect of improvement in the country's external situation. With regard to the payment formulas, whether negotiated or imposed unilaterally, they should be linked *pari passu* with the country's capacity to pay<sup>28</sup>. In this way the banks would have at least the possibility that some day their loans would produce a commercial rate of return and the hope that their sacrifices would not be permanent. At the same time, the formulas should be designed, if possible, to minimize the losses of the banks at any given level of relief. The best formulas will depend on the type of banking legislation in force in the North and will therefore possibly have to be "made to measure", in order to adjust to the particular circumstances of each country.

<sup>28</sup>For example, it might be specified in the agreement that if the terms of trade recover a normal level  $x$ , the debts will be serviced at a commercial rate (e.g., LIBOR plus some spread). Or, alternatively, the payments might be limited to some maximum percentage of exports. A third possibility is to define a reasonable rate of economic growth (for example, 5%) and then allocate the remainder of available foreign exchange to the servicing of the debt.

For the small and medium-sized debtors, any major initiative in the payment programmes should perhaps be made in conjunction with others. The bilateral monopoly framework described above clearly points to co-operation among borrower countries. The banks have shrewdly formed a cartel to protect their own interest and avoid the losses that competition among them would imply. With the exception of the two or three biggest debtors, the monopoly power of the creditors cannot be countered by a country in isolation<sup>29</sup>. Hence, responsible co-operation among debtor countries is a possible form of neutralizing the monopoly power of the banks and reaching a more socially efficient solution to the problem of indebtedness. Moreover, this co-operation need not be regional: two or three debtors together will constitute a formidable negotiating bloc.

The key point to remember regarding co-operation is that the creditors and their governments will not make a present of any concessions to the debtor countries. The capitalist centre of today frequently acts on the basis of cold marginal cost-benefit calculations; as long as the politico-economic cost to themselves of doing nothing about the problem of the debtors is less than the benefits received, the creditors and their governments will most likely support the *status quo*. Only when the crisis of the debtors begins to threaten the centre with higher costs will there be incentives to explore new ways of dealing with the problem. Thus the various forms of co-operation among the debtors are a way of bringing home more clearly to the centre the potential costs of following its current policy, which arbitrarily sacrifices economic development to financial discipline<sup>30</sup>.

Finally, it must be stressed that negotiations with the creditors are always improved when the countries—even in the worst situations—show that they are making serious efforts to solve their

<sup>29</sup>The banks recognize the benefits of unequal power; this is why they insist so categorically on case-by-case negotiations in the rescheduling.

<sup>30</sup>It is interesting to note that the groups with less economic and political power in the centre have traditionally obtained reforms of the system by using co-operation and protest, as happened, for example, with the trade union movement and the great civil rights campaign in the United States in the 1960s.

main economic imbalances<sup>31</sup>. A coherent policy which steers the economy in the right direction helps the banks to justify their concessions and also encourages regulatory authorities to adopt a flexible attitude with regard to loans.

## 2. *The flight of capital*

We have already seen that another component of negative net transfers of resources is the significant flight of capital. Using the "errors and omissions" item of the balance of payments as a rough indicator of this phenomenon, table 4 shows that in 1982-1983 alone there was an outflow of close on US\$ 18 billion of non-registered capital in the balance of payments, which equals slightly more than a third of the total negative transfer registered in that period.

The flight of capital largely originates in the private sector's traditional profit motive and in the undermined confidence in the public management of the economy, especially as regards exchange rate policy, inflation, domestic interest rates, etc. Moreover, the fact that there have been substantial outflows of non-registered capital since 1980 suggests that the confidence of private capital was declining in some countries long before the official outbreak of the crisis<sup>32</sup>.

But the phenomenon of the flight of capital is not wholly independent of the behaviour of the private banking system. First, it was the latter's loans in the 1970s and 1980s which sustained the over-valued exchange rates and the fiscal deficits which have helped to change the expectations of the private economic agents<sup>33</sup>. Second, the procyclical withdrawal of loans in 1982 destabilized the Latin American economies still further, thus accelerating the flow of capital to the exterior. Furthermore, Carlos Díaz-Alejandro (1984, pp. 377 to 380), highlights the complicity of the banks in this flight, through their refusal to disclose interest payments made to their clients and through their active campaign to capture Latin American deposits.

The large amount of capital deposited abroad is a potential source of finance. But it is unlikely that this will return voluntarily until the prospects of growth are restored. Consequently, without the return of autonomous bank loans, or a public solution to the problem of indebtedness which will reduce negative transfers, even that part of the capital which might be subject to repatriation will remain in Europe or the United States, where the profitability is greater than that which could be provided by a Latin America beset by economic depression.

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<sup>31</sup>For some unorthodox adjustment policies see ECLAC (1984a) and Gurrieri and Sáinz (1983).

<sup>32</sup>Some estimates of the flight of capital are impressive. The Bank for International Settlements has given a figure of US\$ 50 billion between 1978 and 1982 (*The Economist*, 1984, p. 75).

<sup>33</sup>Devlin (1983b) develops an analytical plan to show how the lending policy of the banks in the 1970s contributed endogenously to over-indebtedness and the crisis.

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# The external debt of the Latin American countries

*Raúl Prebisch\**

Until a short time ago, the view was frequently held that the worst was over in relation to the external debt of the developing countries: interest rates would fall and a revival of trade was just around the corner.

I do not know what is going to happen in the future. But who can believe in the probability of much lower rates given the current United States budget deficit? Who can expect an intense revival of the developing countries' trade, present conditions in the major industrial centres being what they are?

Meanwhile, the debtor countries have had to resort to emergency solutions. Their heavy interest burden has been paid partly by increasing the debt and partly by obtaining an external surplus through a drastic cut in imports.

According to some projections, the developing countries should cut back on their imports in order to obtain an external surplus, but generally the very serious internal consequences of such a step are ignored. The fact is that the developing countries have to follow a policy of growth to counteract the effects of years of low rates of development or stagnation. So, even if external conditions were to improve, the first priority should be a higher rate of growth.

We should not forget that import restrictions have added to the adverse effects of the fall of exports and the deterioration of the terms of trade. This combination of factors was responsible for the intense contraction of economic activities which resulted in higher levels of unemployment and disguised unemployment. In consequence, chronic inflation has grown considerably worse.

Take the case of Argentina. Very drastic measures have been taken recently in order to ward off the imminent risk of hyperinflation. The task in itself is very difficult, but the lack of a proper solution to the debt problem is seriously jeopardizing the success of the entire plan. Social and political stability are at stake.

However, up to now I cannot see any signs of a fundamental change of attitude on the part of the creditor countries. Moreover, I am extremely concerned by the internal effects as well as the adverse impact on our relations with developed countries, especially the United States.

This is basically a political problem in both its origin and development. Short-term lending operations by important banks using the resources of the Eurodollar market have not been subject to any regulation whatsoever, notwithstanding the recognition that such regulation is indispensable in internal banking activities. On the other hand, developing countries fell all too easily into the temptation to borrow lavishly without a clear sense of responsibility.

I do not in any way mean that governments should take charge of the negotiations. Nonetheless, I do feel that governments should establish a framework within which these negotiations are to be held.

Several suggestions have been offered. There are no magic solutions, however, and both debtors and creditors should share the burden. The share of the former has already been very great owing to the contraction of their economies, but the latter have not suffered except in a few cases. Any deliberate reduction in interest rates would inevitably be detrimental to banks, and the extension of maturities would deprive them of quite large commissions and charges.

But I do not see how this can be avoided. I always bear in mind the wise way in which New York city solved its debt problem a few years ago: a far-sighted solution for all the parties concerned.

\*Testimony given by the author in the United States House of Representatives, July 1985.

The moment has arrived to enter decisively into a new stage. Our countries have been reluctant to form a debtors' club, and rightly so. But the situation seems to me untenable. I am afraid that sooner or later unilateral measures may be taken if nothing is done; some countries have already had to take such measures on a temporary basis.

Such an outcome would be highly regrettable from every point of view, except perhaps from the standpoint of some short-term political interest. In parentheses, I would like to recall that at the beginning of the 1930s, as a young Under-Secretary of Finance, I strongly advocated the full payment of the debt. Argentina was one of the few debtor countries that continued to do so, at a great sacrifice. I do not think that this could be repeated under the present difficult circumstances, if a proper solution is not found.

Several ideas are in the air. I myself feel rather inclined towards the idea that debtor countries should pay the full amount of interest charges but should transfer only a part of it and deposit the rest in a fund to be used for investment purposes, under conditions agreed upon by both parties, taking into consideration the foreign constraints on development. I consider this a very constructive way out of the present serious situation.

This is not the only matter of concern to me. Your country, as well as mine, is wasting a great opportunity to build new relationships with a long-term perspective. We should not repeat the errors of the past. Many mistakes have been made on both sides. An objective appraisal has to be made, but time is getting short. Let us begin a frank discussion right now.

# Latin America and integration: options in the crisis

*Guillermo Maldonado L.\**

While it is true that some of the causes of the present situation in Latin America are of external origin and that there is little possibility that Latin America will be able to change them, it is no less true that, if the region is to grow it must determine what action its members are ready to take together in order to increase their independence. This article's main argument is that Latin America must strengthen its arrangements for regional co-operation and integration and make better use of its own resources; ideas, projects and processes have been set in motion for this purpose and must be given real political support.

In addition, as an external reflection of what is being done within the region, negotiating power will have to be generated and wielded in the international arena in order to enable the region—and each of its countries—to participate on a more equitable basis in world trade and international negotiations, with a view to defending its legitimate interests.

Within this frame of reference, certain questions arise in the light of the present crisis: in what way and at what cost will Latin America come through this crucial decade of the 1980s? What should be the strategies of its future development in a world in which the comparative and absolute advantages of international trade will undergo profound change? What is the role and what are the prospects of regional co-operation in this difficult transition?

If correct answers are to be found for these and other questions, it will be necessary to monitor systematically the development of the international situation, to study the new technological trends which may emerge in the future development of the centres and their possible impact on the Latin American economy, to devise programmes to reduce the region's external vulnerability, to foster the processes of co-operation and integration among the Latin American countries, and to secure a unified Latin American position which will increase the region's negotiating power.

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## Introduction

The author of this article is convinced that a new international division of labour is becoming established as a result of the big technological changes taking place in the main industrialized countries, changes which are reflected in their production structure, in their relations with each other and in the consolidation of a system of international economic relations based once again on the exercise of power rather than on co-operation. The uncertainty, state of crisis and instability of the international financial, monetary and trade systems are also manifestations of the transition towards this division of labour and towards a system of international relations to sustain it. Just as it is high-technology services and activities which provide the driving force for the changes within the centres, it is the unilateral exercise of power and bilateralism which is increasingly replacing international co-operation and multilateralism in the relations among States.

The most serious problem is without a doubt the region's indebtedness. In order to service its debt, Latin America has become locked into a continuous process of adjustment to new circumstances which has not only prevented any growth in the majority of the economies of the region, but has also produced a per capita decline to the levels of 10 or 20 years ago.

In the 1980s Latin America has become a net exporter of capital to the developed world. A historical trend has thus been reversed, essentially as a result of the exorbitant rates of interest payable on the foreign debt. The larger part of the surpluses of foreign currencies have been obtained by cutting back imports and not expanding exports. This development has also been affected by the protectionist policies and practices of the industrialized countries and by the rapid deterioration in the terms of trade.

At the same time, at the end of the 1970s and the beginning of the 1980s, there was a vigorous return to democracy as a form of government and social order. This process has been hindered by the need to adopt austerity policies to service the foreign debt. The reduction of public expenditure, the freezing of wages and the runaway inflation have made the process of democratic consolidation more difficult, especially after the painful experience of life under au-

thoritarian régimes. These facts show how vulnerable the region is and how limited each country's room for manoeuvre in devising and applying economic policies to re-established the former rate of economic and social growth and distribute its fruits equitably. Nevertheless, and despite the continuing state of crisis, the democratic process has shown enormous vigour and has received great popular and institutional support.

Examination of the economic realities of Latin America and of political pronouncements and acts indicate that the situations confronting the countries of the region are difficult to bear. The countries are reaching the limits of social and political tolerance and a situation is emerging in which there could easily be an upsurge of violence, intolerance and polarization of positions. This atmosphere works against the application of policies designed to achieve economic growth on the basis of democratic consensus.

If Latin American is to resume its economic

and social development, it must secure, at least, a steady increase in exports; this means that the protectionist policies and practices of the industrialized countries which are affecting the region must be halted or moderated: the industrialized countries must accept a deficit in their trade with the Latin American nations. However, it is important to move away from the present ridiculous situation in which the region exports capital, and return to the situation in which Latin America receives a net inflow of financing. If this objective is to be attained, there will have to be more order in the macroeconomic policies of the industrialized countries responsible for the high interest rates and growth of protectionism.

The democratic process will also have to be consolidated: democracy must not be limited to the electoral process but must provide the legal, institutional and social framework within which the inequities which remain a feature of Latin American development can be eliminated.

## I

### The crisis in the international economic orders and its implications for Latin America

Five main arguments are analysed in this first section. First, that the system of international co-operation which emerged after the Second World War was a powerful factor in promoting and channeling the economic development of the capitalist world in the next twenty years. Second, that the activities of the economic co-operation institutions controlled by the big developed capitalist nations —such as IMF, the World Bank and GATT— helped to consolidate an international division of labour based on the relationship between the centre and the periphery. Third, that this arrangement has been in a state of profound crisis since the 1970s when the long-term forces which imparted this dynamism became exhausted and the world economy grew increasingly sluggish and unbalanced. Fourth, that the present interregnum necessarily entails a deterioration in the institutional superstructure

of international co-operation and negotiation. And five, that a technological revolution has begun to grow and spread in the centres which will fundamentally change the international division of labour and, consequently, the structure of the centre-periphery system.

#### 1. *The organization of the international economic order and its effect on the periphery*

The system of international relations which emerged from the Second World War produced a wide network of political and economic institutions of a multilateral nature designed to direct and control the understanding among States. Never before in history had it been possible to construct such a universal and complex system of international bodies.

In this system some bodies play vital roles in

the financial, monetary and trade operations of the developed world; for example, the World Bank, the International Monetary Fund and the General Agreement on Tariffs and Trade. The economic power of the big industrial centres is expressed through these institutions, and their functioning is affected both by the struggle among those Powers and by the way in which they exert their influence on the developing regions of the world.

In the promotion of development the assistance furnished by the World Bank usually took the form of tied loans, which helped the periphery to acquire basic infrastructure, but which were used for the purchase of goods and services supplied by the private companies of the central countries. Something like this happened in the case of several institutions, such as the Inter-American Development Bank and the International Development Agency, to name two institutions of special importance for the Latin American economies. The failure to establish preferential treatment for the Latin American suppliers of capital goods encouraged the massive acquisition of equipment from the centres. Development assistance was thus an ambivalent factor. On the one hand, it limited the independent technological development of the peripheral regions, thus impeding the proper expansion of their capital goods industries. On the other hand, it provided the essential infrastructure for Latin American development.

In the trade sphere, the General Agreement on Tariffs and Trade worked to establish uniform and equal treatment in tariff matters on the part of every country in its relations with all other countries. Its rules were based on manufactures where the comparative advantages were on the side of the centres, and they did not deal with primary commodities, where the comparative advantages were with the periphery.

Under the influence of the GATT rules the tariffs on trade in manufactures grew more liberal, but the centres granted high subsidies and strong protection to their domestic agriculture. In the 1960s—owing to the influence of the UNCTAD generalized system of preferences—part IV was added to GATT, providing for the possibility of preferential treatment for the developing countries.

From the end of the Second World War up to

the present time, as several ECLAC studies anticipated, the elasticity (prices and incomes) of the demand for manufactures in relation to the corresponding elasticity in the demand for primary commodities led to a systematic increase in the share of manufactures in the value of world trade. As the developing countries were exporters of primary commodities and importers of manufactured goods, their trade balances showed chronic deficits, with consequent indebtedness.

As a result of these basic imbalances, the world economic system and trade in particular—based on the principle of liberalization—did not bring about balanced and stable development but instead encouraged tendencies towards structural imbalance and inequitable distribution of the fruits of trade. Thus the need for co-operation proclaimed by UNCTAD on the basis of the ECLAC ideas.

In the monetary and financial sphere, these imbalances were controlled cyclically by the application of restrictive measures suggested to the deficit and debtor countries by the International Monetary Fund as a means of adjusting their external balances. Accordingly, the restriction of imports as part of the adjustments made necessary by the external imbalance had a negative influence on levels of activity and development prospects in the countries which depended on manufactures acquired from the centres. The strategy of industrialization by import substitution attempted by the majority of the large and medium-sized countries of Latin America was designed to produce self-centred development<sup>1</sup> which would reduce the vulnerability of the regional production structure to the fluctuations of international trade. This policy could not always be reconciled with the trade and financial openness advocated by GATT and the Bretton Woods institutions.

<sup>1</sup>Development tending to strengthen and diversify domestic production on the basis of national and regional demand. However, the Latin American production of capital goods was not included in the application of protectionist measures. In order to reduce the costs of industrial investments, imports of production equipment were freed from all restrictions and subsidized in many different ways. These policies did not foster the independence of regional development.



The liberalization of trade between the centres —after the reconstruction of Europe and Japan with United States help— was an efficient tool which boosted their economies and strengthened their mutual interdependence but left the periphery in an unfavourable competitive position.

The economic events of the 1970s brought out more clearly the bias and shortcomings in the functioning of some of the institutions established in the postwar period. The official development assistance furnished by the World Bank, IDB and other intergovernmental organs declined in relative importance as financial privatization and transnationalization increased in the 1970s. The GATT rules and regulations are increasingly broken by the new forms of trade controls stemming from the need of the centres to protect their domestic levels of activity and employment. Similarly, the financial and trade difficulties of a more sluggish and less balanced world economy have changed the liquidity and balance-of-payments situations, lessening the usefulness and effectiveness of IMF, particularly in the management of the foreign debt. These problems damage international relations between centre and periphery.

## *2. The North-South negotiations in the framework of international co-operation*

The structural imbalances in the North-South relationship call for a new international economic order and reform of the institutional superstructure. Today more than ever before this new order advocated by the United Nations since the early 1970s is an essential condition for restoring harmonious development in the world economy and mitigating to some extent the dangerous consequences of world economic restructuring brought about by technological change.

However, the adoption by the United Nations General Assembly (on 1 May 1974) of the Declaration and Programme of Action on the Establishment of a New International Economic Order has been followed by more than 10 years of debate, consultations and negotiations among developed and developing countries in a multitude of forums both within and outside the United Nations system, with very discouraging results.

The objective of the developing countries, which became the central topic of the so-called North-South dialogue, was the establishment of a new and more equitable international framework of relations which would give them a greater say and more decision-making power in three closely interrelated areas: primary commodities, trade and monetary and financial matters.

The main aim for primary commodities is to achieve better conditions of access to the markets of the developed countries, greater participation by producers in marketing, distribution and transport systems, and an increase in the industrial processing of raw materials in the producer countries themselves. All these topics are still under study and no concrete measures have yet been adopted.

In the trade sector the developing countries wish to check and reverse the protectionist trends and make progress towards the liberalization of international trade. They are seeking to establish a set of rules and principles which will bring about a juster and more equitable trade system.

In the financial and monetary area the intention of the developing countries is to devise a new international monetary system which will meet their needs and give them a greater say in decisions affecting their interests. Faced with the increasing and serious shortage of financial flows, they are seeking an expansion of the resources available to the developing countries. These resources would come from international financial institutions by means of additional allocations of special drawing rights, an increase in IMF quotas and expansion of the compensatory financing service. None of these proposals has so far been accepted nor has any progress been made on the initiatives for reform of the international monetary system.

Although the developed countries approved the resolution on the establishment of a new international economic order, out of a desire to reach agreements which would bring some order to the energy products markets through price adjustments in the mid-1970s, they fell back in defense of the prevailing system, which they found a useful means of protecting their more immediate interests. Throughout the negotiating progress they maintained a sceptical attitude as to the competence of the United Nations

forums, advocating the full validity of the specialized forums such as GATT and IMF, in which they held advantages in relative power or voting rights. This helped to weaken the general framework of negotiation and no major agreements were reached for the transformation of the system of international economic relations.

### *3. The dynamics of the international economic system and its consequences for Latin America*

The accelerated growth of the world economy in the first decades after the war was due to the great dynamism of the industrial centres. This dynamism began to fade in the 1970s, yielding to the pressures of stagnation and deflation which became more acute at the end of the decade. Throughout this process the non-convertibility of the dollar, which came into effect in 1971, was an important innovation which highlighted the preponderance of a single country in the world monetary system.

The effects of this slowdown were not felt immediately in Latin America, partly because the financial freedom of the 1970s allowed the Latin American economies to continue to grow beyond the limits imposed by the purchasing power of their exports. In other words, the weaker locomotive power of the centres was offset to a large extent by abundant private financing of a transnational nature. The open trade policy of the United States from about 1975 also seems to have been a factor which stimulated imports to a level higher than the corresponding level of domestic economic activity.

The decline in the economic dynamism of the centres has profound structural causes—associated in part with the exhaustion of the postwar technological cycle—which have slowed down the rate of accumulation. The imbalance in the composition of global demand—excessive consumption and insufficient investment—together with energy and ecological restrictions on the supply side, helped to create the troubling conditions of “stagflation” which was a feature of the 1970s. It is a familiar story that, in order to overcome this situation, the United States applied a combination of monetarist and supply-side policies using the reduction of the money supply as its tool; it also went to the private financial market to fund its fiscal def-

icit and reduce the tax burden on the private sector in order to stimulate investment and consumption.

This policy resulted in a great reduction in inflationary pressures and a sharp domestic recession which increased the levels of unemployment and idle capacity. Although economic activity in the United States made a vigorous recovery, investment—a fundamental long-term factor—has not grown at the expected rate, especially with respect to its more productive components.

The monetarist and supply-side strategy reduced the share of wage earners in the global product—a consequence of the higher rate of unemployment and the loss of negotiating power by wage earners—and the return on financial capital increased considerably. Producer businesses experienced a reduction of their wage costs but a relative increase in their financial costs; this impeded accumulation for productive purposes by private business.

The high real interest rates in the United States spread—although at lower levels—to the rest of the developed central economies. In order to avoid domestic inflation or uncontrollable fluctuations in their exchange rates, Europe and Japan had to bear the recessionary effects of the monetarist and supply-side strategy of the United States. Thus, the “stagflation” which emerged in the 1970s is being combatted with policies which have not yet proved their medium and long-term effectiveness as means of restoring the economic growth rates of the centres.

The recession in the centres has had a devastating impact on the Latin American economy. The decline in living standards and increase in idle capacity, sometimes with the abandonment of production by failed businesses, and in unemployment, with all its social and political effects, are some of the most important results.

During the 10 years immediately preceding the crisis the patterns of Latin America's involvement in the world economy had undergone a profound transformation. The processes of internationalization and establishment of financial links with the industrialized market-economy countries had grown stronger, accentuating the vulnerability of the region to external fluctuations (ECLAC, 1983 and 1984).

The large external debt and the burden of servicing it are one of the serious problems reflecting the external stranglehold on the region's economy. Study of this situation illustrates the limited capacity of the region, internally and externally, to take independent decisions on more suitable policies.

The net amount of external investments and loans has been lower than net remittances of interest and profits. For this reason, in 1984—for the third consecutive year—Latin America had to make a sizeable net transfer of resources to the rest of the world. This transfer was in the order of US\$ 26 700 million which, although lower than the US\$ 30 000 million for 1983, signified, for the region's import capacity, a reduction of approximately 24% in the value of exports of goods and services.

The structural aspects and the inadequate domestic economic strategies and policies were important, but it was the external factors which lay at the root of the Latin American crisis and determined its scale. In the majority of the countries of Latin America these factors evolved in similar conditions and with common features.

#### *4. Prospects for the world economy and the consequences for Latin America*

The phenomenon of "stagflation" in the 1970s has been interpreted as an excess of effective demand accompanied by an inadequate rate of productive accumulation rather than as a lack of effective demand in the strictly Keynesian sense (Prebisch, 1984). The increasing share of government expenditure and wages—public and private—in the national income reduced the amount of the private reinvestable surplus and gave rise to a distribution struggle in the consumption sphere which affected investment in two ways: firstly, in consumerist attitudes in the use of the surplus which slowed the investment rate; and secondly, in the internal composition of this investment, both public (defence, space programme) and private (designed to improve the forms of consumption rather than to increase labour productivity and employment). Of course, the monetary and energy crises of the 1970s also played a part in creating problems of inflation and slowing down investment.

As has already been pointed out, the mone-

tarist and supply-side policy applied in the United States from the 1980s succeeded in controlling "stagflation" and after the initial recession (1981-1982) produced a recovery (1983-1984). But this strategy is based on macroeconomic imbalances which are difficult to sustain over the medium and long term: fiscal deficit, trade deficit, and rates of open unemployment above the historic postwar rates. Future modification of this policy depends to a large degree on the decisions taken by the economic authorities of the industrialized world and the international co-operation institutes under the control of the central countries. This circumstance invests any assessment of the short and medium-term prospects for Latin America with a considerable degree of uncertainty. The international situation has become so fluid that the terms of the problem are changing from one day to the next.

In these circumstances the Latin American countries must adopt a regional strategy based on increased co-operation and harmonization in the international promotion of their common interests rather than on bilateral arrangements and vertical relationships.

Perhaps any future concession by the industrialized centres of trade and financial terms more favourable to the region will result not so much from the representations of each individual Latin American economy or greater bilateral co-operation, as from a common, firm and united attitude in defence of shared interests. This proposal is all the more valid in the present financial international situation.

After the period of transition, which will perhaps take what remains of the 1980s, the centres will step up their development on the basis of the new technologies and energy sources which they are now preparing at top speed. The technological revolution in microelectronics, biotechnology and the use of more diversified sources of energy will generate economic structures which will transform not only the societies of the centres but also the international character and distribution of the world's productive capacity. It is difficult to foresee what impact this process will have on the place of Latin America in the world order, but there is no doubt that it will have profound social and economic effects.

### 5. *Some possible action for Latin America*

The present crisis might bring about a reaction on the part of Latin America which would have certain features which must be described. The external restrictions and the shortage of foreign currency is forcing governments to impose tighter regulation of the region's import capacity and compelling the State to take a more active part in the control and administration of foreign trade. With a view to solving the problem of unemployment and correcting the shortcomings in the region's production capacity, attention might be given to strengthening those forms, institutions and mechanisms of planning which are compatible with the operation of the market. The reduced import capacity will perhaps stimulate industrial activity to replace from Latin American sources an influx of imports which is now no longer available. The need to replace with domestic savings the interrupted flows of external financing might encourage tax reforms to penalize luxury consumption and reward the accumulation of capital. Perhaps a more austere and equitable attitude in the areas of consumption will be balanced by a more dynamic and responsible attitude to accumulation. National capital might possibly be repatriated, while the various forms of speculation and corruption—especially in the financial sector—could be combatted with greater vigour.

If these hypotheses as to the Latin American response to the crisis are found to make sense, a strategy would be established for greater recourse to State intervention<sup>2</sup> and planning in economic life; the national market would be protected and productive domestic activities promoted; regional trade would be set up on new bases which are already being explored; and more equitable trends would be encouraged in the distribution of income and consumption, with a view to promoting accumulation based on domestic savings. This picture would be compatible with the con-

tinuation of the democratic régimes which have recently come to power in the region.

Self-centred development, the search for efficient and democratic planning, diversification of production and industrialization, regional co-operation and integration, as well as the promotion of more dynamic and equitable growth, constitute a turnaround in ECLAC's thinking. But the region is not the same as it was in the early postwar years. Today the societies and the economies of Latin America are much more developed and interdependent; they have a degree of real and formal integration which did not exist before; their average level of education is much higher, and they have highly trained teams of scientists, technicians and professionals. Lastly, they also have an increasing potential for joint defence of their common interest in the international, political and economic spheres.

The urgent need to reactivate the national and regional production of Latin America and to retool its industry with a view to long-term expansion means that there will have to be a pragmatic review of foreign policy and of international negotiations. In view of the emergency situation caused by the present shortage of foreign exchange, it is legitimate to use measures of protection and barter trade to maintain levels of activity and employment, facilitate the retooling of production units and, in general, promote the accumulation of capital.

The counterpart of these tactics and strategies of negotiation with the governments and businesses of the centres is to be found in the process of Latin American co-operation and integration. The unity of the countries of Latin America has an external expression in the strengthening of their power to negotiate with the centres and an internal expression in the greater integration of their economies.

The search for self-centred development which will help to solve the basic problems of Latin American societies would seem to require, in the long term, a new ethics of development which will neutralize divisive outside intervention and harness the enormous possibilities of technical progress which are at hand. The new technology must be sifted and adapted for use in accordance with the objectives of self-centred development.

<sup>2</sup>This should not be confused with an inflated bureaucracy or excessive growth in an inefficient public sector.

## II

# Latin America's foreign trade: diagnosis, prospects and policies

### 1. *Characteristics of Latin American trade and impact of the crisis*

The restrictions imposed on regional development by the international environment manifested themselves, where trade was concerned, in the spectacular fall in the prices of primary commodities,<sup>3</sup> a fall which was all the more serious as these commodities accounted for 80% of all Latin American exports. On the other hand, there was no change in the traditional dependence on imports of manufactures, mainly intermediate and capital goods, which at the beginning of the 1980s still made up 60% of the region's total imports. It is thus easy to appreciate the great importance of external purchasing power for this essential supply and the persistent structural imbalance in the relationship of the Latin American countries with the exterior.

In the trade sphere the recovery of the central economy would not necessarily lead to an increase in the real export earnings of the developing countries, particularly the countries of Latin America. The present protectionist trends—features of the trade controls which are on the increase in the centres—might have a harmful effect both on the volumes and on the prices of the goods exported by Latin America.

Although the region has benefitted from the United States recovery in 1983-1984 and from the overvaluation of the dollar, which have facilitated a great expansion of their exports to the United States, for reasons which have already been mentioned it remains to be seen whether the recovery of the centres will continue.

On the other hand, when the dollar returns to a more reasonable value competition from the United States economy will be felt in the markets

of Europe and Japan, regions in which production is also undergoing changes with the introduction of new forms of technology. It must therefore be assumed that in this stage of technological transition, with the consequent restructuring of comparative advantages in the international order, all the central economies will proceed to protect their national markets. This action might extend to control of the levels of activity and the employment situation, and continue until the new structure of comparative advantages in the developed world become clearer.

### 2. *The protectionism of the centres*

In recent years protectionism has been a dominant feature of the trade policy of the industrial nations. In putting protectionism into practice they have made use of a whole series of tariff and non-tariff barriers in their markets which are damaging Latin American production and exports.

One of the negative aspects of tariff barriers is the graduation of tariffs which, by taking into account the degree of processing of the products concerned, has become a powerful obstacle to the region's industrialization. The non-tariff barriers include import quotas, variable surcharges, safeguard clauses, "voluntary" export restrictions, discriminatory practices, compensatory rights, technical trade barriers and production and export subsidies. Protectionism has also grown in other forms. One example is the sharing agreements which the countries of the region have had to accept as the only means of exporting to a developed nation, as happened in the case of the GATT Multifibre Agreement. To appreciate the importance of these measures, it is sufficient to recall that in recent years approximately one half of the region's exports—excluding oil—to the United States, the European Community and Japan were affected by them. In practical terms, these protectionist measures are producing a

<sup>3</sup>The composite index for the 24 main export commodities of Latin America (excluding oil) fell by 25% between 1980 and the beginning of 1985.

situation in which the industrialized countries have the capacity to "administer" their trade with the developing countries.

This new protectionism has developed at the margin of the rules and obligations of the international trade system based on the GATT regulations. As protectionism for the most part involves bilateral arrangements, it represents a steady retreat from multilateralism as a means of solving the increasing economic and trade problems. In turn—as a result of the threat of protectionism—investment in export-oriented activities has declined in many countries of the region, especially with respect to manufactured goods<sup>4</sup>.

Although it is difficult to assess the full extent of the effect of this increased protectionism, it might prove to be one of the main problems affecting international economic relations and hindering the recovery of the world economy.

### 3. Latin American trade prospects

The prospects for a sustained expansion of Latin American trade up to the end of this decade depends on a number of factors, including the following:

i) *The world economic recovery.* This will be determined by the macroeconomic policies of the industrialized countries, especially the United States, owing to the controlling role of their economies in the international financial and monetary system.

ii) *The behaviour of primary commodities.* Owing to the dependence of Latin America on exports of primary commodities—and the close relationship between price movements and developments in world economic activity—there can be no great hope of a recovery of the economies of the region based on exports of raw materials. Some forecasts suggest that the average annual increase in the real value of world exports of primary commodities will be in the

order of 2 to 3% in the period 1985-1995 (ECLAC, 1985). Over the same period the real rate of growth in manufactures is estimated at 12%. If this proves to be the case, the region's terms of trade will suffer yet another major setback.

iii) *The protectionist trends.* There is little prospect of preventing an upswing of protectionism in the industrialized countries, despite the numerous undertakings which these countries have given in recent years. Owing to a number of factors of a structural nature, it is not thought that the protected industries of the developed countries will regain their international competitiveness; this might lead to the adoption of additional restrictive measures for those sectors. If that happens, the region's capacity to service its debt and finance higher levels of imports by means of increased export earnings would be even more seriously affected.

iv) *Adjustment policies.* If the present recessionary processes remain unchanged, some countries of the region will find themselves in situations difficult to control from the social as well as the economic standpoint. The possibility of expansion in the future will depend to a large extent on the external conditions which determine Latin America's trade expansion, such as: the world economic recovery, the international prices for the main Latin American exports, the net amount of external financing and the level of international interest rates.

v) *International negotiations.* Broadly speaking, the prospects for and results of future international negotiations will depend on the negotiating capacity of the developing countries, something which rests to a large extent in their own hands. The first step is to strengthen cooperation and solidarity among these countries. Moreover, there is an obvious need to review the objectives, procedures and strategies of future negotiations with the industrialized countries, so that the dialogue will be more effective and not cause the same frustrations as in the past.

### 4. Negotiating policies and options in the area of trade

The first lesson of the North-South dialogue is that trade, financial and monetary matters have been discussed and negotiated by each country in isolation and in different forums. In the case of

<sup>4</sup>A concrete example of this trend is the law approved on 31 July 1985 by the Congress and President of the United States under which the United States, to protect its own industry, will vote in the international financing institutions against any loan for projects for the mining, smelting and refining of copper.

primary commodities the focus has always been on individual product negotiations. In the GATT multilateral talks the negotiation has been broken down into groups and subgroups either of specific products or of specific barriers. Thus, there has never been a comprehensive or integrated focus for negotiations on the trade problem. The cost of this defect has been very high for the developing countries, for it impedes the process of co-ordination and joint action, makes it easier for the industrialized countries to create division and disagreement and neutralizes the negotiating power of the developing countries.

Latin America should conduct the negotiations with the industrialized countries in a much broader forum which would include primary commodities, manufactures, capital goods, services, technology, investments, and monetary and financial matters, as well as the region's purchasing power, which has never been given any importance at a negotiating table. The struggle to increase the negotiating power of the region will not be based on a desire for confrontation but rather on the intention to safeguard the region's legitimate interests.

If there is to be a new, more equitable and dynamic international trade system, the following objectives will have to be taken into consideration:

- i) Structural adjustment policies must be viewed as a new dimension of the future trade system. The theory that such adjustment would be produced spontaneously through the free play of market forces has proved incorrect.
- ii) A satisfactory system of safeguards will have to be established in order to solve, in a clear, consistent, equitable and non-discriminatory manner, the problems and difficulties which will inevitably arise.
- iii) Attention should be given to the method of handling the processes which fall outside the GATT regulations and obligations or which are not dealt with adequately by the present trade system.
- iv) It will be necessary to secure the active participation of all countries and interaction among the various subsystems.
- v) A strong link must be established between trade and development and this link must

be incorporated in the generalized system of preferences without introducing new concepts such as graduation and reciprocity.

- vi) The trade system must begin to function again on a stable basis. This requires new initiatives in the areas of employment, monetary stability and the transfer of resources to the developing countries.

These objectives will be achieved only by the united will of the various groups of countries. One fact which must be stressed in future negotiations is that the present order has not only ceased to function for the developing countries but has also ceased to suit the developed countries themselves.

It must also be stressed that widespread protectionism has been one of the decisive causes of the erosion of the fundamental principles of the international trade system. Given this situation, two kinds of measure might be agreed at a regional level: preventive measures to prevent the opening of any debate detrimental to the region's exports; and the possible adoption of new measures. This will require a detailed knowledge of the legislation and regulations in force in the industrialized countries and of the pressure groups which might act for or against Latin American exports; it will also require retaliation against protectionism, with the application of similar measures against exports of the developed countries to the region. Such action might also have a preventive effect, since industrialized countries considering the adoption of protectionist measures would study the implications of retaliation very carefully. Furthermore, this kind of equal treatment would elevate the negotiations to a more political level where the regional mechanisms for agreement and co-ordination would have to be strengthened.

The most important contribution that Latin America could make to the world recovery would be to continue to fight for greater recognition of the increasing importance of the developing countries in the functioning of the world economy and of the need for an integrated approach—covering monetary, trade and financial matters—in international action to correct the shortcomings of the present world trade system.

Analysis of the debt situation illustrates the

interdependence between developing and developed countries. It also confirms the close relationships between the monetary, financial and trade systems. In any common formula for debt service, agreements on the extension of time-limits and reduction of interest rates must take

second place to the main goal of facilitating Latin American growth. At the same time, the conclusion of agreements for this purpose would enable the region to increase the volume of its imports from the industrialized countries, which would assist the recovery of the world economy.

### III

## Regional integration and co-operation

### 1. *General background*

Faced with a pressing need to increase and diversify intraregional trade and step up industrialization, the Latin American countries devised systems of integration. Starting from very low levels, trade within the region has grown very rapidly as a result of the liberalization of trade, export promotion programmes and the introduction of other instruments of integration, including payment systems. In addition to growing, trade has changed its composition. The advance of industrialization has made it increasingly possible to incorporate intermediate goods and certain capital goods.

Nevertheless, the participants did not all benefit equally from this process. Some countries accumulated deficits in their trade with the region on top of their deficits in international trade; others saw their national industries threatened by the tariff reductions inherent in the process of integration.

For these and other reasons some Latin American countries became increasingly reluctant to continue to reduce tariffs and derestrict their imports from the region, and although the time-limits for compliance with the agreements were extended and increasing numbers of exceptions were permitted, the integration systems could not attain all their goals. In the 1970s the negotiations not only marked time but even gave clear signs of moving backwards. When the economic crisis burst on Latin America, several countries began to apply a number of non-tariff restrictions which further eroded the agreed preferences.

All this seems to indicate that general, multi-

lateral and automatic removal of tariffs is not of itself a sufficient response to the needs of the countries and the genuine diversity of the region. Owing to the different levels of development of productive structures and the different degrees of openness to the exterior, the costs of integration are perceived more clearly than the benefits. The latter seem more uncertain and distant.

This means that in the present economic circumstances the Latin American countries are willing to grant each other tariff preferences only at reduced levels, or for specific items, or for some members and not for others. These concessions are often granted only for limited periods or are made subject to quotas.

Furthermore, the results of industrial integration have so far been meagre, although this does not invalidate the considerable power of this tool as a means of avoiding costly duplication of certain investments, exploiting the advantages of specialization and distributing the benefits equitably.

Lastly, it must be stressed that the systems of payment and reciprocal credit were the instruments which functioned most effectively in the past. They produced a considerable saving of foreign exchange, since it was necessary to use convertible currency only to settle the trade balances. The systems were easy to administer and the costs were very small in comparison with the great benefits obtained.

The economic crisis in the region also caused the payment systems to collapse. Convertible currency became scarce, since almost all the countries had to bear the heavy burden of servicing



their external debt at a time when external borrowing as a source of financing had disappeared. Some Latin American countries could not pay off the balances of their debt, while others began to exclude certain exports from the payment systems. The countries of the region are now seeking possible ways of reactivating these mechanisms which have proved to be a valuable means of increasing intraregional trade.

## *2. The need to upgrade the integration systems*

It is essential to re-establish the direction and reconstitute the elements of the integration systems of Latin America. The region's external structural dependence and vulnerability authenticate the need to lay the foundations for more dynamic, solid, equitable and independent economic and social development.

Despite the obstacles to integration and the errors which may have been committed in using some of the instruments, these methods still offer the region an opportunity to set in motion economic growth based on their own potential and strengthen the links among the countries to enable the nations of Latin America and the Caribbean, acting together, to solve the problems of their inequitable role in the international economy and strengthen their negotiating power with the rest of the world.

Within this framework one of the specific tasks which the integration systems will have to tackle is the re-establishment of the levels of intraregional trade, which have declined as a result of the crisis. This will require utilization of idle resources and an increase of the imports which the region needs in order to resume its development. This purpose will be served by improving the mechanism of compensatory payments and reciprocal credit, as this will produce an increase in trade with a minimum expenditure of convertible currency.

Another task will be to adapt the productive apparatus of Latin America to the changes taking place in the industrialized centres. If the region wishes to improve the integration of its productive sectors, fill the gaps in its industrial structure and involve itself in world technological progress, all the countries will have to join in a common effort.

The Quito Plan of Action defines sufficiently

clearly some of the tasks which have to be tackled in the immediate future. A large part of this responsibility was assumed by the Latin American Integrations Association at its second Council of Foreign Ministers. The Latin American economic system covers a large part of the region and, given co-operation, can contribute to unity and a greater Latin American presence in international negotiations. The Andean Group, which has played a pioneering role in defining the concept of integration —by adding the political and programme dimension— is a rich source of experience in this area, as are the Central American Common Market and the Caribbean Community with their achievements in the derestriction of trade and development of co-operation in many different sectors.

The integration systems have been under serious pressure as a result of the slowdown in the industrialization process and the Latin American crisis. Nevertheless, their institutions have remained largely intact and ready to operate in the new stage which the region is entering.

## *3. Co-operation and integration*

Economic and technical co-operation has always existed in Latin America and it has grown considerably stronger in recent decades. This process has been facilitated by the integration movements which broke down the isolation in which each country lived. Co-operation differs from integration in its instruments and legal framework, but this difference amounts to little in practice. The integration systems include areas of co-operation which go beyond the limits of mutual open markets. The results of this co-operation tend to foster the subsequent integration of economies, although many of these measures operate at the margin of the integration systems. Both sets of measures should be strengthened on a mutual basis.

Many of the areas of co-operation included in the integration systems have maintained a degree of coherence and dynamism even in difficult times. Mention must be made of the electric power link-up in the Central American Common Market, which continues to advance despite the considerable tensions in the area. In the Andean Group the Hipólito Unanue, Simón Rodríguez and Andrés Bello agreements continue to

function and, working together with the Andean Parliament and the Andean Tribunal of Justice, they are surmounting the economic dimension and aiming at the establishment of a genuine community of countries.

A number of moves have also been made in the Caribbean Community (CARICOM) to give this group greater cohesion. The Organization of Eastern Caribbean States was recently established among the less-developed countries and it already has joint bodies such as a Central Bank and a Supreme Court of Justice as well as joint diplomatic representation. Because of its particular geographical configuration, CARICOM committed itself from the outset to establishing regional maritime and air transport companies.

The Latin American Free Trade Association/Latin American Integration Association has organized special programmes of support for the relatively less-developed countries in which it has called for the co-operation of the other member countries. Unfortunately, these programmes proved of little use to the recipient countries, not only because they were furnished with few resources but also because they were not organically incorporated in the main areas of action of these institutions.

With the establishment of SELA in 1975 the countries attempted to open up a new channel for their aspirations for regional co-operation and to meet the need for co-ordination of policies towards the rest of the world. The system proved fairly effective with regard to the second objective, but less effective with respect to Latin American co-operation. The action committees—the mechanism chosen as a means of securing this co-operation—were rarely able to perform their functions, mainly for lack of commitment on part of the member countries. The most important committees are the ones for assistance in the reconstruction of Guatemala, which has already ceased to operate, for marine products and for drinking water; mention must also be made of the Latin American Technical Information Network and the Regional Food Security System. Other important areas of the work of SELA are the co-ordination of the Latin American position in the international negotiations in UNCTAD, GATT and the North-South dialogue, as well as on the Malvinas conflict (ECLAC, 1985).

At the present time, the renegotiation of the

foreign debt is monopolizing the efforts of the Latin American countries to reach agreement among themselves, though they have not even been able to achieve the desired unity of approach.

This incomplete list gives some idea of the large areas in which regional co-operation could strengthen a productive capacity and trade which, in the narrow national environment, could prove uneconomic. In the light of the variety of options available, provision must be made for an equally broad range of modalities, forums and mechanism of co-operation.

