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CONTENTS

Latin America: crisis and development options <i>Enrique V. Iglesias</i> , Executive Secretary, ECLAC	7
Institutional elements of a new diplomacy for development (Notes for a book of memoirs) <i>Diego Cordovez</i>	29
Orthodox adjustment programmes in Latin America: a critical look at the policies of the International Monetary Fund <i>Richard Lynn Ground</i>	45
The adjustment process in the eighties. The need for a global approach <i>Carlos Massad and Roberto Zahler</i>	83
Global monetarism and destruction of industry <i>Victor E. Tokman</i>	107
The structural crisis in Argentine industry <i>Adolfo Dorfman</i>	123
Population, resources, environment, development interrelationships in the United Nations: in search of a focus <i>Branislav Gosovic</i>	135
Participation: the view from above <i>Marshall Wolfe</i>	155
Recent ECLAC publications	181

The adjustment process in the 1980s: the need for a global approach

*Carlos Massad and
Roberto Zahler**

The Latin American countries are faced with various options for financing or adjusting their external accounts. This article makes a detailed analysis of such options and indicates the main paths followed by those countries and the economic and social costs incurred during the adjustment process in recent years.

It is stressed that this process must not be viewed as an isolated phenomenon, failing to take account of world economic interdependence, since it is a global problem, and not one merely affecting individual countries. When it is viewed as a global problem, new approaches emerge which make it possible to minimize the domestic costs of the adjustment process and to achieve results favourable to the world economy as a whole. These approaches involve drawing a distinction between recessive adjustment and expansive adjustment: the former consists in bringing about a reduction in the level of economic activity and imports, whereas the latter seeks to raise the level of employment and activity by increasing exports. In the final part of the article, a set of measures are proposed for improving the adjustment process and lessening the negative impact on the developing countries of the economic policies adopted in the industrialized countries.

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Introduction

The "adjustment" issue is related to certain basic or fundamental macroeconomic equilibria which need to be under control if undesirable and disruptive effects on the economy are to be avoided. The literature as well as policy makers have traditionally considered two types of situations which tend to be interrelated: external and internal equilibrium.

The achievement of external equilibrium refers to the balance between a country's expenditure abroad and its foreign exchange receipts, and has been perceived as a basic ingredient of a stable world economic system. It is not surprising therefore that high priority has been assigned to the attainment of external equilibrium in the design of economic policy by international institutions and others interested in a global, multilateral perspective. The gold standard, prior to the Great Depression, had a built-in (automatic) mechanism designed to push individual economies quickly toward continuous equilibrium in their balance-of-payments accounts. If a country tried to spend more than what it sold abroad, its gold holdings would decrease, diminishing the banking system's capacity to lend, thus increasing interest rates, depressing domestic residents' spending, stimulating exports, curtailing imports, and, therefore, restoring foreign payments equilibrium.

The system developed at Bretton Woods was also designed with the international economy in mind, attempting to obtain external equilibrium at the country level through the implicit fiscal and monetary discipline associated with the maintenance of fixed exchange rates. That process was to be complemented and smoothed by the IMF's financing facilities, access to which was linked to and conditioned by the country's implementation of adjustment policies aimed at restoring balance-of-payments equilibrium.

But in the 1940s, together with the need to reactivate the world economy along a stable path, nationalist tendencies, the impact of the Great Depression and the "Keynesian revolution" gave high priority to the goal of internal equilibrium. The objective was to run national economies at their maximum output potential, which meant aiming at full employment of resources, and particularly labour. Fiscal policy would play a major role in the attempt to equalize *ex ante* savings with investment flows, complementing private sector economic decisions so as to generate sufficient

"effective demand" to "buy" the output associated with full employment of domestic resources.

In the 1950s and 1960s, although in advanced countries unemployment remained at low levels, slow but steady inflationary pressures and foreign payment imbalances stimulated the development of a "policy-mix"—a combination of monetary, fiscal, and to a lesser extent, exchange rate and commercial policy tools—aimed at the simultaneous restoration of internal and external equilibrium.