#### 4. *Geopolitical aspects of integration*

There are centripetal forces operating in favour of Latin American development and centrifugal forces pushing the region towards disunity in its policy towards the industrialized centres. The natural reluctance of governments to surrender any measure of freedom in determining economic policy is being aggravated by the crisis and by the need to correct, in whatever way possible, the external imbalance caused by debt servicing. The external restrictions occupy the attention of governments, so that discussion of development is increasingly limited to matters connected with the solution of the external problems.

In addition to the disunity caused by the crisis, there are other factors operating against integration: the region's great size and difficult geographical features, which create problems of communications and in intraregional trade, and the economic diversity, hostile attitudes, and tendency towards bilateralism.

Geopolitical tensions and the diversity of political régimes have also slowed integration and co-operation in Latin America and the Caribbean. The geopolitical tensions not only weaken the links between countries but also jeopardize the very basis of the national development of each nation.

Of the 21 countries for which information on the functional distribution of expenditure by the central government is available, eight spend more on defence than on health, three spend more on defence than on education, and two spend more on defence than on health and education combined (IMF, 1983).

In other words, in some countries military

expenditure is in open competition with economic and social development, for government expenditure tends to be fixed in the short term. Furthermore, a large proportion of military expenditures are on purchases of weapons from the big powers and further reduce import capacities, aggravating the problem of foreign debt and creating new links of dependence on the central countries.

From another angle, this preoccupation with weaponry impairs the effectiveness of the action taken to strengthen the political and economic links within the region. The tensions and conflicts, usually bilateral, not only affect the relations between pairs of countries but also tend to paralyze the initiatives for regional integration and co-operation.

If integration is conceived as a process in which all social agents take an active part, then the existence of democratic systems of government is a necessary condition for its attainment. Similarly, integration can only be said to be taking place when its benefits are perceived by a large part of the population of each member country. One of the benefits most easy to appreciate is the freedom of movement of persons among the countries of an integrated system, a situation difficult to bring about in an atmosphere of restriction imposed by non-democratic governments.<sup>5</sup>

How can regional integration and co-operation contribute to solving these problems? A first step would be to extend the concept of integration to the political level, for up to now the

<sup>5</sup>The European Economic Community, for example, grants associate status only to countries with democratic governments.

predominant view has been "commercialist". It will also be necessary to stimulate awareness of the need to achieve regional unity in order to deal with the present situation and future international relations, since regional unity achieved through integration is the only kind of unity which can guarantee the countries genuine security while preserving the attributes of true sovereignty.

In addition to devising mechanisms for the fair distribution of the benefits of integration, it will be necessary to secure active participation in this process for all social, political and economic groups and thereby increase their democratization.

One means of creating a political environment favourable to the solution of border disputes by peaceful means might be the conclusion of a Latin American treaty which would include: a guarantee of the territorial integrity of every country in the region and a commitment to non-aggression; the peaceful solution of disputes; express rejection of the use of force in the solution of conflicts or disputes of any kind; a gradual reduction of military expenditures and allocation of these funds to economic and social development; and reaffirmation of democracy and ideological pluralism as forms of coexistence and government.

Latin America's integration and co-operation organs must be given a role in these political tasks. For unless the secretariats of the subregional integration systems and SELA play a part in removing the obstacles to integration, the process will not be able to break free of the narrow and incomplete framework of "commercialism". The difficulties confronting this undertaking are enormous.

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## Trade and equilibrium among the ALADI countries

*Jorge Torres Zorrilla and Eduardo Gana\**

The Latin American economic crisis, basically caused by the adjustment of the external sector with a view to generating surpluses to service the debt with the international financial system, has had a powerful adverse effect on the trade flows of the ALADI countries. Nevertheless, an effective co-operation among them is now more necessary than ever in order to overcome the external bottleneck and restore the levels of intra-zonal trade. The reactivation of zonal trade should, moreover, generate additional trade on a relatively more balanced and stable basis than in the past, through the multilateral linkages within the zone.

The authors put forward a methodology for selecting products that could potentially be traded among the countries of the zone and for determining which of those products could serve as pivots for the recovery of the trade flows. An important conclusion in this latter regard is that future negotiations within ALADI should give special consideration to the trade relations between the three largest countries in the Association and the eight medium-sized and small countries, since this axis represented the greater part of intra-zonal trade in the past and was the most affected by the contraction of zonal imports in recent years. Another interesting conclusion is that the short-term reactivation of trade might be based on a relatively limited number of products for potential reciprocal trade, which would considerably ease possible negotiations between the two groups of countries.

At the same time, it is possible that the use of a number of non-traditional forms of trade, such as counter-trade and the like, might help to dynamize the recovery of the trade flows of the ALADI countries.

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## I

### The Latin American economic crisis and its effects on zonal trade

The share in world trade of the international trade of the countries of the Latin American Integration Association (ALADI) shows a persistent decline: from 5.7% of total world transactions in 1960 it had fallen to 4.5% in 1983. This historic trend can be explained by the greater relative dynamism of international trade in other regions of the world, such as the trade among the OECD countries or that of the Arab oil-producing countries, since the energy crisis which began in 1973.

Apart from its decreasing participation in world trade, it should be noted that from 1982 the zone has suffered a sharp contraction of global imports, which fell from US\$ 92.1 billion in 1981 to US\$ 52.6 billion in 1984 (over 40%). For their part, global exports, which in 1981 amounted to US\$ 85.6 billion, dropped in the two following years by 4.8% and 0.7% respectively, to rise again in 1984 to US\$ 87.7 billion.

Latin America's export effort has encountered two formidable obstacles: on the one hand, the traditional deterioration in the terms of trade, which penalizes primary commodities (80% of the exports of the region) and, on the other, the growing protectionism in the industrialized countries which restricts access to those markets which absorb close on 70% of Latin American exports.

Along with the aforesaid factors which have limited the exports of the zone since 1977, the external debt of the ALADI countries has acquired its own dynamic, which has little to do with the trade balance of these countries (see table 1). Between 1977 and 1982 the trade balance showed a deficit of US\$ 33.6 billion, while the debt during the same period increased by US\$ 204.1 billion. One reason for this phenomenon is factor services, especially interest payments, which during the same years amounted to US\$ 118.5 billion, equivalent to 58% of the increase in the debt. This suggests that the debt is mainly of financial origin and that consequently it is in this field that

Table I  
ALADI COUNTRIES: SOME ITEMS OF THE BALANCE OF PAYMENTS AND EXTERNAL DEBT  
(Millions of dollars at current prices)

Years	Merchandise balance	Trade balance (goods and services)	Factor services	Profits	Interest paid	Balance on current account	Disbursed external debt
1970	1 124	-160	-2 505	1 695	1 143	-2 671	
1971	211	1 116	-2 793	1 742	1 316	-3 924	
1972	339	-1 015	-2 734	1 498	1 628	-3 770	
1973	2 425	1 094	-3 793	2 325	2 304	-2 692	40 322
1974	721	-1 322	-4 705	2 639	3 506	-5 992	53 850
1975	-4 881	-7 842	-5 225	2 129	4 417	-13 010	62 439
1976	-826	-3 841	-6 429	2 026	5 600	-10 184	82 515
1977	411	-3 198	-7 729	2 699	6 584	-10 832	98 503
1978	-1 955	-6 943	-9 609	3 204	9 064	-16 556	141 991
1979	1 541	-4 877	-12 999	3 666	13 645	-17 879	166 644
1980	662	-7 897	-17 475	3 612	20 270	-25 267	209 542
1981	582	-10 117	-27 299	4 742	30 411	-37 218	262 989
1982	11 844	-594	-36 965	4 692	38 552	-37 820	302 672
1983	32 709	26 874	-33 420	2 776	34 441	-6 254	324 482
1984	40 375	36 409	-36 115	2 697	38 391	+693	337 862
1960-1969	14 965	6 813	-16 698	12 507	5 221	-10 382	
1970-1979	-891	-29 217	-58 526	23 622	49 207	-89 509	
1980-1981	1 199	-18 617	-44 765	8 376	50 661	-62 483	
1982-1983	42 799	28 184	-69 971	7 626	72 236	-41 842	

Source: ECLAC, on the basis of data supplied by the International Monetary Fund.

the solution to its servicing and inordinate growth should be found.

When the time came to repay the debts to the banks and governments of the industrialized countries, Latin America was faced with the hard fact that its export revenues were not sufficient to finance necessary imports together with the servicing of the external debt, and it was overtaken by the financial crisis of 1982. This made it necessary to apply processes of adjustment of the balance of payments and fiscal accounts which sought to obtain the balance-of-payments surplus needed to finance the inflated external debt.

The adjustment programmes led to drastic cutbacks in the imports of most of the countries of the zone and to a decline in domestic production. This reduction in imports was caused by the fall in the levels of overall demand and by the policy of increasing import prices through the application of such instruments as exchange devaluation, high tariffs and non-tariff restrictions.

The most disturbing aspect of the present

situation, however, is that, because of the sluggish recovery of the world economy, it is likely that this state of affairs will persist in the coming years and create a bottleneck for the economic growth of the ALADI countries. It is more than ever necessary today to have effective regional co-operation in order to overcome the external bottleneck, and the priority measure for achieving this goal is the recovery of intra-zonal trade, which has suffered a substantial decline.

In the period 1960-1983 this trade was more dynamic than the trade of the countries of the region with the rest of the world, since it registered an average annual growth rate of 15%. Taken as a whole, the countries' exports to the zone grew faster than their total sales to the exterior. At the same time, in all the countries except Brazil the average growth of their imports from the zone was higher than that of their total external purchases.

In the period 1960-1983 there were five countries with a surplus (Venezuela, Brazil,

Argentina, Mexico and Ecuador), five countries with a deficit (Paraguay, Chile, Uruguay, Colombia and Peru), and one country which just about achieved a balance throughout the period (Bolivia).

When the trade in oil is excluded, however, the picture as regards the trade balances undergoes a radical change. The oil-producing countries with a surplus (Venezuela, Mexico and Ecuador) show a deficit in their trade with the zone, while two of the deficit countries (Chile, Colombia) show a surplus or a balance, particularly in recent years. Brazil's trade surplus with ALADI increases, reaching US\$ 3.2 billion in 1981, which accounts for a high percentage of the total imbalance within ALADI in that year.

In conclusion, the country with the greatest surplus in intra-zonal trade is Brazil, followed by Argentina. The remaining countries show a clear deficit or a relative equilibrium in their trade.

The external crisis caused the collapse of zonal trade in 1982-1983. Intra-zonal exports fell from US\$ 11.1 billion in 1981 to barely US\$ 7.1 billion in 1983, which constitutes a fall of 36% (US\$ 4 billion). The recovery in intra-zonal trade to US\$ 8.1 billion estimated for 1984 represents a growth of 14% in relation to the depressed levels of 1983.

An analysis by countries shows that all, with the exception of Bolivia (thanks to its increased sales of petroleum gas to Argentina), reduced their exports to the zone. The greatest falls between 1981 and 1983 were recorded for Brazil (US\$ 2 151 million), Argentina (US\$ 715 million) and Venezuela (US\$ 716 million).

At the same time, all the countries except Colombia reduced their imports from the zone

between 1981 and 1983. The greatest falls applied to Mexico (US\$ 884 million), Chile (US\$ 705 million), Uruguay (US\$ 513 million), and Venezuela (US\$ 509 million).

The aim of reactivating zonal trade will probably run into the problem of trade imbalance which was so marked in the boom period. Hence it seems advisable that the measures for regional co-operation should be such as to help to generate relatively more balanced and stable intra-zonal trade than in the past. What is needed is not only the recovery of the former trade flows but the generation of new equilibrating flows from the countries at present in deficit. This gives an added importance to the new forms of trading such as counter-trade. If these mechanisms are properly managed for zonal trade they could contribute to the trade reactivation proposed as an objective of the Quito Declaration and Plan of Action.

It must be emphasized that the ideal of equilibrium in trade refers to the multilateral relations within the zone and not to bilateral flows or to the occasional imbalances which naturally occur in trading operations. Similarly, the products which are not subject to preferential import treatment, that is, those which are marketed at international prices, should not be strictly included in this concept of equilibrium, since they do not represent a greater cost for the importing countries.

The main maladjustment in the Latin American balance of payments occurs in the services account—particularly that of financial services—with the industrialized countries; it is with those nations that trade surpluses must be generated in order to compensate for the imbalance.

## II

### Potentials for trade recovery

The trade potential of the Latin America countries, and in particular of ALADI, is enormous. Very substantial possibilities of import substitution would be opened up merely through the diversion in favour of regional producers of the purchases made from third countries of prod-

ucts which Latin America exports to the rest of the world.

The potential is even greater, however, when one considers the amount of trade that could be generated by the reciprocal opening-up of the ALADI economies in the long term. This would

perhaps require large margins of preference in the different foreign trade instruments in respect of products coming from neighbouring countries, which would be a subject for long-term trade negotiations. For the present, the possibilities of the recovery of intra-zonal trade should preferably be defined in a short-term context.

From this angle the analysis should centre in the first place on the trade relationship between the three largest countries of the zone and the medium-sized and small countries. The trade between Argentina, Brazil and Mexico and the other eight countries represented the greater part of intra-zonal trade in the period 1981-1983, and the trade imbalance among the ALADI

countries is basically explained by the relationship of these three countries with the other members of the Association. The collapse of intra-zonal trade between 1981 and 1983 is also concentrated precisely in this relationship.

The foregoing does not imply a disregard for the remaining trade relationships within ALADI. What is postulated is that the nerve centre of intra-zonal trade is—and may become still more so—the relationship between the three largest countries and the remaining ALADI countries. The trade between Argentina, Brazil and Mexico has its own dynamic, and the remaining trade is basically that of the Andean group, which follows its own paths.

### III

## Analysis of intra-ALADI trade

The analysis of trade presented here was based on the information on products with established trade flows. It does not study the possibilities of new export products because of the obvious difficulties in their determination and appreciation and because the statistical sources give the data for external trade only.

For the analysis of trade possibilities, use was made of a sample of each country's export products to the zone which were simultaneously imported in considerable amounts from the rest of the world. The basic information was prepared by the ALADI Secretariat for each subheading of the Tariff Nomenclature. This information provides the potential demand for the export products of the zone and permits the calculation of the trade diversion which might be generated if this demand were partially met by zonal supply.

The analysis accepts that it would not be expedient to redirect exports being made to third countries, since these external sales are already obtaining foreign exchange. What is posited is an increase in exports to ALADI by making greater use of installed capacity.

The methodology of the analysis considers, for each product, the level of demand (imports

from the rest of the world), exports to the rest of the world and exports to ALADI.<sup>1</sup>

It is assumed, in the first place, that the relative importance of the exports to the rest of the world is a basic variable for measuring the export potential, since it offers an index of the capacity for competition of the country analysed. Thus, the analysis excludes products which are not exported to third countries but only to the ALADI market, since such sales can generally only be made when protected by a margin of preference or favoured by geographical proximity. Secondly, it is assumed that the increase in the production and supply of goods exportable to the ALADI market is a function of the situation as regards prices and costs of access to the zonal markets and of the level of output of the producing country's economy.

The ratio between the exportable supply and the conditions of access to the zonal market is expressed in the price-elasticity of the supply. An additional correction is introduced by applying the index of the level of output of the supplying economy.

<sup>1</sup>The method is described in ECLAC (1985a).

The formula used is:  $dx/x = e \cdot (dp/p) \cdot I$ , in which  $dx/x$  is the percentage change in exports,  $e$  is the price-elasticity of the supply,  $I$  is an index of production of the supplying country and  $dp/p$  is the relative price variation. This formula enables an estimate to be made of the level of potential exports ( $dx$ ). Clearly, these additional exports cannot be greater than ALADI's demand from the rest of the world, so that this restriction must be introduced into the method.

For the application of the model two levels of economic growth are assumed (3% and 5% annually), which define the extreme values for index  $I$ . Three different values (low, medium and high: 1.0, 1.5 and 2.0) are used for the elasticity of supply, depending on the relative levels of export of each product considered to the ALADI market and to the world, compared with total demand.

The levels adopted for price variations ( $dp/p$ ) are 10% and 20%; the first level is the lowest that will guarantee a reaction from zonal supply, while the second is presented in other studies as the probable maximum limit for the Regional Tariff Preferences of the Montevideo Treaty of 1980 (INTAL, 1982 and De María, 1982).

It must be stressed that the foregoing method does not constitute a system of statistical projections of intra-zonal trade. The trade level which is finally achieved will depend on many other variables not included, such as the extent of recovery of the Latin American economies, their degree of openness to zonal trade, the exchange, monetary and fiscal policies adopted and the level of growth and economic policies of the industrial centres.

Another factor which has been left out of consideration but which may play an important role in the trade linkages among the countries of the zone is the cost of transport of the goods and the traditional commercial links which may exist. The cost of transport may be decisive, since the distances between some of the member countries of ALADI are very great and access to the markets may therefore prove extremely difficult. Moreover, there have traditionally been commercial links between neighbouring countries or those with some geographical proximity.

The application of the aforesaid method to the case of the trade flows from the eight medium-sized and small countries to the market

of Argentina, Brazil and Mexico gives the following results. The growth potential of exports to the market of the three large countries is in the range of US\$ 350 to US\$ 650 million per year. In this potential Colombia and Chile are clearly pre-eminent, followed by Ecuador, Paraguay, Peru, Uruguay and Venezuela, with Bolivia having the lowest level of export potential. If these additional exports to Argentina, Brazil and Mexico were made within a balanced trade system, the total increase in zonal trade that might be expected would be between US\$ 700 and US\$ 1 300 million. This increased trade represents only a part of the fall which has taken place in trade between the two groups (US\$ 2.6 billion between 1981 and 1983).

Finally, a group of products for export from each of the medium-sized and small countries to the market of Argentina, Brazil and Mexico has been defined at a very disaggregated level (BTN subheadings). This group could be understood as a list of the comparative advantages of each country *vis-à-vis* the zone at the present time (table 2 contains a list of the main BTN sub-items with trading potential from each of the medium-sized and small countries to the three large countries).

In order to calculate the potential trade balance between the two groups and put forward options aimed at securing a relative equilibrium in intra-zonal trade, there remains to be analysed the export potential from Argentina, Brazil and Mexico to the markets of the medium-sized and small ALADI countries. In this case, it does not seem necessary to present a list of sub-items from Argentina, Brazil and Mexico, in view of the range of options of exportable supply from these countries.

The method of estimating the export potential from the three largest countries to the remaining ALADI countries is similar to that described in ECLAC (1985b), adjusted to take into account the aim of balanced potential trade between the two groups of countries. The adjustment consists in defining a list of products, of special interest to the medium-sized and small countries, to which preferential treatment would be granted only in respect of supplies coming from these countries. The exportable supply of these products from Argentina, Brazil and Mexico would be subject to the same treatment as that



Table 2  
LIST OF THE MAIN POTENTIAL EXPORT PRODUCTS FROM THE MEDIUM-SIZED AND SMALL  
COUNTRIES OF ALADI TO THE MARKET OF ARGENTINA, BRAZIL AND MEXICO

BTN Sub-item	Description	Imports of Argentina, Brazil and Mexico from the rest of the world	Exports to the rest of the world	Exports to ALADI	Total Exports	Minimum new exports	Maximum new exports
<i>Bolivia</i>							
230400	Oil-cake	16 190	54	3 437	3 451	797	1 755
260108	Tin ores	7 445	40 813	203	41 016	3 899	3 899
440502	Sawnwood	9 644	439	8 262	8 701	1 437	3 163
<i>Colombia</i>							
020101	Beef	16 615	3 917	41 469	45 386	7 211	15 878
252300	Hydraulic cement	16 112	24 338	9 980	34 318	1 157	2 547
270101	Coal	465 083	1 461	9 765	11 226	2 264	4 985
420200	Travel goods (suitcases)	5 645	11 914	9 723	21 637	1 127	2 482
610100	Men's outerwear	59 195	30 792	29 354	60 146	3 403	7 493
610200	Women's outerwear	61 526	14 219	13 720	27 939	3 181	7 004
610300	Men's underwear	25 442	3 277	4 408	7 685	1 022	2 250
610400	Women's underwear	7 139	2 148	9 226	11 374	1 070	2 355
710203	Other precious or semi-precious stones	12 542	40 185	35	40 220	3 987	3 987
840100	Steam generators	101 919	237	3 820	4 057	886	1 950
<i>Chile</i>							
030300	Shellfish and other crustaceans	3 083	38 608	250	38 858	3 083	3 083
070500	Dried pulses	106 967	5 426	10 808	16 234	2 506	5 518
080500	Fruit	12 460	2 034	9 673	11 707	1 682	3 704
220500	Wines	15 107	3 775	7 414	11 183	1 289	2 839
310500	Other fertilizers	36 458	5 474	12 240	17 714	2 128	4 687
440501	Sawnwood, coniferous	22 751	39 736	15 101	54 837	1 751	3 855
470105	Bleached wood pulp	5 666	65 292	45 557	110 849	5 281	5 666
480101	Newsprint	29 208	2 002	24 857	26 859	4 322	9 517
480105	Other paper and paperboard	88 947	532	8 219	8 751	1 906	4 196
710702	Gold and alloys	10 164	82 053	-	82 053	8 205	8 205
730700	Blooms and billets; iron or steel	57 096	8 083	23 588	31 671	4 102	9 031
740104	Refined copper	58 458	957 170	261 252	1 218 422	30 286	58 458
740300	Copper bars, shapes and wire	7 244	1 976	21 976	23 952	2 548	5 610

BTN Sub-item	Description	Imports of Argentina, Brazil and Mexico from the rest of the world	Exports to the rest of the world	Exports to ALADI	Total Exports	Minimum new exports	Maximum new exports
<i>Ecuador</i>							
030300	Shellfish and other crustaceans	3 083	10 600	485	11 085	623	623
160400	Canned fish	1 835	936	52 185	53 121	1 835	1 835
170400	Confectionery	1 353	16	2 806	2 822	488	1 074
270900	Crude petroleum	8 568 341	1 064 489	90 556	1 175 145	20 996	46 280
<i>Paraguay</i>							
120104	Soya	138 947	13 961	75 651	89 612	13 155	28 966
320100	Vegetable tanning extracts	1 912	20	4 952	4 972	861	1 896
440502	Other sawnwood	9 644	850	18 982	19 832	3 301	7 268
441302	Other planed wood	2 697	6	9 480	9 486	1 648	2 697
<i>Perú</i>							
160400	Canned fish	1 835	29 773	14 302	44 075	1 658	1 835
271004	Refined fuels	42 932	194 213	1	194 214	19 420	19 420
710500	Silver and its alloys	2 952	172 819	17 797	190 616	2 068	2 952
710702	Gold and its alloys	10 164	54 871	2 184	57 055	3 521	3 521
711200	Jewelry	1 941	19 369	32	19 401	1 908	1 908
740104	Refined copper	58 458	215 821	43 431	259 252	5 035	11 086
890102	Ships	255 591	2 937	4 359	7 296	1 011	2 225
<i>Uruguay</i>							
010200	Live cattle	43 036	1 306	7 184	8 490	1 666	3 668
020101	Beef	16 615	128 721	41 869	170 590	4 854	10 687
100601	Unprocessed rice	7 983	11 521	40 031	51 552	4 641	7 983
610100	Men's outerwear (woollen)	59 125	2 392	6 342	8 734	1 470	3 238
610200	Women's outerwear (woollen)	61 526	12 304	5 551	17 855	1 287	2 834
<i>Venezuela</i>							
281600	Liquefied ammonia	2 873	53 703	662	54 365	2 873	2 873
290102	Other hydrocarbons	170 787	10 860	18 629	29 489	4 319	9 510
310202	Other nitrogenous fertilizers	129 776	10 799	20 541	31 340	4 763	10 486
390100	Condensation chemical products	136 443	670	3 895	4 565	903	1 988
731516	Steel sheets and plates	27 959	3 301	4 177	7 478	968	2 132
760102	Unfinished aluminium	53 583	284 324	13 180	297 504	16 570	16 570

Source: ECLAC (1985a).

applied to third countries, or in any case to less favourable treatment than that given to the medium-sized and small countries.

The initial result obtained from the calculations is that the potential exports of Argentina to the medium-sized and small countries vary from a maximum of US\$ 450 million of new exports to a minimum of US\$ 250 million per year. The predominant export products are found in the agricultural and food sectors, the metalworking sector and capital goods. The potential exports of Brazil to the medium-sized and small countries are calculated as ranging from US\$ 1 150 million to US\$ 660 million. These levels alone are higher than all the potential exports estimated from the medium-sized and small countries to the combined market of Argentina, Brazil and Mexico. The predominant sector for Brazilian exports as regards the number of products and volume of trade is the metalworking sector and that of capital goods. Finally, the potential exports of Mexico to these countries reach a maximum of US\$ 170 million per year of new exports and a minimum of US\$ 110 million, the predominant sector being that of fuels and chemical products.

It is appreciated that the joint export potential of the three large countries to the medium-sized and small countries of ALADI far exceeds the export potential of the latter to the former, despite the fact that an adjustment was made in the method through the definition of a list of products of interest to the medium-sized and small countries which were not taken into account in calculating the exports of Argentina, Brazil and Mexico.

An evolution of trade such as that indicated is not viable in the present circumstances and a new concept of trade equilibrium and harmony will have to be considered in order to restore the dynamics of intra-zonal trade.

It should be noted that the disequilibria estimated do not refer to the global trade among the member countries, but to the potential new trade. The global trade may incorporate a structural disequilibrium with the zone caused by the non-coincidence of supplies and demands of the country and the region, but this will not be serious as long as there is a trading equilibrium with all the countries of the world as a whole.

To gain a more precise idea of the concept of

trade equilibrium and harmony it would be necessary to examine in which countries the estimated disequilibrium is concentrated, calculating the exports made by Argentina, Brazil and Mexico to Bolivia, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay and Venezuela separately, and thus deducing indirectly the imports which each smaller country would make from the three large countries. In this way it would be possible to define the trade balance of each medium-sized and small country with the three large countries taken together, and vice versa.

Trade equilibrium is not the only useful factor for assessing the relation of each country with ALADI. The concept of trade harmony also incorporates the criterion of the quality of the trade. A different weighting should be given to the export of a manufacture, compared with that of a primary product. At the same time it would be necessary to consider the direct and indirect effect on domestic production and the net contribution of an export to the balance of foreign exchange, deducting the content of imported inputs, which in some cases can be significant.

Through the application of the methodology of calculating the potential trade flows it can be seen that most of the medium-sized and small countries would register a negative trade balance with the three largest countries. The only exceptions are Uruguay and Paraguay, with a surplus, and Bolivia, with balanced trade. Venezuela shows a substantial deficit, corresponding to 75% of the total deficit between the two groups of countries. Other notable deficits are those of Colombia, Peru and Ecuador.

In conclusion, the system of import substitution and the implicit market allocation of the proposed model reveals a major imbalance on the side of Venezuelan trade and the disequilibria are more marked for the medium-sized countries which have greater economic and trade capacity for overcoming them.

The problem of the trade balance can also be analysed from the standpoint of the three largest countries, but in this case the mechanical application of the method of disaggregating exports by countries of destination would give an overestimation of the exports to Mexico from the medium-sized and small countries. As there is no tradition of exports to that country, it was necessary to include an additional adjustment in the

calculation method. The final estimate is that the three largest countries would have a surplus in their trade relations with the other eight ALADI countries.

All the foregoing shows the seriousness of the trade imbalance between the medium-sized and small countries on the one hand and Argentina, Brazil and Mexico on the other, along with the need to consider, in the course of the coming trade negotiations among the member countries of ALADI, differential treatment in order to achieve the balanced and harmonious development of intra-regional trade, at least in respect of the increases in trade. One solution might be the utilization of a system of limited commercial openness with maximum import quotas per product, in the medium-sized and small countries which consider it desirable. Another suggestion is to review Venezuela's exports to the three large countries. In this case it would be logical to consider a larger supply of oil to Brazil from Venezuela. Although this is a product in which trade preferences do not operate to any significant extent, the expansion of this zonal trade to replace extra-zonal supplies would be sufficient to balance the trade flows.

It might also be feasible to promote the practice of counterpart trade among regional enterprises and the adoption of global counter-trade agreements among the ALADI countries. It might even be possible to amplify this mechanism and consider non-compensated trade agreements in favour of the medium-sized and small countries in their trade with the three large countries, which would help to achieve intra-zonal trade equilibrium.

A category of trade in which the application of counter-trade might be negotiated is that of some public sector imports and of primary products available in the zone. Frequently these latter imports are made through State marketing enterprises and generally enjoy tariff exemptions and freedom from non-tariff restrictions. Many products which meet these conditions are already in the lists of the estimated potential exports. A future task would be the selection of these primary products in accordance with fixed criteria, the determination of the levels of State imports of these products, and the study of the price and financing conditions which apply to them at the present time.

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## A two-front attack to overcome the payments crisis of developing countries

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The developing countries' payment crisis has reached dramatic proportions, and cannot be overcome without large-scale action compassing the two variables that determine payments capacity: the capacity to possess or create liquid assets and the capacity to generate foreign exchange income, especially by means of external trade. The measures proposed in the present article relate to the establishment of an international currency based on primary products, which could be administered by the International Monetary Fund, and to the adoption by the developing countries of a more persuasive strategy in negotiations on access to markets. To implement the measures in question the developing countries would need to assume an active role, inasmuch as they would have to turn their own natural resources and import markets to account, manipulating them as bases for negotiations. The payments problems of the developing countries are too acute to be resolved through mere international co-operation commitments or through the adoption of world programmes, which by themselves will never improve the developing countries' bargaining power. This two-front attack would, however, improve the power of the developing countries to negotiate debt maturities and terms of payment and would also considerably lighten the burden of the adjustment programmes which the said countries are adopting.

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## Introduction

In 1981, the magnitude of total world debt was estimated to be equivalent to 1.4 times world GNP, exclusive of centrally-planned economies. Moreover, world GNP in nominal terms has been growing at an annual rate of 7%, whilst the annual average rate of interest has been above 10%. This economic growth, therefore, has not been enough to cover interest payments.

The situation is particularly grave for an increasing number of developing countries. The outstanding external debt of net-debtor developing countries was estimated to have exceeded US\$ 600 billion by the end of 1984, or 1.8 times their total export earnings during that year (UNCTAD, 1984, table 11). The liabilities of developing countries have been aggravated further by the considerable appreciation of the United States dollar over the past few years, as a large part of the external debt of these countries is denominated in dollars. And while a timid fall in borrowing rates has taken place lately, such rates remain above both the rate of export growth of developing countries and the expected rates of return of most development projects.

At the same time, net transfers of financial resources to developing countries have been declining. Net flows of banking funds to non-OPEC developing countries dropped from US\$ 31 billion in 1981 to US\$ 15 billion in 1982 and to only US\$ 2 billion in 1983; whilst interest payments made by these countries in 1983 amounted to US\$ 15 billion. Gross borrowing of non-oil-developing countries, exclusive of "managed" loans (i.e., loans extended in the context of debt rescheduling), amounted to only US\$ 9.7 billion in 1983 as compared to US\$ 21.9 billion in 1982. As a result, there was a net transfer from developing countries in their transactions with banks of about US\$ 7 billion in 1982 and US\$ 21 billion in 1983 (UNCTAD, 1984, paragraphs 113, 114 and 153). This pattern is likely to have persisted during 1984 inasmuch as overall foreign lending by banks reporting to the Bank for International Settlements slowed down considerably during the first half of 1984, and declined by US\$ 37 billion in the third quarter (*Wall Street Journal* and *Financial Times*, 19 February, 1985). Official flows too fell from US\$ 61.4 billion in 1980 to US\$ 48.1 billion in 1983 (UNCTAD, 1985 (a)).

Multilateral institutions providing financial assistance to developing countries have been experiencing growing difficulties in securing an adequate volume of resources. The IMF has not been able to proceed to a new allocation of Special Drawing Rights because of lack of agreement on the part of major financial powers. A number of industrial countries have shown reluctance to expand their contributions to multilateral agencies, as reflected in the recent failure to agree on an adequate replenishment of the International Development Association (IDA) and of the United Nations International Fund for Agricultural Development (IFAD), and in the refusal of some of these countries to join the Special Facility for Africa South of the Sahara which has been recently established by the World Bank (UNCTAD (b), TD/B/AC. 17/25/Add. 1A, paragraph A, 19).

As their borrowing capacity attains critical limits, a growing number of developing countries have had to submit their economies to adjustment programmes designed in accordance with the conditionality principle and the performance criteria of the International Monetary Fund (IMF). The adjustment programmes are intended to eliminate, or at least substantially reduce, balance-of-payments deficits, in particular by means of exchange rate depreciation and of austerity measures. The social and political cost of such programmes is very high, as they impinge heavily upon the living conditions of the population in the countries concerned. But implementation of these programmes by debtor countries has become a *sine qua non* requirement for the renegotiation of their debt and for securing further credits from lending banks and governments. On the other hand, the programmes do not provide for complementary action to be taken by developed countries with a view to reactivating sluggish demand for imports and arresting protectionist trends, which are major causes of developing countries' losses of export earnings. The burden of adjustment thereby falls upon the shoulders of debtor developing countries alone. Moreover, the adjustment programmes tend to exacerbate cyclical trends for two different reasons. First, the programmes are imposed at times when countries face severe balance-of-payments difficulties, and these normally arise during periods of sluggish world de-

mand. Secondly, they involve a reduction of the demand of debtor countries and, therefore, contribute to a further decline in the levels of total world demand.

Expectations have been nurtured on the prospects for economic recovery in major industrial countries and on the ensuing expansion of the exports of developing countries. The average rate of growth of industrial countries did indeed reach 4.75% in 1984, the highest level since 1976 and contrasting with 2.6% in 1983 (OECD, 1984). The volume of world trade increased by 9% in 1984, and the export earnings of developing countries by 7.5% (GATT/1371). But OECD forecasts point to a slower growth again in industrial countries in 1985; and the IMF predicts an annual growth rate of only 3% in the world economy as a whole for the rest of the decade, a forecast which may even turn out to be over-optimistic (OECD, 1984 and *Financial Times*, 17 April 1985). The menace of protectionism is thus likely to gain renewed strength. The tendency is towards continuing aggravation of the payments position of the developing world.

The payments capacity of any country is essentially determined by three variables, namely: the capacity to create liquid assets of international acceptability; the capacity to generate foreign exchange, notably through earnings from foreign trade; and the capacity to borrow in international markets, which is in turn a function of the first two variables. The gravity of the debt problem of the developing countries and the ensuing need for immediate financial relief have forced these countries to concentrate efforts upon the third, the dependent, variable. Developing countries thus have had to divert their attention from the two key and independent determinants of payments capacity. But action with regard to borrowing capacity alone can at best postpone for some time the showdown, the moment at which the two key issues will have to be seriously tackled. International concern will therefore have to be reoriented towards finding ways of enabling developing countries to participate effectively in the creation of international liquidity and of expanding their export earnings. This paper attempts to identify the major issues at stake as well as the possible elements of a meaningful, effective international line of action.

## I

## The two key determinants of the payments capacity

1. *Creation and distribution of international liquidity*

Throughout the whole postwar period, the volume of international liquidity has been determined by a handful of countries and in particular by the United States. No development has made any real difference to the concentration of the power to create international liquidity. The establishment of the markets for Eurocurrencies and petrodollars has not undermined this concentration; by controlling the conventional money supply, key-currency countries can control the world supply of their currencies (Lindert and Kindleberger, 1982). A new multinational asset has seen the light of day: the Special Drawing Rights (SDRs) issued by the International Monetary Fund. But the SDRs represent a trivial proportion of world liquid assets. They are merely a reserve asset, and have not thus far been utilized on a significant scale as a vehicle of non-official transactions. Even as a reserve asset, SDRs only represent 5% of total official reserves. Moreover, the level and the international distribution of SDRs are decided in accordance with the Fund's quota system and are therefore controlled by the same few traditional financial powers.

The concentration of world liquidity power is reflected to a certain extent in the inadequate growth of the volume of official reserves and in their uneven distribution amongst countries. Reserves have not grown at the same pace as international trade transactions. It is true that reserves are needed not so much to finance trade transactions as to finance deficits. The evolution of the reserve-import ratio, however, is normally used as a proxy for purposes of measuring the adequacy of the magnitude of liquid funds, inasmuch as deficits have actually expanded at least as fast as overall trade transactions. The ratio of world reserves to imports has decreased steadily from 85% in 1950 to less than 25% at the present time. World official reserves in 1953-1954 were equivalent to 37 weeks of imports, but they represented no more than 11 weeks of imports in

1982. Moreover, reserves have remained unevenly distributed. The share of industrial countries in world reserves in accounting values dropped from 77% in 1951 to 58% in 1982 (IMF, 1984). But the actual share of such countries is likely to have remained much the same as in the 1950s; industrial countries hold the bulk (around 90%) of official gold reserves, and the accounting value of such reserves is calculated in terms of prices which are far below prevailing world market quotations. If the value of gold reserves were estimated in terms of world market prices, it would then appear that industrial countries have probably kept their share in world reserves approximately constant even though other countries have meanwhile significantly increased the weight they carry in international transactions and/or are experiencing acute liquidity needs resulting from their heavy debt burden. The gap between reserve holders and reserve seekers is therefore likely to have expanded considerably.

The flow and magnitude of international liquidity is thus chiefly dependent upon the monetary and related policies of a few developed countries. The level of supply of the major vehicle currencies naturally responds to the national concerns of the reserve-currency countries rather than to the objective of meeting the world demand for international liquid assets. Discrepancies can, therefore, easily arise between the growth rates of supply of and demand for liquidity. What is questionable in this regard is not that reserve-currency countries formulate their monetary and trade policies according to their own national needs and priorities. Every country has or should have the sovereign right to establish its own policy objectives and to pursue them by applying policy measures of its own choice. The problem arises rather from the fact that the present international monetary system does not contain a built-in mechanism whereby the market for international liquid assets tends towards equilibrium.

During the early postwar period, the mechanisms of liquidity creation fulfilled their



function reasonably well, inasmuch as the United States was willing to maintain a balance-of-payments deficit and the world was in turn willing to absorb dollars as a means of enhancing war recovery and economic growth. Discrepancies in the liquidity market were thus attenuated by world trade flows. Subsequently, discrepancies between supply of and demand for international liquidity changed their sign: the supply of dollars continued to grow at a relatively fast pace as a result of persistent deficits in the United States balance of payments and of the proliferation of Eurodollar transactions. Countries were accumulating more dollars than they wanted. From the dollar shortage of the 1950s, the world economy moved in the late 1960s into what could be described as a dollar glut. The new situation led to the devaluation of the dollar in 1971 and to the establishment of the flexible exchange rate system in 1973. During the 1970s, two major events momentarily restored confidence in the international monetary mechanism and diluted concern over the possibility of persistent and dangerous gaps between supply and demand in respect of international liquid assets. These two events related to the ability of private banks to ensure the recycling of petrodollars and to the relatively stable operation of the new, flexible exchange-rate system.

The concentration of power and the uneven distribution of international liquidity has been accentuated considerably during the past fifteen years by the macroeconomic policies of key-currency countries as well as by the lending strategies of the major banks. During the 1970s, the policies in question involved in many cases inflationary expansion of domestic aggregate demand aimed at compensating for the deflationary effects of oil price increases. Petrodollar recycling through private banking also probably helped to accelerate inflation; the flow of petrodollars brought about a liberal lending policy on the part of private banks which manifested itself, *inter alia*, in relatively low interest rates and high gearing-ratios.

Because of their inflationary effects, the macroeconomic policies of key-currency countries during the 1970s and the recycling of petrodollars through private banks were tantamount to a re-transfer of real wealth away from developing countries, both oil- and non-oil-producing,

and towards the traditional financial powers. Oil-producing developing countries had thus extracted from the soil and surrendered a non-renewable resource in exchange for financial assets that were denominated in currencies depreciated by world inflation. The reserve assets of non-oil developing countries also depreciated for the same reasons. Some developing countries even engaged in sophisticated portfolio-diversification policies, and they did so under the expensive guidance of private firms of consultants from developed countries. Such eminent guidance, however, proved to be no hedge against the fall in the real value of their financial assets. Moreover, a large number of developing countries had to resort to international borrowing to maintain normal import levels in an inflationary world. As their terms of trade simultaneously deteriorated, these countries had to commit a larger amount of domestic resources to meet their import bills and service their growing foreign debt. The payments crisis and the ensuing demand for dollars in their turn reinforced the United States' privilege of running persistent balance-of-payments disequilibria, a privilege which had been under momentary strain during the time of the dollar glut.

The misadventures that developing countries have experienced in terms of depreciation of their financial wealth *via* world inflation are largely related to the fact that these countries gave up the custody of their wealth to the traditional financial centres and, therefore, had no control over policies which directly affected the real value of that wealth. The increases in oil prices had indeed caused a substantial transfer of income to oil-producing countries. But these countries did not acquire a corresponding say in the creation of international liquidity. Apart from some increase in their IMF quota and some involvement in international banking, no more was made at that time to develop mechanisms whereby oil-producing countries could take a share in decision-making with respect to the creation of international liquidity. Whether or not these countries could or should have envisaged the establishment of alternative mechanisms of liquidity creation is now a matter of hypothetical history. The fact is that the power to create international liquidity was not significantly altered by the emergence of oil power and, furthermore,

that the financial wealth of developing countries has been diminishing steadily and is even pursuing a negative trend.

The macroeconomic policies of the major industrial nations have been appreciably modified in response to the economic recession of the early 1980s. The new policy mix consists in general of i) budgetary policies aimed at attenuating the tax burden of domestic firms and households and/or coping with the effects of rising unemployment; and ii) tightening monetary policies designed to reduce inflation rates. The policies adopted have certainly varied among developed countries, notably as regards their scale and the moment at which they were adopted. But their nature has been, all in all, similar, and they have conducted to unusually high interest rates. The debt burden of developing countries has been aggravated as a result.

Of particular importance for the international liquidity market have been the implications of the new policy mix of the United States. The French economist Paul Fabra has asserted that Chairman Volcker of the Federal Reserve Bank has accomplished a revolution in the world monetary system by de-linking the United States money supply from a target level of the interest rate: a revolution which, in his view, has had profounder consequences than the abandonment of the fixed exchange rate system in 1973 (*Le Monde*, 16 February 1985).

Under the Federal Reserve Bank's new policy, the net capital outflow from the United States has considerably declined, while the foreign trade deficit has reached unprecedented levels. The main supplier of international liquidity is on the verge of becoming a net debtor. According to American Express, the United States' foreign debt (excluding direct foreign investment) will probably reach US\$ 400 billion by the end of 1985, or 126% of the country's export earnings (*The Economist*, 4 May 1985).

A few figures will make it possible to ascertain the magnitude of the phenomenon. The United States' balance on current account has moved from a surplus of US\$ 6 billion in 1981 to a deficit of US\$ 100 billion in 1984 (Karczmar, 1985). Foreign capital inflows finance one-half of United States government borrowing (*Financial Times*, 2 January 1985). Gross purchases of United States long-term securities by foreigners

increased from less than US\$ 50 billion in 1978 to US\$ 224 billion in 1983 and nearly US\$ 250 billion in 1984 (*The Economist*, 2 January 1985). From a net lending position of US\$ 45 billion in 1982, United States banks became net borrowers in 1983 with a net deficit of US\$ 24 billion (*Wall Street Journal*, 10 February 1985). At the same time, new United States investment and lending abroad dropped from US\$ 107.8 billion in 1982 to only US\$ 43.3 billion in 1983, and may have plunged to US\$ 1.8 billion in 1984 (*Wall Street Journal*, 25 February 1985). American banks have reportedly been borrowing from their foreign subsidiaries and lending the funds in the home market. In unprecedented fashion, an increasing budget deficit in the United States is accompanied by more and more net borrowing on the part of United States corporations: a US\$ 200 billion United States Government deficit plus a US\$ 40 billion deficit of corporations in 1984 (*Wall Street Journal*, 10 February 1985). In January 1985, United States borrowers raised US\$ 5.17 billion in the Euromarkets as compared to only US\$ 4.36 billion in the domestic market (*Financial Times*, 11 February 1985). All these figures mean that the amount of dollars available to the rest of the world is shrinking alarmingly, and this tendency imposes serious limitations upon the world's ability to pay dollar-denominated debt and to conduct international trade transactions smoothly.

The inadequate size of capital inflows into the world economy has thus far been compensated to a certain extent by the expansion of world trade resulting from economic recovery in the North during the past two years, particularly in the United States, Japan and Canada. The slower growth expected in industrial countries in 1985, however, will have adverse effects upon the volume of world trade due both to diminishing world demand and to stronger protectionist pressures. Decreasing trade growth will in turn further aggravate the present world liquidity crisis. But even if the decline in the flow of dollars to the rest of the world should come to a halt in the future, the payments difficulties of the developing countries are likely to remain at a critical level: such a halt would probably lead to interest rate increases as a means of recapturing the dollars needed to finance the United States budget deficit. And higher interest rates would entail a

heavier debt services burden for the net-debtor developing countries.