Macroeconomic policy in the less-developed countries (LDCs), since the end of the World War II, has tended to follow a similar pattern to the one described above, with one major difference: development objectives and strategies to accelerate economic growth have had such high priority that, in general, external and internal disequilibria have been present all along. Latin America's experience between the 1950s and mid-1970s has been quite revealing: recurrent balance-of-payments crises and foreign exchange bottlenecks as well as chronic inflationary processes have been the norm rather than the exception in a number of countries in the region. Explanatory hypotheses for these situations have ranged from those that stress that they are the consequence of structural disequilibria inherent to LDCs' economies, to those pointing at basic flaws in economic policy design, with "excessive" government intervention, "repressed" inflation, erroneous pricing policies and inefficient protectionism. In any case, the fact is that countries have had to shift back and forth from policies attempting to solve accumulative foreign, fiscal and monetary disequilibria to those addressed at trying to run the economy at its full potential so as to better the standard of living of the region's increasing population. As a consequence of these "stop and go" policies the stability of the growth and development process and its flexibility and efficiency in adapting the region's economy to new and changing world and domestic shocks have been seriously undermined.

In the early 1970s the industrial countries, and particularly the United States, experienced a slowdown in productivity, stagflation and mounting balance-of-payments problems, which together with the increasing importance of crowding out, floating exchange rates, huge increases in energy prices, speculative capital

movements, inflationary expectations and indexation, undermined and questioned very seriously the adequacy and relevance of traditional economic policy and analytical tools to face these new situations.¹

The 1970s also witnessed successive events that contributed to blur the above-mentioned situation. Privatization of financial international relations (a process which was already underway some years before) accelerated with the first oil price shock in 1973. The booming role of private banks, at the expense of official international financial institutions (mainly the IMF and the World Bank) allowed and stimulated Latin America, perhaps the most "natural" client of the banks, to finance huge current account deficits. It can be said, to a certain extent, that the region privileged financing over adjustment of its foreign imbalances during the 1970s.

After the second oil shock, this process came to a halt in the early 1980s, when the effects of the world recession—the most severe since the 1930s—the deterioration of the LDCs' terms of trade and soaring international interest rates created serious debt service problems which were amplified by reduced capital flows to debtor countries as a consequence of the banks' procyclical behaviour. This has helped to generate a bleak scenario, reducing and making very costly, especially for LDCs the options out of the crisis. In this context, given the magnitudes involved, external financing constraints, and the new international and domestic prevailing circumstances, a reassessment of the traditional views regarding the roles of adjustment and financing is required, and this is the main purpose of this papers.

The next section deals with the main analytical issues regarding the adjustment process, stressing options and alternatives available in the abstract. In section II recent Latin American

¹Naturally, as a result of alternative hypotheses developed to explain these disequilibria and imbalances, different "structural" changes have been proposed: nature and speed of reindustrialization, supply-side economics, redefinition of government intervention in the economic sphere, implications of the size and characteristics of the "welfare State" on overall economic performance, etc.

adjustment experience is discussed. Next section iii deals with the actual alternatives and options available, both at the international and the national levels, pinpointing their advantages, limitations and deficiencies and examining some recent "non-traditional" problems which tend to

complicate ways out of the crisis, challenging traditional economic policy design. Finally, section iv briefly summarizes the main arguments and presents the conclusions that may be of interest to policy makers concerned with debt and adjustment issues in today's crisis.

I

Analytical considerations

Internal and external disequilibria, although interrelated, have usually been studied separately. Furthermore, the analysis (and policy recommendations) have tended to be carried out in the abstract, ignoring the countries' interdependence. While this may be a convenient approach when considering "small" countries and/or when no *generalized* payments or trade problems take place, it may lead to partial and sometimes erroneous conclusions when the opposite occurs.

The internal disequilibrium has generally been analysed for a closed economy or under the assumption that no problems arise in the foreign sector of the economy. It usually refers to a situation where the output gap—difference between the optimum and actual level of economic activity—is larger than some normal, natural or structural rate. In other words, when resource, and more specifically labour unemployment reaches some critical value, the economy is faced with an internal disequilibrium which is assumed to be caused by an excess supply of goods (or savings exceeding investment) and/or by distortions and imperfections in labour markets. According to which interpretation prevails, action tends to be centered on fiscal instruments and/or on wage and indexation policies. Another sort of internal disequilibrium corresponds to inflation. Even though structural considerations may be very important, it is recognized that this situation is characterized by an excess supply of money. Therefore, policy recommendations gyrate around the control of "excessive" internal credit flows (both to the public and private sector) and/or of the determinants of the liquidity ratio, mainly inflationary expectations and the

"management" of certain key prices, such as the exchange rate, wages and interest rates.