The time has therefore come to seriously consider alternatives to a monetary system based essentially on reserve currencies issued by national authorities in the light of their own concerns, needs and *Weltanschauung*. The mere fact that the traditional main supplier of international liquidity is becoming a net debtor is *per se* a sufficient reason for exploring alternative mechanisms. In addition, the weight of international trade in the world economy has doubled during the past three decades and economic relations are far more pluralistic today than they used to be at the time of the Bretton Woods conference: in the new circumstances, the supply of international liquidity can hardly continue to rely essentially on flows of a few key national currencies.

## 2. Foreign exchange earnings

It is difficult to conceive that a stable solution to the current payments crisis can be found without securing significant improvements in the gains derived by developing countries from international trade. The conditions which prevail at present in world trade relations do indeed set serious limits to the benefits that developing countries can derive therefrom. These conditions relate in particular to sluggish world demand, protectionism in developed countries, and adverse evolution of the terms of trade of developing countries. The countries in question have been actively pursuing the objective of improved treatment in international trade relations. Efforts in this respect have multiplied, particularly since the 1960s, when a major diplomatic offensive was launched by developing countries with a view to obtaining international recognition of the detrimental effects that prevailing trade relations had upon their development programmes and policies. The diplomatic

offensive brought about a number of positive results which include: the establishment of the United Nations Conference on Trade and Development (UNCTAD) as a permanent organ of the General Assembly; the incorporation of Part IV into the General Agreement on Tariffs and Trade (GATT), allowing Contracting Parties to grant non-reciprocal treatment to developing countries; the institution of the Generalized System of Preferences (GSP); and the negotiation of various international commodity agreements and of a Common Fund to finance commodity buffer stocks and related measures.

The above-mentioned results, however, have not been free from serious limitations. Notwithstanding the positive aspects of the GSP, the actual gains derived from the system have been very much reduced by the narrow product coverage of the national schemes of preferences as well as by a number of restrictive provisions concerning, in particular, safeguard measures, insufficient tariff cuts, and restrictive rules of origin. A large proportion of imports from developing countries thereby fall outside the GSP and hence do not benefit from it. The trade liberalization secured through GATT's multilateral trade negotiations has been more important for products of export interest to developed countries than for those exported by developing countries. Protectionist measures have been proliferating in many developed countries and they affect numerous products of export interest to developing countries. Industrial policies in developed countries are often designed in such a way as to perpetuate inefficient industries competing with imports from developing countries rather than to facilitate the smooth transfer of resources away from such industries. As regards commodity agreements, major difficulties have arisen even in the renegotiation of agreements already existing. The Common Fund for commodities has not started operations as the minimum number of ratifications has not yet been secured.

## II

## The present strategy of developing countries

The difficulties that developing countries are encountering in regard to their payments capacity appear to be largely related to the nature of the strategy followed by these countries in international economic negotiations. A major revision of the negotiation styles has become an urgent necessity if the payments crisis of developing countries is to be overcome. This section contains a discussion of the major limitations and shortcomings of the present strategy.

1. *Absence of major initiatives aimed at securing participation of developing countries in the creation of international liquidity*

Developing countries have systematically striven for a share in the world financial assets commensurate with their economic weight and development needs. Their efforts have certainly produced many positive results. As early as during the Bretton Woods negotiations, it was the lobbying conducted by a number of developing countries which succeeded in placing the objective of development finance for the Third World on the same level of the World Bank's priorities as that of the recovery of war-torn industrial nations (Ackeson, 1969).

It is also by the active diplomacy of developing countries that a number of facilities have been established in the International Monetary Fund with a view to increasing and smoothing the flow of financial resources available to developing countries.

All these endeavours, however, are intended to alleviate the severe financial constraints which developing countries face rather than to reduce the concentration among a few industrial countries of the power to create and distribute international liquidity. Some action has recently been taken within the framework of the IMF with a view to enlarging the share of developing countries in international liquid funds. This action relates essentially to more ample participation of some developing countries, notably oil producers, in the Fund's quota system, and to the emission of Special Drawing Rights. But these

measures have not significantly modified the concentration of the power to create international liquidity.

The lack of participation of developing countries in the creation and distribution of international liquidity is largely responsible for the acrimoniousness of the relations that many developing countries maintain with the IMF. The Fund's conditionality principle and performance criteria have been under sharp and increasing criticism by developing countries, as they involve severe austerity programmes which undermine the standard of living of large sectors of the population of the countries concerned. There is indeed great scope for improvement of the aforesaid principle and criteria. The question of whether the burden of adjustment should fall upon debtor or upon creditor countries, or on both, is among the long-standing controversies in international economics and has been raised on several occasions ever since the Bretton Woods negotiations. It ought to be admitted, however, that balance-of-payments adjustment inevitably has to form part of any effective action aimed at correcting persistent deficits and at securing viable economic growth. But the application of the Fund's conditionality principle is understandably repugnant to debtor developing countries which have no meaningful say in the creation of international liquidity, while at the same time, they see that the richest key-currency nations can maintain enormous trade deficits without having to undergo any international sanction. Conditionality principles would be more easily justified if debtor countries had a voice in decision-making with respect to the creation and distribution of international liquidity.

2. *Insufficient persuasive power of the present strategy*

The strategy followed by developing countries in international negotiations on monetary, financial and commercial issues has essentially consisted of pleas addressed to the international community in favour of action aimed at enhanc-

ing their trade gains and at increasing the flows of financial resources towards them. The claims made to the international community have been grounded essentially on the benefits that the community as a whole is to derive from more equitable, expanded and stable economic relations. It has further been argued that economic recovery in the West could be accelerated by increased demand from the Third World: an argument which calls both for bigger flows of financial resources and for better access to the developed markets.

The incitements thus offered to governments of developed countries, however, are not infrequently nullified by active counteracting pressures from groups and authorities in the developed countries themselves. These countries have their own priorities, their own conceptions and, most important, their own lobbies which in many cases exert pressures in favour of policies different from and even opposed to those requested by developing countries. The argument for a transfer of resources towards developing countries, for instance, is countered by local lobbies on the grounds that an alternative transfer within the domestic economy could lower the prevailing unemployment rates. Strong protectionist pressures emanate in turn from local groups which are afraid of being jeopardized by increased import competition. Governments of developed countries can hardly meet the claims made by developing countries unless they receive more effective incentives to do so than they have thus far been given.

The ability of any diplomatic strategy to achieve its objectives depends indeed upon its capacity to exercise bargaining leverage so as to mobilize national and international support. The power to create international liquidity has not been a gift received from heaven by any country. Such power has always been secured by the ability of reserve-currency countries to exercise the leverage given by their economic weight, to manipulate successfully their monetary, fiscal and commercial policies, and to persuade other countries of their capacity and readiness to honour monetary and financial commitments. Market access has in turn been secured principally by offering reciprocal concessions, or threatening removal of concessions, to other partners. Any trade liberalization is likely to be more significant

for products of interest to countries which provide concrete concessions than for products of interest to countries which request non-reciprocal treatment, however just the cause of the latter may be. Developed countries normally resort to reciprocal concessions, and this behaviour can be regarded as a major reason why trade liberalization in multilateral trade negotiations has concentrated on products of export interest to them.

### *3. Excessive expectations from bilateral dealings in debt negotiations*

Any viable international institutional framework inevitably has to assign a place to bilateral as well as to multilateral dealings. These two forms of negotiation are actually complementary rather than alternative means of securing mutually beneficial results. They are used in a complementary manner, for instance, in the field of market access: major negotiations are regularly carried out within the framework of GATT, which is a multilateral institution, and they are often complemented by bilateral dealings between individual countries.

But the negotiations on debt relief have not yet been placed in a similar broad framework. Creditor countries and institutions have invariably advocated a bilateral, case-by-case approach. Developing countries, in their turn, would appear to prefer, or at least accept, the bilateral form in the hope of thereby securing better and more liberal relief conditions than if they had to share concessions with other debtor countries. But by acquiescing in bilateral dealings, debtor developing countries may be overlooking the leverage that this type of negotiation gives to their creditor partners. Before agreeing on debt relief in favour of a particular debtor country, such creditors will no doubt bear in mind the concessions that they have granted or are to grant to other debtor countries, even if the latter are not present at the negotiating table. As a token example, the United States was reportedly reluctant to agree on a multi-year government rescheduling package for Yugoslavia's debt on the basis that major debtors from Latin America might seek to avail themselves of the precedent (*Financial Times*, 7 January 1985). Within a pure-

ly bilateral framework, therefore, creditors are in a particularly strong position, inasmuch as they can weigh and actually distribute concessions among debtor countries without having to face a co-ordinated stance on the latter's part. Certainly, some co-ordination among debtor developing countries is secured, notably by the Group of 24

in IMF and by agreements on common positions reached in regional organizations of the Third World. This co-ordination, however, consists in little more than the definition of guiding principles, and has not significantly altered either the bilateral nature or the outcome of international negotiations concerning debt relief.

### III

## The proposed two-front attack

The preceding section was intended to demonstrate the limitations and shortcomings of the strategy which developing countries at present utilize in international negotiations related to payments problems. A new and more forceful strategy appears to be necessary for securing adequate levels both of financial flows and of foreign exchange earnings for developing countries. The new strategy would need to recast the priorities of developing countries in international economic negotiations, and to re-orient attention towards the two key determinants of the payments capacity: the creation and allocation of international liquidity and the generation of foreign exchange earnings. To be effective, the strategy further ought to hold out enough inducements to persuade developed countries to share with developing countries the creation of international liquidity and to carry out adjustments in their own economies with a view to facilitating access to imports from developing countries of origin. To use the jargon of international politics, developing countries need to move from a debate to a game strategy. A debate strategy essentially aims at convincing the counterparts of the validity of one's own arguments, at obtaining consensus, and this is precisely the nature of the present strategy. A game strategy, on the other hand, would seek to secure favourable behaviour on the partners' side by providing them with appropriate incentives and disincentives in the context of a bargaining process (Frankel, 1973, and Rapoport, 1974). The capacity to provide such incentives and disincentives is generally called bargaining leverage, and is determined both by the means at one's

own disposal and by the ability to deploy and utilize them effectively during the negotiation process.

A game strategy for developing countries appears to be not only necessary but also feasible. These countries do have bargaining leverage which stems from the importance of their natural resources and of their import markets. The American Geological Institute, for instance, has drawn attention to the strong dependence of the United States upon foreign supplies of a number of metals and minerals,<sup>1</sup> some of which come from developing countries. Developing countries provide to countries members of the European Economic Community (EEC) a large proportion of the latter's imports of crucial raw materials: manganese (42%), copper (57%), phosphates (68%), tin (85%) and cobalt (92%) (*Europe*, 9 November 1977). Japan's dependence upon purchases of foreign raw materials is likewise a well-known fact. As regards the imports markets of developing countries, their significance has been increasing over time, and today they represent an appreciable proportion of the total exports of developed countries. Developing countries purchase almost one-half of United States exports of manufactures and two-fifths of total EEC exports. It has been assessed that debt-induced import cuts made by Latin American countries accounted for US\$ 15 billion of the deterioration in the United States trade balance over 1982-1983 (Brown, 1984).

<sup>1</sup>*Washington Post* Editorial reproduced in the *International Herald Tribune*, 22 September 1980.

Of course, the bargaining leverage given to developing countries by their supplies of raw materials and by their import markets is not unbounded. A fresh example of its limits is to be found in the misadventures that the Organization of Petroleum-Exporting Countries (OPEC) has been undergoing in attempting to preserve the real value of its foreign exchange earnings and of its financial wealth. It is true that the present difficulties of OPEC have probably arisen, not from any inherent insurmountable handicap, but rather from two corrigible features of OPEC's policy: i) the lack of counter-cyclical mechanisms to cope with the adverse effects of sluggish world demand (a matter which will be touched upon in the next section of this paper); and ii) a portfolio policy which actually gave up the control of the real value of OPEC's financial assets to private Western banks and to the Central Banks of the traditional reserve-currency countries. In any event, the aforementioned cards held by developing countries in the bargaining game could, if played effectively and tactfully, enable these countries to launch a major diplomatic attack on the two key determinants of the payments equation. The possible basic elements of the suggested diplomatic initiative are discussed below.

### *1. Establishment of an international commodity currency*

The present world monetary system was established at Bretton Woods in 1947 in accordance with the necessities and with the international balance of power prevailing in those times. The system, therefore, ought not to be regarded as an immutable framework. It has undergone major transformations as new concerns have arisen and as the balance of power has evolved. The abandonment of the fixed exchange rate régime in 1973 constitutes an outstanding example of the system's capacity to adapt itself to changing circumstances. It should indeed respond to a permanent quest for means of ensuring both monetary stability and adequate liquidity flows in an ever-changing world. The present payments crisis calls for a new major transformation, notably in respect of the mechanisms of creation and distribution of international liquidity.

Developing countries do have the need and the means to play an active role in the mechanisms of creation and distribution of international liquidity. They could in fact pledge and pool natural resources to create an international currency whose supply would be a function of the level of world demand for liquidity rather than, as is at present the case, contingent upon the policy priorities of reserve-currency countries and upon the IMF quota system. The commodity basket would comprise key raw materials and precious metals, and the number of such resources should be large enough to prevent any new concentration of monetary power in the hands of a few commodity-producing countries. The commodity currency could be issued against liabilities denominated in terms of the natural resources committed. The value of the currency could in turn be expressed in coefficients of the reserve resources. All countries, both developing and developed, would be entitled to participate in the supply of the new currency by committing resources which they possess or can acquire through world market operations. Preferential pricing policies and swapping arrangements could further be instituted between developing reserve-commodity producing countries and other developing countries so as to facilitate the latter's participation in the creation of international liquidity.

No currency could, of course, be imposed upon the international community. It has to be willingly accepted by major partners. To ensure universal acceptability, the new currency would have to be managed in line with rigorous criteria by an international authority of established reputation such as the IMF. Management by the IMF would not, however, imply that decisions concerning the level and distribution of supply would be taken in accordance with the quota system. Precedents exist in international institutions of sub-groups of member States which have set up commissions or facilities without having to surrender decision-making autonomy to the universal organs of the institutions concerned. Such precedents include the group of 16 developing countries set up under GATT, which is charged with instituting special tariff preferences among developing countries, and the IMF oil facilities, which were fed by a number of oil-producing countries of the Third World. De-

cisions concerning the supply and distribution of the international currency, therefore, would be free from the limitations relating to the IMF quota system and would rather depend directly upon the willingness of participating countries to commit their own resources so as to secure international liquid funds. This autonomy *vis-à-vis* the IMF quota system would in itself constitute a major advantage as compared to the mechanisms of creation of SDRs. On the other hand, the countries involved would not have to surrender their natural resources but would be committed only to honour their resource-denominated liabilities. Their sovereignty over their natural resources, therefore, would not be impaired. The preservation of the national sovereignty would constitute a major advantage as compared to a proposal, which has been aired for some time, to convert the foreign debt of developing countries into equity shares in natural resources and in State enterprises (*South*, February 1984, p. 71; and *Wall Street Journal*, 1 April 1985).

The idea of establishing an international commodity currency is not new. Its origins could be traced as far back as the late nineteenth century, when the British economist Stanley Jevons put it forward for the first time. Suggestions of a similar nature were subsequently made on various occasions (Goudrian, 1942; Graham, 1944; and United Nations, 1953).

A sound proposal in this regard was put forward in 1964 at the first session of the United Nations Conference on Trade and Development (UNCTAD) by three eminent economists: A. Hart, N. Kaldor and the Nobel Prize-winner Jan Tinbergen (1964). At that time, the proposal did not receive the attention it deserved because international concern was then oriented essentially towards trade issues and because the international monetary system had not yet been shaken by the onslaught of the events which have taken place since the late 1960s. Subsequently, with the abandonment of the gold exchange standard in 1971, attention was concentrated upon the workability of the floating exchange rate system, notably in terms of its capacity to secure monetary stability. In fact, the central concern of the international community regarding monetary matters during the 1970s was exchange-rate stability rather than adequate liquidity flows. However, with the growing risks of debt defaults

and of world financial collapse, proposals for an international commodity currency deserve fresh consideration by the world community as a whole.

It is not the purpose of this paper to endorse *in toto* the Hart-Kaldor-Tinbergen proposal. The conditions and problems of world monetary relations have changed dramatically since 1964. Kaldor himself made elaborations on the original proposal in articles written in the early 1970s (Kaldor, 1971, 1973 and 1974).

The concrete modalities and characteristics of an international currency would have to be worked out by well-prepared negotiations taking full account of prevailing circumstances, needs and interests. But a number of considerations could be made beforehand, and these are discussed below.

The establishment of the proposed currency should not be of an inflationary nature. The creation of an international currency must have a greater impact upon the distribution of liquidity than upon its magnitude. Inflationary effects would be produced if, and only if, the supply increase were to exceed the unmatched demand (Mundell, 1971). As mentioned before, the growth of reserve supply has substantially lagged behind the growth of international transactions. A recent study commissioned by the Institute for International Economics (Director, C. Fred Bergsten) calls for a new allocation of SDRs to meet present liquidity demand and argues that such an allocation would not have inflationary pressures as long as the growth of reserves were no greater than the corresponding demand (Williamson, 1984). Actually, the issuance of the proposed currency would be even more neutral, in terms of inflationary effects, than the emission of SDRs. The latter are created and distributed among countries according to the IMF quota system (irrespective of whether such countries have liquidity shortages), whilst the currency would be issued only in the measure of the liquidity needs of purchasing countries. An emission of SDRs aimed at meeting liquidity needs would therefore involve a greater increase in world liquid funds than the issuance of the proposed currency. Moreover, the fact that the international currency would be supported by the reserve commodities would in itself be a means of preserving the real value of the currency in a world where



fiat money tends to depreciate as a result of inflation. The currency could thus become a non-depreciating asset in which financial wealth could be placed and protected from inflation-induced erosion of its real value.

A commodity currency could further have beneficial counter-cyclical effects. At times of sluggish world demand, deficit countries would be inclined to purchase the commodity currency from the IMF against liabilities denominated in terms of reserve resources. Countries would thereby be securing a volume of international liquidity which their foreign trade was momentarily not providing. The commodity currency would accordingly enhance international purchasing power in times of recession. Conversely, these countries may be required to repurchase their resource-denominated liabilities as their export earnings re-establish their trend values. Export earnings would be higher during world economic booms, and the repurchase of resource-denominated liabilities would thus help to deflate the world economy, precisely at times when inflation may be needed or viable. The counter-cyclical effects of an international commodity currency have been admitted even by one of its critics, Milton Friedman (1951). And its counter-cyclical elements constitute a conspicuous merit if compared with the pro-cyclical effects of present adjustment programmes based upon conditionality clauses. The counter-cyclical potential of the commodity currency should not, however, foster a belief that the currency would constitute a disguised mechanism for the operation of commodity buffer stocks. The purpose of the currency would not be to stabilize commodity prices but rather to guarantee adequate liquidity flows.

The proposal of an international commodity currency deserves particular attention in the light of recent moves in favour of a rehabilitation of gold in world monetary affairs and of the creation of new currencies for developed countries. The return to a gold standard was ventilated by the United States Administration a few years ago and has been supported in particular by some "supply-side" economists. It has not yet been considered formally, but neither is it buried (Wanniski, 1984 and 1985; and Anderson, 1985). The gold standard, however, seems to be an inferior alternative to an international com-

modity currency for a variety of reasons, such as: concentration of liquidity power among a few producers or holders of gold; inelasticity of the gold supply; and difficulties inherent in the maintenance of gold parities by national Central Banks. Such disadvantages do not arise in the case of an international (as compared to a national) currency supported by a basket of commodities rather than by gold alone.

Two proposals have been put forward for the use of gold holdings in favour of developing countries. De Silva (1979) proposed the creation of a new currency unit which would be 100% supported by IMF gold holdings and would be aimed at promoting economic transactions within the Third World. Brodsky and Sampson (1980 a) and b)) have in their turn suggested that the differential between the market value and the under-rated official value of world gold reserves (largely held by developed countries) should be distributed to all countries in accordance with the IMF quota system: developing countries would receive a proportion of this differential value and their liquidity position would thereby be strengthened.

Whilst these two proposals reflect noble pro-Third World sentiments, past experience in international relations does not warrant envisaging that major holders of official gold would relinquish a significant portion of their financial wealth on the grounds of solidarity with poorer countries. As a matter of fact, a gold-backed "substitution account", aimed at channeling financial resources towards developing countries, was considered in IMF in 1980 but failed to see the light of day because of the reluctance of major financial powers to sponsor it. The solution of the payments crisis of developing countries cannot come from hopes of solidarity action by the North but rather from skilful bargaining by the South.

Other proposals have been recently put forward by Richard Cooper (1984) for the creation of a new currency for industrial countries, and by M. Jacques Delors, President of the European Commission for an expanded role of the European currency unit (ECU) as an official reserve currency among EEC countries (*Financial Times* and *Wall Street Journal*, 15 January 1985). The creation of a new currency for developed countries and/or a more important role for the ECU would improve the distribution of liquidity pow-

er among such countries, but it would be ineffectual as regards reducing the existing gap between those who create liquidity and the major debtor nations.

*2. A new strategy for the negotiation  
of market access*

The second part of the proposed diplomatic initiative relates to the negotiation of market access. Developing countries are in a position to resort to a more forceful strategy in this regard. They could manipulate their import markets and their supplies of natural resources so as to secure more liberal access to the markets of developed countries. The conditions of access to developing countries' markets and to natural resources could be laid down in such a way as to accord individual developed countries differential treatment depending upon whether, and to what extent, the latter's import markets were accessible to developing countries. Developing countries could resort to a differentiated imposition of import and export duties and quantitative restrictions on products of interest to developed countries. Imports from and exports to developed countries granting easy access would accordingly be subject to lower duties and/or larger quotas than those originating from or destined to more restrictive developed countries. Import and export duties could thus consist of two different components: i) one fixed MFN (most favoured nation) component, which would be applied, as is traditionally the case, irrespective of the origin of the imports or the destination of the exports affected; and ii) one variable component, imposed on individual developed countries according to how stringent their commercial policies were. The new strategy could further involve the use of counter-trade or package deals whereby sets of goods of export or import interest to developed countries would be bartered against sets of goods of export interest to developing countries. Developed countries would thereby feel encouraged to acquire large quantities of goods of export interest to developing countries so as to secure reciprocally natural resources from and sales to developing markets (Fiallo, 1978 and 1971; for a similar proposal, see Schafaeddin, 1984).

The suggested two-component system

would constitute a qualification of GATT's MFN principle. Despite its non-MFN element, however, the system can be implemented in conformity with GATT rules. Article XIX provides that, in the absence of adequate compensation, exporting countries affected by safeguard measures may be authorized to impose non-MFN restrictions against imports from the offending country. Non-MFN countervailing action may similarly be authorized in the light of Articles XXII and XXIII, particularly in the case of Contracting Parties affected as a result of measures taken by other parties (Jackson, 1969; and U.S. Executive Branch, 1973). Moreover, the numerical majority which developing countries hold within GATT unquestionably allows them to exercise the voting power provided for essentially by Article XXV. The voting power gives authority to the majority of Contracting Parties for an extremely wide range of action (Jackson, 1969, appendix to section 5.4). As regards export controls, these measures are not stipulated by the General Agreement as possible countervailing elements. An interpretation made in 1950 asserted that export restrictions are not to be resorted to for the purpose of obtaining the relaxation of another Contracting Party's import restriction (GATT, 1950). But such an interpretation does not form part of the Agreement. It can be reviewed in the light of present circumstances, notably in the context of the powers conferred by Article XXV. In any event, developing countries could hardly be prevented from resorting to export restrictions when they are forced to impose upon themselves voluntary export restraints or orderly marketing arrangements as a means of avoiding the further protectionist action that would otherwise be taken by their developed partners in GATT.

The proposed strategy could best be adopted through consultations among developing countries aimed at ensuring adequate policy co-ordination. Policy would need to be co-ordinated in such a way as to allow each developing country to determine and impose commercial policy measures, especially where variable components were involved, in accordance with its own concerns and priorities. Thus, the co-ordination exercise need not entail a high degree of harmonization of the commercial policies of developing countries. In fact, access to the markets

of individual developing countries is of interest to developed partners irrespective of how restricted the markets of other developing countries may be: countervailing measures may, therefore, diverge among developing countries; yet their effectiveness as instruments of persuasion will not be impaired thereby. In the case of controls on export supplies, harmonization would certainly be necessary so as to avoid self-defeating competitive bidding among developing countries. But such harmonization should not be expected to be as deep and sophisticated as that necessary for the successful operation of international producers' associations: the purpose of the strategy would not be the appreciation and/or stabilization of international prices (which indeed requires production and sale arrangements and homogeneous pricing by all producers) but simply a differentiated access to natural resources. Hence the use of resource diplomacy in the context of the proposed strategy is likely to be effective even in cases where concerted pricing has not proved successful.

The strategy could encourage in developed countries a policy environment of less readiness to yield to protectionist pressures from local groups. It would make governments of developed countries more inclined to formulate alternative policies such as those designed to facilitate the reallocation of factors of production away from inefficient industries facing import competition. The proposed strategy would further strengthen the bargaining weight of government branches and of private groups in developed countries which do not share the protectionist ideology and are instead interested in granting more liberal access to imports from developing countries. Such sectors include: monetary authorities which are aware of the inflationary effects of protectionist measures; anti-trust authorities and commissions on restrictive business practices, inasmuch as tariff barriers tend to reinforce unduly the dominant market position of local corporations; importers, retailers and consumers interested in low-cost supplies; and firms in developed countries which depend upon export sales to and/or commodity supplies from developing countries, and which could be affected by the countervailing measures that these latter countries might take. What is more, the proposed strategy may induce pro-

tectionist groups in developed countries to reconsider their positions and to search for alternative approaches to the solution of their problems. Likewise, the strategy would tend to provide the less protectionist States members of economic groupings of developed countries with the motivation necessary to defend their positions and to resist claims from other developed partners in favour of restrictions on imports from developing countries.

The aforementioned considerations should by no means be interpreted as suggesting that developing countries should attempt to exploit divergences of approach among governmental authorities or local private groups in developed countries. After all, authorities and groups within developed countries normally tend to have common national interests, and it is thus legitimate for them to adopt common stances, particularly in foreign trade issues. It is, however, equally legitimate for them to differ as to priorities and/or in opinions on how to meet and accommodate common concerns. The proposed strategy would accordingly be useful, not for exploiting conflicts or divergences, but for fostering within developed countries the understanding that it is in their national interest to facilitate access to imports from developing countries. Such a strategy would contribute to the mobilization in developed countries of non-protectionist forces in favour of imports from developing countries: forces which might otherwise either remain passive or tend to advocate market access in favour only of developed partners which do resort to game strategies.

The proposed strategy could lead to a move in favour of imports from accessible countries even if these do not represent the most efficient and/or cheapest suppliers. The system might, accordingly, give rise to some diversion of trade towards less efficient sources. But the net impact of such diversion should not necessarily be negative. Firstly, restrictions could be imposed mainly on the least essential imports, thereby avoiding trade diversion in cases where domestic economic development and/or social welfare could be significantly jeopardized. Secondly, the strategy is intended to stimulate improved market access for exports from developing countries. The alternative may, therefore, be a lower level of purchasing power and hence a smaller volume of

imports rather than a better, cost-efficient allocation of purchases. Thirdly, the strategy would entail an incentive to domestic production of the goods of which imports are restricted. Variable components can, in fact, be used as a means of providing protection to domestic industries without unnecessarily harming the interests of those developed partners which grant relatively easy access to exports from the developing country concerned. The burden of protection for the development of infant industries would thus be basically removed from the less restrictive developed partners. Finally, the system might constitute a meaningful instrument to promote trade among developing countries. In fact, intra-Third-World trade would be free from variable components and, therefore, imports from other developing countries would enjoy preferential access as against those originating in restrictive developed countries.

The level of foreign exchange earnings of developing countries is not determined only by conditions of access to the markets of developed countries. Other factors also play a crucial role, and these include: the terms of trade and their evolution; the limitations of foreign exchange earnings which arise from monopolistic practices of transnational corporations, such as transfer pricing and territorial market allocations; the

terms and conditions of the transfer of technology to developing countries; the participation of these countries in world shipping; and the promotion of economic co-operation among developing countries. The emphasis placed in this paper upon the need for a new negotiation strategy in the field of market access should by no means be construed as reflecting an underestimation of the importance of the other determinants of the level of foreign exchange earnings. The emphasis is due rather to the fact that the strategy currently used by developing countries in the negotiation of market access has not been subject to any major revision since the 1960s, when developing countries succeeded in securing international support conducive to the incorporation of Part IV into the General Agreement and to the establishment of the General System of Preferences. The present circumstances, in particular protectionism and sluggish world demand, are substantially different from those prevailing in the 1960s, and the revision of the strategy has become an imperative and urgent need. Moreover, liberal market access is in consonance with the free market philosophy that major developed countries invoke and, therefore, negotiations in this field are likely to have particularly good chances of success provided that they are carried out with an effectively persuasive strategy.

## IV

### Negotiation of debt payments and implementation of adjustment programmes

#### *1. Negotiation of debt payments*

The establishment of an international commodity currency and the adoption of a more persuasive strategy in the field of market access would strengthen the leverage of debtor developing countries in the renegotiation of their debt payments. Of relevance in this context is the possible establishment of a debtors' club, an idea which has been attracting some attention. The

club would seem to be intended to strengthen the position of debtor developing countries in their effort to obtain from lenders better terms and conditions of payment. The club's power would lie in the possibility of resorting to the threat of a joint repudiation of its members' foreign debt. Action along such lines, however, would not be exempt from adverse boomerang effects. A joint debt repudiation would no doubt shake the bases of the world financial system. But, at the same

time, the doors of the international capital markets would be shut for the debt-repudiating countries.

A debtors' club would, however, become a viable project in the context of the proposed two-front attack. In this case, the card that the club could play in the bargaining game would relate not to debt repudiation but rather to making debt payments conditional on the creditors' acceptance of the international currency as well as on liberal access to the creditors' import markets. Agreements could be reached between debtors and creditors whereby: i) a proportion of the foreign debt would be paid in the international commodity currency; and ii) the size of debt payments would be made dependent upon the level of the debtors' exports to the creditor countries. The IMF's conditionality upon adjustment policies would thus be matched by a debtors' conditionality upon currency acceptance and upon market access. Negotiations on these matters could best be conducted in a multilateral framework and would be complementary to the traditional bilateral dealings of debtor countries with their respective partners.

It would be difficult to conceive of major countries refusing to accept payments in an international currency managed by such an orthodox institution as the IMF. Lenders could even

become active supporters of the new currency inasmuch as its establishment would facilitate the reimbursement of their loans. As regards the linking of debt payments with the level of the debtor's exports, this type of trade-off has already been used by a few pioneers among the debtor developing countries, and would become more effective if resorted to jointly by a group of such countries.

### 2. *Implementation of adjustment programmes*

The adoption of the two-front initiative would considerably enhance the ability of debtor developing countries to effect their debt payments without having to submit their domestic economies to unduly over-deflationary policies. An increase in foreign exchange earnings as a result of better market access would narrow the balance-of-payments deficit and, therefore, would reduce the magnitude of the adjustment which the national economy required. As regards liquidity, it is certainly a separate and different dimension, and does not constitute an alternative to adjustment.<sup>2</sup> But an increase in liquidity could complement adjustment programmes and could thus alleviate the burden of the austerity which such programmes normally embody.

## V

### Conclusion

The payments crisis of the developing countries has attained dramatic proportions and cannot be overcome without major action upon the two key determinants of payments capacity, namely, the capacity to hold or create liquid assets and the capacity to generate foreign exchange, notably through earnings from external trade. The action proposed in this paper relates to the establishment of an international commodity currency which could be managed by the IMF, and to the adoption by developing countries of a more persuasive strategy in market access negotiations. The proposed action would require developing countries to play an active role, notably

by committing their own natural resources and import markets and by manipulating them as negotiating cards. The payments problems of the developing countries are indeed too acute to be resolved by mere pledges of international co-operation or by the adoption of global agendas which will not *per se* improve the bargaining leverage of developing countries. The two-front initiative would further strengthen the leverage of developing countries in the negotiation of the terms and conditions of debt repayment and

<sup>2</sup>The difference between liquidity and adjustment is explained in detail by Mundell (1971).

would serve to alleviate considerably the burden of the adjustment programmes which developing countries need to implement.

The proposed action would constitute a breakthrough in international economic relations and would represent a major departure from prevailing conventional wisdom. Wisdom today indeed avers that developing countries do not have the resources and the power to participate actively in international bargaining, and that their role should thus be limited essentially to attempting to convince other partners by means of debate exercises. A story of the blinding effects of conventional wisdom appears to be useful in this context. It relates to the rational expectations theory, which, to put it roughly, asserts *inter alia* that an individual can hardly take advantage by himself of his own expectations on

the future (unless he holds relevant information which is not available to others): if his expectations were wrong, he would obviously be a loser; if they were correct, others would have already thought on the same lines and acted accordingly, and, therefore, both the present and the future would already have been modified. According to the story, a professor of rational expectations theory was walking along the university campus with one of his students. The latter saw a US\$ 20 bill on the floor and drew the attention of his professor, who replied without even looking at the floor: "It can't be. If there were such a bill, someone would have already picked it up". The bill for the solution of the payments crisis of the developing countries is on the floor too. It is waiting to be picked up and put on the negotiating table.

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# The imperfections of the capital market

*Eduardo Sarmiento P.\**

The classical theory of capital is based on an ideal functioning of markets and assumes that economies have a great capacity for adjustment, goods being easily substitutable, supplies relatively elastic, prices flexible and markets composed of a large number of individuals. Nevertheless, most underdeveloped economies exhibit traits far removed from such assumptions. Are these traits important enough to modify the results of the classical model and explain the imperfections of the capital market? The author answers this question on the basis of a number of central concepts and the experience of the Colombian economy.

The article consists of four parts. Part I identifies some outstanding elements which have not been explicitly incorporated into the analysis of the capital market. A detailed analysis is given of the complementarity between credit and the demand for goods, the supply of physical goods, the monopoly power of agents and the predominance of adaptive expectations. As these phenomena are irregular, their repercussions on the capital market cannot be analysed with traditional techniques. A large part of the section is devoted to an outline of a number of concepts and tools for dealing with this type of problem.

In part II the effects of the liberalization of the capital markets are examined, while part III discusses how far the information given in part II corroborates the assumptions of the capital market behaviour presented in part I. In addition, these elements are analysed simultaneously in order to synthesize the causes of the imperfections in the capital market and their relation to financial liberalization.

The final part outlines the features of the financial reforms required to achieve the reconciliation of efficiency with stability.

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## I

### Basic concepts

#### 1. Credit and durable goods

Some empirical studies suggest that the effects of credit vary with the characteristics of the goods. The evidence is particularly clear in the case of durable and non-durable goods, and agrees with the theory that distinguishes between flows and stocks. In general, it is recognized that flows are related to income and stocks to wealth and that each depends in the short run on different elements. The fluctuations of credit initially affect stocks and wealth and only later have an influence on durable goods. The processes associated with the two types of goods may fluctuate in the short term, interfering with the adjustment process.

These concepts can be illustrated by the identity:  $W + C = P_K + P_D + F$ . In which  $W$  = wealth,  $C$  = credit,  $K$  = capital goods,  $D$  = durable goods,  $P_K$  and  $P_D$  = the prices of capital goods and of durable consumer goods and  $F$  = financial assets.

According to this identity the sum of wealth and credit is equal to the total of physical and financial assets. If credit increases and production does not vary, the prices of durable investment and consumer goods will rise<sup>1</sup>. The funds, after passing through the sellers of the goods, would return to the financial market in the form of financial assets, or would be employed to acquire physical assets. The effective wealth of the economy would be greater than the desired wealth. Equality would only be reached through a rise in the level of prices or a reduction of credit. This relationship also holds in the opposite direction. The rise in the prices of assets can only be made effective when the desired wealth is augmented or the credit expanded. Thus the demand for credit increases in the same direction as the prices of the assets.

<sup>1</sup>The final impact of credit depends on the conditions of supply, which are not easily generalized. The adjustment process described in this section applies mainly to durable goods with an inelastic supply, such as assets which require a long production period: housing and investments subject to large indivisibilities such as those pertaining to large enterprises.



The expansion of credit, therefore, generates a rise in the prices of physical assets and then an expansion of financial assets. Both factors, taken together, determine an increase in the effective wealth of the economy in relation to the desired wealth. Individuals would respond to this situation by replacing physical assets by non-durable consumer goods, which would result in a rise in the general level of prices. The new equilibrium would be attained at the point where relative prices returned to their initial level.

This adjustment does not occur when the prices of non-durable goods are subject to controls, or are determined by external prices in an open economy. The correction of the imbalance would occur only if the prices of assets fell to their previous initial level and met the resistance of the owners. These would try to retain their holdings and would press for the maintenance of the initial increase in credit. Hence a widespread tendency to avoid the liquidation of assets at a lower price might be manifested in a high demand for credit, which would prevent a fall in interest rates.

It is usually assumed that the prices of assets are determined in a system in which all supplies and demands are satisfied. But in the real world economic agents have no data to let them know when a situation of this kind is reached. Thus in capital markets, which are exposed to serious imperfections, the prices obtained do not always reflect what is happening with actual transactions. In these markets it is common to find prices incorrectly set above market clearing levels, thus leading to lower sales. Such a possibility is quite possible if expectations are adaptive, where individuals fix their prices in accordance with past rather than current experience, so that prices remain higher than those which satisfy the wealth equation. It would be a typical situation in which the wealth obtained by individuals would be greater than the effective wealth. The attempt of individuals to maintain these prices would create a demand for credit higher than that which provoked the initial slack. Interest rates would be determined, therefore, by the structure of expectations of unreal prices which could place them at any level.

It is clear that physical assets and credit are closely interrelated; that is, they are complementary goods. Although this fact is not

openly rejected, it is not always recognized in practice. The influence of the neoclassical theory has led to the belief that all goods are substitutable. In these conditions the fluctuations of a market, although they may affect other markets, do not change its basic features. Formulations in which supply, demand and the interest rate of the financial market are independent of the rest of the economic system may be justified at times, but this simplification is mistaken when the goods are complementary. In this case the alteration of a market can destabilize other markets which operate satisfactorily by themselves. Thus, in the adjustment described, it is clear that credit affects the processes of assets and these affect the interest rates. This linkage between the credit market and the market for physical assets plays a central role in the interpretation of real phenomena. Further on it will be shown that many events that take place in the credit market originate in the market for physical assets, and vice-versa.

## 2. *Liquidity and indivisibility*

The possibility of acquiring a good and then selling it at another price is limited by the resources necessary to effect the transfer. Hence liquidity appears as one of the main requisites for carrying out any speculative operation and is clearly related to the characteristics of the goods. If these were perfectly divisible, speculative options would be scarce. Everyone could take part in them in accordance with their possibilities, as happens in the market of goods and services. The expected value of the speculative gains would correspond in the long run to the normal profitability of capital. Naturally, the greater the indivisibility of the goods, the smaller the number of individuals who can operate in these markets. The assumption of competition among speculators thus becomes invalid. Speculation in large-scale goods markets confers obvious monopoly powers on those who have access to liquidity. This is confirmed by the behaviour of economic groups in the transactions of large enterprises. Their technique consists in precipitating price movements to obtain enormous gains in buying and selling operations.

The Keynesian concept of speculation is

based on the maintenance of liquid resources by individuals in the expectation of opportunities which will give them a profit in the buying and selling of products. Large-scale indivisibilities modify this idea in the sense that liquidity is not only required to take advantage of the buying and selling opportunity, which is in a way fortuitous, but also to acquire a good to which others have no access. The gain does not derive so much from taking advantage of an immediate operation but rather from the administration of the activity by those who have the liquidity. The advantage comes from the profit resulting from obtaining existing enterprises at low cost.

Here it is important to distinguish between ownership without control and ownership with control: the former relates to small shareholders and the latter to the economic agents who administer and direct the enterprises. While the attitude of the former is influenced by short-term elements, that of the latter is determined by the possibilities of the enterprises and the effects on other activities. In this context, there is no validity in the hypothesis that large enterprises become divisible in the stock markets. Ownership with control is indivisible in the sense that the power to influence the decisions of enterprises is only attained with a certain minimum participation in the ownership of the assets.

In the standard formulations of economic theory it is generally assumed that the holding of goods and liquidity are substitutable. Individuals can increase their possession and consumption of goods to the extent that they sacrifice liquidity. The foregoing propositions constitute an argument against this hypothesis. Some goods tend to be complementary to liquidity and the ratio becomes narrower in proportion to their indivisibility. Their demand tends to be restricted by elements of a quantitative nature. Liquidity, therefore, introduces a constraint in the functioning of economies which prevents individuals from achieving their desired ends.

In economic theory it is generally assumed that the distortions that obstruct the automatic adjustment of markets occur in isolation and in very small amounts. However, this interpretation cannot easily be extended to the case of liquidity, which affects a wide variety of economic agents and of goods. The limitation imposed by the size of the goods results in a demand much smaller

than the economic agents' desire: a factor which has serious repercussions on the whole economic system.

Experience shows that the development of large enterprises takes a number of years. Their supply is inelastic in the medium term. Hence greater demand to acquire them is manifest at the outset in a rise in prices. As this effect is of short duration, the volume of these enterprises remains unchanged. The adjustment will be made mainly through the channel of quantities. The higher relative price of these assets creates an increase in wealth, which stimulates an expansion of expenditure and a rise in the general level of prices. Thus the initial rise in the prices of assets and the expansion of the nominal amount of money neutralize each other. The relative prices and the real quantity of money tend to return to the initial situation. Hence an obvious vicious circle is formed. Production does not expand because the rise in prices is temporary, and this rise is temporary because production does not expand.

### *3. Substitution between financial and physical assets and the stock market*

Substitution between physical and financial assets has been the subject of a long debate (McKinnon, 1973; Levhari and Patink, 1968). Sarmiento (1984a, chapter vi) shows that it does not happen in global terms. The shift of wealth into financial assets results from an expansion of credit which enables the same volume of physical assets to be maintained with a smaller number of owners. The relation is of interest when it occurs between financial assets and entrepreneurial capital and depends on the method of channelling the credit generated in the expansion of financial resources. If this is used to finance the purchase of durable goods or to maintaining speculative balances, the two assets will appear as substitutes.

These concepts acquire more theoretical significance and more practical utility when they refer to specific economic agents. Thus the substitution between financial assets and entrepreneurial capital is very different for ordinary shareholders and for those who control the en-

terprises. It can be presumed that the former are willing to sell their shares for financial assets if they will thereby obtain more profit. In contrast, the profitability of the controlling shareholders is determined by the long-term prospects of the enterprises, which cannot readily be replaced by momentary financial returns. Besides, we have seen that the exercise of entrepreneurial control is contingent on liquidity. The buyer of an enterprise should be in a position not only to make a transfer of wealth, but also to maintain credit to cover the greater part of the assets. Consequently, the physical assets of the ordinary shareholders are highly substitutable with financial assets, whereas those of the controlling shareholders are relatively complementary.

The link between the financial market and the stock market is clearly seen in this context. Let us suppose that the interest rate of financial securities rises through the application of administrative or market mechanisms. The ordinary shareholders would shift towards the financial assets and the expansion of these would be reflected in an expansion of credit. There is no mechanism, however, to guarantee the channelling of these credit resources into the enterprises which have suffered a reduction in their ordinary shareholders. It all depends on the behaviour of capital markets. If the enterprises manage to attract the credit generated by the shift of their ordinary shareholders, a situation would arise in which the liabilities would be represented in a greater proportion by credit and in a lesser proportion by paid-up capital. In general terms, there would be an expansion of bonds and credit, a reduction in the number of shareholders in the enterprises and a strengthening of the economic power of the controlling shareholders.

The different motivations of the ordinary shareholders and the controlling shareholders have had a decisive influence on the conduct of the stock market and the financial market. Many of the defects observed in recent years originated in a failure to grasp this fact. The hypothesis that the two types of shareholders behave in the same way led to the assumption that the expansion of financial saving derived from a net increase in saving and that the weakening of the stock market was neutral as regards investment and economic power. These attitudes had a decisive influence on the passive position of the gov-

ernments in face of the strange phenomena taking place in the financial sector.

The evolution of the stock exchange in the last 25 years in Colombia provides valuable information on these behaviour patterns and empirical proof of some of the hypotheses. The figures are based on a survey of 30 enterprises carried out by the Comisión de Valores and published in a study by J.C. Restrepo and others (1983). The basic findings of the survey are summarized in tables 1 and 2.

In the appendix an approximate expression of the profitability of shares is worked out. If this profitability is equal to the interest rate of a financial security with the same risk, the financial market and the stock market will be related in conditions of equilibrium by the following equation:

$$r = \frac{D}{Pa} + \frac{D^*}{D} - \frac{P^*}{P}$$

where  $D$  = dividend,  $Pa$  = price of the share,  $P$  = level of prices,  $\frac{P^*}{P}$  = rate of variation of the level of prices,  $\frac{D^*}{D}$  = rate of exchange of the dividends and  $r$  = real interest rate.