The external disequilibrium is related to an imbalance in the foreign sector of the economy. Specifically, when the current account is in deficit (surplus), it means that a country is spending on foreign goods and financial and non-financial services more (less) than what it receives from abroad. Until recently the literature has focused the analysis on the trade account, assuming away as exogenous the developments taking place on the financial area. For LDCs this may have been justified during the 1950s and early 1960s when direct foreign investment and official capital movements represented the bulk of the capital account of the balance of payments. In that context both the elasticity and absorption analysis of the balance of payments stressed the role of devaluation and movements in national income, respectively, on the balance of payments (narrowly defined). The integration of these two analytical approaches attempted to trace out the outcome of the "impact" and "multiplier" effects of changes in the determinants of exports and imports of goods and non-financial services on the "balance of payments" and on the level of economic activity and employment. The analysis allowed, under certain restrictive assumptions, for the simultaneous presence of internal and external disequilibrium, and it was recognized that non-dilemma cases were the combination of unemployment and surplus in the trade balance (expansive monetary and fiscal policies being called for) and inflation and deficit (which required restrictive monetary and/or fiscal policies). The combination of unemployment and de-

ficit on the one hand, or inflation and surplus on the other, were perceived as dilemma cases which required additional policy tools such as changes in the exchange rate.

The recent revival of the monetary approach to the balance of payments shifted the focus from the trade account to the overall balance of payments, concluding, under the theoretical assumption that the main developments in the foreign exchange markets respond to disequilibrium in the domestic money market, that "the current account does not matter". In other words, balance-of-payments flows are interpreted as one of the main mechanisms to restore equilibrium in the monetary sector. Policy instruments emphasize the control of domestic credit (rather than the more "direct" determinants of exports and imports), so as to accommodate it to money demand in such a way as to generate a desired balance-of-payments surplus or deficit; the latter would basically reflect excess supply or demand for local money. The precise way in which domestic residents try to satisfy their money demand, by offering abroad goods or real or financial assets, would be of minor importance. Consequently, adherents to this approach, which prevailed in many countries during the 1970s, argued that little importance should be given to the huge inflows of financing addressed to some LDCs since they represented the "natural" response of domestic agents to an excess demand for local currency.

The magnitude, nature and persistence of recent external imbalances and their relationship to domestic imbalances suggest that the current theoretical models for analysing the balance of payments are based on various sets of unrealistic and decidedly restrictive assumptions, and have produced piecemeal and at times erroneous interpretations and policy recommendations with respect to the developments which have occurred in this sphere. In particular, there has been little analysis of the determinants of private international financial flows or of the external debt's impact on the national economy. In addition, given a *ceteris paribus* assumption in relation to world economic activity, international interest rates, etc., policy prescriptions put the burden of restoring a balance in the "problem country", with little or no recognition of the interdependence of the external imbalances among the countries,

with respect both to their causes and to the responsibility involved. Since the attempt to construct another theoretical synthesis clearly exceeds the scope and purpose of this paper, we will concentrate on certain analytical issues which seem especially well suited to helping us to understand present foreign imbalances and to clarify alternative options and elaborate more realistic and efficient policies.

A country's deficit on the current account of its balance of payments responds to the fact that domestic residents' expenditure exceeds their income. This may correspond to a case where *ex ante* (desired) investment exceeds public and private domestic savings, requiring foreign savings to close the gap; under certain conditions and within bounds, this process can be sustained for long periods of time.

This has been the traditional situation observed in most LDCs, which turn out to be net international debtors. Since "young" developing countries have a lower capital-labour ratio and higher returns on investment than advanced countries, it tends to be in the interest of both to transfer resources from relative capital-intensive countries to LDCs.

The basic factors which determine the stability and regularity of net inflows of capital to LDCs are the availability of international financing and the creditworthiness of the country. The former element is independent of the country's economic policy and the latter is usually related to the way in which the country incorporates foreign savings into its economy. In the case where borrowing is used to maintain or increase consumption or to finance low-return investments, not only will the country's creditworthiness be negatively affected, but forthcoming debt service payments, instead of taxing future growth of income, will force a reduction of consumption levels in the years to come. On the other hand, the higher the complementarity between foreign and domestic savings and the more foreign savings are used to increase productive capacity, especially in the tradeables sector, the "better" will be the evolution of the traditional creditworthiness indicators. However, in spite of "sound economic management", creditors may tend to reduce their loans if outside factors (such as an increase in international interest rates, or deterioration in the terms of trade of debtor coun-

tries) negatively affect their evaluation of the country's debt servicing capacity; naturally, this process by itself tends to worsen even more the debtor's balance-of-payments position. It should be clear, therefore, that a regular flow of foreign savings may unexpectedly and quickly turn into a foreign exchange bottleneck and an urgent problem in economic policy management, and what in other circumstances might have been a "normal" deficit turns out to be an external disequilibrium "problem".