The information on dividends and inflation given in table 2 was introduced into this equation to estimate the equivalent interest rate of the shares. The results of this exercise are summarized in table 3.

Tables 1 and 2 show respectively that the levels of participation of the paid-up capital of enterprises and the price of shares have been declining in the last twenty years. The trend has not been very even, however. The prices fall in some periods and rise less markedly in others. Similarly, it will be seen that the behaviour pattern differs in the two decades.

In the 1960s two periods can be distinguished. In the first (1960-1966) share prices went down, whereas in the second (1967-1970) they went up in real terms. In the last period the returns were higher and in most years grew at a higher rate than inflation. Thus the expected profitability was 4% in the period 1960-1966 and 11% in the period 1967-1970. The close relationship between real prices and returns shows that the stock market is highly sensitive to short-term returns. Undoubtedly this was influenced

Table 1  
COLOMBIA: FINANCIAL STRUCTURE OF JOINT-STOCK COMPANIES, 1960-1981  
(Percentages)

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
<b>I. Assets</b>																						
Cash in hand	4.0	4.0	5.0	4.0	4.0	4.0	3.0	3.0	3.0	3.0	2.4	2.5	2.6	3.1	2.9	3.1	3.2	3.4	3.9	3.2	2.9	3.3
Debtors:																						
Short term	20.0	20.0	21.0	23.0	24.0	25.0	26.0	24.0	24.0	25.0	23.7	23.7	24.3	25.3	23.8	25.1	26.8	28.3	26.3	27.5	29.5	27.6
Long term				1.0	1.0	1.0	2.0	2.0	2.0	3.0	3.1	2.7	2.9	3.1	3.4	4.4	4.3	3.9	4.3	5.7	4.0	3.1
Stock	31.0	20.0	27.0	26.0	26.0	25.0	28.0	26.0	24.0	27.0	26.4	27.2	26.1	25.5	30.3	30.2	30.9	30.5	30.1	29.7	30.0	24.1
Installations and equipment	31.0	32.0	33.0	31.0	29.0	28.0	26.0	23.0	23.0	23.0	21.9	21.6	21.9	21.2	19.2	19.6	18.8	17.4	15.9	15.1	20.8	29.8
Others	14.0	15.0	14.0	15.0	16.0	17.0	15.0	17.0	19.0	14.0	22.5	22.3	22.6	21.8	20.4	17.5	16.0	16.5	19.5	18.8	11.8	12.1
	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
<b>II. Liabilities</b>																						
Creditors:																						
Short term	31.0	32.0	35.0	26.0	28.0	25.0	29.0	26.0	26.0	27.0	26.5	27.4	28.1	30.9	34.8	34.1	34.6	38.3	37.3	40.3	44.3	41.0
Long term				8.0	10.0	13.0	12.0	14.0	14.0	15.0	10.1	12.2	14.3	13.6	13.0	16.0	15.0	12.3	14.1	14.8	16.7	22.2
Other liabilities	6.0	5.0	5.0	6.0	5.0	5.0	4.0	4.0	4.0	4.0	7.8	7.8	7.4	9.2	9.7	10.4	12.5	11.0	9.6	10.0	8.6	8.5
Total	37.0	37.0	40.0	40.0	43.0	43.0	45.0	44.0	44.0	46.0	43.9	47.4	49.8	53.7	57.0	60.5	62.1	61.6	61.0	65.1	69.6	71.7
Paid-up capital	31.0	31.0	30.0	28.0	27.0	26.0	24.0	23.0	22.0	21.0	16.1	14.4	12.8	11.2	9.5	8.8	7.8	6.6	5.4	4.8	7.1	9.0
Profits	6.0	5.0	6.0	6.0	5.0	4.0	5.0	4.0	3.0	5.0	6.6	6.0	6.1	6.3	6.8	5.4	6.3	6.5	7.8	6.1	5.3	3.9
Surplus	26.0	27.0	24.0	26.0	25.0	27.0	26.0	29.0	31.0	28.0	33.4	32.2	31.3	23.8	26.7	25.3	23.8	25.3	25.8	24.0	18.0	15.4
	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100

Source: ABC (1973); Pieschacón (1982). Calculations of the Comisión Nacional de Valores (National Securities Commission). Market Development Division.

Table 2  
COLOMBIA: DIVIDENDS,  
PRICES AND EXPECTED PROFITABILITY  
OF INDUSTRIAL SHARES, 1960 TO 1982  
(Percentages)

Year	Dividends	Prices	Expected profitability
1960		178.0	
1961	14.5	163.0	
1962	12.0	160.5	-2.3
1963	11.7	131.7	-8.3
1964	112.5	125.8	11.1
1965	13.4	106.4	-0.6
1966	15.2	83.6	20.6
1967	15.2	83.3	20.7
1968	13.8	89.4	11.0
1969	10.9	97.8	3.1
1970	10.0	100.0	9.7
1971	14.7	75.5	14.3
1972	16.4	55.5	11.1
1973	17.1	46.1	3.0
1974	14.2	33.4	10.4
1975	22.0	23.6	8.5
1976	18.7	23.6	8.6
1977	17.8	26.4	19.9
1978	10.8	33.3	3.9
1979	9.6	33.9	9.9
1980	15.1	23.6	6.0
1981	16.0	23.0	-37.5
1982		22.8	

Source: Restrepo and others (1983).

by economic agents for whom stocks and financial instruments were highly substitutable.

The trend is less clear in the 1970s. The spectacular fall of real prices between 1970 and 1975 cannot be attributed to the expected profitability, the values of which in that period were not very different from those of the period 1966-1970. The same may be said of the price recovery that occurred in 1976-1979, when profitability was also very similar to that of the preceding years. All this suggests that the behaviour of the stock market during the 1970s cannot readily be attributed to conjunctural factors. The explanation must be sought in the structural changes of this market and in exogenous factors.

In table 3 it will be seen that the expected profitability was much higher in the 1970s than in the preceding decade. This is clearly related to the transformation of the capital market which took place in the course of that decade. The rise

in the interest rate of financial securities that occurred during that period created a competition that impelled the agents to demand higher returns in order to maintain the shares.

Table 3  
COLOMBIA:  
EQUIVALENT INTEREST RATES AND REAL PRICES,  
1962-1966 TO 1980-1982  
(Percentages)

Period	Annual equivalent interest rate	Average variation of real prices (annual)
1962-1966	4.02	-12.1
1967-1970	11.1	4.6
1971-1975	10.5	-24.9
1976-1979	10.6	10.0
1980-1982	-15.7	-10.9

Source: Calculations of the author.

The alterations observed during 1970-1980 reflect many of the phenomena accumulated during that period of transition. The continuing fall in prices and the shifts of ordinary shareholders to the financial market brought with them a reduction in the number of owners and in the percentage of paid-up capital in the assets of enterprises. The control of these could be obtained with less wealth and always redounded in more profit. Thus the market came to be increasingly influenced by the shareholders with power, and the substitution between shares and other financial assets was gradually reduced. The close relationship between prices and returns observed during the 1960s came to an end. Hence the rise in prices between 1976 and 1979 is not explained by a better return but by the competition between different agents to obtain control of enterprises. Consequently the variations in prices increased and were unrelated to the short-term profitability of financial assets.

The systematic weakening of the stock market cannot be attributed to inevitable structural causes. The high substitution between physical and financial assets for the ordinary shareholders and the low substitution for the controlling shareholders is probably the only factor that can

be regarded as inherent in the functioning of the economic system, but its presence alone could not generate the transformation. The fall in prices, the shift of the ordinary shareholders towards the financial market and the concentration of ownership are connected with a series of elements whose emergence and reinforcement can be identified through the course of the two decades. In the 1960s they are explained by the low returns on shares and in the following decade by the rise in the interest rate and the growing power of economic groups.

None of this was inevitable. The low returns of the 1960s could have been counteracted by a more open policy of profit distribution. The rise in the interest rate, caused by the same economic policy, could have been avoided by administrative measures. What is certainly true is that the enormous power of the groups was very difficult to counter at the end of the 1970s without provoking critical states of crisis. It is also true, however, that this situation would not have occurred had it not been for the conditions that facilitated the transformation that ended in the heavy concentration of economic power.

Another factor that has affected the stock market is tax legislation. The régime in force in recent years includes regulations of different types that discriminate against shares. The most important of these is that which authorizes enterprises to include interest payments as costs. As these payments have a high component of inflation, which corresponds rather to appreciation of liabilities, credit brings with it a substantial subsidy which increases with inflation and conceals real profits. This structure stimulates the replacement of shares by credit, facilitates an entrepreneurial management which aims at distributing only a small fraction of the profits, and has created a highly inequitable taxation system.

These results have practical and theoretical repercussions. There is no doubt that the economic groups possess monopoly powers which affect share prices. Thus, the policy of increasing nominal dividends at a lower rate than inflation impelled individuals to sell their shares, thereby provoking a fall in their prices, of course this behaviour was also encouraged by the rise in the interest rate of financial securities and by the lack of effective regulations.

#### 4. *The economic groups*

Together with the rise of capitalism, large firms have come into being which require substantial financial resources for their creation and maintenance. This is a result of the general proposition that mass production can be carried out more favourably in large enterprises. The characteristics of the process have varied, however, from one place to another. Industrialization in England went ahead through a system of largely self-financed investments. In Germany, however, it was based on a close relationship between the banks and industrial firms. On the other hand, the rapid growth of the United States at the end of nineteenth century coincided with the emergence of large firms and cartels which led to a high concentration of ownership.

The industrial and financial growth of Latin America in recent decades has been associated with the so-called economic groups or conglomerates. These groups have something of the German and of the United States model. They consist of individuals who frequently have some family link and profess a strong loyalty to the organization. They tend to operate in the financial sector and in the industrial sector and generally seek to expand into a great variety of activities. The common aim is to obtain the greatest benefits for the organization, which in some cases may mean losses in certain activities in order to favour others.

The most outstanding feature of the economic groups is undoubtedly their enormous propensity for taking risks. Many of the financial phenomena that have occurred in recent years both in the economic and institutional sphere are the result of this attitude. Nevertheless, the current explanation that the groups are in a better position to diversify risks by acting in different activities is not sufficiently convincing. There are undoubtedly much more cogent reasons.

The chief of these has to do with the nature of the activities of the groups. Some have properties which are public goods and generate externalities for other activities. The best example is that of the financial institutions, whose failings cause losses of confidence that work against the stability of the financial system and that of the whole economy. Something similar occurs with

the large industrial firms, whose health is often regarded as an indicator of the state of the whole sector and as a responsibility of government. Their paralysis is reflected in sharp falls in employment, since the machines cannot be moved to other activities, and is often forestalled by government subsidies, which tend to correspond to only a small fraction of the fixed costs. In the short term the economic and, of course, the public costs of maintaining them in operation always seem too small to justify their closure. Hence in practice no government allows the bankruptcy of large enterprises during its term of office.

Moreover, the groups are so organized that the finances of the different activities are independent. This is why it is common practice to register the enterprises in the name of different persons and to generate losses in some activities in order to make profits in others. Naturally, the simultaneous action of the groups in activities of different types which have no solidary responsibility leads to forms of conduct out of keeping with the traditional concepts.

This institutional framework has conferred on the groups of power of administering a public good. They are in a position to take possession of the benefits of activities which affect a large part of the population. Naturally their aim is to seize and concentrate the profits of the good periods in the hands of the owners of the groups and to transfer the losses of the bad periods to the government and to shareholders who do not belong to the organization.

The best example of this is found in the economic crisis of recent years. The groups took action to obtain government subsidies to avoid bankruptcies among the large enterprises. The economic boom of the late 1970s ended in far-reaching State intervention in the principal banks and in the large enterprises to avoid their disappearance.

No less indicative has been the action of the groups to the detriment of the shareholders who do not belong to them. We saw earlier that the economic groups are in a position to distribute the profits which go specifically to the ordinary members, and even to influence the price of their shares. Moreover, there is evidence that the illegal operations which led to the penalizing of the groups were the result of practices designed to

transfer the losses to the small shareholders. The best-known of these practices consisted in causing brusque changes in share prices in favour of the members of the group, through speculative procedures supported by fictitious enterprises.

It is clear that the groups operate in a typical game of large positive elements.<sup>2</sup> The expected value of the gains is greater than zero, increases with the number of activities and constitutes an indefinite stimulus to expansion. The only limiting element to their activity is credit and liquidity and perhaps the administrative diseconomies which result from operating in a large number of different activities.

The expansive capacity of the groups led to the assumption that they had an enormous potential for making heavy investments of high risk. It was not noticed, however, that activities of this type were not the most attractive of the features and options of the capital market. If the profitability of existing firms were greater than that of new investments, it was only natural that the groups should direct their efforts to obtaining the most benefit from that situation. Hence their organizations ended by being particularly effective in taking rapid action with a substantial supply of liquidity in a large number of activities. Their profits derive from activities of speculation and transfer rather than from the creation of wealth.

Thus, the groups succeeded in setting up organizations which were highly efficient in the management of liquidity and in obtaining advantages in a game of large positive elements. It was difficult to conceive a framework more propitious for obtaining advantages from the distortions and imperfections of the capital market. Naturally, the benefits of a structure of this type did not stem from the efficiency attributable to the virtues of the market. On the contrary, they originated in its weaknesses.

<sup>2</sup>In all games there are winners and losers. The former reflect the positive elements and the latter the negative. In a zero sum game, which is usually the case in sports, the positive elements equal the negative. The groups participate in a zero sum game or in a slightly positive sum game and are highly likely to win in numerous activities. Thus, they operate in a game in which they obtain large positive elements.

### 5. *The heterogeneity of capital markets*

One of the weaknesses of economic theory is its assumption that all markets behave in the same way as the markets of homogeneous and perishable products. The adjustment of these markets takes place rapidly, and producers tend to assume that the rise in the relative prices of their articles is temporary, or at least that the profits resulting from storing them are slight. Supplies and demands would be in permanent equilibrium and expectations would be formed on the basis that interest rates tend to remain relatively constant. In contrast, because of imperfections and the delayed response of supply, asset markets exhibit sluggish adjustments. Investors, knowing that the prices of these goods are exposed to cycles that may last for several years, tend to interpret the variations in relative prices as a sign of something that will continue to happen in the future. A speculative demand thus arises which helps to amplify these fluctuations. Thus the rise in the prices of shares and property creates expectations which intensify it.

This error of appraisal is evident in the usual formulations of the financial market. As in the case of homogeneous products, it is assumed that the market is permanently in equilibrium and that the interest rate reflects the scarcity of funds. We have seen, however, that assets are highly complementary to credit and that the alterations in the markets of physical assets are inevitably transferred to the financial market. The adjustment problems of one market are manifested in the rest. Thus, the tendency of individuals to assume that price rises lead to greater increases in the future causes an expansion of the demand for goods and credit which leads in the end to a rise in interest rates. Hence a result is obtained which is contrary to the orthodox theory. The prices of physical assets and the rate of interest move in the same direction.

The presence of economic groups has also helped to change the characteristics of adjustment. These groups operate within a game of large positive elements which enable them to withstand losses in some activities for certain peri-

ods. Profits are generated over long periods and are sometimes realized at the moment of the transactions. Consequently, the decisions of the groups are not very sensitive to temporary price changes and their general attitude is to finance temporary losses by the expansion of credit. It may be that the rise in the prices of assets and the increase in interest rates will end in a greater demand for credit. This behaviour has been facilitated and intensified by the link between the financial institutions and industry. The financing of enterprises is not subject to the provision of guarantees and to bank filters capable of making it conditional on a general situation which will guarantee the amortization of the debt. The groups, on the whole, are ready to carry out these operations with their banks as long as the enterprises generate income which will enable them to maintain their loans indefinitely.

It is evident that the characteristics of the financial institutions and industry. The financing of enterprises is not subject to the provision different from those of the competitive markets described in textbooks. In the latter, forces of different kinds are assumed to be present which tend to regulate and stabilize the market. In contrast, the monopoly markets can be exposed to permanent pressure, both in periods of expansion and those of contraction, to maintain and expand their indebtedness. The demand for credit would be infinite, or at least far greater than the supply, and this would lead to high real interest rates and, what is worse, would introduce great instability into the system. There is nothing to prevent and regularize the increase in the prices of assets and interest rates. The process may be prolonged and lead to a total collapse of the system.

The infinite demand for credit is a short-term phenomenon. The rise in the prices of assets and interest rates gradually leads to a state of insolvency. The power of expansion of the groups may prolong the process for several years, but it does not prevent collapse, which generally results in the failure of the banks and industrial firms and in heavy losses for savers. Asset prices and interest rates fall abruptly.



## II

## The Colombian experience

The Colombian economy developed during the 1960s with a highly regulated financial system. Credit was directed by the government into activities regarded as productive; interest rates and the characteristics of securities were fixed by the economic authorities; and private external indebtedness was limited to certain projects. Financial liberalization was based on two types of policies. On the one hand, the banks were authorized to negotiate the interest rates on loans and to fix the returns and characteristics of financial securities. On the other hand, part of banks' portfolios was given freedom of action, the field for development funds was reduced and the mechanisms of bank supervision were weakened.

The liberalization of the Colombian economy cannot be compared with that which took place in other Latin American countries. For example, Argentina and Chile went much further, above all in relation to credit. In both countries the banks were authorized to distribute their portfolio as they chose and the restraints on procuring foreign credit were lifted. In Colombia, in contrast, the liberalization of credit was only partial and external credit remained under central government control.

1. *The liberalization of credit  
and of financial assets*

Prior to the liberalization, the economy operated with a system of regulated interest rates and directed credit. Resources were primarily assigned to entrepreneurial investment. Credit for the remaining activities, such as durable goods and speculative activities, was rationed, and it was therefore necessary to pay a higher rate than that fixed by the monetary authorities.

Naturally, the financial liberalization resulted in the movement of funds into restricted activities. This process was clearly visible in the financing of durable goods, for which there was a notable increase in demand. The price of housing reached record heights and there was a strik-

ing rise in expenditure on cars and electrical household appliances. Moreover, in this latter area there was a gradual rise in interest rates, as a result of the practice of paying and accepting exaggerated interest rates for credit.

The most interesting case was connected with the large enterprises. The traditional constraint on the mobilization of credit for the acquisition of existing activities together with quantity restrictions kept down the price of these enterprises for a long time. This behaviour was a simple sequel to the complementarity between liquidity and the control of large enterprises. The liberalization of credit opened the way to their purchase at prices below their real value. But this option was confined to the groups which had access to financial resources and possessed the organization necessary for managing the enterprises. The practice of acquiring enterprises with credit granted to them by financial institutions appeared attractive and soon became widespread.

This development created a strong link between industry and the financial sector. The groups acquired firms in most cases with credits in their favour. The indexes of indebtedness rose markedly, their prices went up progressively and the financial sector became more vulnerable.

The figures given in table 4 show the evolution of share prices before and after the financial liberalization. An exact cross-section cannot be established because the process was developing for several years. Nonetheless, the chief measures on the subject were adopted during the period 1973-1975 and were followed by a time-lag, which it is not easy to identify, because of a marked change in the real prices of shares. These increased appreciably between 1976 and 1979.

The evolution of share prices shows clearly that the adjustments were not in accordance with the traditional criteria of competition. The drastic fall in prices and the subsequent recovery suggest that the enterprises were initially undervalued and later overvalued. This behaviour can only be understood in the context of the

Table 4  
COLOMBIA:  
INDEX OF REAL PRICES OF SHARES AND HOUSING  
AND REAL INTEREST RATE, 1971 TO 1982

Year	Real share prices	Real housing prices	Real interest rate
1971	76.1		
1972	57.8		
1973	52.0		
1974	41.9		
1975	30.2		6.8
1976	30.8		8.2
1977	33.3		- 0.4
1978	45.6	64.5	7.6
1979	50.4	81.9	11.4
1980	22.8	100.0	11.8
1981	39.8	111.6	13.4
1982	25.1	108.6	13.7

Source: Share prices (including all shares traded on the Bogotá Stock Exchange): Bogotá Stock Exchange; housing prices: National Centre of Construction Studies (CENAC); interest rate: Bank of the Republic.

optimistic expectations which accompanied the financial liberalization.

The rapid rise in the prices of the enterprises seemed in some degree to confirm the initial assumption that they were undervalued and to give grounds for assuming that there would be additional increases, which ended in an increasing acceleration of prices.

No less important was the liberalization of financial assets. Sarmiento (1984a, chapter VIII) shows that in the 1960s financial options in Colombia were limited to the shares of joint-stock companies, the certificates of the Banco Central Hipotecario and a few transferable assets, whose returns were, in general regulated. The financial liberalization modified this structure by authorizing financial intermediaries to issue bonds of any type and to be free to fix the returns. Its defenders considered that the discretionality of the financial intermediaries would be very efficiently regulated by the market, which would operate as a filter to select the socially, most beneficial alternatives. In such conditions the returns on bonds would be fixed according to their liquidity and the predominant maturity period would correspond to that which made the capital market most efficient.

The weakness of these hypotheses lies in their disregard for the role of liquidity. In the Colombian economy there is ample evidence of its importance. The estimates of the elasticity of substitution suggest that individuals require an enormous reward in order to move from a short-term asset to one of long duration. Apparently the maturity period is not determined by the profitability of funds in productive activities but by that of those in speculative opportunities. The validity of this appraisal is confirmed in the light of what took place when the capital market was liberalized in Colombia. Sarmiento (1984a, chapter VII) shows that the appearance of short-term bonds created a competition that could not be sustained by long-term bonds. Through their market preference for liquidity, individuals were only ready to maintain long-term bonds with enormous differences in interest rates. Moreover, the economic groups did not make much effort to avoid this. On the contrary, they followed a policy of restricted distribution of profits which accelerated the fall in share prices and caused the withdrawal of ordinary shareholders.

The presence of these factors had a marked effect on the financial structure of firms. These took aggressive action to replace the resources obtained through shares with loans from the banking system. But this action did not depend only on them. The short-term resources supplied by savers could not be directly transferred to enterprises which need loans of a certain duration in order to undertake long-term activities. The connection had to be made through financial intermediation. As the banks are open to deposits and withdrawals which, by the law of probabilities, do not take place simultaneously, they are in a position to receive short-term resources and issue them as long-term loans. Thanks to this, enterprises have access to loans with longer time-periods than deposits and to the frequent renewal of their short-term credits.

The dependence on credit created a powerful link between the industrial sector and the financial sector. The stability of the enterprises remained dependent, to some extent, on the willingness of the financial institutions to transform short-term resources into long-term ones. Moreover, the shifts of financial assets affected the structure of economic power. The control of firms is easier when liabilities are represented

mainly by credit, because the real assets can be obtained with a smaller holding. Credit, then, is seen to be a determining factor in the administrative organization of the capital market and access to it results in monopoly powers.

## 2. *The financial-industrial link*

The financial liberalization created opportunities of huge profits in the use of credit to acquire goods and raised the profitability of the interrelated operations of industry and the financial sector. These opportunities were confined to organizations which had the capacity to manage large enterprises or to operate simultaneously in several activities. Hence the financial liberalization coincided with the strengthening and expansion of the economic groups.

Unfortunately this strengthening originated in the main in the monopoly powers obtained through access to credit and the advantages obtained from the link between industry and the financial sector. The most visible activities of the groups were in transfer operations, which required rapid decisions and liquidity, and in the acquisition of existing enterprises. Hence their expansion was reflected more in the price of the enterprises than in the volume of new investments. Nor did it result in more efficient activities. The balance sheets show that the profits of the ten largest enterprises in Colombia declined in the last five years and that several of them are now operating at a loss. Something similar occurred with the financial system. Ortega and Hommes (1984) disclosed in a detailed study that the profitability of the banks declined between 1979 and 1984. The closer linkage between the financial system and industrial activities did not create more efficient enterprises or financial intermediaries. The large profits that it apparently brought with it were more the result of transfers than of the creation of new wealth.

The strong link between the enterprises and the banks robbed the economic system of room for manoeuvre. This was clearly seen in the period 1980-1983. The traditional procedure for absorbing the losses of enterprises brought on by a fall in sales consisted in reducing dividends. This adjustment mechanism lost its efficacy when the enterprises of the groups became de-

pendent on credit obtained from their banks, and was replaced by the system of simply not honouring financial liabilities. The covert form of doing this in practice consisted in increasing the indebtedness by an amount equal to the interest on the previous debt. Thus the entrepreneurial weakening which took place, instead of resulting in a fall in the demand for credit (which in the long run would force down interest rates), led to increasing indebtedness.

The most serious result of this structure has been instability. On the one hand, the dependence on short-term indebtedness has reduced enterprises to a permanent state of insolvency, which has interfered with their programming and jeopardized the position of the banks. The increase in indebtedness coincided with a rise in the portfolio of bad debts which has reduced the banks' capacity to take risks. Bank failures have increased and the State has had to create substantial subsidized credit lines to avoid the disappearance of large enterprises. On the other hand, the concentration of portfolios in the holdings of the groups is contrary to the principle of diversification of risks and made the economy more vulnerable. A defect in one small part of the structure is enough to cause the fall of the group and create chain reactions in economic activity.

It is evident that financial liberalization did not stimulate competition among multiple economic agents. In practice what was created was rather a monopoly competition which did not even result in an increase in the number of groups, because the bigger the conglomerate, the bigger were its opportunities. The larger groups proceeded to acquire multiple activities and to expand to an extent never before conceived. The concentration of ownership was greatly intensified, and just a few conglomerates managed to gain control of a large part of the economy.

## 3. *Interest rates*

One of the most noteworthy aspects of the liberalization process was the rise in interest rates. It was natural that financial liberalization, in making resources accessible to a larger number of activities, should provoke an expansion of demand for funds and end by raising interest

rates. The levels observed in practice, however, were much higher than might have been predicted for systems of perfect competition, and real interest rates settled at levels well above the estimates of the marginal productivity of capital. Nor did the assumption of competitive models prove correct, according to which such rates could be regulated through the expansion of credit.

The rise in the prices of property caused by financial liberalization created an atmosphere of optimistic expectations. There was clear corroboration of the hypothesis that in these conditions markets fail to behave in accordance with the dictates of equilibrium models. For individuals interpreted the variation in the relative prices of property as something that would continue in the future. A speculative demand for goods and credit was generated which drove up these prices. Hence the price of shares, the price of housing and interest rates all rose during 1975-1979 (see table 4).

The assumption that, just as speculation had at the outset caused a rise in interest rates, so it would finally produce the opposite effect, was not borne out. During the financial collapse which began between 1980 and 1981 the fall in property prices was not accompanied by a drop in interest rates. This behaviour may be interpreted in terms of the concepts expounded in the first part. At the end of the speculative period it is found that the prices of assets have risen to a level above normal, and their maintenance at that level requires great liquidity on the part of the debtors. Indebtedness is incurred to finance both past loans and the prevailing interest rates. The reluctance to liquidate assets at lower prices results in a demand for credit similar to or even greater than that observed at the beginning of the boom. To put it simply, the credit which produced the rise in the prices of existing assets turns later into a demand for more credit to prevent their fall. Thus, the tendency of real interest rates to remain above the marginal productivity of capital both in periods of expansion and of contraction is a powerful argument in favour of the hypothesis that such rates are determined by speculative factors. The demand for liquidity results from the efforts both to obtain profits and to avoid losses.

Let us now consider the relationship between the high interest rates and the strengthening of the financial groups observed during recent years. The origin of the two phenomena is similar. We have seen that the groups which owned banks found that the most profitable option was to employ the funds received by the banks to acquire existing and related enterprises. At the same time, the groups which had no financial property moved to obtain bank resources and acquire financial institutions. In this process, credit appeared as a central element for the development of operations of high profitability.

The demand for credit increased and put pressure on interest rates. We saw above that, as long as the stock market was dominated by ordinary shareholders, share prices were very sensitive to the interest rate. However, this relationship tends to weaken as groups acquire the assets of the ordinary shareholders and intensify their control over the firms. Decisions cease to be sensitive to temporary changes and become more dependent on long-term profitability and on the monopoly powers of the enterprises. Adjustment is not governed by current returns and prices but by the play of large positive elements. In these conditions, the reduction of the profits of enterprises does not lead to a process of liquidation, resulting in a reduced demand for credit. Consequently the decisions of the groups in relation to credit are not very sensitive to the current interest rate.

On this point it is not difficult to synthesize the effects of the financial changes on interest rates. The high levels cannot be attributed merely to the elimination of administrative restrictions. They are mainly explained by the phenomena generated by the liberalization of a market exposed to serious rigidities and distortions. Credit was mobilized to acquire firms which were clearly in a state of disequilibrium, in the sense that the limitations imposed by liquidity had suited their market values below their real values. The greater demand, in conjunction with the presence of adaptive expectations in the stock markets, provoked a rise in the prices of assets which was interpreted as a sign of similar increases in the future, thus causing the demand for credit to expand even further and disassociating access to credit from the situation of the enterprises. In this context, interest rates could

stand at any level and would not be very sensitive to variations in credit. Not even financial collapses succeeded in lowering them to reasonable levels.

#### 4. Efficiency, saving and investment

The liberalization of the financial sector was justified in terms of efficiency (McKinnon, 1973). On the one hand, it was assumed that high rates of interest would cause an increase in saving. On the other hand, it was hoped that freedom to mobilize funds and interest rates would create a favourable framework for directing resources into the most profitable activities. It was also assumed that the organization of the economic groups was very effective for channelling resources into activities of high risk and large scale. With this frame of reference it was taken for granted that the greater saving resulting from the rise in interest rates would be shifted into the most productive activities. All this led to predictions of an increase in amount and improvement in the quality of investment and an acceleration of growth.

The supporters of financial liberalization took a very optimistic view of the relationship between saving and interest rates. This link has been the subject of a long and inconclusive debate, which need not be revived in this article. Part of the analytical difficulty lies in the fact that the variations in interest rates, since they were relatively small in practice, did not have an appreciable effect on saving. It was known that a change of two points in the interest rate did not affect the consumption habits of families, but the impact of variations of 6 or 7 percentage points was unknown. Thus, the magnitude of the rise in interest rates which occurred during the financial liberalization process provided something approaching a laboratory setting for elucidating the question.

Sarmiento (1984a, chap. VII) shows that the influence of interest rates on saving in Colombia is very slight. The variations in saving are mainly explained by the fluctuations of the external sector and by fiscal policy. Ramos (1984) found a similar behaviour pattern in Argentina and Chile. Table 5 shows that the rate of saving did not increase in these countries in 1975-1982, when interest rates reached their highest levels.

Table 5  
ARGENTINA, COLOMBIA AND CHILE:  
NATIONAL SAVING AND INTEREST RATES

Year	Argentina		Colombia		Chile	
	Saving	Interest rate	Saving	Interest rate	Saving	Interest rate
1970	20.4		17.8		15.7	
1971	21.5	-15.4	16.6		13.1	
1972	21.6	-23.5	16.9		6.5	
1973	21.4	-14.8	18.2		7.9	
1974	19.8	-12.4	19.5		16.8	-40.8
1975	18.5	-67.6	16.6	6.8	7.6	127.1
1976	22.8	-62.0	18.1	8.2	11.7	17.7
1977	26.2	15.4	20.1	-0.4	8.4	34.1
1978	23.9	0.4	19.5	7.6	8.1	35.1
1979	21.2	-2.2	19.0	11.9	11.6	16.6
1980	18.7	5.7	18.8	11.8	14.1	12.0
1981	15.0	19.3	18.3	13.4	7.8	38.7
1982	15.4	11.4	17.0	13.7	0.5	35.1
1983	12.8		17.6	19.0	5.9	

Source: Saving: ECLAC; Interest rates: Argentina and Chile, J. Ramos (1984); Colombia: Bank of the Republic.

These findings contrast with the trend as regards financial securities. In table 6 it will be seen that the rise in real interest rates was accompanied by an increase in savings deposits.

Table 6  
COLOMBIA: RATIO BETWEEN FINANCIAL  
SECURITIES AND THE GDP

Year	Annual balances	Annual increments
	GDP	GDP
1971	6.5	0.7
1972	6.4	0.4
1973	8.7	2.6
1974	8.8	0.7
1975	9.7	1.5
1976	13.0	3.6
1977	19.3	2.0
1978	15.2	1.7
1979	15.2	0.5
1980	19.1	4.8
1981	21.9	4.8
1982	22.3	0.0

Source: Bank of the Republic and author's estimates. Financial securities include all savings deposits and bonds, but not shares.

How can this behaviour of time deposits be reconciled with that of global saving? The first explanation is that part of the increase in time deposits originated in shifts from other holdings. Thus, in Colombia financial securities displaced direct investments in enterprises and securities sold in informal markets. Furthermore, much of the expansion of financial saving derived from the income generated by the high interest rates, which constitutes a transfer from the enterprises. This outgoing signifies lower share prices or smaller profits.

These adjustments affected the behaviour patterns and relationships of the economic agents. Heretofore, the decision to acquire shares or to engage in direct participation in firms virtually implied a like decision to invest, and so the profits of the enterprises were largely converted into physical capital. Financial liberalization, however, in stimulating the move to short-term securities, naturally favoured financial intermediation, thus weakening the direct link between saving and investment. The resources which previously went directly into investment came to depend on the discretion of the financial intermediaries, who in many cases found it expedient to divert them into other activities. During the financial liberalization there was an increase in credit destined for the acquisition of durable goods and speculative activities such as the purchase of existing enterprises. It might be thought, however that since the resources employed in these speculative operations, were simple transfers, they need finally end up in new activities. This observation would be correct if the adjustments occurred in a short space of time. But what has happened in practice is that the resources pass from one set of speculative activities to another, and in this process the interest

rates remain at high levels which prevent the transfer of resources to productive activities.

None of this rules out the possibility that the rise in interest rates may have helped to increase the saving of some economic agents. But this increase, assuming that it occurred, was more than offset by the shift of credit to consumer durables and speculative activities. In reality, the effect of the financial reform was not to increase saving but to expand financial intermediation. The error of interpretation lay precisely in the assumption that the two concepts are equivalent.

The greater scope for mobilizing saving did not direct it into productive activities. In the first place, it favoured a shift of resources into durable goods and speculative activities which had been restricted by the systems of directed credit. Secondly, the greater access to credit did not result in greater competition among the economic agents to mobilize it, but in greater flexibility for the economic groups. These employed their banks to direct it to the acquisition of enterprises whose prices were depressed by the shortage of liquidity and to interrelated enterprises which enabled them to strengthen their monopoly powers. Nor was it the case that the groups, because they had less fear of taking risks, would undertake large-scale investment. On the contrary, they showed a clear preference for activities of transfer and speculation.

Finally, the high interest rates generated by the liberalization were not the reflection of the high profitability and efficiency of the enterprises which obtained the credit. On the contrary, they were the result of the marked preference for liquidity, for the purpose of obtaining speculative gains or preventing losses due to falls in the prices of assets.

### III

## Conclusions

The theoretical arguments put forward in Part I sought to identify certain outstanding features of the economic system which differ from the neo-classical conception of the capitalist market. Some of these elements were observed during the financial liberalization process and later during the recent crisis. The following section presents a summary and practical assessment of their general repercussions on the functioning of the economy, along with the information which gives them empirical support.

The complementarity between physical goods and liquidity runs counter to many simplified versions of the orthodox view. Neoclassical theory is based on the assumption that different goods are highly substitutable. It is considered that individuals are in a position to obtain a certain good in so far as they sacrifice others. In the formal conclusions of economic theory it is shown that, in such conditions, changes in one market affect the others without modifying their particular features. Hence there is a tendency to treat the processes of supply and demand in the capital market and the determination of interest rates in isolation from the rest of the economic system. This is not so when the goods are complementary, however. In this case, changes in one market can destabilize the functioning of another which operates satisfactorily when left to itself. It is not difficult to show that complementarity between large enterprises and liquidity introduces a linkage of similar type. The limitations imposed by liquidity are transferred to the market of the large enterprises and the inelasticity of the latter's supply is passed on to the credit market. Both markets tend to operate in disequilibrium in the sense that the desired demand is greater than the supply.

The complementarity of liquidity and large enterprises is confirmed by factors of various types. To begin with, the greater access of individuals to credit made existing enterprises more marketable. The increase in indebtedness recorded in the period 1976-1980 coincided with a larger number of transactions and a rise in their prices. The direct relationship between the

prices of durable goods and the interest rate is a further proof of complementarity. This behaviour would not be observed in conditions of equilibrium. On the contrary, it is the result of situations of imbalance created by complementarity, the low supply elasticity of large enterprises and of some durable goods, and the prevalence of adaptive expectations.

The presence of economic groups invalidates the classic hypothesis that the capital market is the result of competition between a large number of individuals. The action of these groups in a game of large positive elements unleashes a monopolistic competition to maintain and expand credit resources. In addition, the traditional role of the banking system in regulating and rationing out this demand is diminished in an interdependent structure of creditors and debtors. The financial market is deprived of mechanisms to orient the funds, interest rates reach excessively high levels, and the system tends to be highly unstable. There is nothing to prevent an indefinite increase in the prices of physical assets and in interest rates.

The way the groups act in a game of large positive elements was clearly corroborated when the financial crisis arose. The losses of the banks and of the enterprises of the groups were not covered by the profits obtained in the past or in other activities. The State had to capitalize the banking system to compensate for the overdue portfolio, which in many cases was made up of loans to subsidiary enterprises, and to grant lines of credit with subsidized interest rates to industrial enterprises. At the same time, small savers suffered heavy losses through the incapacity of the financial institutions to return their deposits and through the spectacular fall in the prices of shares. There are also indications that this game leads to a competition in which not many survive. The groups took possession of a large part of the economy and the portfolios of the financial system were concentrated in a few hands.

There was no corroboration of the general assumption that the financial market is stable and

achieves gradual adjustment. The rise in the prices of shares and durable goods and interest rates recorded in the period 1976-1979 suggests the contrary. The system can operate in disequilibrium for long periods thanks to the complementarity between credit and physical assets and to the inelasticity of the supply of large enterprises and of some durable consumer goods. Moreover, the system can be highly unstable through the presence of monopolies and the prevalence of adaptive expectations.

The facts did not substantiate the hypothesis that liberalization of the financial sector results in an expansion of saving and investment which subsequently leads to greater economic growth. As it was assumed that the administrative regulation of interest rates had depressed saving and this had reduced investment, it was regarded as certain that the lifting of restraints would radically modify these conditions. The main error of this reasoning lay in assuming a high elasticity between saving and the interest rate. Another serious error was to imagine that the constraint on saving had affected entrepreneurial investment. In general it was observed that the elimination of the restriction facilitated the transfer of funds to durable consumer goods and speculative activities.

Nor is it true that saving is automatically channelled into the most efficient investments. The characteristics of the financial markets tend to stimulate the movement of funds into durable consumer goods and the acquisition of existing enterprises. The best evidence of this is found in the expansion of external saving that occurred in

the 1960s and 1970s. The inflow of external resources in those years was mainly destined for consumption and the financing of physical infrastructure (Sarmiento, 1984b, chap. III).

The simultaneous presence of these elements gives rise to a financial structure which is very different from the traditional concepts. The complementarity between large enterprises and credit, the activity of the economic groups in a game with large positive elements and the predominance of adaptive expectations create a capital market which is highly unstable and unable to generate the signals for mobilizing resources into the most appropriate activities. The system is exposed to increases in the prices of physical assets and in interest rates and to a concentration of financial portfolios. Private profitability is not achieved by the more efficient conduct of activities but by the exploitation of the imperfections of the market and of opportunities for speculation. Moreover, the inelasticity of saving with respect to interest rates, the fact that the elasticity of entrepreneurial investment in relation to interest rates is greater than that of durable consumer goods, and the high profitability of existing enterprises all combine to deter the preferential movement of funds into productive investment. The free movement of funds and the high interest rates do not guarantee the most efficient allocation of resources, as orthodox theory maintains.

In this context there is an evident need for State intervention in order to guarantee the stability of the financial market and to mobilize resources towards more appropriate activities.

## IV

### Policy repercussions and reforms

The imperfections of the financial market originate in the characteristics of the economy and in institutional factors. The former are inherent in the system and are associated with complementarities, low supply elasticities and the delay in market adjustments. In general, little can be done to modify them. In practice, the options

are reduced to measures designed to moderate their undesirable effects. On the other hand, the institutional factors, which are particularly related to the economic groups, offer more room for manoeuvre, and several of them are susceptible of being radically changed.

The imbalance created by the com-



plementarity between liquidity and physical assets cannot be corrected by a general expansion of credit. As we have seen, this expedient does not modify relative prices or the real quantity of money, and ultimately it does not alter the effective demand for durable goods. It is a distortion which can only be lessened through State intervention in resource allocation. But this is not possible without a strengthening of the traditional mechanisms of directed credit. The systems of development credit would have to be improved in order to favour the movement of resources into new investments. Moreover, bank loans would have to be subject to strict control and supervision to prevent their diversion into the purchase of existing properties or the acquisition of durable consumer goods.

We cannot ignore the institutional difficulties of carrying out a policy of this type. It is possible that the instruments will be used in accordance with the political priorities of each government or in response to the pressures of the economic groups. For this very reason the viability and desirability of a system of directed credit are dependent on the existence of development banks which maintain some degree of continuity and are not subject to political conditions and pressures. This is by no means an impossible proposal, however. There are several examples of institutions which have succeeded in liberating their activities from political considerations. A good example is found in the activities of the energy and mining sector in Colombia, where there has been marked continuity during the last ten years without much political interference. There are also more general examples. Thus, the development banking system in Mexico has achieved suitable orientation of resources by adhering to relatively stable programmes established in the development plans. Perhaps the first step in obtaining an autonomous credit structure would be to establish a general body responsible for the mobilization of development funds and to give it a series of specific functions which would limit the possibilities of political or group pressure. It is not the purpose of this paper to analyse the institutional framework required for the functioning of such a body. It may be assumed, however, that it would not be very different from certain bodies which, through boards composed of offi-

cial of the Executive and independent experts, have achieved some autonomy in the performance of their functions.

State intervention should also be extended to interest rates. Experience shows that high interest rates do not materially alter saving, but they do discourage investment and raise the operational costs of enterprises. Naturally, market solutions have little chance of orienting a variable determined by economic distortions and speculative conditions. The effective control of interest rates calls for the application of administrative mechanisms. The experience of the 1960s, however, shows that negative interest rates created enormous deviations of loans and stimulated a demand for credit which seriously hampered the control of the money supply. The maintenance of this structure seems much more difficult in the present conditions of openness of the world economy and with the returns prevailing in external markets. In these conditions, the interest rates must be positive, but not by more than one or two points.

There should be a change in the conditions which give advantages and monopoly powers to the groups. The privilege of administering public goods should be eliminated. A clear definition is needed of the activities which ultimately require State intervention, and they should be subject to a treatment similar to that envisaged in bank legislation. The State should have the faculty to intervene in these activities when it considers that they are being administered in a way which does not benefit society or the shareholders.

The composition and organization of the groups should also be a matter for open decision. Recent experience shows that the existing legislation has facilitated their expansion by ignoring them. The correct course would rather be to define a series of presumptions and conditions which would force the groups to reveal themselves as such and to respond in a solidary manner with regard to the different activities administered and controlled by them. In this way the losses suffered in some activities would have to be covered by profits obtained in others. The game of large positive elements would thus become a fairer type of competition.

The regulation of associations among economic agents is the field which calls for the

most innovative reforms. The development and consolidation of economic groups originated in the desire of governments to facilitate the establishment of organizations capable of undertaking projects of high risk and large size, which has been one of the most serious constraints on economic growth. The link between the financial and industrial sectors, however, resulted in organizations which were very skilful in speculative operations. Their prohibition would not prejudice the capacity of the economy to undertake large investment projects. On the contrary, it would stimulate the creation of self-sufficient organizations with a greater capacity for devoting themselves exclusively to productive activities. It would be a decisive step towards achieving the development of a stable financial sector that would favour investment.

We cannot overlook the fact that the enterprises succeeded in replacing the long-term financing of shares by short-term credit thanks to their control of the banks. If that link disappeared, the enterprises would not have the same guarantees for prolonging short-term loans. They would find themselves under pressure to follow a realistic policy of dividends in order to attract small shareholders and thus achieve a better structure of liabilities. The development of the stock market would be facilitated by a structure in which the two sectors are independent. The same would also occur in the opposite sense; the formation of an independent structure would be facilitated within the framework of an advanced stock market.

The feasibility of a structure in which the financial and industrial sectors are independent is conditional, therefore, on the formation of a capital market based on securities with a longer period of maturation. The issue of securities cannot be left to the entire discretion of the financial institutions. Some administrative and economic action is required to encourage them to offer bonds with longer maturation periods. Moreover, it is essential to reorganize the stock market.

Dividend policy should be regulated and supervised so that the dividends reflect the real situation of the enterprises. Taxes which discriminate against shares should be eliminated and perhaps replaced by incentives. The necessary institutional conditions should be created for the development of secondary markets.

The desirability of associations in the financial sector is much less clear. Experience shows that thanks to these some entities were acquired with loans granted by others, ending in a crossed and highly concentrated system that enabled the limits on capitalization to be evaded. The solution, however, does not lie in a structure based on totally independent institutions. The universal trend is in the direction of the joint supply of bank services, and in some studies it is indicated that this has brought with it appreciable economies of scale (Bernal and Herrera, 1983). The most practical solution would be rather to establish norms setting out the solidarity between different institutions and prohibiting the granting of credit to acquire the properties of the group. This measure would eliminate the factors of instability, while preserving the advantages of the provision of bank services on a large scale.

The linkages in the industrial sector are largely determined by natural reasons. The dynamics of industrialization generate processes of learning and experience which can be exploited by investments in allied activities. Any attempt to interfere in this natural process would delay the possibilities of technological diffusion and transfer. Even so, the practice of acquiring activities simultaneously in the industrial sector cannot be left to the discretion of the private sector. As in the financial sector, these associations must be declared and must involve legal solidarity. Moreover, they should only be authorized in those cases that are clearly desirable for society as a whole and they should be subject to strict supervision to prevent their use for monopoly purposes.

## Appendix

### The expected profitability of shares

The profitability of a share is equal to the dividends paid, plus the real appreciation of the price. This appreciation is unknown and introduces great uncertainty into the market. The means employed by individuals to infer it can be analysed with the help of elementary mathematics.

The profitability expected by individuals is equal, as we said, to the dividends plus the anticipated appreciation:

$$\frac{D}{P_a} + \left( \frac{\dot{P}_a}{P_a} - \frac{\dot{P}}{P} \right)$$

Where  $D$  = dividend,  $P_a$  = price of the share,  $P$  = level of prices,  $\frac{\dot{P}_a}{P_a}$  = percentage of price variation, and  $\frac{\dot{P}}{P}$  = variation of the level of prices.

Let us suppose that the interest rate on fixed-income bonds, adjusted for risk, is  $r$ . In conditions of equilibrium this would be expressed as follows:

$$r = \frac{D}{P_a} + \frac{\dot{P}_a}{P_a} - \frac{\dot{P}}{P}$$

If the term on the left is greater than that on the right, individuals would sell their shares, thus provoking a fall in their real prices. If, on the other hand, it is less, the prices of the shares will rise. The alteration in the price of the shares will in its turn alter the dividend and the expectations of appreciation. Each variable will be cause and effect of the rest.

This process can be simplified by the introduction of some practical elements. Let us suppose that the share market is operating in conditions of equilibrium with a given dividend. If this dividend increases less than inflation, the return will tend to fall in the following period. If the conditions and possibilities of investment in other options do not vary, the individuals will try to sell their shares until their real depreciation is equal to that of the dividend.

This interpretation of the behaviour of the market is relatively simple and is known by most of the agents operating in the stock exchange. It is, in fact, possible to assume that individuals formulate their forecasts on the assumption that the depreciation of returns is accompanied by an equal depreciation of the price. In algebraical terms:

$$\frac{\dot{P}_a}{P_a} = \frac{\dot{D}}{D}$$

In equilibrium the following approximation would occur:

$$r = \frac{D}{P_a} + \frac{\dot{D}}{D} - \frac{\dot{P}}{P}$$

The term on the right of this expression can be calculated on the basis of historical figures of returns and inflation.

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# The agriculture of Latin America: changes, trends and outlines of strategy

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The task of presenting a general picture of Latin American agriculture is complicated by the diversity of national situations, which is reflected in major agricultural differences among countries. However, some important aspects of the structure of agriculture and changes in recent decades are common to almost all the countries; it is thus possible to compose an overall picture which, without over-generalizing, throws light on the situation and the prospects for the region's agriculture.

The first part of this article considers changes and trends in the region's agriculture, beginning with the rapid penetration of capitalist relations of production and the formation of the two dominant types of structure: business and peasant. It also analyses the various aspects of the evolution of the region's gross domestic farm product and describes the impact on the sector both of the present crisis and of the policies adopted to deal with it.

The second part suggests the outlines of a strategy to attain the principal objectives of elimination of rural property and reduction of external vulnerability with regard to food. These objectives are an integral part of the desire to achieve food security, which means ensuring that the necessary foodstuffs are produced, that their supply is stable and that the whole population has access to them. After describing the main policies which should be applied in working towards these objectives, the article concludes by emphasizing the role of the State and the need to create a democratic and participatory framework.

## I

### Changes and trends

#### 1. *The transformation of the structure of agriculture*

This description of changes in the structure of agriculture concentrates on changes in population distribution, in the structure of production and in the labour force.

Between 1950 and 1960 the urban population of Latin America grew three times faster than the rural population; 63% of the total population is now urban, as against 43% in 1950. There has thus been a gradual shift from a predominantly rural society to a predominantly urban one. The overall structure of production has also changed: the share of industry in the region's gross domestic product rose by six points between 1950 and 1980, while the contribution of agriculture declined by 10 points in the same period. Services increased their contribution by four points, while mining and construction maintained their relatively stable share.

The changes in the geographical distribution of the population and in the structure of production have had enormous effects on the growth of the urban and rural labour forces. In 1950 the population economically active in agriculture accounted for 54% of the total; in 1980 this share had declined to 30%.

The gradual integration of agriculture in general development and the greater sectoral interdependence have fundamentally changed urban-rural relations, which have become closer and more diversified and fluid both economically and socially. The difficulties and the ways in which the conflicts between the main segments of agricultural productive forces have been resolved, under the influence of the penetration of capitalist relations of production, have contributed to the changes in the structure of agricultural production.

In past decades industry had to be stimulated and protected; this did not favour the development of agriculture but, despite this, agriculture did perform an important function: it made a major contribution to industrial growth through the transfer of resources and provision of foreign exchange and by supplying cheap food and manpower. In many Latin American countries

agriculture still retains its importance and, even if to a lesser degree, still provides the basis for sustaining the process of diversification of production. In other countries the urban-industrial complex now generates and controls the bulk of the real or potential surplus of the national economy and the contribution of agriculture is of little importance in the overall process of accumulation.

The growth of metropolitan centres and urbanization in general, industrialization and transnationalization, the development of financial markets, and the expansion of domestic markets and of the consumer society form the basis for the modernization of Latin American agriculture. The rapid penetration of capitalist relations of production modified the old dichotomy between large estates and small farms, replacing them with two very different new structures—business and peasant—and is incorporating them more closely in the functioning and development of the whole economy.

The large estate, the age-old controlling unit of the production structure lost its socio-political and economic force, thus facilitating the development of the business economy towards capitalism. As social and labour relations changed, the peasant economy was subjected to a process of disintegration, differentiation and recomposition or reordering, the forms, scope, depth and consequences of which varied between countries and within each country and still prevail in a large part of Latin America.

The State played a decisive role in overcoming the tensions which arose between agribusiness and the emerging industry—generated by the extraction of the agricultural surplus—which laid the foundation for agro-industrial development. Some of these tensions were absorbed in the resolution of the conflicts between agribusiness and peasant farming.

The expansion of the internal markets also influenced agrarian change; agriculture became involved in the increasing trade flow both in the foodstuffs which it produced and in the energy, biological and industrial inputs which it needed to produce them. Urbanization and industrialization meant greater sectoral trade, the expansion of farm markets and intensive monetarization. This latter development encouraged the payment of wages for work, thus help-

ing to change the rural life style through the widespread adoption of urban values and habits.

Industrial and commercial capital have become integrated in agribusiness in many different ways. Its most relevant manifestations are in productive modernization and the adoption of technological patterns suited to agriculture, its profound penetration of the more dynamic production lines, with the agricultural units losing control, partly or totally, over production and marketing, and its preference for areas of greater productive potential.

The industrialization of agriculture has been rapid in the majority of the Latin American countries. There has been sustained growth in the share of agro-industry in the gross domestic farm product, with the food branches showing the greatest development. This growth has led to the establishment and consolidation of links in the agro-industrial chain and to the expansion of allied activities and by-products. The linkages with the production of agricultural inputs and with the processing of the sector's products have had an impact on the productive and social bases of agriculture and have thus produced a greater interdependence between agriculture and industry. Agriculture has been compelled to react in different ways than in the past in order to meet the demand for inputs for subsequent industrial processing. Industry has become a viable and secure market for many crops and livestock products and has stimulated the development of a number of production lines whose dynamism depends on agro-industrial processing.

The involvement of transnational corporations and other private foreign investors in Latin American agro-industry dates from long ago. Their share ranges from one to three-fifths of paid social capital in the branches of milling, oils and fats, chocolates and sweets, and meats and dairy products, with various levels of intervention in and control of the production of these agro-industries; consequently, they have a heavy influence on the development of agriculture and the food economy of the countries, an influence which spreads outwards to the whole of the economy and society of Latin America.

Agribusiness responds to an economic climate favourable to investment and greater profitability when this climate is created by the State

and it makes rapid and efficient use of biochemical and machine technologies.

The productive units take many different forms; however, three broad types can be distinguished: i) the big modern farm industries which constitute the nucleus have a high density of modern means of production per man employed and an exclusively wage relationship with the labour force; ii) the big agribusinesses undergoing modernization, characterized by extensive land exploitation, a low density of modern means of production per man employed, the joint use of mechanical motor power and draft animals (with the latter predominating), a preference for low demand production lines, and changing labour relations; and iii) the medium-sized agribusinesses which resemble one or the other of the first two groups. They contribute between one-third and one-half of the annual production increases and are selective in what they produce.

The process of agricultural growth without rural social development has accentuated differences between the business and peasant economies; a feature of the latter is the need to ensure the survival of the family unit and the reproduction of its members by working the land and securing an income from the labour market.

The expansion of capitalist relations of production in Latin American agriculture has not led to general proletarianization of the rural labour force: the semi-proletarian peasant predominates, clinging to his means of production and his traditional subsistence economy without increasing his participation in the labour markets. His semi-proletarianization allows him to tolerate wages lower than the cost of maintaining and reproducing his manpower. The result of this is the extreme poverty in which a large percentage of the rural population lives. The agricultural labour force which has no other occupation finds shelter in the peasant economy, although with declining levels of productivity and income.

The peasant has been obliged gradually to direct his production towards the markets and to buy what he formerly produced or to acquire new manufactured goods. Accordingly, his reproduction depends increasingly on his links with the market, which accentuates the differences within the peasant economy itself and

lays it open to competition from the business economy and subsidized food imports.

Two main types of productive unit can be distinguished in the peasant economy: i) family businesses using modern technology which form an important but small nucleus and whose development has been closely linked with the penetration of industrial and commercial capital in agriculture; and ii) a large number of subsistence or sub-subsistence units engaged in the traditional production of basic foodstuffs, in which human labour is almost the only source of energy and which are undergoing an intense process of disintegration or are managing to hold their own only with difficulty.

The changes have modified not only the productive structure of agriculture but the whole of rural life; agribusinesses and peasant farms, with all their different features, have been joined by a large body of technocrats, administrators, dealers and intermediaries, which form a genuine intermediate rural sector responding to the economic expansion of agriculture and spreading into the present productive system.

As a result of the separate evolution of the business, peasant and intermediate segments, rural poverty has not declined in the majority of the countries but has persisted and even increased. Some of the direct causes of this phenomenon are: insufficient individual production, a result of the flawed structure of landholding and the fragmentation of peasant properties, which aggravates the physical restrictions and undermines the viability of the economic exploitation of the property; changes in the levels of employment and in the nature of farm employment resulting from the replacement of permanent by seasonal work; the higher rate of reproduction of the rural population; migration, which plays a part in modifying the age structure—greater relative weight of children and old people—and in reducing productivity; and the lack of public and private goods and services to meet the people's minimum needs, for they are not sufficient to maintain the people's own production, the trade in that production and their wage levels.

Between 1970 and 1981 the agricultural population of Latin America increased by eight million persons, of whom five million were peasant farmers: four million may be described

as producers and one million as landless workers. It can be computed from estimates made in 16 specific studies that approximately 60% of the rural population of Latin America lives in conditions of poverty, i.e., some 65 million people, of whom 35 million can be considered indigent, as against one-fourth of the urban population—about 55 million people—living in conditions of poverty. The available information indicates that neither urban-industrial development, nor agrarian restructuring, nor the mechanisms for transfer of goods and public and private services have brought about any reduction in the actual numbers of rural poor, which in many countries would seem to be increasing.

The progress made by agrarian reform in the region has been of a conceptual and administrative-institutional nature rather than economic and social. Expropriations affected barely 15% of the land which could be expropriated, and the beneficiaries of agrarian reform amount to approximately 22% of the potential beneficiaries. Little progress has been made in the solution of the problem of the hundreds of thousands of peasants with and without land who were not included among the beneficiaries of the changes in landholding.

In few countries has agrarian reform made any substantial change in the landholding system; the main achievement of the reform has been a considerable reduction in the number of large estates. It has had no significant effects on employment, income, productivity and production. There can be no doubt as to the historical relevance of this process from the political and social standpoints. There has been no systematic study of the importance of the structural changes for the recent development of national agricultures. The value judgements and contradictory arguments which are bandied about have not removed the doubts as to the true economic, social, political and cultural scope of agrarian reform in Latin America.

## *2. Main trends in the farm economy*

The region's gross domestic farm product, according to national accounts and global figures produced by ECLAC, grew by 3.3% a year between 1950 and 1980. In the 1970s it grew by 3.2% a year. From 1981 the recession resulting from the

external debt crisis duly affected agricultural production, which nevertheless grew by 1.6% a year between 1981 and 1984, compared with an annual reduction of 0.4% in the total gross domestic product of Latin America. This total product increased by 2.6% in 1984, while the agricultural product registered an increase of 3.4%. Per capita agricultural production in 1985 is one-third lower than in 1980 and is close to the 1977 level.

The production of four crop groups increased in the past decade at a faster rate than the population: oil crops, vegetables, fruits and saccharides. The livestock products include poultry and pork, eggs and milk. Grains, alcoholic beverages, dried legumes and beef increased at a slower rate than the population. There was a decline in the production of roots and tubers and vegetable fibres with the exception of cotton. Between 1980 and 1984, in contrast, the highest rates of production were in sugar cane, grains, oil crops, legumes, roots and tubers, followed by poultry and eggs, while the production of vegetables and fruits lost ground.

In the 1960s two-thirds of the increase in the harvest was due to the expansion of the cultivated area and the remaining third to increased yields. In the 1970s three-fifths was due to a larger cultivated area and two-fifths to improved yields. The rates of growth tended to be the same: the harvested area increased by 1.7% a year, and yields by 1.4%. This trend appears to have been maintained in 1981-1983. In 1984 the increase in production seems to have resulted mainly from the expansion of the harvested area.

The physical production capacity was increased by applying technical advances. This process varied according to the characteristics of each production unit and production line, according to the requirements for technical inputs and the volume of technology introduced in terms of the number of components and the degree of interdependence among them. These advances also depended on the economic agents who introduced and applied them and on the stimulus of the market.

The region's consumption of fertilizers increased from 3.6 to 6.8 million tons of nitrogen, phosphorus and potassium between 1970 and 1980 (an increase of 8.5% a year). The consumption of fertilizers declined by 13% between 1980

and 1983 owing both to the drop in prices and to the decline in imports. The ratio between imports and consumption, which was 56% in the mid-1970s, declined to 44% in 1983 as a result of the big increase in the region's production, especially of nitrates. The region has a shortage of potassium fertilizers; its self-sufficiency coefficient reached 70% for phosphates and 73% for nitrates.

Between 1970 and 1980 the consumption of all pesticides climbed from 77 to 136 million tons of active ingredient, which corresponds to an annual rate of increase of 8.4%. Pesticides as such accounted for 49% of consumption, fungicides 24% and herbicides the remaining 27%. Herbicides (13.9%) and insecticides (9.1%) grew at a faster rate than fungicides (8%).

Mechanization has been the decisive condition of the expansion of the cultivated area and has led to increased yields. The number of tractors increased from 615 000 to 880 000 between 1970 and 1980 and reached 930 000 in 1983.

Private operating expenditure and capital formation have been strongly influenced by mechanical, chemical and biological innovations. The former grew by 5% a year between 1960 and 1980, and the latter by 4.1%.

Three groups of political measures stimulated investment in agriculture: i) the reduction of the cost of capital by means of loans at often subsidized interest rates; preferential reductions of import duties on machinery and agrochemical inputs or their sale by the State at subsidized prices; ii) the construction, extension and diversification of the infrastructure outside the properties; and iii) the programmes of technical assistance for domestic production and marketing and exports, the promotion of specific priority crops for the expansion of agro-industry, and the extension of the agricultural frontier.

State investment in agriculture was designed to encourage, guide and facilitate private investment. Approximately 10% of the growth in agricultural production in Latin America between 1950 and 1980 was due to the effect of the various incentives provided by public agricultural investment. There was a sustained increase in the ratio between the amount of agricultural credit and the sector's gross domestic product: from almost 35% in 1965 to 40% in 1970 and over 60% at the end of the 1970s. The ratio between agri-

cultural credit and total credit was 13% in 1965, 16% in 1970 and almost 20% in 1980. The increase in these two ratios reflects a gradual process of indebtedness and dependence in the agribusiness economy.

There have been slight variations in the characteristics of the concentration, dependence and vulnerability of Latin American exports. Nine products account for 80% of exports, directed mainly towards the developed countries; intra-regional trade absorbs barely 10% of exports, despite the efforts made through the integration systems.

The agricultural exports (in volume) of the Latin American countries grew by 2.8% a year between 1950 and 1970, 1.7% between 1970 and 1980, and 0.9% between 1979 and 1983. The proportion of total production exported declined from almost 19% to 17% between 1970 and 1983. The most rapid growth was in exports of oil crops, wheat, tobacco, tea and fruits.

The imports of the Latin American countries account for approximately 12% of the region's supply of farm products; imports increased by 10.4% a year in the 1970s, as against 4.1% in the 1960s. This acceleration was due to wheat, maize, sorghum, vegetable oils, dairy products, beans and sugar. Between 1980 and 1983 imports declined by 3.4% a year.

The value of agricultural exports in current dollars increased from 6 800 to 23 100 million between 1969-1971 and 1977-1979. The value of imports increased from 1 700 to 6 700 million dollars in the same period. Thus, the region's favourable balance increased from 5 100 to 16 400 million current dollars. In 1981 agricultural exports totalled 31 200 million dollars; they declined to 27 600 million in 1982 and rebounded to 29 900 million in 1983. Imports amounted to 14 500 million in 1981 and declined to 11 500 and 11 800 million in 1982 and 1983 respectively. In the years of crisis the favourable balance was not only maintained but even slightly increased, owing to the sharp reduction in imports.

Between 1950 and 1980 the region's per capita food production grew at 1.0% a year, while per capita agricultural production grew by 0.7%. In the same period the apparent per capita food consumption increased by 1.1% a year, a rate higher than that of production which was met by means of imports. Between 1980 and 1984 the



region's per capita food production declined by 0.6% a year and the apparent food consumption grew by barely 0.5% a year.

As a result of the changes in relative prices, which were due, among other factors, to the structural changes in the national economies and the different rates of expansion of demand resulting therefrom, the effects of inflation, variations in the flow of goods and international prices and the trend towards increased growth of industrial foodstuffs, in many countries the increase in the cost of an average basket of foodstuffs was higher than the increase in the cost of living. This caused an increase in the share of expenditure on food in total family spending, an increase which was greater in the low-income strata of the population, which make up 60% of households.

This cost increase reduced the quantity and changed the composition of the food consumed and produced a poorer diet. The consumption of the low-income strata of the population declined in quality and quantity and became less varied. There were declines in the per capita consumption of dairy products, beef, dried legumes, vegetables, oils and fats and some wheat derivatives; there was increased consumption of eggs, poultry, fruits and sugar, the latter by reason of the greater consumption of carbonated beverages. Changes have been initiated in food consumption habits which might take permanent root.

In the medium- and high-income strata of the population of many Latin American countries there has also been an increase in the amount of spending on food, accompanied by changes in consumption habits, which have become more varied and rich. Statistical data indicate this clear development in the patterns of consumption and show that the strata of the population most affected by inadequate diet are those which spend more than 50% of the family income on food.

There are several reasons for this increase in food dependence, which is particularly strong in the case of cereals, dairy products, vegetable oils and oilseeds; they have to do, *inter alia*, with the productive potential and its degree of utilization, with changes in the production structure, in the nature of what is produced and in the share of imports in the domestic supplies, with the

relationship between the domestic and international prices for each product and with the degree of agro-industrial development of each country. On the other hand, owing to the fact that over the years short-term measures have been taken to cope with emergency situations, an implicit long-term policy of cheap imports has emerged, with an unfavourable effect on the development of national production. In other cases, in accordance with the theory of comparative advantages, an explicit policy of increasing food dependence was adopted; this policy has been discontinued or is being reviewed in the light of the consequences of the crisis and the corresponding adjustment programmes.

### 3. *The impact of the crisis: initial perceptions*

Without underrating what has been achieved in production terms, the end result of the agrarian changes and of past trends is unsatisfactory, given the persistent structural weaknesses, such as underemployment, the uneven distribution of income and the rural poverty. The external debt crisis and the readjustment programmes adopted from 1981 have had serious effects on agriculture: its productive capacity has declined, as have production and employment, and the general conditions of life in the countryside have deteriorated.

The adjustment programmes have combined various policies for reduction of expenditure and changes in its composition, depending on the nature of the external imbalance, including fiscal, monetary and income restrictions, devaluations, tariff changes and the promotion of exports. Common features of the crisis and the programmes of adjustment and debt renegotiation have been the decline of production, the increase of unemployment and underemployment, the drop in real wages, the expansion of informal services, the reduction of public expenditure for social purposes and restrictions on foreign currency for the import of goods and services.

Up to 1981 agricultural policy followed a more or less common pattern, the main feature of which was a set of tools of economic policy which directed, regulated and stimulated production with the backing of government pro-

grammes and services. The recession has disrupted this policy, weakening it or even causing its disintegration.

Recent macroeconomic management has affected farm producers in different ways. It altered the framework within which agribusiness functioned and reduced its profitability; this explains the slow rate of growth of the region's farm production in 1982 and 1983. On the other hand, by reason of the very economic characteristics and purpose of peasant agriculture, it must be assumed that it continued producing and contributing to the basic food supply in accordance with its long-term trends. This would explain why, broadly speaking, the bulk of basic food production for consumption by the people has not declined to any great extent. The contraction of the business economy depressed the rural labour market and increased unemployment and rural poverty.

The cutback in public expenditure had a harmful effect on programmes for reform of the production structure and for integrated rural development, as well as on public agricultural services, including public credit, since it intensified the competition for fiscal resources and widened the gap between the amounts originally allocated and those effectively transferred. The adoption of fiscal austerity measures has been accompanied by stricter taxation policy on the part of the agricultural authorities, and priority has been given to the attainment of financial targets, with little attention paid to the actual economic results of agriculture or to rural social objectives.

In these circumstances agricultural recovery will be a difficult and complex task, but a feasible one. The mere fact that production levels are

somewhat below their previous maximum levels indicates that the desired expansion can be achieved. To this must be added the considerable agricultural potential of Latin America, which is not being fully utilized.

The immediate production crisis facing the region's agriculture has its roots in the cost of the financial resources required, the severe shortage of foreign currency for import of essential technical inputs, the contraction in domestic demand for foodstuffs as a result of the recession, and the difficulties of access to international markets. The freedom of manoeuvre available to each country with respect to these restrictions will determine the speed of its agricultural recovery and subsequent expansion.

The recent decline in the volume of imports both of foodstuffs and of technical inputs might give the impression that there will be a reversal of the tendency towards sustained increase in food and technical dependence on the part of Latin American agriculture. On the other hand, it must be remembered that the developed countries have a definite interest in maintaining and extending markets or acquiring new markets for their export goods, and interest which will clash with the national efforts to substitute imports.

In some countries the volume of official agricultural credit began to increase from 1984 and guaranteed prices began to reappear for selected products. Both these facts reflect national recovery strategies which give high priority to agriculture owing to its capacity to generate foreign exchange, its important role in improving and stabilizing the domestic supply of foodstuffs, its importance for agro-industry and the part it plays in easing rural tensions arising from the growing list of unsatisfied basic needs.

## II

### Outlines of strategy

#### 1. *Principal objectives*

A strategy alternative to passive acceptance of the trends described above would be to give maximum priority to two main objectives: the elimination of rural poverty and the reduction of external vulnerability in foodstuffs. The elimination of rural poverty is nothing more than the expression in a specific sphere of the national objective of eliminating poverty in all its forms. The scale, location and determining factors of rural poverty are by now so well known that it is difficult to believe that this poverty will disappear within an acceptable time frame without decisive action by the State. Similarly, the significant reduction of external vulnerability, with respect to lines and processes of agricultural and livestock production which are vital for the satisfaction of basic needs, is an objective directly linked to the terms of integration in the international economy and, in that sense, is nothing more than a sectoral aspect of a more general objective—the quest for independence in development. However, as it is connected with the satisfaction of basic needs the reduction of external vulnerability acquires particular importance in this case.

The two objectives form an integral part of another goal which transcends the strict sphere of agricultural policy and affects the whole body of development strategy. This is the quest for food security, recently defined by FAO as the guarantee that people will have, at any time, physical and economic access to the basic foods which they need. Food security should have three purposes: to ensure production of an adequate quantity of foodstuffs; to obtain maximum stability in the flow of these foodstuffs; and to guarantee access to them by the people who need them.

In other words, it is a question of progress in the establishment of national food systems—understood as the whole complex of socio-economic relations, from primary production to the final consumption of foodstuffs, a process which has the following characteristics: i) *sufficiency*: to generate a domestic food supply, the

volume and composition of which can satisfy both the effective demand and the basic needs of those sectors which, by reason of income or other problems, cannot translate those needs into a market demand; ii) *stability*: to have mechanisms which utilize cyclical fluctuations in production volumes and prices, in particular for those products which are important elements in the diet of the most populous sectors; iii) *independence*: to reduce to a minimum, in securing an adequate and stable domestic supply, any vulnerability to external market influences; iv) *long-term sustainability*: sufficiency, stability and independence should not be achieved at the cost of the sort of exploitation of natural resources (renewable and non-renewable) which makes it impossible to maintain those conditions over the long term; and v) lastly and most important, *fairness*—a necessarily elusive concept; however, in the present circumstances in the countries of the region it would be acceptable to define it as an attempt to guarantee all the people the essential minimum levels of nutrition and prevent the consumption of luxury foods by certain sectors if that would impair one or more of the five qualities described above.

#### 2. *The main processes of an alternative strategy*

If the stated objectives are to be achieved, the whole complex of policies for the agriculture and livestock sector will have to focus on generating and sustaining a process of change characterized by the following features:

i) *Reduction of the diversity of production in the agriculture and livestock sector*. In the majority of the countries of the region this implies the modernization and strengthening of the peasant economy in order to ensure access to productive resources (land, water, inputs and tools) on a scale and on terms which at least satisfy the basic needs and facilitate the sector's independent control over production and marketing. Since the peasants are major producers of basic foods and constitute the majority of the rural poor an increase in their levels of production and pro-

ductivity would meet the double objective of increasing the supply of food and eliminating rural poverty. If to this is added the possibility that the sector might use technological solutions involving more intensive use of manpower and less demand for imported inputs per unit of production, then the close correlation between strengthening peasant agriculture and attaining food security on the terms described above would become obvious.

ii) *Selective redirection of the transfer of surpluses.* If standardization is to be achieved, especially in the framework of the restrictions imposed by the crisis, there will have to be a long period of retention of its own surpluses by the agriculture and livestock sector or of transfers of surpluses not only from non-agricultural sectors to the agricultural sector, but also from the modern agricultural sector to the backward but potentially dynamic sectors of peasant agriculture and to other dynamic activities which are or could be located in the countryside.

This change, of course, should take place under conditions which will create for the agriculture and livestock sector as a whole and within a reasonable time frame (which can never be very short) the capacity first to attain self-sufficiency and then to generate transferable surpluses.

Many mechanisms are required in order to bring about the suggested redirection and, given the specific nature which these mechanisms will have in each country, they cannot be described in detail here. But it should be mentioned that they range from different pricing and credit policies to the reallocation of public expenditure, on infrastructure investment in particular (small hydraulic works, local roads, small centres for producers' organizations, research and dissemination of technology from peasant products).

iii) *Strengthening the interrelationship between agriculture and industry and upgrading of rural areas.* This means the establishment, strengthening or modification of various kinds of link between the two sectors. The first and most obvious link is that of agro-industry as a processor of farm inputs; the task is to give priority to the production of essential consumer goods (food and some kinds of clothing) and the export of existing agro-industrial products or other products which may offer comparative advantages. Agro-industry is

capable of operating as a nucleus for generating higher forms of organization of agricultural activity (thus facilitating the intensification of agriculture) especially by establishing allied enterprises and encouraging self-management by peasant and medium-sized agricultural producers; when it comes to larger-scale initiatives, mixed enterprises with public participation might be established.

The second basic link is the role of industry as a supplier of inputs and means of production to agriculture, which makes industry one of the greatest influences on the direction of technological change. In the past this process led to the passive incorporation of technological elements which accentuated agriculture's dual nature, with the intensification of the diversity and external vulnerability of the production systems. One of the main tasks here is to correct this trend and to find techniques which facilitate the modernization of the great mass of small and medium-size businesses (in peasant agriculture in particular), thus increasing their productivity and at the same time reducing the imported elements in the inputs and means used.

The third link is the introduction into rural areas of industrial activities taking advantage of seasonal unemployment and tending to absorb manpower which would otherwise contribute to swelling the migration to the cities.

Generally speaking, the redefinition of the links between agriculture and industry, and the implementation of supplementary measures, should aim at the increased utilization of rural areas.

Part of the redirection of surpluses, which will vary from country to country, should be aimed at the development of rural industries of various sizes, preferably ones which can be effectively incorporated in peasant production by means of co-operative or similar undertakings, in order to increase the value of their products and to provide jobs (in addition to agricultural activity as such) in industrial undertakings not necessarily engaged in the processing of agricultural inputs. It is a question of physically reconstituting, on the basis of traditional agriculture but at higher levels of organization, a series of activities which were originally part of that agriculture but became separated from it in the process of the division of labour and specialization, not only

sectorally but physically as well. It is also necessary to encourage the decentralized development of activities which, although not part of the industrial processing of agricultural inputs, can be integrated in that process through the labour markets with mutual advantage and with great social benefits, given the over-urbanization and high rate of industrial concentration which are features of the majority of the countries of the region. It goes without saying that the integration of industrial activities will have to be matched by coherent transport, education, health and leisure policies.

The experience of Europe and Japan with respect to the interrelationship between peasant agriculture and agro-industry and between handicrafts and industrial work of various kinds, offers an example of the effectiveness of this kind of solution.

iv) *Reduction of the imbalance in the terms of integration in the international market.* The difficulties of overcoming this imbalance should not be underestimated, if only because some of them are beyond the control of the countries of the region, acting individually or together, since they are determined by the policies of the big importer and exporter countries. However, there are a great many underused possibilities of increasing exports and reducing or substituting imports in the agro-food area; these possibilities could come to have great importance.

The diversification of agricultural and livestock exports has been a slow process in Latin America. The process is still dominated by a small number of lines whose growth is far from dynamic in the world market; their expansion cannot therefore still be considered as a basis for the future development of the sector. The incorporation of a range of products for which there is a more vigorous demand and which have a greater local value added (however small each one of them may be individually) may prove to have an enormous overall importance, as some recent experiments have shown (citrus and other fruits, vegetables, forestry products, footwear). This has the added advantage of diversification in preventing large fluctuations in foreign earnings.

There has been spectacular progress in some countries of the region in the penetration of international markets with certain "modern" lines.

This suggests that, given the right conditions, the agricultural sector has a degree of flexibility and a capacity to react which are not normally attributed to it in Latin America.

With respect to imports, apart from the obvious measures to reduce or eliminate purchases of luxury foodstuffs which the crisis itself would require, progress must be made in the substitution of imported agricultural inputs, especially in the case of food products which have shown very fast growth (animal feeds, oilseeds, dairy products), where there are no complex technical obstacles to substitution.

Another underused possibility is to open up regional and subregional markets in which joint purchases from third countries, increased internal trade and the establishment of ties of interdependence in agriculture and the food industry, as well as the intensification of barter trade, might bring about a large reduction in the expenditure of foreign currency on imported foodstuffs. However, it must not be forgotten that many of the factors determining the source of imports are connected with the financial facilities which the big exporter countries can grant and which acquire greater importance in times of crisis.

v) *Reduction of technological dependence.* Where this objective is concerned, it is important not to underestimate the cost or the time it takes to establish technologies or to make changes to adapt them to the resources available locally. However, this does not mean conforming with the present trend of passive acceptance of technologies created in different situations; rather, it points to the need to establish for the agriculture and livestock sector the kind of durable and coherent technology policy which is needed if the time-limits are to be met. It is impossible to dispute the importance of the role of the State in this matter, with respect both to the volume of resources required and to the social characteristics of the bulk of the recipients. An important step would be to stop importing whole packages of technology, which include imported inputs and means of production and entail the displacement of manpower, for some of these components, given a perfectly feasible effort to adapt, could be replaced by domestically produced inputs or by labour. Another step would be to check the tendency towards more diversified patterns of

foodstuffs demand, which require inputs or means of production from outside the region, no matter how slowly these patterns are changing.

Regional and subregional agreements on technology have obviously made too little progress, for the division of labour at the regional level based on a common policy of scientific and technological development in the agro-food sector would have clear advantages, many of which have indeed been properly assessed.

vi) *Rehabilitation of natural resources.* The processes of erosion, desertification, salination, exhaustion of water tables and deforestation have reached catastrophic levels in many regions, and this problem cannot be skirted in the public and private decision-making process. Nor can the ecological degradation caused by the transfer of peasant agriculture to marginal land as a result of the takeover of peasant land by agribusiness continue to be accepted with indifference. When designing policies adapted to different types of product it is important to include the specific requirements of each type of physical environment, so as to establish food-supply systems which can be sustained over the long term. Because of the diversity of situations found in the countries of the region, the relevance of the principles stated above will vary from case to case, and their expression in more specific and concrete terms will require attention to the following variables: the absolute size of the economy (or if it is preferred, of the country in question), for this affects the relative importance of the internal and external markets in agricultural supply and the potential function of agricultural exports in the overall dynamics of the economy; the proportion of the population living in rural areas and, as a corollary, the proportion of the economically active population engaged in agriculture, for this affects the diversity of the sector's production structure (relative weight and degree of differentiation of the peasant economy in comparison with the business economy) and the choice of more suitable technological options; and differences in the amount of agricultural land available per inhabitant and in the relationship between cultivable land and employed population, which has implications for the choice of technology, for the scale on which surpluses of food and other products may be generated for the development of the urban-industrial sector,

and for the diversity of the production structure.

Diversity of crops and in the size and type of farm is of great importance in the design of sectoral policy. The greater the diversity (within each region and among regions, and within each country), the greater will be the need for policies suited to each type of producer (and region) and the greater the need for decentralization, co-ordination and organization of producers, in order to establish an agricultural policy capable of co-ordinating and mobilizing the agents who are to be incorporated in agricultural development. Accordingly, it will have to be decided, in each national situation, which social sectors, which economic agents and which types of relationship between them will be most capable of mobilizing the State for this purpose.

### 3. *The role of the State*

Many different arguments lead to the conclusion that the free operation of the forces of the internal and external markets, far from increasing the standardization and integration of the productive structure, reducing external vulnerability and securing more equitable distribution, tend, on the contrary, to exacerbate polarization and dependence. This is simply the result of the diversification of the production structure and the consequent inequality with which the agents are faced when they buy and sell in the various markets. This argument is borne out by the results of the recent experiment in neo-liberalism, which advocated the theory of the subsidiary role of the State. In contrast, there are many examples of agricultures which have succeeded in developing with the firm support of the State within a framework of relative standardization of productive units and a high level of organization and influence on the part of producers' associations. Policies of price maintenance, State purchases of crops, regulation of sown areas, substantial direct and indirect production subsidies (equivalent in some countries to more than half the value of production), protection against external competition and encouragement of penetration of export markets, establishment and maintenance of vast scientific and technological research networks and agriculture and livestock extension structures —these are only some of the most noteworthy forms of public in-

tervention in the most advanced agricultures, intervention which, moreover, is based on a long-term view and is intended to continue for several decades.

Latin American history also offers many examples of direct and indirect public intervention in the agriculture and livestock sector, and such intervention increased considerably from the 1930s. In the majority of cases, however, it has tended to consolidate or even accentuate tendencies towards diversification of the production structure, owing both to a marked urban-industrial bias, which neglected rural areas, and to a pronounced leaning towards modern agribusiness. Agribusiness, for example, was the main beneficiary of the development of the sectoral infrastructure, the allocation of credit, generally subsidized, for agriculture and livestock production, the lack of a fiscal structure levying taxes proportional to the productive potential of the land, reductions in tariff or exchange rates and terms favouring the import of machinery and certain agricultural inputs, and price-control policies, which, in an effort to keep wages down, eventually created comparative advantages for products suited to the business rather than to the peasant structure.

Though there are no economies of scale of any significance in the use of the essential components of the new technologies (in particular technology associated with the green revolution)—since fertilizers, seeds and irrigation water are perfectly divisible, once the infrastructure work has been completed, usually by the public sector—the landholding structures and the institutional base polarized the adoption of these technologies, which included a mechanization element not inherent in the technologies, an element which only the larger-scale units could handle. Furthermore, the pattern of technological development, in addition to accentuating the polarization of levels of productivity and income in the agriculture and livestock sector, brought about a faster rate of increase in external dependence for inputs and machinery.

In the cases in which policies of transfer to the peasant and small-producer sector were applied, there was a considerable element of paternalism or clientism, which deprived these policies of the direction and continuity needed for increased production. A similar limitation

was found in the various forms of assistance to the poorest rural sectors.

It would be wrong to assert a clear choice between State intervention and a subsidiary role for the State, with a greater or lesser degree of intervention in the economy; that would be to avoid the heart of the matter, which is the content and the orientation of public management or, more accurately, the kind of relationship established between the State and the social agents participating in the process of devising and carrying out policies. It is in this area that fundamental reforms are needed if the stated objectives are to be attained. Broadly speaking, the changes proposed are aimed at the gradual establishment of a democratic and participatory framework which will ensure an effective relationship between planning and market with respect to the stated objectives.

#### *4. The democratic participatory strategy in rural areas*

The establishment of a democratic participatory framework will require significant changes on two fronts: the adaptation of the public apparatus and the organization of producers (and, it may be added, of urban consumers, especially in the peripheral zones of the big cities). It is essential to decentralize political and administrative functions and the use of resources and to integrate the multiplicity of public operations at the local level, in particular those which are directly or indirectly complementary. Producers' organizations will have to be strengthened (or set up where they do not exist) and made to operate with as much uniformity as possible in matters relating to the interests of their participants; they must also represent clearly defined constituencies and be recognized as doing so by the producers themselves, who constitute the local aspect of the integration of public management.

Proposals must be matched by the political will and force needed to overcome the natural tendency of bureaucracy towards concentration of power and vertical management and the tendency of producers' organizations not to represent the interests of their smallest members.

Only in the context of an organized rural social system and a political and administrative structure which has been decentralized and in-

tegrated at the local level will it be possible to establish participatory policies, at least in areas having a more direct influence on the living and working conditions of the producers, in order to transform the producers' organization itself into a productive resource of great potential. It is certainly not asserted that participation should be expressed in more or less detailed rules relating to the representation of the groups concerned on commissions or committees of various sectors of the bureaucracy, located near or far from the group's territory, or in the formal convening of assemblies by civil servants in various public institutions with a view to deciding matters of common interest. Quite to the contrary: participation should mean a continuing activity which truly expresses the power of the participants over the conditions of the work process and the utilization of its products.

The degree to which a rural social system of uniform organizations is established and the political and administrative structure is adapted to the requirements of participatory management will determine the possibility of transferring functions and resources from the State to local group organizations, as well as the planning and application of political measures suited to each type of producer (and not to each type of product as was the case in the past).

The adoption of different measures for each type of producer is the only approach consistent with the goal of eliminating rural poverty by reducing diversity and strengthening the weak-

est sectors in the production structure through the selective transfer of resources to the ones with the greatest potential to absorb the resources productively within a reasonable time-limit.

It goes without saying that the production and application of different measures for each type of producer is not feasible, by virtue of the nature of the measures themselves, in an authoritarian and bureaucratic environment, for the application of such measures would tend to swell the public apparatus and produce great technical and economic efficiency.

The different and specific nature of these policies, and their participatory content, must find expression in the whole range of sectoral policies —investment, credit, training, marketing— and in the policy of technological development itself, for much excellent experience has been accumulated in the extension of experimentation and selection of high-yield techniques and varieties.

The vast experience of rural development programmes shows that non-participatory public management requires more resources and more and better qualified staff in order to obtain worse results than can be obtained by mobilizing the local potential and delegating many of the functions to local collective bodies or community representatives. In other words, the mobilization of organized producers must be converted into a high-potential productive resource.





## On the role of small and medium-sized enterprises in the improvement of the production structure of developing countries

*Carlo Secchi\**

This article focuses on the structure of the production system and on policies for improving it, with particular reference to medium-sized and small enterprises. Information and specific examples are provided based on Italy's experience in this respect and on the role which such enterprises have played in that country. It is suggested that, from this standpoint, Italy's experience may be of much greater interest to many developing nations than that of other industrialized countries, both as a model to be followed and in terms of the errors that should be avoided.

The article opens with an analysis of the interplay between entrepreneurship and a firm's external environment (section i) as a basis for laying down guidelines concerning the reciprocal relationship between development and economic efficiency (section ii). A discussion of the advantages of small and medium-sized industries (section iii) is followed by a description of the conditions which permit and promote their creation and growth (section iv). After discussing the role performed by these industries in the introduction of innovations and in the processes of internationalization (section v), a number of concluding remarks are offered (section vi), concerning public policy challenges in particular.

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## Introduction

It has often been said that instead of thinking in terms of a "world crisis", it may be more correct to consider the past few years as a time of deep transformations and of transition from a long period of continuous growth (according to some, of a Kondratieff sort), which has gradually ground to a halt, to a period of renewed prosperity. If we are fortunate, this new long cycle of growth may start before the end of the century, and all economies—both industrialized and developing—must prepare for it in order not to miss the opportunities it will bring.

In all likelihood, the new mechanism of growth will be based on factors of both supply and demand. On the supply side, new technologies will play a key role by allowing a better use of raw materials and energy sources, increasing productivity levels, and helping to satisfy both traditional and new human needs. On the demand side, the situation may be viewed in terms of a combination of "new" needs in the industrialized countries (which are also linked to demographic factors), and of "old", so far unsatisfied, needs in the developing countries. The latter will also provide a "new frontier" for growth in the world economy (Gasparini, 1981), if economic policies are pointed in the right direction.

Italy's experience can teach us a great deal about the role that small and medium-sized enterprises (SMSE) may play in this process. According to the 1981 census, 59% of total manufacturing employment in Italy was in firms with less than 100 employees (quite similar to the figure for Japan, which was about 58%), while in the United States, the Federal Republic of Germany and the United Kingdom, only 16%-18% of workers in the manufacturing sector were in firms with less than 100 employees. France (whose statistical sources on employment are based on different categories of firms) was at an intermediate point between the two.<sup>1</sup>

Very recently, a detailed analysis of the evolution of small Italian firms was published by

<sup>1</sup>For detailed information, statistics and analyses, see Baroin and Fracheboud (1983); Greffe (1984); IREP (1984); Small Business Administration (1984). See also the following footnote.

Table 1  
 ITALIAN MANUFACTURING INDUSTRY: CONTRIBUTION TO NUMBER  
 OF PLANTS AND TO EMPLOYMENT BY CATEGORY OF FIRM  
 (ACCORDING TO NUMBER OF EMPLOYED), 1971-1981

Category	1 to 9	10 to 99	100 to 499	Over 500	Total
<i>Number of plants</i>					
Percentage variation 1971-1981	+18.3	+37.4	+5.1	---	+20.5
Absolute variation 1971-1981	+82 291	+24 605	+326	---	+107 222
<i>Employment</i>					
Percentage variation 1971-1981	+25.6	+23.1	+3.0	-6.0	+12.0
Absolute variation 1971-1981	+271 036	+402 202	+37 821	-74 763	+636 296

Source: Confindustria (1985), table 3, p. 9, and table 7, p. 12, based on census data.

the General Confederation of Italian Industry (Confindustria, 1985) and discussed during a Conference organized by its Comitato Nazionale Piccola Industria in Venice on 29-30 March 1985.<sup>2</sup> This study, which was also based on the results of the 1971 and 1981 general censuses, shows that from various standpoints SMSE have played an important part in the development of the Italian manufacturing sector. Table 1 indicates their contribution during the 1971-1981 period to the total number of production units (plants) and to employment broken down according to the four categories into which all firms were subdivided, based on the number of employed. It may be seen that almost all new plants were established by firms with less than 100 employees and that such companies also produced the great majority of new jobs. As a result, the average size of each plant decreased from 75.5 employees in 1971 to 56.4 employees in 1981.