The determinants of the current account developments may be classified as "external", in the sense that individual countries are not responsible for and may be unable to offset them, and "internal" or domestic factors, which can be attributed to consequences of the country's policy actions, or omissions, affecting its international competitiveness and overall foreign payments situation. Naturally, this distinction is neither exhaustive nor precise or rigorous. However it sheds light, once empirical evidence is available, on the role these factors have played, or may play in the future, and suggests more efficient and equitable strategies, at the country and international levels, to face the problem.

The main foreign or external factors negatively affecting the current account are a deterioration in the terms of trade, reduced demand for LDCs' exports by advanced countries and increases in international interest rates. Fluctuations and procyclical behaviour of capital flows to LDCs can also help very decisively to worsen an external imbalance by reducing the availability of foreign financing to face a given deficit on current account.

Besides supply shocks, which although domestic in nature are in a sense "exogenous" to policy makers, two main internal factors can be broadly distinguished that may exacerbate foreign payments disequilibrium. On the one hand, aggregate demand management may stimulate excessive spending by the public and/or private sectors. On the other, relative price movements may stimulate, through exchange rate, commercial interest rate and income policies, non-tradeable goods supply and tradeable goods demand, contributing to a loss in international competitiveness. An intermediate situation, which has recently been quite important in some countries, relates to the combined implementation of

financial reforms and stabilization programmes resting on exchange rate overvaluation. This may lead to domestic policy inconsistencies which end up as a direct stimulus to aggregate demand and current account deficits through the monetization of financial flows stimulated by expectations of speculative capital gains.

The former classification, while allowing a better appreciation of the relevant factors explaining an external disequilibrium to be obtained, should be complemented by the consideration of two additional elements. The expected time dimension of the shock, whether foreign or domestic, plays a crucial role when evaluating alternative solutions: temporary effects should be distinguished from permanent ones. Although it is sometimes difficult to assess correctly the duration of a shock, efforts should be made to incorporate that element into the analysis. Another useful distinction relates to whether the shock is of a "real" or "monetary" nature. Examples of the first may be found in losses in productivity, obsolescence in technology or deterioration in "real" terms of trade (such as the one caused in oil-importing countries by the successive increases in fuel prices). Monetary shocks are typically derived from money market disequilibria. For example, if money supply continuously exceeds money demand, attempts to improve the balance-of-payments position through a once-and-for-all devaluation will be inefficient and should be complemented by policy tools addressed at the control of domestic credit expansion.

The relevance of the above-mentioned categorization may be visualized when analysing alternative ways to deal with foreign payments imbalances.

From a purely accounting point of view, external imbalances (in a country whose currency is not accepted as international money) have to be financed by running down gross foreign exchange reserves or increasing the stock of foreign debt outstanding and the level of payments arrears, or some combination of them. However, an *ex ante* disequilibrium in the external accounts may be substantially larger than the imbalance which is finally financed, the difference being wiped out through adjustment of the imbalance. This latter mechanism consists in domestic policy measures designed to produce an expansion of

a high liquidity preference, such as the oil-exporting ones, is clearly one of the most outstanding characteristics of that period from an international financial viewpoint. If oil-exporting countries had decided, and had been in the position, to accumulate real assets rather than liquid funds, the latter would have gone back to the suppliers of real assets, and the expansion of the financial market would have depended on their preferences as regards portfolio composition.

Of course, the working of the international monetary system lies at the root of the expansion of the financial markets. Asset rather than reserve currency settlement would have allowed a more moderate, regulated expansion of reserve currency holdings outside the country of issue.

At all events, rapid growth of financial markets during the 1970s created an international capital market largely outside the regulatory controls of any monetary authority or international institution. Capital movements have become more and more important in international payments and exchange rate determination, and consequently private and specially banking sources of finance have increased their importance while the role of official institutions and governments has weakened in an increasingly market-based monetary and financial system. This has resulted in turn in a sharp reduction of average maturity as well as in substantial increases in the cost of borrowing for LDCs, specially those of Latin American.