Although more detailed sectoral and regional data like the figures provided by Confindustria in 1985 are needed, Italian industry can be said to have reacted to the crisis during the 1970s and

to have tried to adjust to the changing international context through a process of de-verticalization and decentralization in order to gain more flexibility. SMSE accounted for almost all new undertakings, while large firms were still struggling to restructure in order to overcome their marketing technological and financial problems.

For various reasons, in recent years SMSE have aroused a great deal of interest among both researchers and policy makers in view of the important part they can play in solving some of the problems of the production structures in both industrialized and developing countries. Various schemes have been introduced for promoting the creation of new, mainly small-scale, enterprises such as those proposed by Bénoun and Séricourt (1980), Binks (1979), Hutchinson (1978), and Jarrett and Wright (1982).

Pursuant to a proposal made by the European Parliament, 1983 was declared the "European year of small and medium-sized enterprises". The purpose of this measure was to underline their importance, foster debate on their problems and potentialities, encourage the study of new and more efficient policies to promote such enterprises and improve their access to the financial instruments of the European Community. A great deal of very useful information, material and research work was produced, thus shedding new light on the phenomenon.

<sup>2</sup>Two very interesting studies for purposes of comparison of performance and experiences were published under the auspices of Confindustria, one on France and Germany (Malerba, 1985) and one on the United States (Marelli, 1985).

## I

## Entrepreneurship and the economic environment

First of all, it must be made clear that entrepreneurship can produce its best results only if it operates in a favourable economic environment, a concept which includes all collective actors (the State, local authorities, trade unions, financial institutions, business associations, chambers of commerce, etc.) external to the enterprises themselves (Vaccà *et al.*, 1984).

These collective actors must in turn function on an entrepreneurial basis in order to interact efficiently with production units. Only in this way can the system (enterprises plus the environment) grow effectively. Thus, for example, the services that are provided to industry must be economically efficient, as measured by a market yardstick (i.e., the price to be paid by their users), in order to stimulate entrepreneurial behaviour. Assistance, in contrast, will inevitably produce an inefficient production system.

In Italy, for example, efficient SMSE have developed not in the heavily-assisted *Mezzogiorno* area (with the partial exception of Puglia), but in other parts of the country where, although little public assistance has been given, there has been a favourable environment for their efficient development. This applies not only to the more economically advanced regions such as Lombardy and Piedmont but, surprisingly enough, even more to some regions in the north-east (the Veneto area)<sup>3</sup> and in the central zone along the Adriatic coast.

The rapid growth of these previously backward regions after the Second World War was indeed of a quite different nature from that of the regions of the north-west where industrialization came earlier. This fact has given rise to a number of studies on the features and policy implications of this type of development, sometimes called the "Veneto" or "Adriatic" model (Antonelli and Momigliano, 1980), although it may be preferable to refer to it as the NEC (North-East and Central) model, as sug-

gested by Fuà (1983), among others. The impressive growth of manufacturing activity, mainly on a small scale, was in no way supported by special public programmes (as was the case in the *Mezzogiorno* area), but on the contrary, was primarily based on the local labour supply, saving capacity, and entrepreneurial skills inherited from the preindustrial period of economic development. Another major factor was the existence of a united community with its institutions, its culture, and its physical infrastructure (the "environment", as defined above). According to Fuà (1983) and others who have studied the NEC's experience and prospects, the success of the NEC model lies in its capacity to combine all its pre-existing strengths and resources and to use them, without causing any drastic shock, to modernize economic life and production.

SMSE have also played a major role in the recent restructuring of the Italian regions where industrialization came earlier. This applies in particular to some very dynamic areas, such as the Brianza, to the North of Milan, which was recently studied by Senn *et al.* (1985), in a comparative context with reference to the areas of Worcester in the West Midlands of the United Kingdom, Augsburg, Federal Republic of Germany and Besançon, France. The purpose of this research project was to confirm the existence of quite a few comparable successful local economic systems in Europe. Some of their more interesting characteristics include a high level of economic development and a diversified industrial structure. The latter is mainly composed of a great number of SMSE which are highly dynamic, capable of self-restructuring, able to combine local resources and different factors of production creatively, and highly competitive on the international market. These basic characteristics, shared by the Brianza and the other areas studied, are both the cause and effect of a variety of circumstances, the most important of which are widespread entrepreneurship, a marked propensity to adopt new technologies and a strong orientation towards adaptation and restructur-

<sup>3</sup>For a brief discussion of this subject, see *The Economist*, 30 March 1985, p. 69: "Out of the shadows. Can the Veneto's boom last?"

ing in response to exogenous changes. In particular, a minor but noteworthy role has been played by the public authorities in the promotion of growth, together with the remarkable autonomy shown by local entrepreneurs in creating and implementing co-operative instruments of industrial policy. There emerges a very interesting regional development model that, while still based on the fundamental role played by entrepreneurship within SMSE, may perhaps be better suited to areas of earlier industrialization,

in contrast to the NEC model, which is based on the experience of areas of late industrial development.

Of course, similar considerations to the above, which counsel against providing assistance to the production sector, also apply in large measure to the use of protection as a means of stimulating the growth of industry. Such protection can produce overall positive results only if it takes place within a context of economic efficiency.

## II

### Economic development and economic efficiency

Numerous mistakes and unsuccessful policy options are to be found in the strategies adopted by many Third World countries to foster their development.

First of all, over the past 20 years attempts by individual countries to promote economic growth and development in an autarkic context have in most instances failed. After the initial ("easy") stages, import-substitution strategies, particularly in the case of countries with limited domestic markets, have caused a great deal of economic inefficiency and waste of resources, together with other negative welfare effects deriving from the distortions thus produced.

Better results are achieved with import-substitution strategies at a regional or sub-regional level. However, economic co-operation and integration among developing countries have also made slow progress and met with many failures. The success stories that do exist are more the result of outside actors which have stimulated economic integration either in a positive way or as a reaction to what was seen as a potential danger from without.

Economic growth and development must first of all be a self-sustaining process; in other words, they must satisfy all those conditions that will guarantee their continuation over time on an autonomous basis. It is a mistake to think that such a development model might work in a context of autarky.

Economic efficiency is the only way in which

developing countries can achieve an optimum use of their resources for the well-being of their people. Virtually without exception, this can only be done through specialization at both the domestic and international levels. Thus, it is in the interest of each developing country to participate in the world economy inasmuch as its trade and other relations will provide it with a means both of fostering the best domestic allocation of resources and of exploiting its comparative advantages in international trade. This, contrary to what is often said, does not mean that internal economic problems must come second to the type of place in the international setting an individual country tries to achieve. Devoting attention to domestic economic problems not only helps to better satisfy some crucial needs, but also makes it possible to strengthen many aspects of the internal production structure. Thus, the "ideal" model of development should be both "inward looking" (in the sense that it pays due attention to internal needs) and "outward looking" (in the sense that it is oriented towards active participation in the world economy).<sup>4</sup>

Due to the various advantages they offer,

<sup>4</sup>It goes without saying that industrial countries have a great responsibility to help the developing nations in their efforts to pursue an efficient development model, and hence their co-operation policy should include measures to this end. With respect to the case of Italy, see Secchi (1985).

SMSE have a fundamental role to play in strengthening the production structure of the developing countries, provided that their de-

velopment takes place within a general economic policy framework which is consistent with the above.

### III

## Advantages of SMSE

Taking into account what has been said so far, and particularly the need to promote growth along with economic efficiency, SMSE can be said to have a number of well-known advantages.

First of all, SMSE are flexible, i.e., they can rapidly adapt to changing market conditions, both domestic and international, provided they have all the information they need in order to modify their behaviour and strategies accordingly.

Secondly, in some cases SMSE can better exploit new ideas and can take greater advantage of "niches" left free by large firms both in the domestic and in the international markets.

Thirdly, SMSE involve lower investment costs per unit of employment and value added, and consequently may allow (*ceteris paribus*) a more rapid growth of employment and income.<sup>5</sup>

Fourthly, SMSE function more satisfactorily than large enterprises from the standpoint of urban-rural relations, ecological and environmental constraints, etc.; they can fully exploit existing craft traditions and skills; and, by using this craftsmanship in a creative way, they can subsequently promote new entrepreneurial activities.

<sup>5</sup>Two recent surveys cited in *The Economist* (8 January 1983, p. 12) indicate that two-thirds of new private-sector jobs (industry plus services) in the United States since 1969 have been created in firms with less than 25 employees. In addition, see table 1.

Finally, SMSE also have many advantages over larger production units from the standpoint of economic democracy and industrial relations since, by allowing entrepreneurship potential to be realized they make an invaluable contribution to the overall economic development of the country concerned.

This article is primarily concerned with the SMSE within the industrial sector. However, in a developing economy as well, they can also play an important role with respect to tertiary activities. A few examples will suffice to illustrate the potential benefits offered by SMSE in this sector (in addition to the great contribution they have made during recent years as regards keeping up employment levels in most of the industrial countries).

Efficient SMSE can rationalize and improve distributive trade activities. This is particularly important in connection with agricultural reforms and efforts to increase agricultural productivity. Indeed, SMSE can provide better marketing services for agricultural products, as well as other services and intermediate products, and can productively absorb manpower as it leaves the agricultural sector.

Tourism is another sector in which SMSE can play an important role. Furthermore, they can promote service activities which contribute to foreign trade and to internationalization of small-scale production units (Alessandrini, 1985).

## IV

## The birth and growth of SMSE

SMSE can be created and can flourish only if a number of conditions are satisfied, such as those mentioned here. First of all, the process must take place within a favourable economic environment. In addition, a wide range of entrepreneurial skills are required which may have been developed either in industry (former employees leaving their jobs to set up their own firm, in what is known as the "spin-off" phenomenon) or in agriculture. Economic history shows that in the areas of early industrialization, entrepreneurship originated mainly in agriculture. This was particularly true in cases where conditions were more difficult and thus stimulated individual ingenuity and creativeness.

An appropriate institutional context is also required, in terms of both the regulatory and legal apparatus and the application of an active policy to encourage SMSE.

Transparency in the market and an efficient flow of information on domestic and international market conditions are important aids for SMSE in selecting a successful strategy. Public policy (together with private specialized service activities) can be of great help in providing easy access to all the necessary information and in keeping its cost as low as possible. SMSE must also maintain appropriate relations with the rest of the production system (large enterprises, specialized services, etc.). Finally, SMSE must have a sufficiently large market, as well as access to foreign markets. Hence the need for regional economic integration, which can provide a partial alternative to a completely "open door" policy, allowing SMSE to take advantage of markets that are geographically closer and, for obvious reasons easier to penetrate.

Again, the Italian experience in this respect is quite interesting, since the European Community is now regarded as a "domestic" market by Italian SMSE. A very informative analysis of Italian exports by firm size and market of destination was recently published by the Italian National Institute for Foreign Trade (*Istituto Nazionale per il Commercio Estero*). This study not only underscores the great importance of the

Western European market for Italian SMSE (ICE 1985, pp. 23-24), but also provides very useful insights (from the standpoint of the subject under discussion in this article) on the percentage distribution of the different categories of export firms and on foreign sales by category of firm, based on each firm's export sales in 1983 (see table 2). This analysis was made possible by the fact that the Italian Foreign Exchange Office (*Ufficio Italiano Cambi*) records each individual foreign trade transaction;<sup>6</sup> these transactions were then ascribed to each export and import firm's external operations.

The records indicate that there were 85 910 export firms in Italy in 1983. As shown in table 2, 85 996 of them were small export firms, with annual sales abroad of less than 1 billion lire, which accounted for 11.1% of total Italian exports. More than half of the total Italian exports (55.8%) in 1983 were sold by medium-sized exporters, which made up 13.9% of all export firms.

Finally, large exporters (with annual sales abroad of over 50 billion lire) represented 0.2% of all export firms and contributed one-third (33.1%) of total Italian export receipts.

These figures leave no doubt about the crucial importance of Italian SMSE as regards the country's exports, contrary to the common belief that foreign trade is mainly the preserve of large enterprises.<sup>7</sup>

Before moving on to the next topic, two issues are worth discussing in more detail.

The first refers to SMSE *vis-à-vis* large enterprises. The system of production requires a suitable combination of SMSE and large enterprises.

<sup>6</sup>Except very small transactions (under 3 million lire, in 1983) those classified as "occasional", and of course, transactions in which no payment is involved.

<sup>7</sup>As noted by Secchi *et al.* (1983), an analysis of the role of Italian SMSE in the internationalization of production yields equally surprising results, inasmuch as SMSE constitute a growing presence in Italian foreign investments, mainly of the so-called "new type" (typically, non-equity investment such as joint ventures, international sub-contracting, etc.; cfr. OECD, 1984).

Table 2  
 PERCENTAGE DISTRIBUTION OF EXPORTING  
 FIRMS IN ITALY AND OF EXPORT  
 SALES BY CATEGORY OF FIRM  
 (ACCORDING TO EXPORT SALES IN BILLION LIRE)

Category	Under 1 billion lire		1 to 50 billion lire		Over 50 billion lire	
	% of total	% total sales	% of total	% total sales	% of total	% total sales
1978	86.0	10.2	13.8	54.6	0.2	35.2
1979	87.0	10.9	12.8	55.5	0.2	33.6
1980	87.2	11.4	12.6	56.7	0.2	31.9
1981	88.0	12.5	11.8	54.1	0.2	33.4
1982	87.1	11.5	12.7	54.0	0.2	34.5
1983	85.9	11.1	13.9	55.8	0.2	33.1

Source: ICE (1985), pp. 16-17. Each category is defined on the basis of each firm's export sales in 1983. All data on export sales have been converted into 1983 Italian lire at the 1983 exchange rate as of 30 December 1983, US\$ 1.00 = 1 659.5 Italian lire.

The latter perform a functional role in relation to the former (e.g. decentralization of production, sub-contracting, etc.) and vice-versa (SMSE provide large companies with more flexibility).<sup>8</sup> Moreover, in many cases SMSE are just small firms which will grow, and they must therefore be seen in a dynamic context. Finally, an appropriate mix of enterprises is necessary not only in terms of their size, but also in terms of the different sectors.

The second issue relates to SMSE vis-à-vis the

<sup>8</sup>For a theoretical treatment of this subject, see also Mariti (1980).

informal sector (see also Alessandrini and Dallago, 1985). As a matter of fact, this sector is mainly made up of SMSE (at least as far as legal activities are concerned), and SMSE sometimes are confused with the so-called "underground economy". In this connection, there are a number of questions which certainly require more research work and analysis as a basis for policy-making.

One such question is to what extent the informal sector is a functional part of the socio-economic system and thus whether it should be tolerated or even encouraged. Another important question refers to the correct timing of an attempt to bring the informal sector to the "surface" through fiscal and other measures.



## V

## SMSE, innovation and internationalization

Introducing innovations and engaging in international activities are both similar (Schumpeter-type) processes because they involve breaking away from past, deeply-rooted patterns of behaviour and moving into new (and often unknown) spheres. Both processes, however, require the presence of entrepreneurship not only within the firm in question, but also in the external economic environment. Public institutions and private enterprise must provide an array of services functional to these entrepreneurial activities and particularly those of SMSE.<sup>9</sup>

Clearly, not only the introduction of innovations, but internationalization, as well, is a vital process for SMSE because it provides larger markets, stimulates specialization and fosters economic efficiency. Again, at a regional level, one finds another justification for economic integration, which favours the development of an efficient system of SMSE, while autarky and protection, on the other hand, clearly produce assisted and inefficient production units.

SMSE should not be considered as "traditional" enterprises (only large companies being able

to qualify as "modern", according to some). On the contrary, many innovative activities (process or product innovation) can and do take place in SMSE. Indeed, technical progress now largely favours the creation of small-scale units, both in industry and in services.<sup>10</sup> In addition, they seem to be much more efficient than large companies in producing innovations. A 1981 study conducted by the National Science Foundation of the United States<sup>11</sup> showed that small firms produce about 24 times as many innovations as large firms do for each dollar invested in research and development. In spite of this fact, nearly 90% of research and development funding is absorbed by large enterprises and nationalized industries. In view of this situation, changes in the current policy in this field are urgently needed, although it is true that many SMSE may be too small to have research facilities. Hence their efforts should be supported in various indirect ways.

Moreover, some international activities, such as joint ventures undertaken with foreign firms, are a very powerful vehicle for the acquisition of innovations, and in some cases SMSE are particularly active in this connection.

## VI

## Concluding remarks: challenges for public policy

There is a broad consensus in many industrial countries about the fact that public policy aimed

<sup>9</sup>In this regard see, for example, the preface by C. Secchi to Alessandrini (1985). This research (which shows how small-scale units also predominate in Italy in international activities elsewhere carried out by very large trading companies) was sponsored, in order to offer a service in terms of better and highly detailed information, by the *Centro Estero Camere di Commercio Lombarde*, in an effort to provide improved and highly detailed information services. This centre is a public institution of the Chambers of Commerce of Lombardy which was set up to promote internationalization by offering technical support and services to SMSE of the region.

at encouraging SMSE should concentrate on creating a favourable environment and a set of external economies, rather than interfering with entrepreneurial options. Those who study these and related matters in Italy have introduced a distinction between "sector" policies (which involve some form of planning, programmes of direct assistance to industry, etc.) and "factor" policies (which improve the performance of fac-

<sup>10</sup>On innovation and SMSE see, *inter alia*, Bollard (1983), Malerba (1985), Moore and Eads (1983), OECD (1982).

<sup>11</sup>Cited in *The Economist*, 8 January 1983, p. 11.

tors of production, such as training programmes, specialized services, advisory activities, and external economies in general). The latter interfere to a much lesser extent with the role of the market in the allocation of resources, and yet they foster efficiency, higher productivity levels and competitiveness.

One of the major problems of SMSE concerns their access to financing (see also Mussati *et al.*, 1981), which is obviously more limited than that of large enterprises. A key role is therefore played by financial institutions (and public policy in this field), and these institutions should make innovative financial instruments available which are particularly suited to the needs of SMSE.<sup>12</sup> In Italy, for example, experience has shown that *ad hoc* institutions such as co-operative banks for short-term financing, banks specializing in medium-term credit (similar to development banks, but meant in particular for small-scale financing), credit consortia, etc., serve the purpose better.<sup>13</sup>

Indeed, many problems connected with "smallness" can be solved by SMSE in a co-operative manner, e.g., through specialized consortia. This applies not only to credit consortia, as just mentioned, but also to a variety of other co-operative associations; such as export consortia which are set up to facilitate the penetration of foreign markets.<sup>14</sup> By carrying out some basic activities on a joint basis, SMSE are better able to deal successfully with a variety of problems. This is also the case with associations of small-scale producers which are formed to improve marketing activities or to obtain inputs at a lower cost. These collective efforts also allow SMSE in a given

region or sector to become a true "system" of production units having various synergistic interrelations. Obviously, it follows that public policy should strongly encourage such co-operative efforts.

Among the many other fields in which public policy must (and can successfully) operate, such as training programmes (which are of fundamental importance during periods of rapid technological change) and information services, it may be interesting to conclude this paper by focusing on three crucial areas of action in which further research work and empirical analysis are clearly required.

The first relates to the question of *how to promote entrepreneurship*. This is plainly a crucial issue, because entrepreneurship is one factor in satisfying the prerequisites for an efficient system of SMSE. Various experiments have been carried out in some industrial countries, and efforts have been concentrated on the fundamental problem of how to make the transition from a good entrepreneurial idea to its practical realization. This requires a co-operative effort among management schools, specialized services, financial institutions, business associations and chambers of commerce.<sup>15</sup>

A second crucial area of public policy has to do with *how to promote innovation*. SMSE need some form of public support for their research and development efforts, and this can be given in various ways: financial resources, easy access to existing knowledge, technical assistance, information programmes, etc. Particularly in the case of small firms, institutions—promoted or supported by the public sector—whose purpose is to transfer appropriate technologies from research centres to small-scale users are one factor of major importance. Moreover, some recent and successful endeavours have demonstrated how public enterprise can also play a key role in

<sup>12</sup>Two examples are leasing and factoring; these instruments allow fixed costs to be converted into variable ones, which are better suited to the cyclical nature of small businesses.

<sup>13</sup>With reference once again to the case of Italy, cfr. Mediocredito Regionale Lombardo (1979 and 1980). *Mediocredito* is a medium-term credit institution operating in Lombardy (each Italian region has a similar institution) which primarily provides financing for SMSE investments, export activities, etc. Its capital was provided by most of the banks specializing in short-term credit in the region, which also co-operate in its activities.

<sup>14</sup>In many regions of Italy, for example, export consortia work in close co-operation with the regional foreign trade centres of the chambers of commerce.

<sup>15</sup>A programme named Gemini was started in 1984 at the Business School of Bocconi University, Milan; the aim of this programme is to select a number of potentially successful ideas, bring together all the concerned parties, assist the "new" entrepreneur and carefully monitor the various phases until the new enterprise is able to continue on its own. This programme is financed, *inter alia*, by the Commission of the European Communities, by the Lombardy Region, and by the Chamber of Commerce of Milan.

the association of various firms —particularly SMSE— with research programmes co-financed by public and private sources. In addition, important advances in other areas (new management methods, a better knowledge of the market) can also be achieved in this way, especially if these programmes involve firms from different countries, as in the case of the ESPRIT Programme of the European Community<sup>16</sup> which was implemented in 1984.

Finally, a third basis issue has to do with *how to promote internationalization*. The reason why internationalization processes are of major importance to SMSE was discussed at the beginning of this paper. Obviously, these activities are more difficult for SMSE to carry out than they are for large enterprises. If they are to be successful, SMSE, in particular, require appropriate promotional, information, training, advisory and other services which can be supplied by both public and private institutions. Public bodies should be able to provide many of these services at a lower cost, as well as being able to implement many pioneering activities to help SMSE wishing to internationalize. After their initial stage, such activities can, of course, be picked up by the market and conducted by private enterprise as well. In addition, public institutions have a basic catalytic role to play in helping to match up SMSE

<sup>16</sup>European Strategic Programme for Research and Development in Information Technologies, which may soon be followed by a similar programme named RACE (Research and Development in Advanced Communications Technologies for Europe).

demand for specialized services with the services offered by private institutions, such a service activities, trading companies, etc., through information, promotion and advisory programmes.<sup>17</sup>

Further theoretical and empirical research is certainly needed, not only on the policy guidelines discussed above, but also on other experiences in addition to that of Italy,<sup>18</sup> which has been the main focus of this article. The outcome would be a clearer picture of the advantages of an efficient system of SMSE in strengthening the production systems of developing countries which would round out the brief presentation given here. Although it would clearly be a mistake to create a mystique out of the positive role of SMSE (indeed, large enterprises also have a vital role to play, particularly where economies of scale still predominate), their advantages and potentialities have been almost universally neglected, at least until very recently. In the developing countries, as well, a greater awareness of their potential contribution is wanting. More effective general and specific policy measures should consequently be taken in order to achieve a more satisfactory and beneficial composition of the production system.

<sup>17</sup>Again, in connection with Lombardy, see footnote 9.

<sup>18</sup>Because of language problems, the bibliography includes only a limited number of references in Italian, chosen from among the vast body of literature which has grown up so rapidly in recent years and which the interested reader can easily trace, starting from the bibliographical information given by the various Italian authors cited here.

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## Twenty-five years of the Inter-American Development Bank

*Felipe Herrera\**

From 1974, under pressure from the new trends in the world economy, international public financing began gradually to lose its relative importance for the Latin American countries. The growth of international monetary liquidity gave the international banking system an unfamiliar weight in absolute and relative terms. However, the world recession persisted, and it became evident that our countries must again seek a response to their needs in bodies such as the Inter-American Development Bank.

In the author's view, the experience of the last 25 years in Latin America shows that international public financing, from whatever standpoint, is an essential form of co-operation for the advancement of the region.

*CEPAL Review* wished to draw attention to the importance of the role played by the Inter-American Development Bank at a time when this institution has just completed a quarter of a century of activity on the regional and international scene. This article by its first President, Mr. Felipe Herrera, is published as a tribute to a sister institution.

\*First President of the Inter-American Development Bank.

## I

### Some of the background to the founding of IDB

A few years after the Second World War the countries of Latin America found themselves taking second place, in their efforts to obtain a greater amount of financial co-operation, to the great international priority which was given to the reconstruction of Europe and the economic development of Africa and some regions of Asia. The inflexibility of the working policies of the public authorities of the time was also subjected to universal criticism in the continent. Both these sources of dissatisfaction, together with the region's ancient aspiration to have its own regional financial system, transformed the establishment of a regional bank into a fighting banner in the inter-American economic forums. This aspiration was not shared by the rulers of the United States in those years, who saw no point in creating new mechanisms and thought it preferable to make better use of the resources offered by private capital, by Eximbank and by the World Bank.

The initiation of the Marshall Plan in 1947 encouraged the hope that the United States, following the pattern of the programme announced for Europe, would soon make major resources available for Latin American development. These expectations proved false and a feeling of frustration surfaced at the Ninth International American Conference (Bogotá, 1948). At this Conference the countries of the region expressed their unhappiness with the amount of resources allocated to them by bilateral and multilateral public bodies. To remedy this situation they formulated the idea of establishing an inter-American bank. In March of the following year the Inter-American Economic and Social Council (CIES) completed a study of the arguments for and against the establishment of a regional financial organ, without giving an opinion either way. Later, at the special sessions held in March and April 1950, this body adopted a resolution which stated: "in the present circumstances it does not seem feasible or advisable to set up institutions of this kind".

At the Special Economic Conference (Quintandinha, November 1954) Latin America put forward for the first time some concrete ideas on

the forms which inter-American cooperation should take. Although there was a feeling of scepticism at the meeting with regard to the viability of the proposed institution, at least in the short term, a decision was taken to establish a committee of experts made up of representatives of the central banks of nine Latin American countries to prepare and submit to the Organization of American States within six months a plan for the creation of a regional financial body. The group of experts met at Santiago, Chile, in February 1955 and prepared draft statutes which were submitted to CIES so that consultations could be held with all the countries members of the inter-American system. Although this plan led to no immediate action and the idea of creating an inter-American bank was not taken up again until later, the Santiago meeting had prepared a suitable framework for systematic study of this ancient Latin American aspiration.

The OAS Economic Conference (Buenos Aires, August and September 1957) initiated a process of change in inter-American relations which culminated in Operation Pan America proposed by the President of Brazil, Dr. Juscelino Kubitschek, and supported by all the countries members of the system. Operation Pan America was a decisive factor in the establishment of IDB not only because it included a mechanism of this kind among the measures it proposed but also because it influenced the United States to decide to review its policy of co-operation in the economic and social development of Latin America.

It must be recalled that at that time President Eisenhower, by proposing the establishment of a Regional Development Agency for the Middle East, with financial participation by the United States, had accepted the possibility of incorporating regional development instruments in the existing global systems. On 12 August 1958, at a special meeting of CIES, the Under Secretary of State announced that the United States was ready to participate in a regional financial organization such as the one proposed for Latin America. This coincided with the convening of a meeting of Ministers of Foreign Affairs which was to be held in the following month with a view to analysing the proposals on which Operation Pan America was based. At that meeting the countries members of the inter-American system supported the

operation proposed by President Kubitschek and set up a group of experts to negotiate the agreement founding the new regional financial organ. That decision initiated the last stage in the establishment of IDB.

The establishment of the Bank made a reality of the ancient aspiration of the Latin American countries to have a regional financial instrument in the management of which they would have an effective role. The Bank's long period of gestation was due to the need to combine in the planned institution its Latin American characteristics and its incorporation in the inter-American system. Regionalism and multilateralism thus determined the nature and essence of the new body. The original regional characteristics of IDB were expanded from 1976, and the Bank was transformed into an international organization with the admission of West Germany, Australia, Belgium, Denmark, Spain, Finland, France, Italy, Israel, Japan, the Netherlands, Portugal, the United Kingdom, Sweden, Switzerland and Yugoslavia.

I personally had the honour from 1954 to 1959, on behalf of my country first of all and also on behalf of other sister nations, to play a part in building on this initiative, especially in my capacity as General Manager of the Central Bank of Chile and, later, as Executive Director of IMF, representing the Southern Cone. I was a member of the drafting and organizational committee of IDB and later, at the first annual meeting of the Board of Governors of IDB (San Salvador, January 1960) I was elected President of the institution, being re-elected in 1964 and 1968.

In my speech of thanks after my appointment in San Salvador I had the following to say about the challenge which lay ahead of us: "The size and quality of the Bank will be determined by human and organizational factors and by the volume of resources available and the modalities for their utilization. The Bank's success will depend basically on the people who run it. We must elucidate the true scope of the Inter-American Bank and stress that only a calm and solid beginning and clarity of purpose will enable the institution to grow and assume greater responsibilities. Those who expect so much of us must give us time and their good will in this period of formation and growth. We will search

diligently for the most suitable ways of making the Bank part of the collective awareness of our people. It has been judged necessary that the institution's headquarters should be in the United States, for convincing technical and practical reasons. This circumstance, however, obliges us to be more vigilant than ever and keep in mind that the Bank exists to serve Latin America; the Bank and its staff must identify themselves with the vigorous and exciting reality of Latin America. We must create a sound and efficient institution which will win the trust and gain

the interest of the capital markets; but we must also be ready with the same decisiveness and the same conviction for the Bank to live and develop with its roots in our own communities. The various factors which will influence the work of the Inter-American Development Bank and the specific circumstances of the framework in which it will have to act point to the complexity of our institution. It is a banking organization specializing in the regional financing of economic development projects. However, while it is a bank, it is also 'something more than a bank'.

## II

### The task of IDB

The long process of gestation and negotiation described above produced a bank with clear objectives and characteristics laid down in its own Founding Agreement; however, it was the work of IDB itself which shaped its contours and determined its image and nature.

Attention must be drawn, first of all, to its capacity to mobilize resources, not only among its founding members but also in other developed countries. A regional body is in the best position, together with the countries receiving the assistance, to generate adequate local counterpart funds. IDB's experience was very successful in this respect, since each unit of foreign currency made available was matched by the commitment of at least double the amount in local currency.

Clearly, the object of stimulating local investment around an external input is to improve the whole mechanism of savings and investment in the developing countries in both public and private spheres.

Furthermore it is clear that the institution performed effectively in areas of action not covered by other bodies. We should mention in particular:

a) The promotion of the balanced development of the continent; to this end policies were adopted which gave priority to the relatively less-developed countries and to the backward areas within each country. In my speech in San Salvador I had put my views on this topic in the follow-

ing terms: "It is a fact that our continent, made up as it is of developing nations and regions, has areas which for complex reasons are more backward than others. Our conception of the economic unity of Latin America cannot leave this reality out of account. Just as the backwardness of one part of a country can create serious problems for the whole national economy, so at the continental level areas or nations of marked underdevelopment can signify dangerous imbalances and tensions for the economic, political and social future of our community of nations. Accordingly, on the basis of the resources available and the modalities established in our statutes, we must give priority to the solution of these problems. We must not forget that we have not established an institution for individual nations but for a whole continent in all its vigour".

b) A high percentage of the Bank's portfolio was made up of loans for the strengthening of the region's physical infrastructure, because infrastructural shortcomings imposed a severe limit on the yield on any productive investment. The lack of an interlinked transport and telecommunications network and the underutilization of energy resources accentuated the distortions of a development process centralized on a few unconnected poles and hindered the conquest of the interior of Latin America and the processes of regional and national integration.

c) International financing of the agriculture



and livestock sector had been neglected before the establishment of the Bank; the Bank's work in this area therefore had a pioneering and stimulating value. The operations approved for projects of irrigation, agricultural diversification, development of cattle farming, and live stock raising and marketing make IDB the principal source of external capital for agricultural development in Latin America.

d) The solid support of the industrial sector took the form of the massive financing of national enterprises through global loans made to promotional corporations and industrial banks and through direct operations and financing of intra-regional exports of capital goods. The importance of this latter programme should be measured not so much by the trade figures achieved as by its promotional effect. Latin American industry has also been stimulated by the purchase with Bank loans of goods and services in Latin American countries, many of which have been suppliers for projects financed by the Bank. In the San Salvador speech when I became the first President of the Bank I stressed that: "In the Bank's operations I give great importance to the ways in which it can work through national organs for the financing of economic development, such as promotional corporations, development banks, agricultural or industrial banks or similar financial bodies. The experience of these organizations and their knowledge of the economies and needs of their countries can make them useful channels for the Bank's resources. There are large areas generally served by medium and small private businesses where we can help with our funds and increase the number of projects. It is perhaps in agriculture and livestock and in industry that our action is most needed and can be most productive. For these purposes we must also seek the support of private sources of local financing, especially through lending institutions and stock exchanges. From what I have said it is clear that the

co-operation between the Inter-American Development Bank and promotional organs, private and central banking systems and the financial market in each country will naturally be very close".

e) The Bank has given priority to urban development in view of the intense concentration of population in Latin American cities resulting from the modernization of agriculture and the advance of industrialization. The Bank has attached great importance to financial, technical and institutional co-operation for the establishment and improvement of the infrastructure in member countries.

f) Since technological capacity is one of the most dynamic factors for development, financial support has been given for higher education and training. The Bank has joined in the efforts of the Latin American countries to increase the capacity and improve the quality and efficiency of their university and technical educational systems. The operations of IDB have been aimed mainly at strengthening those academic institutions which are most effective in the training of human resources in productive activities and at introducing or consolidating fundamental reforms in the organization of educational institutions and in teaching methods and scientific and technological research.

g) The importance of a regional bank in creating an institutional infrastructure for development cannot be underestimated. Lending activities serve as a stimulus to the whole planning process, which developed in an interesting way in the 1960s, and to the establishment and improvement of promotional organs of various kinds. A regional body also serves as a real university for development, not only because of the exchange of experience among its staff members but also because of the multiplier effect which they have when they return to take up key positions in their own countries.

### III

## IDB's innovative plans

In all this work an effort has been made to act pragmatically, blending economic investment with social and "hard" financing of highly productive projects with "soft" financing. An attempt has been made to reduce the imbalance between countries with different levels of development and even between areas of unequal development within a single country. The aim has been to surmount the barrier between the public and private sectors, taking as the guideline the decisions of the Governments themselves: support has been given to state and public enterprises if in the opinion of the Government they are the main agents of national development, or to private business if the Government decided to channel international resources in that direction.

The guiding criterion has been more effective and better utilization of the resources. Together with this faithful interpretation of the objectives and targets established as their sovereign right by the countries themselves, efforts have been made to foster the capacity for innovation which is an essential requirement for success in a rapidly changing environment. The continuing search for new areas for financing, from education to tourism, from health to the financing of exports or exploitation of marine resources, despite the risks inherent in such innovations, has prompted other international bodies to follow in the steps of IDB. In the San Salvador speech I said: "These ideas lead us to the conclusion that in practice the Bank will surmount the artificial distinctions between the public and private sectors which in theory should grow stronger. The level of importance of one or the other in the economic organization of the country depends on its particular institutional structure. It is not for the Bank to interfere in this. The coexistence of public and private enterprises is a fact of our communities: in its lending policy the Bank must concern itself only with the degree of efficiency with which these activities are run and with the benefit which utilization of its funds can bring to them and to the whole national economy".

By increasing its "soft" lending the Bank was

quickly able to achieve a proper balance between its social operations and its fundamental activity of financing economic projects. This original feature of the Bank as an organ for financing social development in Latin America may be found in embryo in the regulations governing its Fund for Special Operations established in the Founding Agreement. When the idea of the Inter-American Development Bank was being discussed, the notion already existed that the balanced development of the countries of the region would require less-conventional projects or ones which were less directly productive; by their very nature such projects would need to be financed on more flexible terms. However, the Bank's work in the social sectors and the activities of the Fund for Special Operations increased considerably after the Act of Bogotá, signed at the end of the third session of the Special Commission of the Inter-American Economic and Social Council in September 1960, i.e. months before the programme of the Alliance for Progress of President J.F. Kennedy came into effect.

The Act of Bogotá meant for the Bank and for the whole of Latin America not only the adoption of previously unknown operational modalities but also the acceptance of new doctrines. The Act recognizes that the impact of economic development programmes on the welfare of the people tends to operate over the long term and, accordingly, it proposes a set of measures for social improvement, especially in rural development, housing, education and health. When the Act was signed, the United States announced that it was ready to contribute US\$500 million to the attainment of its objectives. The United States Congress allocated these resources as follows: US\$6 million to the Organization of American States for collaboration with member countries in the preparation of their development plans; US\$ 100 million to the International Co-operative Administration (ICA) for bilateral grants or aid in education, public health and technical assistance; and US\$ 394 million for the establishment of the Social Progress Trust Fund, which was to be administered by IDB, to support

the efforts of those Latin American countries which were prepared "to initiate or expand effective institutional improvements and take steps for the effective utilization of their own resources, with a view to achieving greater social progress and more balanced economic growth". On 19 June 1961, when IDB had just started operating, the Trust Agreement was signed by the United States Government and the Bank, authorizing the Bank to make loans from this Fund for the settlement and better use of land, housing for low-income groups, environmental sanitation and higher education and training. The Bank was also authorized to give technical assistance in those sectors. The Fund thus officially established the financing of social projects as one

of the Bank's operational policies.

In the early days there was some concern that the Trust Fund might distort the Bank's purpose and work by drawing it away from mainly economic projects. It must be remembered that at that time, when the member countries had hardly paid the first installment of their contributions to Bank's regular and special resources, the Social Progress Trust Fund represented a considerable increase in resources. Today we can see that no such distortion took place and that, although the Bank did considerably expand its role in the financing of social investment in Latin America, it did so without reducing the attention it gave to the economic sectors.

## IV

### The integration bank

Another of the Bank's functions, which was implicit in its Founding Agreement and which has been gradually developing over the years, was its role as promoter of Latin American economic integration. Although the use of the term "collective development" in the basic Charter already contained in a way the concept of regional integration, the provisions of the Agreement defining the Bank's functions referred essentially to the financing of national projects and activities. However, one of these provisions invests IDB with broader scope of action and assigns it the task of "co-operating with member countries in directing their development policies towards improved utilization of their resources in a manner compatible with the objective of a greater complementarity among their economies and promotion of orderly growth in their external trade". Although these ideas do not cover everything that is now understood by economic integration, they did provide a mandate which the subsequent development of Latin America and of the Bank itself helped to clarify.

To this end, the Bank participated in the rich intellectual process of determining the scope of regional economic integration, a concept which was only just coming into its own at the beginning

of the 1960s. Nowadays there is often talk in the United States of the "golden sixties"; this term is also very appropriate for the new coming-together in Latin America and the growth of prospects for the historic convergence of our countries in that decade.

As the intellectual influence of the Bank increased in the process of Latin American integration, there was increasing concern to invest these ideas with an operational foundation. At the fourth annual meeting of the Board of Governors (Caracas, 1963) a mechanism was set in motion for the financing of intra-regional exports of capital goods, the objective being to make them competitive with imports from other regions. The programme originally operated on the basis of lines of credit made available to national financial organs and at the start it had an allocation of US\$ 30 million from the Bank's regular resources. The programme's success can be seen by the volume of trade stimulated, by the nature of the goods traded, which represented an innovation in the region's traditional trade flows, and by the institutional improvements which resulted. The use of part of the Venezuelan resources made available to the Bank in 1975 to expand the financing of regional exports

and the establishment in 1978 of the Latin American Export Bank (BLADDEX), with its headquarters in Panama, constitute, in my view, interesting examples of the operation of this programme.

The final launching of IDB as an integration bank dates perhaps from the sixth annual meeting of the Board of Governors (Asunción, 1965). At that meeting unanimous support was expressed for the so-called "document of the four", i.e. the report on speeding up the establishment of the Latin American common market which, at the suggestion of President Frei, had been prepared a few weeks earlier for all the Heads of State of the hemisphere by Raúl Prebisch (ILPES), Carlos Sanz de Santa María (CIAP), José A. Mayobre (ECLAC) and the author of this article in his capacity as President of IDB. In the last part of the document we reaffirm our faith in the future of an integrated Latin America in the following terms: "We must learn to work together; we must build a community of Latin American peoples. We have still not been able to come to grips with this great task because we have not succeeded in breaking free from the mold in which our development began in the 19th century. Separated from each other and with no active relations to bring them together in a vital union, each of our countries was headed at that time along separate paths towards two great world economic, political and cultural centres. We lived in the light reflected from those centres, and this had profound consequences for the Latin America of the past which are still felt in the present. Important elements of that situation still persist; and we must break free of them if we are to cope with a changing world and with the growing tensions in our own development. We must unite our efforts to overcome these and other obstacles to Latin American development and focus our efforts on the attainment of great common goals. It is not merely a question of responding to the demands of technology or of having to work together to gain more economic room and extend the cultural, scientific and technological horizons. We must also do this in order to gain greater political weight in the international arena".

The Bank's role in the integration process was rendered more effective by two initiatives: the establishment of the Institute for Latin

American Integration (INTAL) and the subsequent establishment of the Preinvestment Fund for Latin American Integration. The idea of setting up an institute of this kind had already been proposed at the ALALC meeting in Mexico City in 1963. That meeting had discussed the need to create a mechanism to co-ordinate the various existing integration institutions in Latin America. As time was passing without anything being done along these lines, the Bank decided to set up an institution of its own to carry out training, research, dissemination and evaluation work in connection with regional economic integration.

The Preinvestment Fund for Latin American Integration was established in 1966 on the specific instructions of the Board of Governors. The Fund had an initial capital of US\$ 15 million taken from the resources for special operations, and the United States Government added a further US\$ 3.5 million from the Trust Fund for Social Progress. The Fund's primary area of action was the implementation of infrastructure projects of an integrational nature, especially in transport and communications, the organization of services at the regional level for the development of economic areas including territory belonging to two or more countries, and the establishment and expansion of basic industries which sold to multinational markets or used inputs from several countries, etc. The Fund was very useful in speeding up the integration of the region's economy, for it facilitated the identification of new multinational investment opportunities. These developments were again ratified in the 1967 Declaration of Punta del Este in which the Heads of State of the inter-American system recognized the priority which IDB should give in its work to the financing of multinational infrastructure projects, with a view to accelerating the attainment of Latin American economic unity. It is a challenge for IDB to transform itself effectively into an integration bank. Not more than 10 % of the Bank's total lending is for multinational projects; we thus reaffirm our conviction that IDB must be an instrument for promoting the financial integration of Latin America by means of joint initiatives on the part of two or more countries.

## V

## Final comments

Clearly, the financial and political environment in which the Bank operates is different in 1985 from what it was in the early stages. It must be remembered that at the beginning of the 1960s economic inter-Americanism reflected a new concept of the responsibility of the United States towards Latin America; its best expression was the "Alliance for Progress". From 1968 Nixon and Kissinger changed the rules of the game by introducing a general policy of gradual abandonment of the transfer of public resources from the industrialized countries to the third world.

In the early 1960s the integration and regional unification of Latin America accelerated swiftly with the establishment of ALALC and the Central American Common Market. In recent years this trend has taken a different turn, with greater emphasis on sectoral convergence. The Latin American Economic System (SELA) is an expression of this reality. IDB has secured a permanent presence in this process and has financed major multinational infrastructure projects.

In May 1985 INTAL held a seminar to study the problem of financing the subregional organs. The Fund for the Development of the River Plate Basin (FONPLATA), the Central American Bank for Economic Integration and the Andean Development Corporation (CAF) took an active part in the seminar. This meeting noted the support which IDB had given to all the subregional financing systems and the present difficulties which those institutions were experiencing as a result of the restrictions imposed by the general indebtedness of Latin America.

The Bank was born at a time when Latin America had fluctuating development rates, a negative trade balance and low monetary reserves. In the 1970s the region achieved growth rates of 6 to 8 %; its exports increased and diversified; and its monetary reserves climbed from US\$ 3 thousand million to more than US\$ 30 thousand million. In that context the volume of lending available from international bodies declined in importance for many countries, for they had new sources of internal and external investment produced by the changing

terms of trade and of international financing. Unfortunately, with the emergence of new economic and political conditions during that decade, instead of progressing towards Latin American regionalism, the countries gave priority to poorly understood principles of economic freedom and abandoned a general tradition of democracy. In recent years, however, integrationist and democratic beliefs have been re-born in Latin America; paradoxically, this has been due in many cases to the new policies which were put into practice and which led to the excessive external financial indebtedness of the whole region.

The internal composition of the Latin American conglomeration also underwent major changes which influenced the activities of IDB. At the beginning of the 1960s Brazil was still considered a risk by international financiers (it was IDB which reopened the door to international public credit for that country). Although Venezuela was fighting to consolidate its democracy and stimulate its internal economic development, it was still a long way off from its spectacular bonanza. In South America, the conditions in Bolivia, Uruguay and Ecuador reflected a situation of acute underdevelopment which has tended to improve in these last 15 years. The nine countries of the Caribbean, now independent of the United Kingdom and the Netherlands or in the process of decolonization, were not part of the regional system and had very few links with the majority of the Latin American nations. In contrast, between 1967 and 1969 Trinidad and Tobago, Barbados and Jamaica, and more recently, Guyana, Bahamas and Suriname became members of IDB.

When IDB was established the only industrialized country to commit major resources to it was the United States. From 1962 the Bank began to win the financial collaboration of all the capital-exporting countries. In 1972 Canada became a member and since 1976 17 developed nations from outside the region have become share-holders; at this point the Bank ceased to be an organ limited strictly to the hemisphere and

became increasingly cosmopolitan.

One of the acid tests for the Bank was its access to the international capital markets, which it secured throughout these years on excellent terms and with the technical support of a first-class portfolio.

In the early days the Bank's operational activities were considered heterodox by many people, as it sought pragmatically to overcome the contradiction between conventional and soft loans, between public and private sectors, between financing and technical assistance. IDB was economic investment and social investment, between investment and preinvestment and between financing and technical assistance. IDB was establishing itself in this way as the central bank for the development banks of Latin America, as the integration bank and as a truly thinking bank.

At times it has been criticized for being a bank run by its debtors, i.e. in a Latin American spirit and with a Latin America majority, and it was alleged to have become politicized. I had to rebut those arguments at the end of my term of office in March 1971 when I said: "If this Bank had not been concerned and anxious to speed up development in Latin America with a view to integration and for the benefit of the majority, none of that political motivation would be what it is. And since in the 1970s it is very probable that the pluralist framework of Latin America will become broader and more complex, I believe that we will have to harness our goodwill and intelligence in the search for agreed formulas for combining the increasing centrifugal forces; and the only way of achieving such agreement is by appeal to higher political considerations".

When I became President of the Bank in 1960, I defined our responsibility towards a bank which was at the same time "something more than a bank". I tried to be consistent with that belief for a whole decade; at the conclusion of my term of office in March 1971 when I passed my functions on to the Bank's new President, my distinguished and capable friend, Antonio Ortiz Mena, I put it as follows: "Perhaps today we perceive with greater clarity all the things which we knew intuitively eleven years ago when we said that IDB was something more than a bank: a great regional public organ, with a solidly established reputation and financial capacity, which remains profoundly Latin American despite the participation of the industrialized countries, with the ultimate objective not only of modernizing production structures and merely achieving economic growth, but also of enhancing the well-being of the great masses of the Latin American people. It is something more than a bank in the increasing orientation of its institutional efforts towards the promotion of the integrated development of our peoples and in its assumption of the functions of sounding board and spokesman for the interests of Latin America. In this contribution which the Bank can and must make to assist the countries of the whole region to find their own path of independent development and prompt their creative daring, it is worth recalling the words of that unforgettable public servant, the Secretary-General of the United Nations, Dag Hammarskjöld: "Do not examine the ground before you take your next step: only the man who keeps his eyes fixed on the distant horizon will find his true path".



# A SELECTION OF ADDRESSES DELIVERED AT THE EXPERT MEETING ON CRISIS AND DEVELOPMENT IN LATIN AMERICA AND THE CARIBBEAN

(Santiago, Chile, 29 April to 3 May 1985)

In CEPAL *Review* No. 26 (August 1985), we published some of the papers presented to the Expert Meeting on Crisis and Development in Latin America and the Caribbean. In view of the large number of participants, it would be impossible to include in this issue the remainder of the statements made; nonetheless, it was felt to be of interest to pick out a few of them in order to broaden the perspectives and propositions reproduced in the previous issue.

## I

### The new role of the State in Latin America

*Francisco-Javier Alejo\**

The questions put to us by the Secretariat are a challenge in themselves, since they fall within the sphere of sociology and the political theory of the State; an adequate reply would require considerable time and reflection and a multi-disciplinary approach which would certainly be beyond my scope. I shall therefore confine myself to a personal reaction to some of the issues presented. First and foremost: Is there a crisis of the State in Latin America? Yes, there is, but it is multiple and varied in its manifestations and degrees, inasmuch as the region is multiple and varied in its essence and temporality. We have long recognized that we are a community in diversity. Any comprehensive appraisal must be interpreted from this viewpoint.

Yes, there is a crisis of the State in the region, widespread to an extent without parallel in any other region of the world. It is a crisis centered on the ability of the governments to produce or supply what the whole world agrees should be their essential services: internal order, a reasonable degree of stability and peace, social justice and economic progress.

In the 40 years since the Second World War the Latin American countries have made considerable progress, much of which has undoubtedly been due to ECLAC. The problems of today, which we find so disquieting and even

distressing, should not obscure this undeniable fact.

The problems of the last 10 or 15 years, however, have been so serious, and so many governments of very varied type and structure have met with such difficulties in solving them, that today the very nature of the State and its role in development have come under keen and widespread scrutiny. But what are the problems? ECLAC has made some clear appraisals of the issues. Let us summarize them briefly:

- The end of easy import substitution;
- Inability to keep in step with the dynamic centres of the world economy, in respect of the pace of structural and technological change;
- The transformation of a capital-importing region into a capital-exporting one, with converging internal and external deficits;
- Loss of monetary sovereignty in most of the countries;
- The entry of many countries upon their second phase of demographic transition, in which they are faced with the greatest pressure in history on labour markets, urban growth and adult age groups in general;
- The difficulty, in these conditions, of feeding, clothing, educating, housing and employing all their inhabitants;
- The imperative of incorporating all segments of society into a political process meet-

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ing real needs and aspirations and providing good government;

- The necessity of guiding the economy in such a way as to increase the product per worker, as a condition for social justice, development and political stability.

There is no simple answer to these problems. No solution emerged from the democratic experiments of the 1950s and 1960s nor from the military régimes of the following decades. It would be unpardonably pretentious here to attempt to dictate to the nations the form and structure of government that they should adopt. Nonetheless, Latin America's wealth of experience can afford us some lessons that should be heeded. I will go on to mention some of them.

1. It is impossible to do everything at once for long. To adopt a system of priorities implies that *not* everything is a priority at all times. To plan means *to act* in accordance with plans, not merely to draw them up.

2. Military governments may for a certain period represent elements of order and equilibrium, but their solutions are neither cheap, nor efficient, nor ethical, nor stable.

3. Although all prosperous modern national development has been the result of an intelligent, graduated and temporary manipulation of basic relative prices in the economy, it is clear that such manipulation has its limits, and if it becomes indiscriminate, unconsidered and permanent, in a world of increasing interdependence and rapid technological change, the result will be the opposite of what was originally intended. In the World Bank study for 1983 it is clearly shown that the most successful countries in the last 20 years are those which have been most moderate in price distortion.

4. Attempts to direct everything end in directing nothing.

5. To try to develop a capitalist economy without entrepreneurs or in opposition to the "animal spirits" (Keynes) of investors is a flagrant contradiction in terms. Similarly, to try to innovate without motivating the innovators is a waste of time.

6. To seek to impose a managed economy régime without sufficient administrative and management capacity is, to say the least, ingenuous.

7. International interdependence is essentially asymmetrical and unstable. When ice without thermal insulation is put into hot water the ice *invariably* melts. In the same way, capital is lost in face of the large economies.

8. As regards development there is no substitute for an increase in productivity. Correlatively, a long-term development strategy cannot possibly be conducted with an annual change of policies.

9. The idea of withdrawal from the international economy is illusory without full and speedy integration of the Latin American economies. Unless clear-sighted attention is paid to international changes, articulation will always be inefficient and unstable. Persisting in loss-making activities produces loss-making nations.

10. Crises are largely the result of lengthy indulgence in one or more of the following practices: consuming more than is produced, spending more than the income obtained, importing much more than is exported, and incurring financial obligations with rates of repayment higher than the rate of income growth.

11. Hegemony and dependence are objective facts of reality. The important thing is to know how to turn them to one's own advantage. Skill is more effective than strength.

12. A government that is not genuinely representative of its people and does not listen to it continuously cannot hope to be supported in its policies. The people cannot be expected to back up economic adjustment policies if the distribution of the costs is unfair; nor will they support development policies if the benefits are not equitably distributed.

13. In recent times many Latin American nations have *not* had the governments they deserve.

With regard to the economic aspects of the nature and function of the State, a very sober conclusion to be drawn from history is the necessity of *moderation* and *stability*. Neither the *laissez-faire* posture of many theoretical economists nor absolute central control, which even socialist countries are beginning to abandon as impracticable, provides the answer. Instead, the best solution is a limited number of judicious interventions where objectives are clear, problems are grave and there is a reasonable possibility of effective State action. The recent history of

the Southern Cone shows the damaging effects of both too much and too little State intervention, and the harm done by the frequent switch-over of policy from one extreme to the other.

Undoubtedly protection and import substitution are correct strategies, always provided that they are adapted to each country's real potential (from the dynamic standpoint of comparative advantages) and are administered so as to motivate infant industries to grow and gain strength rapidly, until they reach maturity without need of special treatment. A steel plant in the Andean highlands or a petrochemical complex based on costly raw materials will almost always be a charge on the country concerned, whoever the owner may be.

If we know how to negotiate with them, the transnational corporations have much to offer—and this should be required of them—in respect of technology and access to the international markets.

The State can and should on occasion assume positive leadership in the establishment and financing of enterprises, above all in areas in which the country can count, at least potentially, on some advantage. However, these firms should operate with entrepreneurial criteria of efficiency and productivity and their institutional framework should prevent their con-

version into mini-welfare states for their employees and a burden on society as a whole.

Private entrepreneurs deserve and require a stable and dependable environment in which they can plan their long-term activities. They should be given clear signals directing them towards activities profitable for the nation and society and for themselves.

Capital markets, like those for goods, also need judicious promotion and regulation. Their institutional development and appropriate rates of interest are necessary for mobilizing domestic saving and channelling it into development projects.

Fortunately, there is a multilateral body, the property of close on 140 governments (recently including China and Hungary), whose task it is to help developing countries in the last two areas mentioned: their entrepreneurial development and that of their capital markets. Such is the International Finance Corporation. In its five-year programme for 1985-1989 it proposes to invest—on its own account and through third parties—US\$ 7.5 billion in aid of entrepreneurial projects for a total value of US\$ 30 billion.

In conclusion, I will merely say that the crisis of the State of which we are speaking is related to the need to make government more effective in the promotion of development.

## II

### On the role of the State

*Luis Alva Castro\**

Although I am attending this meeting in a personal capacity, my words reflect the thinking of my party, the Peruvian Aprista Party, and the scenario to which I shall refer is naturally that of my own country. We reject with equal force the traditional concepts of the State which define it either as a subsidiary and supplementary agent of private interests, as a mere arbiter between

opposing social interest, or as a totalitarian power which in a pretence of collective representation imposes its political will on society from above.

We believe that in profoundly dependent and heterogenous societies, like that of Peru, the State should perform a double role. On the one hand, it should be a leader in economic development. On the other, it should provide opportunities for dialogue and the concerting of all

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national interests. If it fulfils only the first function, it runs the risk of evolving in the direction of authoritarian and arbitrary management of society. If it confines itself to the second function, the real inequality of power among the different social agents will ultimately turn it into the expression of the most powerful interests. It is therefore essential for the State to direct development with initiative and vigour and at the same time to base this function on dialogue with the social institutions and on expression of the national interests.

### 1. *To modernize or to transform the State?*

To transform the Peruvian State, not only to modernize it, is the essential aim of an Aprista Government. To modernize the State means to technify its procedures, rationalize its structure, increase the efficiency of its functioning and endow it with skilled personnel. Although all this is necessary, it is clearly insufficient in the Peru of today, since the crisis of the State is by nature structural. It cannot be overcome by merely improving, increasing or perfecting the present organization of public power, which is precisely the meaning currently attributed to the concept of "modernization of the State".

Transforming the State signifies for us nationalizing it, democratizing it and decentralizing it.

To nationalize the State implies its conversion into an instrument of society, that is, into the agent of the national will. It must therefore be independent of the international centres of power, especially the foreign banking system and the International Monetary Fund, and its action must be based on the economic and political interests that have their roots within the country itself.

To democratize it implies to make it accessible, in its structure and decisions, to the presence and interests of all national groups, organizations and classes. To achieve this it is essential to ensure the progressive participation of the country's different social, economic and political interests at the local, regional and national levels of government. To decentralize it signifies the transfer of resources, decisions, faculties and capacity for taking action—in a word, power—from the central administration

to the base organizations, local governments, departmental corporations and regional governments. To this end, it is necessary for the State to come down from summit levels and for its services effectively to reach the place where the producers and consumers are found. The challenge in this case consists in broadening the base of the State; that is, expanding it horizontally, not by increasing personnel but rather by geographically and functionally transferring resources and faculties.

### 2. *The State as economic agent*

The role of the State as an economic agent will be multiple, the following being its main functions:

a) *A guiding role*: planning and guiding the whole conglomerate of the national economy. Introducing order and rationality into Central Government activities; likewise efficiency, productivity and a sense of opportunity into the State enterprises, which should also be used to complement and reinforce private initiative.

Another essential and in our case innovative aspect will be its performance in concerting action with the private and co-operative sectors, with a view to agreeing on goals, defining incentives and providing resources and stable regulation which will guarantee the development of the main branches of activity in an economy where more than 50% is in private hands.

b) *A regulatory and compensatory function*: preventing or attenuating the serious disequilibria of Peruvian society, in pursuit of the objective of social well-being.

This will involve limiting the power of the big national economic groups and strengthening the bargaining power of the workers, the consumers and, in general, the large urban and peasant contingents whose main resource is their manpower, which does not make them strong enough to avoid social conflict. Inevitably, therefore, the State will have to side with the poorest, and this also will be in our case an innovation.

The State will have an important regulatory and compensatory function to perform in the insertion of foreign investment in the national context, maintaining a vigilant attitude in the exploitation of the great national resources and the undertaking of large-scale national projects, in which it will inevitably have to take part until

the emergence of national entrepreneurs sufficient in volume and capacity to counterbalance transnational influence.

Its guiding role and regulatory function give the State priority of action in selective orientation of consumption and investment and in regulation of the economic cycle, through the use of its various policy instruments to promote saving and channel investment into priority sectors of production.

c) *A distributive responsibility*: which will be assumed with resolute energy in order to achieve redistribution of income and wealth in the country and to prevent its continued concentration in few hands and in limited geographical areas. To this end it will act via taxation, bearing more heavily on the more affluent sectors, luxury consumption and external signs of wealth. At the same time, via public expenditure, it will provide essential services such as health, education and recreation, among others, and will make investments specially intended to create employment and to promote strategic sectors and depressed regions.

d) *A productive and accumulative function*: that of utilizing Peru's great natural resources, increasing the saving and investment coefficients and actively participating in the development of the country in all those lines of production or geographical areas in which the drive of the private sector is not sufficient, on the basis of a strict order or priorities in accordance with the National Plan which we have drawn up, and which it would be very difficult to describe in detail here.

e) *In short, a nationalist and anti-imperialist function*: rallying and helping to unify national forces, putting them before oligarchic or externally-linked projects and contributing to the creation of an adequate interrelationship with the international environment.

### 3. Requirements of the State

To fulfil such extensive functions, the State itself must undergo a series of transformations which will qualify it to meet such a challenge. The basic requirements are:

a) *A modern and efficient State*: which will adopt a functional organization suited to its purposes in respect both of its functions as central

government and of its entrepreneurial activities; which will be capable of issuing clear, simple and in particular timely norms, with possibilities of generating stability and confidence; which will stimulate technological development and productivity, but in conditions suited to the environment, with particular regard to the duality or multiplicity of the country (a feature that is essential if the State is to be linked with the marginal or informal sector rather than merely left as at present harnessed to the modern sector, governing for a few while the great majority of the country is scarcely aware of its existence); a State which will be capable of generating through taxation and returns on its investment sufficient resources for its operation, while at the same time redistributing income and wealth by social strata and by regions. This aspect alone will signify a veritable revolution in Peru.

b) *A State promoting a new development mentality*: for lack of time, and perhaps also through professional bias, I have touched mainly on economic aspects, but the State that my country needs is undoubtedly one transcending this narrow area and encompassing political, cultural and moral aspects of life.

What is really required is a leader State which will arouse the national conscience and put new heart into a people battered by the crisis, showing by its example of honesty, morality and hard work that it is feasible to reconstruct the country and to steer it in the right direction.

But perhaps what is most essential is that we should be able to build a democratic and popular State, which will foster the cultural values of the nation, mobilizing it and making it participate in such a way that the results obtained are not the fruit of a paternalism inhibiting potentialities but the reflection of a united effort.

This vision of an eminently nationalist State is not circumscribed within the national territory. We know very well that the true liberation of our peoples calls for the fraternal impulse of Latin American integration, in depth, and going far beyond the mere rhetoric of intent. In its minimum initial programme, drawn up in 1931, Aprism supported Latin American economic and political integration and in fact helped in the work of establishing it, being on that account proscribed, perhaps because it was ahead of the times. In assuming power today, after 60 years of

struggle, it confirms the validity of this postulate, and calls on all the Indo-American peoples to renew their faith in it, as the only efficacious instrument for grappling with our serious international problems, among them the external debt and the defence of our foreign trade, to which we have constantly referred at this meeting. Only when we can present a united front shall we be able to avoid situations such as those

we heard about yesterday in connection with Nicaragua.

Let us make a joint appeal to ECLAC, SELA and in general to all our Latin American institutions to help us in this crusade, since our point of departure is acknowledgement that the destiny of Peru is closely linked with that of Latin America, to whose cohesion and unity we aspire.

### III

## The crisis of development in Latin America

*Norman Bailey\**

The causes of the so-called debt crisis are well-known, and no purpose would be served by reviewing them yet again. Responsibility is amply shared by debtor and creditor governments, private companies and banks.

The nature of the crisis is also widely recognized now. It is systemic and structural in nature and therefore must be dealt with in a systemic and structural manner. Further short-term measures taken on the false premise of a temporary liquidity shortage are already counterproductive and will become increasingly so if not supplemented and eventually supplanted by a development, trade and growth strategy.

In short, if present circumstances continue, ever greater indebtedness and eventual default (under whatever name) by several of the debt-ridden countries are inevitable. None of the premises upon which the "temporary liquidity shortage" conclusion was based has proved correct:

- Indebtedness has grown. As of year-end 1984 the Latin American countries owed US\$ 75 billion *more* than at year-end 1981, with, of course, the corresponding interest.
- OECD growth has slowed.
- LDC export growth is declining.
- Real interest rates have remained high.

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- Commodity prices have remained low and in some cases, such as that of sugar, have actually declined.
- Several countries, such as Costa Rica, Dominican Republic, Bolivia, Nicaragua and Peru are already in default in all but name. So far in 1985, the following events have taken place:
  - President-elect Alan García of Peru is on record as proposing that debt service payments be limited to 20% of export earnings.
  - Argentina and Brazil have been declared out of compliance with their IMF programmes.
  - Brazilian exports are down significantly from the same period of last year.
  - The Interim and Development Committees of the IMF and World Bank have met and the results were non-existent.

Before debtors and creditors reach a confrontational impasse which will have unpredictably disastrous results for world trade and development as well as for the international financial systems, all major parties to the crisis must agree on a programme including some variation and mix of the following elements:

- Protectionist measures taken by industrialized countries affecting LDC exports must be halted and preferably rolled back.
- Bank and corporate trade credits, properly

- documented, must be exempted from re-schedulings and all trade credit arrears cleared up so that trade financing can return to normalcy.
- The IMF must establish a compensatory financing facility (CFF) for interest rates. Capping interest and capitalizing the differential makes no sense since it only postpones the day of reckoning for the debtors and has very negative implications for bank earnings. IMF subsidization of the differential would provide true relief and would be a more efficient use of IMF resources in most cases than Extended Fund Facility (EFF) funding.
  - The World Bank must be encouraged to establish the structural adjustment loan subsidiary it has proposed, funded with its own profits and leveraged 10 or 12 times.
  - All medium-term project loans must be re-scheduled on a long-term basis.
  - All balance-of-payment loans should be converted into 30-year or perpetual bonds at a fixed rate of interest at approximately present levels.
  - Cases where debt levels are hopeless (mostly smaller countries) should have a substantial portion of the debt converted into grants. More specifically all their governmental and international organization debt should be so converted.
- As for formulating and negotiating such a programme, the next meeting of the Cartagena Group, scheduled for Montevideo, should be carefully prepared for, should adopt a concrete and specific programme and should demand a meeting of representatives of major debtor countries, smaller debtor countries, certain banks (or perhaps the Institute on International Finance), selected creditor governments, IMF, the World Bank and the Inter-American Development Bank to discuss agreement on the programme. I would strongly recommend that observers from other continents be invited to the Montevideo meeting, such as Yugoslavia, Nigeria and the Philippines.
- It is clear that vague statements of goals, complaints and requests for meetings will not work. This was made evident early in April. Action is urgently required.

## IV

### The nature of the Latin American crisis

*Sergio Bitar\**

On the immediate cause of the crisis—the abrupt contraction of external credit— there is agreement. Nevertheless, as regards future action, the main question is to analyse the nature of the international factors which have produced it and the domestic reasons which account for the acute vulnerability of our region.

Our argument is that the crisis is largely due to elements of a structural nature and that consequently a dynamic and stable solution implies

changes of direction and alterations in styles of development.

The current Latin American diagnosis places undue emphasis on financial constraint and on the economic policies of the developed countries. Such a view involves the risk of acceding to the theory that the partial restoration of flows, accompanied by a strict adjustment programme, would make it possible to return to a balanced and dynamic development process.

I believe that, if our purpose is to regain autonomy, achieve a better-balanced insertion in the world economy and aim at greater internal equality, the path to take is an explicit process of

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transformation which includes adjustment, and not a process of adjustment leading, implicitly and indirectly, to a haphazard transformation process.

It is evident that in order to survive we must give urgent attention to the financial problem. There can be no argument about that. The basic question is whether the concept governing our action is one of transformation and development or of adjustment and equilibrium.

1. *The impact of the crisis depends on structural factors, as does its solution*

To illustrate some of the structural aspects which have generated such a high degree of vulnerability, I think a relation can be established between weakness in resisting external impacts and the development characteristics of each country. The magnitude of the dislocations was greater and the capacity for recovery less when the following features were present:

a) A frail national production capacity, deriving from the lack of a prolonged and stable policy of industrialization and intersectoral integration, especially between agriculture and industry;

b) A State with few mechanisms for offsetting cyclical effects, with reduced participation in saving and investment, and without will or power to regulate relations with the international financial system;

c) A low level of participation and articulation among the main social groups, high marginality and inequality, and the consequent deterioration of internal cohesion;

d) The absence or debilitation of a national endogenous development project, or the lack of widespread popular support for it; and

e) The crumbling of the regional or sub-regional integration agreements.

It is in the countries in which the combination of these factors has been most unfavourable that the crisis has been most profound.

Consequently, the overcoming of these structural flaws defines the nature of the changes required for meeting the Latin American challenge.

A first requisite is to make progress in industrialization, surmounting the false dichotomy between exports and import substitution, revalu-

ing the domestic market, creating a more autonomous domestic technological capacity, and forging closer links with the agricultural sector.

A second requirement is to strengthen the State apparatus, raising its efficiency in critical areas, such as: regulation and guidance of the financial apparatus, increase of saving and investment, support of technological development, application of policies in favour of the poorest groups, redistribution of income and wealth, and control of the principal links with the transnational system.

A third requisite is the articulation of new and stable social alliances which will reflect the modifications in the occupational structure and the new values and behaviour patterns that have grown up in recent decades. It is a question of identifying the social agents, conferring more autonomy and decentralization, and seeking ways to create a new social consensus, or social pact or formulas for concerted action, which will provide a stable basis for supporting a new scheme of development.

A fourth factor is to project a national and Latin American course which will give priority to the objectives of growth, satisfaction of basic needs, employment and the strengthening of national productive capacity and will subordinate to these the adjustment policies imposed by the foreign banks and IMF.

Finally, it is essential to revitalize regional unity, with new formulas for increasing intra-regional trade, fighting to bring about a modification of the adjustment processes, giving industrialization a co-ordinated boost into the advanced technologies upon which no country has as yet decisively ventured, and adopting other measures which will help to reduce external vulnerability and increase collective economic security.

2. *The world economic system has also undergone structural modifications*

It is not only structural factors of a national character that have determined the development of the crisis in Latin America; the changes in the financial and commercial flows have also resulted from profound modifications in the international economic system. One example is sufficient to illustrate the magnitude of the

change: the development of a highly integrated capital market which is increasingly inaccessible to the economic policies of the peripheral countries. This market has reached close on US\$ 50 million million (trillions in United States nomenclature) per year, while the necessary financing for international trade and investment requires only US\$ 2 million million. Naturally the determinants of the rates of exchange and Latin America's balance-of-payments vicissitudes have nothing to do with those of the recent past.

The spectacular evolution of the world industrial structure has been no less significant than the financial transformation. This evolution has taken place in the midst of the international recession of the 1980s. Financial restriction credit has partly concealed from Latin Americans these changes in the structure of world production.

A balanced analysis of worldwide change shows that an exclusive preoccupation with financial adjustments is wholly inadequate. The financial flows will not be restored, nor will the behaviour of external agents be the same as before. Furthermore, the flows of international investment, of trade in manufactures, technology and services are undergoing radical changes. And even if the governments of developed countries were proved correct in their assertions that the worst is over, that the world economy is on the upswing and that with the continuation of internal adjustment policies the current problems will be overcome, Latin America would be left at a greater disadvantage than ever. It would still have its high external vulnerability, and would face a situation of productive weakness and internal inequality which would make all improvement an illusion.

I consider, therefore, that we must be more resolute in undertaking the modification of a development pattern which in the last ten years has not enabled us to reduce either our external vulnerability or our internal inequality. Worse still, both appear to have increased.

### *3. The lesson of the developed countries: a strategic approach*

One of the principal gaps in current Latin American thinking is due to our incomplete un-

derstanding of the economic dynamics of the developed economies, of their internal logic and their strategic objectives.

To understand the countries of the centre we must place ourselves in their position, in the position of the governments and the main actors of those nations, especially the United States, and not generalize proposals and intentions on the basis of the measures they apply to a peripheral region or the statements they make about Latin America. We know very little of the forces and mechanisms which determine the economic policy decisions of the United States and therefore we cannot foresee the most probable trends or safeguard ourselves effectively against measures adopted by a power which has a decisive influence on our situation.

The study of how economic policies are worked out in the developed countries teaches us an important lesson: namely, that the predominant approach is structural and strategic.

It is evident at this stage that in recent years the United States has not had what was known in the 1950s and 1960s as "a policy for Latin America". What appears as such is an indirect by-product of global policies. The initiative in respect of the Caribbean, the only operation of a specific nature, also arose from considerations of overall security.

The policies of the developed countries in favour of free trade, a free market, direct foreign investment, liberalization of trade in services and repudiation of regulations, of the role of the State, of import substitution and of regional tariff preferences, have derived from more basic goals. In the case of the United States they are dictated by the strategic aim of outstripping economically and isolating the Soviet Union and its other adversaries; they also pursue the relative strengthening of the United States *vis-à-vis* its allies in Europe and Japan, and seek to consolidate a world economic structure integrating the Third World, so as to reduce the possibility that the latter may break with the international economic system.

When the objective is to preserve technological pre-eminence, the United States government applies all the measures necessary for attaining it, including direct public participation on a massive scale, financing of more than 50% of the cost of research in the spearhead sectors



and deliberate support for the training of highly skilled human resources. When it is a matter of ensuring domestic production and supplies of certain strategic items, quotas are established and a certain level of self-sufficiency is assured. The recent trade legislation, passed in October 1984, contains new and powerful instruments of reprisal and trade regulation.

Furthermore, the large countries have adopted a scheme which integrates economic and security concepts. In Latin America, in contrast, not only has there been no strategic focus but the doctrines of national security have been frequently dissociated from the concepts of development, autonomy, Latin American integration, equality and participation. This divorce has weakened national impetus and, worse still, as has occurred in the last decade, has destroyed a minimum national consensus with the implantation of a repressive and conservative internal order. A strategic vision should also integrate the concepts of development and security in order to attempt a different incorporation of the military sector in the national and Latin American project.

The planning of the domestic and international economic policy of the great powers is not, therefore, the outcome of a mere analysis of equilibrium and efficiency. The main framework is structural-strategic.

From this angle, we can understand more clearly that they promote liberalism among us because it is structurally functional to their strategic interests. When in certain circumstances it is not in line with the "security interests" of the United States, the latter alters its economic principles, even coming to deny them as in the case of trade blockades. Moreover, the subject of the Latin American debt acquired more importance in the United States when it was seen to involve risks to that country's security interests, whether through the instability of the financial system or through the political instability of the region. It is no accident, therefore, that more flexible attitudes to the debt problem have arisen in the National Security Council and in the CIA than in the Treasury Department. From this standpoint, Latin America will do well to place the debt problem in its political dimension, in the context of national interests, instead of confining itself to the exclusively financial sphere.

In short, for reasons both national and international, it is imperative to analyse the present crisis in a structural and strategic perspective.

There is little or nothing to be gained by seeking export expansion unless a decided advance is made in industrialization, in the strengthening of technology and human resources, in closer internal linkage between industry and agriculture, in import substitution and in Latin American integration. Without this, exports will be confined to natural resources, will require that real wages be low, will impose a contraction of domestic demand—and all this to generate a surplus for the financing of interest payments.

Little or nothing is to be gained by seeking to increase domestic saving in order to raise investment if this is accompanied by a sharp contraction of external saving, because of financial constraints.

Little or nothing is achieved by aiming at a reduction of public and State expenditure if this creates more inequality and poverty and undermines the foundations of national co-existence.

International economic relations are increasingly based on the power position. Otherwise there is no accounting for the fact that in the most critical phase for the region since the 1930s a massive transfer of real resources to the exterior is being made. The net movement of capital less interest payments and dividends has left a deficit, for Latin America, of US\$ 18.4 billion in 1982, 30.1 billion in 1983 and 26.7 billion in 1984, i.e., US\$ 75.2 billion in the last three years. At the same time, the United States has become a net receiver of capital. This startling turnaround explains part of the crisis and must be reversed for a way out of the impasse to be found.

I do not fail to recognize the reality of the external financial forces, but neither should we forget that another cause of the muddle we are in is the smooth infiltration into our milieu of arguments and scenarios conceived in the countries of the centre.

#### 4. *Democracy and economy*

A strategy for the coming years should envisage the possibility of a political setting characterized by institutional instability.

A trait which seems to be widespread in Latin America is the inability of governments, States and political parties to cope with the problems which are looming ahead. The situation in many cases will be one of increasing institutional debility, even more so in view of the financial crisis and its social consequences. At the same time the armed forces, especially in those cases where they have been obliged to abandon their government positions, have neither legitimacy nor internal institutional conditions to favour a renewed intervention in political life.

This is a fact of key importance for democracy: we shall be faced with a situation of weakness in respect of leadership. Should this be so, I consider it useful to mention three factors of compensation for consolidating the democratic system, both in those countries which have already instituted democracy and in those which will have it in the near future, like Chile. These factors are:

a) The return to democracy should rely more and more on local governments, with regional and sectoral decentralization; there should be a drive to promote co-operatives and medium-sized and small enterprises. This line of action gives scope for social energies and local initiatives and eases the burden on the State, allowing the public apparatus to concentrate effectively on strategic problems. At the same time it decentralizes conflicts, thus preventing them from overwhelming the central capacity of control.

In confining itself to specific areas, the State will achieve legitimacy through its efficiency and will achieve efficiency through its greater specificity. The idea is that the State should be muscular, not obese.

Decentralization also means restriction of the growth of large economic groups which are a hindrance to the economy and a menace to democracy.

b) Social alliances must be re-established to strengthen democracy and give it deeper roots. The forms of agreement confined to political parties or to professional and trade associations, which are not representative of the whole of society, and today are less so than before, no longer seem sufficient. The growth of informal sectors and the changes in the occupational structure alter the bases of the former alliances.

There should be a closer linkage between the question of the new composition of employment and the new behaviour patterns and attitudes of the social agents, on the one hand, and that of alliances and forms of adhesion, on the other. There should also be new forms of co-ordination between the State and the workers and entrepreneurs, to tackle specific tasks.

In sum, it is a matter of shaping a new social consensus or social pact or other formulas of national concertation. At the same time, the goal must be the strengthening of the civil society.

c) More vigorous effort should be put into the formulation of a doctrine which associates security with development and democracy.

We cannot impose on a fragile democracy, like a sword of Damocles hanging over its head, the discredited doctrine of national security based on the concept of the enemy within.

I also think that to reinforce development and democracy it is imperative to foster the notion of collective economic security in Latin America. Measures directed to this end accord with the objectives of a broader integration, enhance Latin American self-awareness and reinforce democracy by increasing capacity for protection and rejection of interventionism. In such a case as that of Nicaragua, which we are experiencing today, we should have more capacity for self-defence against an aggression which shows us our impotence.

### 5. *The force of ideas*

Admittedly, in the midst of such radical changes in the Latin American and world economy, it is difficult to distinguish clearly the causes of the present crisis and to decide on a fixed course. Hence the frequency with which we employ the terms perplexity and confusion.

To shape a broad-based social agreement and to make headway, ideas are a vital force. We might assert that ideas should be considered a part of structure, and that in recent times they have constituted a factor of structural weakness.

From a political standpoint, it is essential to uphold certain convictions in order to mobilize

national capacity. There are concepts and actions which we need to reconsider, rearticulate and renovate.

In the face of perplexity, it is worth while to

recall what Goethe said in his *Faust*: "The man who in uncertain times is uncertain in spirit magnifies and intensifies evil, but he who holds firmly to an idea creates a new world".

## V

### Towards new styles of development

*Luis A. Feroppa\**

#### 1. *Restructuration of the world order*

In what remains of the 1980s the international situation will be characterized by great instability, which will derive from the reorganizations imposed by the progressive consolidation of the new power structure that the two superpowers have been building up in recent decades.

The reformulation of the capitalist system existing in the 1930s began at the end of the Second World War. Assisted by the circumstance that the European economies were devastated and the Soviet productive apparatus seriously weakened, the United States became pre-eminent in economic, technological, political and military potential; this was based, first and foremost, on the performance of large enterprises which incorporated technological innovations with speed and continuity, thus generating expansion and promoting international reorganization on a far-reaching scale. The concurrence of government policies with those of the transnational corporations, functioning in an international institutional framework very favourable to their objectives (the GATT-World Bank-International Monetary Fund triangle), ensured them control of trade and of capital flows and enabled them to promote a restructuring of the international order in consonance with their interests. This stage continued—not without instabilities—until the end of the 1960s.

Simultaneously and gradually, however, the

economic recovery of the European countries came about—partly facilitated by the United States enterprises themselves and the relative weakening of the superpower caused by the war in Vietnam—and the growth of Japan, which pressured for a modification of the international structure existing under the capitalist system. This phase witnessed a decline in the convergence between the government policies of the United States and the management of its transnational enterprises, which, coupled with an expansive revival of the other capitalist powers, gave rise to tentative changes in the distribution of power and irradiated new instabilities which continued up to the earlier 1970s.

With the outbreak of the oil crisis a new phase of restructuring began in which the United States fostered the growth of its own production of crude and promoted technological innovations designed to reduce its consumption; it passed the protectionist law of 1974 to strengthen its world position and intensified its pressure on Japan, Western Europe and the Third World to bring them into line with its new strategic vision, characterized by the growing subordination of the international economy to the aims of its policy of national security. In this phase government policies and those of the transnational corporations became once again complementary and both vigorously extended their activities in Latin America and in the rest of the world.

The process of transnationalization had dif-

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ferent effects on the powers and on the peripheral countries. The formation of the trilateral system increased the relative importance of trade in manufactures in world transactions, the interdependence of financial markets, and the rapid integration of the industrialized economies by the transnational enterprises; this system became the predominant nucleus of the international division of labour and displaced the traditional centre-periphery trade as the major proportion of world trade.

The peripheral countries, for their part, while revealing capacity for expansion, were unable to safeguard and retain the fruits of growth and to abolish poverty, degradation, backwardness and a chronic external deficit. While the industrial growth of some developing countries (Brazil, Mexico, India, Korea) must be accorded due recognition, transnationalization actually worsened the position of the peripheral regions, since the gap between the "haves" and the "have-nots" grew wider.

We are now witnessing the culmination of the last restructuration imposed on the capitalist system by the policy of national security and the line of monetary and fiscal conduct pursued by the United States government in the course of the present decade. The strengthening of its power in the international order and the quest for military and political supremacy *vis-à-vis* the rival superpower have conduce to a national growth mainly financed by the economic slowdown of the other developed countries and the depression of the underdeveloped countries.

The different recompositions undergone by the capitalist order, basically stemming from the political decisions of the United States, were confronted with those imposed by the Soviet Union in the socialist order as the consequence of different interventions (Angola, Ethiopia, South Yemen, Afghanistan, etc.). Moreover, just as had occurred in the capitalist system, the expansion of the economies of the East came to a halt at the end of the 1970s and was replaced on an increasing scale by failures in the implementation of plans, rises in prices and production difficulties in the energy and agricultural sectors. Notwithstanding recourse to a reduction of imports and investment, the 1980s are witnessing a state of instability in the socialist world.

This instability, generated by both

superpowers and accounting for the crises in the respective orders, will be aggravated during the rest of the decade: this is ensured by the persistence of the expansionist military policies of both powers in a world whose economic resources are insufficient to finance them. Hence, the instability generated by the transition from a world organization ruled by a single superpower to the culmination of another tending to incorporate the two projects fostered, respectively, by the United States and Russia will increase, since the economic and financial factors will tighten their distorting grip on the political and social factors.

## 2. Critical instabilities

Consequently, the present crisis has the following features:

—*in the political sphere*, the instability stemming from the security measures pursued by the United States and the Soviet Union. To these must be added the secondary instabilities caused by China and Japan (with their fear of Russian policy), Western Europe (with the uncertainties deriving from the negotiations on medium-range missiles) and by the Third World itself, with its aspirations to autonomy;

—*in the social sphere*, the instability fomented by increasing poverty, largely an offshoot of the aforesaid policies, incompatible in the long run with individual liberty. The lack of a minimum measure of material well-being for broad segments of the population and of any soundly-based hope of improvement acts as a spur to dissatisfaction and socio-political instability. National conflicts between groups, sectors and classes exacerbate those generated, in each nation, by the confrontations between superpowers and powers;

—*in the economic field*, the instability provoked by a production capacity in excess of purchasing power, with the ensuing increase in structural and conjunctural unemployment. The insolvency of demand—rendered more acute by a swollen financial debt—combines with an unusable surplus of production capacity to produce depressive and inflationary effects which aggravate the crisis of the international monetary system. This, disorganized since the

late 1960s by the monetary conduct of the United States, was distorted still further by President Reagan's policy of national security, implemented by means of an expansionist fiscal policy coupled with a restrictive monetary policy which raises interest rates and curbs the economic expansion of Western Europe and the rest of the world;

—*in the technological field*, the instability imposed by the realignment of industry. This was reflected, in the course of the 1960s and 1970s, by the decline in the growth rate of output of consumer goods (textiles, clothing, footwear, agro-industrial products such as pulp and paper, etc.) of relatively less scientific content, *vis-à-vis* the more rapid growth rate of lines of production with a relatively high scientific content (the electronics, nuclear energy, aerospace, chemicals, petrochemicals and other industries).

This restructuration is closely connected with the political and economic decisions of the superpowers and powers which give extra impetus to scientific and technological advances.

### 3. Outlook for Latin American growth

All the features referred to above will severely condition Latin American growth since they ensure:

—sluggish expansion of the developed economies, which will condition demand for inputs produced by our countries. This fall in relative demand for Latin American products will be aggravated, besides, by political causes (protectionist pressures on the part of the national sectors and groups affected by little or no domestic economic expansion) and by technological causes (growing improvements in productivity through the incorporation of technological innovations);

—tardy adjustment of the international financial system to the new conditions imposed by the external overindebtedness that characterizes the Latin American nations. In addition to the insufficient inflow of capital to these countries, there will be the temporary outflow of financial surpluses resulting from the servicing of the external debt;

—meagre or insufficient payment and borrowing capacity, originating in the aforesaid

obstacles to export expansion and capital inflows.

The final result of these constraints will be a lack of growth or a very limited and contained expansion in the coming years. This will aggravate the lacunas and deficiencies of Latin America's current styles of development, conducive as they are to external imbalances, to the disarticulation and heterogeneity of the productive apparatus, to discrepancies between patterns of demand and resource endowments, and to shortfalls of domestic saving in relation to the amounts of investment needed for modernization. There will be an increase in vulnerability and dependence and a still further diminution of the autonomy of national decisions, which will prevent the attainment of greater equity through redistribution.

It is clearly foreseeable that external dependence will be intensified, that the situation in respect of equity will deteriorate, that levels of living will fall still lower, that social disintegration will advance farther and that the possibilities of establishing and consolidating democratic régimes will become more and more remote. The trend towards a modernization based on external decisions, partial in character and beneficial only for specific economic sectors and social groups, will lead to an exclusive development style which will militate against integration—economic, technological and social—and hence against the constitution of a progressive and stable political system.

### 4. The distribution of world power

In essence the issue is one of distribution of power—of world, regional, national and local power. The distribution of power among the dominant superpowers and powers affects the distribution of power in regional and national societies, and these determine—in relation with their respective development models—the internal distribution of opportunities, well-being resources and income.

In order not to lose their share—and, indeed, to increase it—the superpowers and powers need to maintain their economies at high levels of activity and productivity, since this enables them to procure the resources which will

finance their war and security apparatus; at the same time they guarantee high levels of employment and income to their inhabitants, which will encourage them to accept the necessity of making these contributions.

These activities and levels of productivity call, in turn, for maximum freedom of access to the sources of supply of raw materials, to the markets where they sell their products and to the financial markets: hence they are always proclaiming free-trade theories and doctrines, based on unrestricted openness, and promoting the organization of an institutional system of international freedom, since this will assure them fulfilment of the final aims of security pursued through the economic, financial and technological policies which they maintain.

During the next ten years massive transfers of resources as in the 1970s cannot be hoped for, still less debt settlements by means of grants. Nor can concerted security policies be expected (particularly between the two superpowers), or solutions based on military supremacy. Consequently both crises —conjunctural and structural— will go on affecting the world order. In Latin America, therefore, solutions will have to be projected on the basis of the existing situation, characterized by the superpowers' and powers' continuing defence of the free play of market forces (which signifies the free play of the forces of the transnational corporations and of the relatively more powerful countries). This will inevitably lead to the creation of a new order reconciling the increasing internationalization of the economy with national projects making viable new and more democratic styles of development.

##### *5. The emergence of new political projects*

In Latin America, the replacement of the existing development style by others with the characteristics proposed, for example, by ECLAC will have to be based on widely supported and relatively well-defined political projects, at the regional and national levels. Given this approach, the problem will cease to be exclusively technical; it will have to embrace the multiplicity of social values and agents and the difficult ways and means of achieving effective consensus. Its degree of feasibility will be determined, therefore, by the nature of the political project pre-

dominant in each nation or region and the alliances or exclusions arising from it.

In other words, the feasibility of the project depends on the socio-political structure that sustains it. Its economic viability, in turn, will be conditioned by this structure and by its greater or lesser degree of stability.

Furthermore, the rate of economic dynamism will largely depend on the degree of capacity of the majorities to consume domestic production, a question which is closely linked with the success that a national project can achieve on the social plane as regards its aspirations to reduce inequalities and improve the quality of life. Neither can be achieved without political stability.

Social inequalities are a typical political reflection of the distribution of power in a society. Progress, from the development standpoint, takes the shape of a movement towards a society which is participative, politically pluralist and open, that is, a democratic society. Inequalities find eloquent expression in trends towards the concentration of wealth and in the lack of participation by the majorities in the fruits of growth, characteristics which generate technological and occupational heterogeneity and the social discontent which ensues. The indispensable elimination of these trends calls for technical coherence, economic efficiency and political will: this demonstrates the need for the integration of technical and economic elements and of both with social and political aims.

The new national projects, in their quest for a more egalitarian society, will have to give priority to increasing the number of jobs available and raising their productivity (all which is linked with the objective of growth); at the same time they must concern themselves with increasing the quantity and productivity of assets transferred to the poorer groups (which is associated with the distribution of the fruits of growth).

In consequence, the nexus between political, economic, social and technological aspects is the process of accumulation and distribution. The magnitude, form and characteristics of this process condition the initiation, acceleration or self-sustaining capacity of economic growth. All in all, however, the major determinant of progress is the social order in force, since it is this that determines the technical and institutional con-

ditions in which the community creates the economic surplus and the way in which it is used. So decisive is it that frequently, in Latin American society, accumulation and distribution are at issue at the same time as the maintenance or loss of the legitimacy of power.