By the end of 1981, and particularly in 1982, the growth of the financial markets slowed down dramatically in the wake, on the one hand, of the breakdown of the oil cartel and, on the other, of the increased perception by international lenders of the risk of deterioration of their portfolio. In those years, together with smaller capital inflows to LDCs, banks also increased their spreads, fees and commissions and shortened the maturity of new loans.

The fast growth of credit implied the rapid growth of debt, a process which is sustainable, as analysed in the preceding section, as long as the debt burden does not grow out of proportion to GNP and exports. This seemed to be the case in a number of Latin American countries during the 1970s: Mexico, for example, averaged 6.4% growth in real GNP from 1970 to 1979 while its exports grew in real terms by 10.9% annually. In

the same period, comparable figures for Brazil were 6.7% and 9.1%. Argentina had a less enviable annual growth, 2.6%, but still expanded its exports by 10.7% per year.

However, a deterioration in the terms of trade of debtor countries, or an increase in international interest rates, could make debt burden unbearable and that was what happened in the early 1980s. Although it may be said that many countries in Latin America did not adjust to the two oil shocks of the 1970s and incorrectly perceived the growing external financing available during the decade as stable and permanent, it can be stated that for many countries the debt service crisis was due less to mismanagement and/or unwise borrowing and lending than to high interest rates and a world recession that reduced Latin American export earnings.

As a consequence of domestic economic policies in industrial countries, the rate of growth of the world economy came to a halt in 1982, real interest rates in international markets soared and protectionist tendencies in advanced countries increased; at the same time, the terms of trade moved rapidly against debtor countries, including oil-exporting ones. As the recession took hold, both the domestic and international portfolio of banks in industrial countries suffered. In the LDCs this process of bank portfolio deterioration led to financial crisis in several cases, which compounded the portfolio problems and risk perception of internationally lending banks (see table 1).

It is worth noting that domestic policies in some LDCs also provided stimulus to the capital inflow in the form of debt, through inconsistent financial reforms and exchange rate movements (devaluing at rates substantially below domestic inflation). Some governments believed that high inflationary pressures and high interest rates in the domestic credit markets, as well as tight monetary and (sometimes) fiscal policies, could be avoided by borrowing abroad. Furthermore, in many cases speculative capital movements were also stimulated by huge interest rate differentials between domestic and foreign rates. This situation allowed, during some time, for the simultaneous presence of current account deficits and overall balance-of-payments surpluses: a process which could only be sustained by an increasing foreign debt.

It is not obvious whether an imbalance should be financed or adjustment measures should be taken, the answer depending on the nature, magnitude and persistence of the deficit, as well as on the availability of financial resources to the country in question. An imbalance originating in factors which are of a transitory and monetary nature, expected to last for a short period of time, should generally be financed; this conclusion is derived from efficiency criteria. In turn, a deficit emanating from real and/or permanent changes in the economic environment or from facts which, while transitory in character, are expected to last for a prolonged period of time, requires adjustment.

From another perspective, when external factors predominate it seems reasonable on grounds of equity and in some cases of efficiency (i.e., interdependence both in trade and payments between deficit and surplus countries) to argue in favour of financing. Again, this is especially true when the external disturbance is perceived as temporary and is of a "monetary" nature (e.g., the increase in world interest rates), and less so when it appears as more permanent and is based on "real" factors (e.g., the increase in oil prices).

However, it is not always easy to determine, at an early stage, whether permanent and transitory or monetary and real changes are at work. So, more than a "fundamentalist" approach to

external imbalance, a cost-benefit approach is usually taken to determine the policy instruments to be used in facing a disequilibrium in foreign payments. Financing a deficit has costs measured in terms of future debt burden, while adjustment implies some current real income foregone and a transitory increase in unemployment and inflation.

The usual "small country assumption" regarding foreign financing implies an infinitely elastic supply of foreign credit; the borrowing country determines the amount borrowed per year, at the going interest rate and other costs. In this approach, the amount of indebtedness per year is essentially demand-determined, while supply conditions determine the cost of borrowing. This assumption is a useful one when international financial markets are growing rapidly, as they did up to 1981, and when "country risk" perceptions of the creditors do not limit the supply of external credit to borrowing countries. As financing reaches its maximum limits, however, a country is not in a position to evaluate the cost and benefits of alternative ways of settling the imbalance: it is forced to adjust, whatever the costs. Under these conditions, it is not surprising to find in many cases of external imbalances that countries act unilaterally in the financing area, through arrears in commercial and in other foreign payments which may be properly dubbed "involuntary lending".

II

Financing and adjustment: Recent tendencies and the current situation

As it is well known, world financial markets expanded at a rapid rate during the 1970s. Total assets of banks reporting to the BIS expanded at an average rate of 25% during the period, and in no year was the rate less than 19%. Between 1973 and 1981, the net flow of banking credit to non-oil LDCs grew more than fivefold, increasing from US\$ 10 billion to more than US\$ 50 billion in 1981, when it reached its historical peak.

This rapid growth is explained both by institutional and structural factors. Among the institutional factors, perhaps the lack of regulation in the Eurocurrency markets, including the absence of minimum reserve requirements and of mandatory maximum debt-to-capital ratios, are the two most important single ones. As regards structural factors, the accumulation of liquid balances under the control of countries with

remain far above their real historical levels for comparable stages of previous business cycles.

With annual interest rates at nominal levels of 12% to 18% (including spreads) between 1981

and 1983, interest payments consume a substantial proportion of the gross export income of debtor countries. The figures are shown in table 3.

Table 2
EFFECT OF 1% CHANGE IN INTEREST RATES ON FOREIGN
PAYMENTS OF NON-OIL-EXPORTING LDCs, 1981-1983

Area ^a	Amount of debt subject to floating rates (billions of dollars) (1)	1% interest rate change (billions of dollars) (2)	Total exports of goods and services (3)	(2:3) (percentage) (4)
Western Hemisphere ^b	227.9	2.3	115.2	2.0
Africa	37.7	.4	54.8	.7
Asia	76.4	.8	178.4	.4
Other	73.9	.7	99.5	.7
Total	415.9	4.2	447.9	.9

Source: IMF, *World Economic Outlook*, 1983.

^a The classification of countries corresponds to IMF, *International Financial Statistics* from March 1980 on.

^b Western Hemisphere excludes only Venezuela as oil exporter.

Table 3
NON-OIL-EXPORTING LDCs' INTEREST PAYMENTS IN 1981-1983,
BY AREAS

Area ^a	Interest payments (billions of dollars) (1)	Exports of goods and services (billions of dollars) (2)	(1:2) (percentage) (3)
Western Hemisphere ^b	31.4	115.2	27.3
Africa	4.4	54.8	8.1
Asia	9.8	178.4	5.5
Other	10.0	99.5	10.0
Total	55.6	447.9	12.4

Source: IMF, *World Economic Outlook*, 1983.

^a The classification of countries corresponds to IMF, *International Financial Statistics* from March 1980 on.

^b Western Hemisphere excludes only Venezuela as oil exporter.

Table 1
EVOLUTION OF INTERNATIONAL ECONOMIC INDICATORS AFFECTING THE BALANCE
OF PAYMENTS OF LATIN AMERICAN COUNTRIES, 1965-1983

Period	Terms of trade, Latin America ^a		Real interest rate ^b (percentage)	Growth rate of industrial countries ^c (percentage) change)	Net inflow of capital	
	Total (percentage change)	Non-oil exporting countries			Billions of nominal dollars	Billions of 1983 dollars ^d
Average						
1965-1972	.3	.2	2.82	4.6	3.4	8.8
1973	13.4	10.6	2.94	6.2	8.1	18.3
1974	15.8	-7.0	.11	0.1	11.6	23.5
1975	-13.5	-12.0	-2.21	-0.7	14.5	27.3
1976	4.6	7.4	-0.22	5.3	18.3	32.0
1977	6.0	10.7	-0.50	4.3	17.3	28.5
1978	-10.5	-10.2	1.23	4.5	26.4	40.3
1979	3.5	-6.7	0.66	3.5	29.0	39.7
1980	4.2	-7.2	0.86	1.1	29.9	36.1
1981	-7.3	-13.0	6.11	1.5	38.0	41.5
1982	-7.0	-7.6	6.91	-0.4	16.6	17.1
1983 ^e	-7.2	-1.6	6.71	1.8	4.5	4.5

Source: ECLAC, *Economic Survey of Latin America*, 1982; *Economic Survey of Latin America*, 1983: *Advance Summary*.

IMF, *World Economic Outlook*, 1983. OECD, *Economic Outlook*, 1972; IMF, *Balance of Payments Yearbook* (various issues).

^a From 1970 on excludes Venezuela, Bolivia and Ecuador; from 1976 on, Mexico and Peru.

^b Refers to three-month Eurodollar London interest rate minus United States inflation, as measured by the Consumer Price Index (CPI).