#### 6. *Obstacles and definitions*

In the light of all that has been said, it seems probable that the reorientation of development styles promoted by the new political projects will take place in a context of scarcity of available resources to finance investment, imports of goods and technology and the servicing of the external debt.

This will necessitate a change not only in the growth strategy but also in the system of accumulation: it will require a redistribution of consumption, greater saving and a resource allocation different from that applied hitherto. Hence growth will be slow until such time as the necessary changes are made in respect of production; composition of demand; acquiescence in increased saving—especially on the part of the public sector—; institutionalization of strict management of foreign exchange; reformulation of the financial system; the public sector (as regards the management both of expenditure and of taxation and investment); and improvement of currently neglected areas (technological development, social infrastructure for meeting essential needs and securing better distribution of well-being).

The aforesaid reorientation of development, moreover, will have to be undertaken in the midst of the anomalies which will arise from the current situations of dependence, the attempts at achieving autonomy, the restructuring of the public sector and the consolidation of the transnational corporations; all this in a context of international, regional and national instability in which the new nature, form and organization of the State will come to be a sensi-

tive issue for the dominant groups and the dominated alike.

This being so, there will be an inescapable need to redefine the State-nation-social groups relationship in face of the supreme importance reassumed by the basic question: What sort of alliances of sectors, groups and classes will be best-fitted to promote the economic growth that will make the new style of development possible?

In the 1970s the answer was an alliance between dominant national enterprises, the financial system and the transnational corporations, with a repressive State and the exclusion of the popular sectors; the countries came under military control and bureaucracy and technocracy expanded their functions.

In the 1980s these relations must inevitably be reviewed. The reply to the interrogative should be primarily directed to determining the social bases of support for growth: alliance of State with workers? of workers, entrepreneurs, and State? of foreign and national enterprises? of public and private enterprises? a predominant State, supported by civil bureaucracies? Etcetera.

In my opinion the response should be to advocate a mixed economy, directed by a State capable of integrating the economic spaces and promoting—within a coherent political conception—all the means to facilitate accumulation, along with a participative policy bringing it into closer contact with the nation, since in future the priority aims will be social development and sovereignty.

In this conception, the role of the State will be fundamental during the transition from the present distribution of power and confrontation of group, sector and class interests to the projected distribution, democratically concerted.

Success or failure in the construction of the new democratic system will essentially depend on the confidence of trade-union leaders and national politicians in the strategy collectively approved, and on their offering—thanks to commitment to it—new prospects of democratic and popular development at national and regional levels.

## VI

## The crisis and political reform

*Angel Flisfisch\**

Whenever the crisis is viewed from the Latin American standpoint, academic and intellectual—and even political—circles have a strong tendency to conceptualize its problems in terms of a marked economic *reductionism*. This trait, which is perhaps understandable on account of the notable financial component of the crisis, so dramatically patent in the Latin American situation, certainly calls for correctives.

In the central countries themselves, an explanation of the origin and development of the crisis which merely took into account endogenous economic movements and domestic characteristics of a strictly economic type, would not only appear insufficient but would result in failure. The fact that the most unequivocally conservative ideological reactions—usually labelled as neo-liberal or neo-conservative—emphasize in their diagnoses phenomena much more complex than exclusively economic dynamics or cyclical movements produced by endogenous economic causes (such as a peculiar socio-political logic stemming from the association between democracy and a welfare state, or the development of co-operative organizations in civil society on an unsuspected scale, or the emergence of cultural anomalies in capitalism) is not to be regarded as merely fortuitous or circumstantial. Imbued with a keener sensibility to the risks and threats that loom over the type of economic order in force, these defensive ideological reactions have shown a capacity for conceptualization more complex than the conventional techno-bureaucratic or academic outlooks.

In sum, it might be said that the crisis in the central countries has had its origin in the contradictions between a set of requirements imposed by a global socio-political logic, which has its historical roots in the development of democracy, the welfare state and the civil society,

and the logic of accumulation in the strict sense of the term. The essence of this socio-political logic is to be found in processes of *reinterpretation* of the category of citizenship, clearly apparent since the end of the Second World War. This progressive reinterpretation has implied not only an extension of the category of citizenship—for example, the inclusion of rights with a clear economic content, which is the most obvious aspect and the most notable in terms of its dysfunctional effects and the burdens it places on accumulation—but also its qualitative enrichment through new significances which are of a more symbolically expressive nature, or which look towards political and cultural benefits whose economic connotations are not immediate. Contrary to the usual argument of Marxist or neo-Marxist analysts, for whom the operation of the aforesaid socio-political logic maintained a functional relationship with the demands of accumulation, history has highlighted important contradictions between them, so that the final outcome will depend on how these contradictions develop; that is, on the capacities of the social agents as a whole to steer these developments in certain directions and not others. From a superficial angle, the crisis could be surmounted simply by the annihilation of one logic or the other. Both the neo-conservative propositions, on the one hand, which aim at a drastically restrictive redefinition of the political and positions, on the one hand, which aim at a drastically restrictive redefinition of the political and on the other hand, the visions of a final collapse of the economic order characteristic of a mature or belated capitalism, subscribe to an uncritical acceptance of this alternative. Nonetheless, more careful consideration of the situation seems to indicate that, taking reasonable time-horizons into account, both radical authoritarian solutions that imply the destruction of democracy and revolutionary transformations of the economic order are equally improbable. The main problem posed by history seems to lie in the search

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for redefinitions of the political society —of its institutions and of the prevailing styles of practical politics— which will make possible relatively stable and at the same time dynamic *syntheses*, conducive to progressive surmounting, of the crisis. Undoubtedly, if these *syntheses* are found, they will imply redefinitions not only of socio-political logic but also of the economic order.

From the standpoint of the Latin American countries, the problems arising are not so dissimilar, despite the obvious existing differences: less material development, peripheral economies, their own peculiar political histories. If we confine ourselves for the moment to the countries of the Southern Cone, it is evident that the failure of the dictatorships or authoritarian régimes initiated in Brazil in 1964 is tantamount to the failure of the historical solution which consists in liquidating types of socio-political logic directed towards progressive reinterpretations of the category of citizenship, by imposing the exclusive predominance of the exigencies of accumulation. In turn, the development in the very midst of these régimes of revaluations of political democracy, of notable reinterpretations of political theory —where the notion of human rights holds a central place— and of new contents emergent in the political visions of different social groups (contents hitherto inadequately identified and superficially studied, inasmuch as analysis has confined itself to the more dramatic manifestations, like the theology of liberation or the *Sendero Luminoso* phenomenon): all this reveals the shaping of forms of socio-political logic whose operation conflicts with those of accumulation. In democratization results in Argentina, Brazil or Uruguay, these types of socio-political logic have played an important part, not only as conditions *sine qua non* —for how are the specific *dénouements* of the crises of authority to be explained without them?— but equally as major ingredients of the said crises.

On the other hand, the alternative historical solution, consisting in revolutionary transformations of the essential nature of the economic order, is faced with highly unfavourable conditions. Social heterogeneity in most of the Latin

American countries is such that it implies socio-political conditions in which military “establishments” are able to neutralize, and in the last resort to destroy, revolutionary projects. The authoritarian régimes of recent decades provide evidence of this. Nevertheless, the authoritarian forces which give rise to these “establishments” cannot annul the development and operation of types of socio-political logic which soon come into conflict with the exigencies inherent in a peripheral capitalist order.

Irrespective of personal preferences or value judgements, the very features of the situations call for social *syntheses* conducing to stable and dynamic processes which will resolve these conflicts. This way of conceptualizing the problem posed by the crisis, which seems particularly valid in cases of recent return to democracy like those of Argentina, Brazil and Uruguay, can be extended, *mutatis mutandis*, to practically the whole of the region. Together with this need for a synthesis reconciling socio-political logic with requirements of accumulation —obviously, *syntheses* necessarily provisional and temporary— there is another element shared with the capitalism of the central countries: the State has ceased to be the proper place in which to seek and consolidate a synthesis of this kind. It is doubtless difficult to conceive that State action should not be a necessary instrument of the historical unfolding of a synthesis, but its formulation and crystallization belong to the sphere of the political society. It is this latter domain which constitutes the Achilles’ heel of the Latin American countries, with perhaps some exceptions. Over against civil societies which, contrary to what was thought some decades ago, show a striking vitality, and States effectively or potentially modern —in all respect, including their technobureaucratic capacities— there are political societies which are notoriously weak, with embryonic party systems and representational and deliberative structures that are anachronistic or ineffective. One might argue that in these societies the problem posed by the crisis is mainly one of political reform rather than economic or State reform. At all events, the former is a determinant of the possibility of the latter.

## VII

## A possible international solution to the problem of the external debt

*Jorge González del Valle\**

### *Introduction*

In 1985, up to the time of writing, there has been a noticeable increase of interest in the discussion of ideas and proposals to give a practical content to the still somewhat vague postulates of the "political dialogue" to which the Latin American authorities hope to refer the disquieting question of the external debt. The proposals are numerous and range from the radical idea of a unilateral cancellation of the debt on the part of the creditors to a mere substitution of one creditor for another by means of an official compensatory mechanism which will facilitate deferrals of interest payments.

Hence it will do no harm to explore the viability of a solution based on conventional principles which will satisfy debtors and creditors alike, with the apparent advantage of clearing up the accumulation of interest payments due and amortization payments in arrears so as to open the way for a renewal of the financial flows which Latin America continues to need. Moreover, since this solution necessitates an international concertation transcending the bounds of separate and piecemeal renegotiation of debts, it would fall precisely within the political setting which the Cartagena Agreement has been promoting.

The basic premise of the mechanism proposed in the following pages is that the problem of Latin America's external debt is one of international dimensions and therefore requires an international solution. Worldwide financial stability is called upon to guarantee collective security, and it is this that is in jeopardy as long as the external debt (with its train of economic depression, high social costs and internal and external political confrontation) continues to ob-

struct the renewal of economic growth and development.

### *1. Characteristics of the mechanism*

The mechanism proposed would be attached to the International Monetary Fund (IMF), since the latter is the institution most directly responsible for the maintenance of the international financial order, and that is what is at risk as a result of the external debt problem. Besides, the explanation of the mechanism will show that IMF possesses the legal, financial and technical means of putting it into operation within a short time.

#### *a) Trust Fund for the debt*

As a start, IMF would set up within itself a Trust Fund empowered to: i) accept from the member countries transfers of international obligations fulfilling the requisite conditions (point b) for their refinancing; ii) consolidate all international obligations for their amortization in periods of 10 or 15 years, in accordance with the payments capacity (point d) of the debtor countries; iii) issue negotiable bonds in favour of banks and financial institutions in replacement of their consolidated credit balances, on the terms and with the maturities laid down in the amortization programmes approved by the Trust Fund; iv) administer the resources transferred to it by IMF for the purpose of subsidizing interest payments (point e); and v) carry out the financial operations required for the fulfilment of its objectives.

The IMF has sufficient legal faculties to administer trusteeships like the one proposed, requiring merely the approval of its Board of Governors. In this sense it would be enough for an External Debt Trust Fund (EDTF) to emerge as an initiative of the Executive Board (supported by the Interim Committee), as has happened in

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previous years with the establishment of special financial mechanisms and trust funds for specific purposes.

As can be seen, the crucial feature of such a Trust Fund consists in the replacement of external debts which are a burden to the debtor countries by bonds with international backing which the creditors would retain in their portfolio or could negotiate on the market. Although these bonds would not legally constitute direct IMF liabilities, the mere fact that the consolidation and internationalization of current debts were carried out through its intermediation should represent a sound enough guarantee to meet market requirements. Besides, there would be nothing to prevent the IMF, on its own account or through other international financial institutions (World Bank, IDB, etc.) from ensuring a secondary market for these bonds.

#### b) *Eligible external debts*

In order to be reliable and effective, the proposed EDTF would confine itself to the consolidation and refinancing of external debts which are really burdensome for the debtor countries. Among the various criteria that might be applied for the selection of eligible debts the following may be mentioned: i) that the maturities of the original or rescheduled loans should not exceed five years from the date of transfer to the Trust Fund; ii) that the interest rates agreed upon in the original contracts should be variable in accordance with the market rates; and iii) that the amount represented by the annual servicing of the applicant's total external debt (amortization plus interest payments and bank commissions) should have averaged, in nominal or real terms (20%) (25%) of the value of its exports of goods and services during the three years prior to the date of application to the Trust Fund.

Other selection criteria could be devised, and certainly this would constitute one of the most controversial aspects of the mechanism, in view of the heated (and, perhaps, unnecessary) dispute as to the responsibility for the external indebtedness of the developing countries. The latter should in any case firmly resist the imposition of criteria which subject the prospects of refinancing of the debt to the discredited IMF

conditionality in respect of adjustment policies. It may be said without exaggeration that acceptance of the traditional IMF conditionality would so greatly restrict access to the EDTF as to invalidate its objectives.

On the other hand, it must be recognized that the Trust Fund could not function without a high degree of selectivity respecting the external debts which merit consolidation and refinancing. In this regard, the debtor countries would have to adopt a self-discipline which would eliminate the temptation, in some cases pressing, to transfer to the international community the responsibility for external debts which do not represent a heavy burden on the payments capacity of the debtor country concerned.

#### c) *Consolidation bonds*

The bonds which the proposed EDTF would issue to replace the direct external debts accepted for conversion would have to meet the needs of the creditors. For this they would fulfil the following conditions: i) they would have the direct guarantee of the Trust Fund, which in its turn implies the participating member countries' responsibility for collective payment; ii) they would be freely transferable, at the option of the holder, before maturity; iii) they would be redeemable in periods of from ten to fifteen years from the date of issue, by means of escalated annual draws chargeable to the amortization fund set up by the debtors; and iv) they would earn interest at the market rate applicable to similar medium- and long-term bonds.

In assuming responsibility for the conversion operations, the EDTF would negotiate directly with the creditors (banks and financial institutions) to which the consolidated external debts are owed. It would not be altogether unlikely that in some countries the Trust Fund would meet with objections on account of regulations pertaining to the composition of the portfolio, the constitution of deposit reserves or the maximum maturities of the lenders' authorized investments. Many of these regulations are inconsistent from the technico-financial standpoint, so that the EDTF should be capable of exercising sufficient international influence to promote their liberalization or abolition.

On the other hand, there would not be any

technical reasons for objecting to the replacement of the external debts which have fallen (or are likely to fall) into arrears by international bonds which by their very nature tend to resolve the problems of concentration of risks, effective rates of return and sufficiency of payment which affect existing loan operations. This should be the main argument for promoting acceptance of the bonds issued by the EDTF, which could be strengthened by the establishment of a secondary market based on the amortization fund for its own issues and any arrangements for conditioned investment which the EDTF might concert with IMF, the World Bank and other regional or national financial institutions.

d) *Amortization fund*

To redeem whatever consolidation bonds it issued, the Trust Fund would need to set up an amortization fund fed by the payments that the debtor countries would make in proportion to the external commitments which they had transferred for conversion. These payments could not and should not exceed the financial capacity of the debtors, which would be determined in each case by the EDTF on the basis of medium- and long-term balance-of-payments projections. Such projections, however, would require a standardized (i.e., generally applicable) correction to mirror the effect of the easing of the external debt burden which is the whole *raison d'être* of the proposed Trust Fund.

Among the technical criteria that should be applied to establish rectified projections of each debtor country's payments capacity, the following are particularly important: i) every debt matured or pending should be amortizable in annual quotas, whatever the form of payment originally agreed upon; ii) a general moratorium of up to five years from the original maturity date, including debts fallen due, and reckoned from the date of their acceptance by the EDTF, should be applied; iii) the uniform aim of the annual balance of payments should consist in a zero balance on the basic account (i.e., the balance on current account plus net income from capital on deposit for more than five years) after completion of such operations as deferment and annual amortization of the debts accepted by the EDTF for conversion; and iv) any adjustment resulting

from a negative balance on the basic account would conduce to an additional moratorium for the amount of payment pending, up to its settlement.

The author's preference for a zero balance on the balance-of-payments basic account as an objective indicator of payments capacity is essentially attributable to the desirability of avoiding useless confrontations between the EDTF and the debtor countries over the policies of the latter regarding international reserves, import levels, etc. In effect, general acceptance of this objective indicator would leave the debtor countries free to allot income from exports or from capital on deposit for up to five years to import financing, or to increase their reserves with surplus income from these sources, or even to use it to amortize external debts not consolidated in the Trust Fund.

It must be recognized, however, that the question of the debtor countries' "true" capacity to pay would be another controversial aspect of the operational rules of the EDTF. There is a tendency among creditors to consider that payments capacity might be increased by severe external adjustment policies on the part of the debtor countries, because this is what IMF has been saying for several years. In contrast, the debtor countries rightly allege the impossibility of carrying adjustment to the extreme of creating an external bottleneck accompanied by explosive political and social conditions at home.

e) *Subsidizing interest payments*

Although the proposed Trust Fund could conceivably operate as a mere intermediary between debtors and creditors, its main (and certainly also controversial) attraction would consist in its being able to offer the debtor countries some concrete relief from the high cost they have to bear on account of the present levels of external indebtedness. It is said, with reason, that the adverse effect of this cost is relatively more severe than an accumulation of overdue amortization payments, since when all is said and done the latter is negotiable and is of equal interest to the creditors. Besides, the worldwide trend towards an increase in interest rates seriously distorts the payments capacity of the most indebted countries, irretrievably hampering their

precarious access to the international credit they need in order to continue financing their economic growth.

For the EDTF to be able to subsidize an appreciable part of the cost of the consolidated external debt, the following minimum norms are suggested: i) the IMF would transfer to the Trust Fund the product of any sales of its gold holdings in the free market that were authorized by the Board of Governors; ii) the subsidy would be limited to the difference between the interest rate effectively paid on the bonds issued by the Trust Fund and a nominal interest rate, uniform for all external debts accepted for conversion, equivalent to (2%) (3%) per annum, plus the annual average increase in the index of the deflator of the gross domestic product of the United States of America, and iii) if the financial resources of the EDTF destined exclusively for interest subsidies were insufficient, the Trust Fund could decree a proportional and uniform increase over the nominal interest rate chargeable to debtors in order to make up the deficit.

As is common knowledge, the sale of gold by IMF for subsidizing interest payments has a specific precedent and is not a censurable novelty. From the technical standpoint, this procedure would be all the more justified in a project aimed at averting dangerous disruptions of international financial stability, since gold still has no monetary value and IMF has no pressing needs. The question is whether there is the political will to commit IMF to a project of this calibre.

## 2. Critique of the mechanism

The possible advantages of the mechanism outlined above can be summed up in its pragmatism, both from the institutional angle and from a technical standpoint. None of the characteristics of the mechanisms is really novel, but for this very reason it should be acceptable if it could obtain international political support, which in its turn depends on a general recognition that the external debt problem of the developing countries could give rise to a world financial crisis of catastrophic proportions. Hitherto the arrangements negotiated between individual debtors and creditors have warded off this recognition, but the expectations on which these arrange-

ments are based hold out little encouragement or promise.

The key role assigned to IMF in the functioning of the proposed Trust Fund is in keeping with the political support that the industrialized countries have given it throughout the country-by-country negotiations and agreements on external debt in recent years. Moreover, from the standpoint of the debtor countries, it is preferable to resort to the technical experience and legal flexibility of IMF in the search for a short-term solution rather than to continue somewhat idly groping after the possibility of miraculous panaceas.

As it is conceived, the mechanism for the internationalization of the external debt would meet the most pressing needs of debtors and creditors, without changing the traditional conventions of free contracts in the financial sphere. The creditors would reinforce (and in some cases improve) the quality of their external assets, although at the same time they would have to lengthen the maturities of their investments. The debtors would have the considerable respite of a general moratorium and a reduction in the cost of their commitments, so that the servicing of their debts would be better adjusted to their capacity to pay. The international community, moreover, would avoid the danger of a financial *contretemps* of unpredictable, but certainly disastrous, consequences.

The limitations of the proposed mechanism are apparently inevitable and have to do with the selection of the external debts eligible for refinancing and with some uncertainty regarding the amount of the interest subsidy. In the former case, the mechanism could not be left open to every type of external debt, since priority is bound to lie with those which are really onerous by reason of their early maturity or their high financial cost. With regard to the subsidizing of interest, the source of financing suggested (sales of gold by IMF) would not be unlimited and the debtors might ultimately have to absorb the total amount of interest paid by the EDTF to the creditors. Nonetheless, the interest subsidy might represent an appreciable relief in the medium term, taking into account the potential price of IMF's gold holdings which now amount to some 100 million troy ounces.

Lastly, due heed must be paid to the fact that

the formalization of the replacement of external debts by the proposed Trust Fund's bonds would do away with the main obstacle to the renewal of the international financial flows which up to a few years ago represented an appreciable contribution to economic development. The estimates and calculations that might be made in this respect are futile as long as the confidence and security required by the lenders are still lacking. It is one thing to measure the external financial "gap" and quite another to quantify real expectations of capital inflows. It should not be forgotten that the disparity between these two variables was one of the causes of the inordinate external debt depends both on the expectations devise remedies and solutions.

### *3. Concluding remarks*

The opinion held as to the need to find overall solutions to the problem of the Latin American external debt depends both on the expectations of economic recovery and on the view taken of the political viability of an international concertation to this effect. In both respects there has been a slackening in recent month which calls for comment.

On the one hand, as regards economic recovery, the economic figures for 1984 are apparently being interpreted in several Latin American countries as the commencement of a new era of

prosperity. A complete evaluation of these results must necessarily take it into account that the economic crisis which began in 1980 has brought about changes in certain structural aspects of external financing which it would be dangerous to disregard in a projection of the future payments capacity. These factors include Latin America's new role as a capital-exporting region, the mass deferment of imports (many of them necessary) which has contributed to the improvement in the trade balance, and the ever-present instability in commodity export prices.

As regards the political will to solve international problems, there is no doubt that the doctrinaire cold-shouldering of respectful and constructive dialogue that has been bringing its pressure to bear on us of late is having an adverse effect on Latin American expectations. But it would be a mistake to play into the hands of ideological terrorism in projecting political solutions for the economic problems posed as a long-term issue. After all, the economic history of Latin America shows that the doctrinaire attitude of the North is endemic and that in the long run it is also ineffective.

Be that as it may, we Latin Americans would be quite wrong to shirk the discussion of ideas, whether allured by vague hopes of economic recovery or alarmed by foreign control of international political will. Neither hope nor fear can contribute to sobre and common-sensical reflection on matters of economic policy.

## VIII

# Centre-periphery relations: orientations and opportunities for Latin America and the Caribbean

*Oswaldo Martínez\**

In dealing with relations between the countries of the centre and those of the periphery I propose to return to the question of the debt, which is the most urgent and one of the major reasons for our meeting here. It is also a central issue in these centre-periphery relations, and the worst of it is that the problem, far from being resolved, is escalating to critical levels.

Moreover, although it is certainly of strategic importance to look for long-term solutions in respect of the equitable and democratic society which we desire for those in Latin America that do not have it, it is also certain that without immediate solutions to the problem of the debt, our reflections on a future development model might come to be mere expressions of wishful thinking and nothing more.

The debt is a time-bomb threatening the democratic processes recently launched in the region, and the most serious thing is that time is running out and that what is at stake is the very survival of these democratic processes, which have largely been established through popular pressure to find a solution to the oppressive economic situation and which if it is not found, might provoke violent social outbreaks. Obviously, the survival and continuity of openness to democracy depend on the surmounting of the crisis, and this means, above all, relieving the Latin American economies of the crushing weight of the debt, without which alleviation there can be no economic growth.

I think that however much we turn the matter over we shall not find a way out until we resolutely face and explicitly admit the fact, of which perhaps many of those present are by now convinced, that the debt simply cannot be paid by

the debtors and that neither renegotiations such as those of the last three years nor even a moratorium or grace period for a given length of time can offer effective solutions. This conclusion was reached by President Fidel Castro in a recent interview published in the Mexican newspaper *Excelsior*, in which, after analysing the situation of the debt on the basis of information from ECLAC, he proposes a formula that involves neither a breakdown of the international financial system nor even a direct adverse effect on the transnational banks which have been reaping record profits in these anxious years of debt crisis. Far from it: he proposes a way of activating economic growth, stimulating trade and entering upon a possible road to development.

Not many figures are needed—merely some of those supplied by ECLAC—to demonstrate that the debt is unpayable. Some countries such as Argentina are using 52% of the value of their exports to pay interests; Bolivia 57%, Mexico 36.5%, Peru 35.5%, Brazil 36.5%, Chile 45.5% and so forth. An enormous export effort is wasted and exhausted in servicing the debt. In 1983 and 1984 alone the net outflow of financial resources to the exterior was US\$ 56.7 billion. How remote and insignificant does that Alliance for Progress now appear which 24 years ago sought to apply an antidote to the Cuban Revolution consisting of US\$ 20 billion for investment in a period of 10 to 15 years!

At present, with a much larger population than 24 years ago and many more accumulated social problems waiting for solution, Latin America is handing over to the industrialized creditor countries US\$ 40 billion in one year under the head of interest on the debt and in 10 years, if this situation were to continue, it would have to spend US\$ 400 billion on interest payments alone; that is, 20 times what the Alliance for Progress was proposing to invest in 10 or 15

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years, and at a time when there was no international economic crisis and the terms of trade were relatively better for Latin America than they are today.

Although it is true that corruption and squandering have played some part in Latin American indebtedness, it is also true that these are not the determining factors and that the democratic processes of recent date cannot be blamed for the luckless legacy they received. The basic responsibility rests with the governments of the industrialized creditor countries, and especially with that of the United States for having permitted and encouraged the creation of an uncontrolled international financial bank market and because of its domestic economic policies which, far from converting its economy into the engine of growth which was to carry others with it along the road to recovery, have been a key factor in the disproportionate rise in interest rates, in the deterioration of the terms of trade, in the overvaluation of the dollar and in the flight of capital: elements these which taken together decisively account for the present Latin American debt crisis.

As a matter of fact, our terms of trade between 1980 and 1984 deteriorated by close on 22%; this figure, when applied to Latin American exports, which in 1984 amounted to US\$ 94.7 billion, represents a loss of around US\$ 20 billion merely as a result of the decline in the terms of trade. Because of the rise in interest rates above the levels in force when the debt was contracted we are handing over annually some US\$ 10 billion. Through the overvaluation of the dollar we are paying out, at a conservative estimate, about US\$ 5 billion annually and another 10 billion take flight from the region attracted by the high interest rates and alarmed by the devaluations that IMF prescribes. Totalling these items, we should find that Latin America is annually handing over US\$ 45 billion as a result of the policies imposed by the United States Government. This transfer of resources may be legal in terms of old juridical norms which demand payment from the debtor or his ruin, but it is essentially illegitimate in historical, social and political terms. Obviously this drainage is intolerable, as it is obvious from a few simple mathematical calculations that the debt is unpayable and calls for a radical solution, not a mere palliative.

If we start with the debt officially indicated by ECLAC at the end of 1984, i.e., US\$ 360 billion—and we all know that it is really higher—and assume as a first hypothesis that ten grace years would be granted in respect of payments on capital, that in that period interest would continue to be paid as at present, and that ten years would then be allowed for amortization with an interest rate no higher than 10%, we should find that Latin America would have to pay US\$ 400 billion in the coming ten years and another 558 billion in the following ten years. In 20 years we should have transferred US\$ 958 billion to the creditor developed countries. Another hypothesis might envisage application of the formula of paying an annual maximum of 20% of the value of exports, with an interest rate not exceeding 10% per annum. Our exports are now approaching US\$ 100 billion, but we may assume that even if they were to surpass that figure, annual interest payments would not exceed US\$ 20 billion. In this case, in 20 years we should have paid US\$ 400 billion and at the end we should have a debt of US\$ 1 161.85 billion, i.e., three times what it is today. A third variant might be that ten grace years were allowed, including interest payments, and a further period of ten years for amortization, the interest rate never exceeding 10%. We should have a respite of 10 years, but in 20 years we should have to pay US\$ 1 447.31 billion.

And finally, a particularly "generous" variant: that the interest rate would be reduced to 6%, ten years of grace would be granted, including interest payments, and a subsequent period of ten years in which to pay. In the case of this "generous" and "optimistic" variant we should have to pay in 20 years a total of US\$ 857 471 million.

Obviously, the debt is simply unpayable, even considering grace periods and generous and improbable scenarios. It is clear that all possibility of growth is wiped out and that the payment or non-payment of this debt—which in terms of transfer of resources and in a broad historical perspective we have already more than paid in full—signifies for Latin America that it will be able to develop or, on the contrary, must resign itself to being the western sector of Africa that a participant was mentioning this morning.

What then is the solution? The only feasi-



ble one is that the creditor industrialized countries, acknowledging their responsibility in the debt crisis, should take over this debt to their private banks, thus halting the rapid spread of default, and that the debt should be written off.

The mechanism could be an issue of bonds by the governments of the creditor industrialized countries which would finance the private banks' debt without disrupting the bases of the international financial system. There is no reason for this financing to reduce the already meagre resources destined for official aid to development, nor should it necessarily increase the public debt or fall on the shoulders of the taxpayers, but it should have its logical and rational source in a reduction of the enormous and absurd military expenditure. In this way the solution of the debt problem, which represents the removal of the obstacle at present blocking all possibility of development, would be linked with a curtailment of the crazy escalation of armaments which threatens to annihilate us all and

turn our exercise in intellectual reflection into a meaningless verbal contest.

This formula assumes, of course, firm Latin American unity around a problem which has clearly ceased to be a technical matter and has become one of the great political issues of the time. This unity should be based on the participation of all the countries and should also be an effective instrument for solidarity with countries of the region which, like Nicaragua today, have been dealt a blow intended to bring them to their knees.

The trade and air embargo decreed by the United States Government of which we have just heard, and which recalls similar measures practised against Cuba 25 years ago, is the "gift" which Mr. Reagan is offering the Nicaraguan workers on 1 May, International Labour Day. It is in situations like this that the indispensable unity of Latin America is put to the test and shows whether it is an effective reality or mere discursive rhetoric.

## IX

### International negotiating strategy

*David H. Pollock\**

There are four points I would like to make in the few minutes that have been allotted to each of us in this panel. Because of the time constraints, my comments will be both schematic and telegraphic. One of them is quite general and conceptual in nature. The other three are much more action-oriented; geared directly and specifically to "what to do in the short run". All four points, though different, are intimately interrelated in that they are aimed at Chapter 6, Volume III, of the Secretariat document suggesting that countries in the LA/C (Latin American and Caribbean) region evolve a *new* kind of international negotiating strategy. All four points, moreover,

are of much personal interest and importance to me, both as a Canadian and as a long-time student of Latin American development.

My first point is that the Secretariat documents—which constitute a very comprehensive and competent series of analyses on crisis and development in the LA/C region—do not, regrettably, make any mention of multilateralism as a general concept nor of the United Nations as a specific delivery system for the goal of international development co-operation. The absence of any such mention is understandable, in that both multilateralism and the United Nations development system are undoubtedly taken for granted by United Nations staff members writing for a United Nations regional economic commission. But I assure you that they

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are not considered as “self-evident truths” in many other parts of the world: nor indeed in many other institutional forums. Thus, to the extent that there is systematic and practical “follow-up” to this Conference—by the ECLAC Secretariat and by the individual participants—I begin by urging them not to forget those two very important omissions.

My second point is to urge, equally strongly, that the Secretariat embark as soon as possible upon a new and careful series of studies on the United States political economy. This need is fully as important to Canadians as it is to LA/C countries; which is why I assign it such a high priority. Canada is very sensitive to changes in the global economy (our ratio of foreign trade to GDP is almost three times as high as the LA/C ratio). Additionally we are extraordinarily vulnerable to shifts in the United States’ economy (the proportion of our total exports going to the United States is more than twice as high as that of LA/C). In consequence we follow and analyse whatever happens in the United States with very great attention indeed, not only to understand the socio-economic and political trends emanating from that powerful country but also—from time to time—to see whether and how we can influence those trends. But is there an equivalent analytical focus on the United States within LA/C? I am told hardly at all. I am told that, whereas there are over 130 United States research centres studying LA/C on a full-time basis, there are only some half-a-dozen LA/C research centres that devote full-time study to the United States. This is a gap that badly needs to be filled.

What are some of the principal economic, financial and technological trends characterizing the United States today? What are their projected magnitudes and implications tomorrow? Where are the most important developmental decision-making entities in the United States, and who are the key actors influencing those decisions? To answer such questions, even if only partially, is a task for which the ECLAC Secretariat has an undoubted comparative advantage, and through which it could have a multiplier effect in helping its constituent LA/C countries to advance more effectively towards their international developmental objectives.

Thirdly, in two United States cities there is a concentration of a small but potentially very in-

fluential group of LA/C development specialists; namely the LA/C Executive Directors of the IDB, IBRD and IMF in Washington, D.C., and the LA/C Ambassadors at the United Nations Headquarters in New York. They act largely, as is their directive, in the interests of their individual national governments. If, however, they could be mobilized to act jointly—even if only from time to time—as an informal regional pre-caucusing body for specified international trade, finance or technology themes, they could be of much importance for a future LA/C global negotiating strategy. Currently, for instance, they might consider debt restructuring, conditionality and adjustment, capital replenishment, and trade issues, among others. The goal would not be to substitute for other LA/C negotiating entities, such as the Cartagena Group, but rather to complement and strengthen them, on an as-needed basis.

My fourth and last point concerns the following. To refer again to Chapter 6, Volume III, of the Secretariat document, emphasis is given to the need for LA/C governments to disaggregate their current international negotiating strategy: to make it more flexible than has been the case since it evolved in UNCTAD more than 20 years ago. In this respect I share the ECLAC Secretariat’s views. It is now clear to all in the LA/C region that there is a need to disaggregate in terms of both countries and issues. This would make the region’s negotiating strategy more realistic and more effective. But simultaneously I would suggest that the LA/C countries also seek to disaggregate the North as well, dividing it into at least two broad country subcategories; namely i) what I call “North of the North”, namely the three or four largest, most economically powerful, and in general the most cautious and conservative negotiators in terms of the North-South dialogue; and ii) countries that I describe as “South of the North”—for example the Netherlands, Sweden, Norway, Denmark, Canada, Australia, and New Zealand, among others—which are often more ready, willing and able to ally themselves with LA/C countries in respect of certain specific international development negotiations. The North-South dialogue is currently stagnating: it badly needs a push, albeit if only at the margin. The potentialities of a new negotiating alliance—even if only activated from time to

time, and for a few carefully selected issues—could be a most valuable follow-up to this ECLAC Conference. Canada and other “like-minded” countries of the North can and should be viewed as allies, *on occasion*, with “like-minded” countries of the South.

To conclude, i) multilateralism and the United Nations development system, ii) new studies of the United States political economy, iii) tapping the combined talents of the LA/C Executive Directors in Washington and their United Na-

tions Ambassadors in New York, and iv) disaggregating the “like-minded” countries of the North for LA/C negotiating purposes, are four ideas which, though separate, are closely interrelated. I would very much hope that the ECLAC Secretariat and the invited participants can find formulae for bringing them together in a practical way, for future LA/C negotiating purposes. The North-South dialogue is currently in dead water: it must be energized before it sinks completely out of sight.

## X

### Crisis and food self-sufficiency

*Jorge Ruiz Lara\**

#### 1. *Adjustment and transformation*

This morning Mr. Jorge Méndez asked a question which I consider of major importance: When does the adjustment process end and that of transformation begin?

I believe that the transformation process has already begun, but that only the first few steps have been taken. The devaluations of the Latin American currencies and the major financial adjustments which have been made imply a substantial transformation of the economic structure of the region. It will suffice to mention the most outstanding aspect of this change: the new relationship existing between exports and imports. Previously there was a trade deficit in most of the countries of the region. As from 1982, it has been necessary to generate a substantial positive balance, mainly through a marked reduction of imports, in order to create a surplus with which to pay the interest on the external debt. This situation will persist during the coming years.

\*The author is a staff member of the Inter-American Development Bank, but his comments are made in a strictly personal capacity.

Mr. Jorge Méndez is right in inquiring what are the implications for Latin American development of so radical a change in the structure of the balance of payments.

In the Inter-American Bank a detailed analysis has been made of the adjustment process and of its repercussions on the outlook for development of the seven largest Latin American countries. For the sake of accuracy, a simulation exercise was carried out in respect of the main economic variables of these countries for the period 1985 to 1990.

The chief assumptions of this exercise are the following:

1. Interest on the external debt will continue to be paid;
2. The LIBOR interest rate will rise to a maximum of 13% and then will fall to 11% in 1990;
3. The annual rate of inflation of the OECD countries will be 5%;
4. The external debt of the Latin American countries will grow at an annual rate of 5% in nominal terms. This implies that the debt will not vary in real terms;

5. The national income of the OECD countries will show an average annual growth rate of 3%.

On these assumptions, the annual growth rate of the seven largest countries in Latin America taken together, i.e., Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela, will be approximately 3% from 1985 to 1990.

This slow rate of development signifies that Latin America will suffer the effects of a prolonged recession during the coming years. Economic development will be sufficient to raise per capita income levels slightly, but will not suffice to avert a considerable increase in the indexes of unemployment.

To prevent this deterioration, without ruinously affecting labour productivity, it will in my opinion be necessary for the State in each country, within its field of action, to assume responsibility for adopting the policies and programmes required for the immediate application of widespread programmes of structural change, and for the burden of interest payments on the external debt to be alleviated through an effort of international co-operation.

*2. Food self-sufficiency and the region's capacity for international competition in agricultural production*

The Inter-American Development Bank has traditionally given high priority to agriculture in its programmes of operations. Of the total value of the loans approved by the Bank from 1961 to 1984, about a quarter was assigned to the agricultural sector. It is highly probable that, at least during the next five years, the Inter-American Bank will continue to accord high priority to this sector.

Several reasons, mainly related to the adjustment process which has taken place in Latin America in the last three years, support the validity of this statement. Latin America has traditionally been a great net exporter of agricultural products. Year by year, the value of the exports of this sector has exceeded the value of imports by a considerable margin. During the three-year period 1981 to 1983, the value of Latin America's food exports was more than double the value of imports. Despite this favourable situation,

it is alarming to trace the trends of international trade in agricultural products in Latin America.

In the past ten years, the agricultural imports of Latin America rose much more rapidly than its exports. Between 1973 and 1983 the volume of agricultural exports expanded by 36%, whereas that of the imports of the sector grew by close on 100%. The increase in food imports was even more rapid, since it amounted to 128%. This growth, so considerable in agricultural imports and so sluggish in exports, was caused by a series of factors, some of which will operate with less intensity in the coming years. The overvalued exchange rates of most of the Latin American countries helped to encourage imports and discourage exports. This effect was more pronounced in the case of agricultural products.

The growth of food imports has been closely linked with the changes in consumption patterns that have taken place in the region as a result of rising incomes and rapid urbanization. Food consumption has been no exception to the general tendency in Latin America to imitate the consumption patterns of the centre. In fact, during the period mentioned, food consumption patterns in Latin America became more similar to those of the temperate-zone industrialized countries. Thus, for example, the proportion of consumption of proteins of animal origin in the region increased from 33% to 37% between the quinquennium 1961-1965 and the triennium 1979-1981, while the proportion based on traditional foodstuffs, such as maize, beans and others, diminished.

Apart from the stimulus of the devaluations, farmers have been particularly benefited by the tariff reductions for imports of inputs and agricultural machinery, and by the reduction or in some cases elimination of controls on food prices, export duties and subsidies for imports of foodstuffs competing with domestic production.

The adjustment policies adopted in recent years by the countries of the region, which will need to continue pursuing them in order to achieve an economic reactivation during the next five years, tend to encourage agricultural exports and discourage imports.

Despite these measures in favour of agriculture, there are still serious obstacles to a rapid reactivation of the sector. In many cases the rise

in internal interest rates has increased financial costs and discouraged investment.

The sector has also suffered the consequences of retrenchment in government expenditure, with the production of public investment and of the extension and other services provided by the State.

In the next ten years the Bank will continue to give priority support to the agricultural sector.

We do not believe the goal to be the achievement of food self-sufficiency. Criteria of economic efficiency will undoubtedly make it necessary to import food from outside the region. But the new adjustment policies will give a powerful stimulus to a beneficial change: that of arresting the decline that has occurred in the trade surplus with which the agricultural sector has traditionally contributed to the balance of payments.

## XI

### Crisis of development style or conjunctural crisis?

*Bernardo Vega\**

In the course of the years, Latin America and the Caribbean have put into practice different strategies or styles of development in accordance with the economists' greater or lesser degree of enthusiasm for each. At the end of the 1940s and during the 1950s, industrialization through import substitution became the ideal of the epoch, thanks to ECLAC's preachings, until this thesis came not only to be applied in most of the countries of the region but also to be accepted in the academic spheres of the industrialized world in which totally contrary ideas had previously prevailed.

At the beginning of the 1960s, with the Alliance for Progress, attention was centered on the distributionism implicit in the agrarian and tax reforms. The controversy between structuralists and monetarists then supervened. Midway through the 1960s economic integration was considered to be the wisest strategy. In the 1970s the pendulum swung towards extraregional exports; while some countries of the Southern Cone experimented disastrously with the neo-liberal doctrine of openness.

Today not only are the economies of Latin America and the Caribbean passing through their greatest crisis since the 1930s, but because of this, the economists too are suffering from a

crisis of ideas. Even a vacuum of ideas, some would argue. The very theory of economic development, which has gained substance in the academic world during the last 40 years, is also in a state of crisis.

Meanwhile, from the political centres of the industrialized world come invitations to take advantage of the magic of the market.

The crisis has forced almost all the economies of Latin America and the Caribbean to apply to the International Monetary Fund in order to obtain financing and then to be able to renegotiate their external debt, and they have found themselves obliged to put into practice the monetary and exchange policies suggested by the Fund. One of the more important results of the crisis is that, for the first time, Latin America has lost its capacity to apply autonomous economic policies. As a result, never before has there been such uniformity in the economic policies of the region, since the adjustment process imposed involves a virtually identical formula.

The economic crisis coincides in time with two political phenomena of exceptional importance. The first is the co-existence of conservative governments in the leading industrialized countries (the United States, the United Kingdom and the Federal Republic of Germany), which hampers the management of the

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crisis because of the unhelpful attitude of these governments in the forums of discussion (Interim Committee, Development Committee, summit meetings, etc.). The second is the coincidence of the crisis with the resurgence of democratic governments in the region. The clash between the long-repressed expectations of the population and the real fall in levels of living resulting from the adjustment might well provoke a disastrous political reaction. The recent assumption of power by populist movements—for instance, by APRA in Peru, after more than 30 years in opposition—, coinciding with the worst moment of the crisis, is only the most recent example of the traumatic conflict between promises and realities.

Is this crisis provoked by errors in the regional development strategies or is it the result of factors exogenous not only to those policies but also to the region itself? The external causes of the crisis are clear: a drastic deterioration of the terms of trade, high prices of hydrocarbons, high interest rates and a negative balance on capital flows. However, let us submit the assertion that the crisis is caused by external factors to an empirical test. In 1982 only two countries in the region recorded an increase in their per capita gross income and only three in 1983. Let us see which countries of the region, oil-importing, have managed to weather the crisis. The only economies without a substantial bottleneck in their external sector are Colombia, Panama, Barbados and Bahamas. The last three are small countries, with a weak agricultural and industrial base, with great openness to the exterior, and with exports of services as their chief engine of growth. Colombia has the advantage not only of domestic energy production but also a vigorous informal export sector, although admittedly it has always followed a policy of cautious external borrowing and dynamic export promotion. Even so, its per capita income fell both in 1982 and in 1983, and the same thing happened in Panama in 1983.

Since different development styles or strategies co-exist in the region, the fact that practically all the countries are affected by the crisis indicates that this phenomenon is essentially of external origin and not provoked by policy defects.

But let us broaden the empirical test and make it universal. Which oil-importing-developing countries have shown satisfactory growth in the last two years? Only the four "Asian tigers": Korea, Taiwan, Hong Kong and Singapore. Although it is true that in all these the engine of growth has been the export sector, that they made a rapid adjustment of their domestic prices in face of the petroleum shock and that in all of them market forces operate vigorously, it is no less true that in the cases of Korea and Taiwan exports do not represent so high a percentage of the gross domestic product as was thought and that the current prosperous phase of export of industrial products is merely the sequel of an import substitution process (with the ensuing expansion of the domestic market), and also of agrarian reforms which have made food self-sufficiency possible. Moreover, these models are not easily transferable to our continent, in view of cultural differences, and even if transferable they would be undesirable, since they are viable only in repressive political régimes where trade unionism is extremely weak.

At present the policy of the industrialized countries is causing an enormous transfer of real resources from our region to them. This signifies that a large part of the saving of the region is transferred outside it. We consider that no development style is viable in these circumstances.

We Latin Americans and Caribbeans are criticized for underestimating our own strength and resources and for laying the blame for our problems on the rest of the world. Analysing this criticism with objective honesty, we must conclude that in present circumstances at least it lacks validity.



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