^c GNP growth rate of Canada, United States, Japan, France, Federal Republic of Germany, Italy and United Kingdom.

^d Deflated by United States Consumer Price Index.

^e Preliminary estimates. Data for interest rate and United States inflation cover period up to October 1983.

So, both from the supply and demand side the increase in foreign debt was stimulated at rates which made the debt level incompatible with a sharp or prolonged world recession. In fact, the overwhelming importance of private banking as the main source of the flow of new financing, given its commercial and risk-avoiding nature, has helped to amplify rather than moderate the recessionary tendencies of the early 1980s.

Present levels of foreign debt are such that changes in interest rates in international markets produce a substantial impact on foreign payments. As an increasing proportion of the stock of the LDCs' debt is subject to floating rates, the bulk of the stock, and not only new lending, will

be affected by changes in rates. Table 2 shows the effect of a 1% increase in interest rates on foreign payments in non-oil-exporting LDCs. For Latin American and Caribbean countries this figure is some US\$ 2.3 billion, which represents 2% of the region's exports of goods and services. It should be noted that this effect, which has predominated in the 1980s as a consequence of the rapid increase and changing structure of foreign debt, as well as extraordinarily high interest rates in world financial markets, is substantially bigger than that of a US\$ 1 increase per barrel of oil. Although nominal interest rates in the United States have declined from their extreme levels of 1981 and 1982, they have fallen neither as fast nor as far as the (us) rate of inflation and they

exports of goods and services, a reduction of imports, or some combination of both so as to reduce the projected current account deficit and the consequent need for additional foreign finance.

Adjustment measures have typically focused on *expenditure reducing* and *expenditure switching* policies. The former consist in restraining aggregate demand via restrictive monetary, fiscal and/or incomes (including lower wages and higher interest rates) policies, with the objective of directly reducing domestic spending on tradeables. Increases in the exchange rate also work in the direction of reducing domestic spending through their effect on the real money supply, at least in the short run.

Expenditure switching from tradeables to non-tradeables goods works through relative price changes, typically exchange rate movements and changes in tariffs and other import regulations, as well as different forms of export subsidies. These policies tend to depress domestic spending on tradeables and to stimulate resource allocation towards tradeables production.

If adjustment could be promoted rapidly through changes in relative prices, its cost in terms of output foregone and higher unemployment might be quite small. However, real resource transfers between sectors and regions take time. Lags and inertia in factor mobility, price and wage rigidities, and the uncertainty regarding the temporary or permanent nature of the policy changes contribute to a situation where sectors incentivated by price stimulus to contract do so rapidly, while those stimulated to expand generally take an extended period to do so. In the process, global output suffers, unemployment and inflation go up and real wages are negatively affected. Furthermore, traditional policies have placed greater emphasis on reducing aggregate demand than on increasing output and changing its composition; therefore, if spending is reduced as part of the programme, there will be an added tendency towards output losses and unemployment. Experience has shown that when both relative price changes and expenditure reductions are promoted by the authorities of the debtor countries, the process of adjustment in case of a deficit involves unemployment and output losses which take a relatively long period of time to disappear. Adjustment,

in the sense of a reduction in the external imbalance, may occur relatively rapidly, but at a substantial, and prolonged, economic and social cost.

From an international perspective, when an adjustment process takes place in a stagnant world economy and when current account deficits are not located at a country, but at a regional level, the costs of adjustment policies increase. This is true for individual countries, through the lack of foreign demand for their exports, so that huge relative price changes (with the already mentioned associated costs) are needed in order to better their trade balance. But it is also true internationally, since due to the importance of LDCs in world trade and payments, when a region as a whole curtails its imports, it will slow down the recovery of advanced surplus countries. When many countries attempt to increase their exports, some expansionary effects follow for the world economy. However, a deterioration in the terms of trade may occur and protectionist policies in developed countries may be strengthened thus worsening the prospects of recovery through adjustment policies in LDCs.

The above discussion suggests that in many cases countries opt, and should opt, for financing a current account deficit, which ultimately consists in delaying adjustment for the future.² These two components of the settlement of an external imbalance, adjustment and financing, are frequently interrelated. In most cases of a large *ex ante* external deficit, financing for this can be obtained if, and in some cases only if, adjustment measures are taken that reduce the need for financing to what creditors consider "manageable" or "credible" proportions. In fact, the International Monetary Fund makes its regular resources available, over and above certain limits, only if the country in difficulties puts into effect adjustment policies designed to eventually eliminate the deficits.

²It is implicitly assumed that authorities sterilize the monetary effects of the net increase in foreign debt; otherwise the fall in money supply generated by the net inflow of foreign exchange would induce a sort of endogenous adjustment process through its depressive effects on aggregate demand and expenditure.

Furthermore, interest payments by Latin American and Caribbean countries in 1982 and 1983 exceeded increases in their net foreign borrowing, so that a reverse transfer of resources from debtors to creditors was taking place. This would be a natural result as the LDCs' economies mature, but it is a heavy burden when it is a consequence of world recession rather than a by-product of the growth process (see table 4).

In addition to the effect of high international interest rates on debt service, they have an impact on primary commodities, since they tend to be negatively correlated with the terms of trade of primary producing countries. Hence, the burden of high interest rates is amplified by a deterioration in the terms of trade, in what has been called the "scissors effect", which has produced the squeeze that nearly caused some major debtor countries to default (see figure 1).

The mechanisms that explain this negative relation are related to the direct impact of interest rate changes on the trading in, inventories of, and speculative demands for primary commodities (see Padma Gotur, "Interest rates and the developing world", *Finance and Development*, Vol. 20, No. 4, December 1983). Also, high interest rates discourage domestic expenditure, the level of economic activity suffers and demand for primary products falls. As most of these products are sold in highly competitive markets and

their supply is inelastic, prices tend to change rather sharply with changes in demand.

The recent international monetary and financial developments, the macroeconomic policies in the industrial countries, and the world recession have been the main external factors that have negatively affected the LDCs' economies. To this should be added some domestic or internal factors which were quite common in Latin America during the second half of the 1970s. Overvalued exchange rates, expansive aggregates demand policies and stimulus to and inadequate use of foreign indebtedness have also contributed, although to a lesser extent, to generate the balance-of-payments crisis that started in 1981 and continued during 1982 and 1983.

The magnitude involved and the adjustments made are quite clear and impressive. The deficit on current account reached a maximum in 1981. Since then the trade balance changed from deficit into surplus, peaking in 1983 to an extraordinary amount of more than US\$ 31 billion, a figure more than triple the improvement attained in 1982. The balance on current account before interest payments and profit remittances improved by US\$ 37 billion between 1981 and 1983, a figure equivalent to around 4% of Latin America's average GNP in the period. The current account deficit, as a consequence of the changes affecting mainly trade, and to a much smaller extent, financial services, contracted abruptly from US\$ 36.4 billion in 1982 to US\$ 8.5 billion in 1983: the smallest deficit since 1974 (see table 5).

Parallel to this, and responsible to a certain extent for the extraordinary reduction in current account deficits, the Latin American countries suffered in 1983 a drastic contraction in the net inflow of capital to the region. Such inflow, which had already been reduced in 1982 to less than half the historical maximum of 1981, when it reached US\$ 38 billion, fell again in 1983 to less than US\$ 4.5 billion. This is why, in spite of the huge surplus on trade account and the sharp fall in deficit in current account, foreign exchange reserves fell for the third consecutive year. In terms of the region's imports, the reserve coefficient was reduced from an average of nearly 50% in the period 1973-1979 to about one-third in the 1980s, in spite of the fact that imports fell by over 40% from 1981 to 1983.

Table 4
INTEREST PAYMENTS AND NEW DEBT
OF NON-OIL-EXPORTING LDCs
IN 1982-1983
(Billions of dollars)

Areas ^a	Interest payments	Net external borrowing	Net transfer
Western Hemisphere ^b	31.4	18.2	-13.2
Africa	4.4	9.0	4.6
Asia	9.8	15.6	5.8
Other	10.0	9.9	-.1
Total	55.6	52.7	-2.9

Source: IMF, *World Economic Outlook*, 1983.

^a The classification of countries corresponds to IMF, *International Financial Statistics* from March 1980 on.

^b Western Hemisphere excludes only Venezuela as oil exporter.

Table 5
EXTERNAL IMBALANCES IN LATIN AMERICA, 1979-1983
(Billions of dollars)

	1979	1980	1981	1982	1983
1. Exports of goods	69.6	90.5	96.8	88.6	87.5
2. Imports of goods	69.1	91.5	98.4	78.9	56.3
3. Trade balance	0.5	-1.0	-1.6	9.7	31.2
4. Non-financial services (net)	6.5	8.5	11.4	9.6	6.4
5. Current account balance before financial services	-6.0	-9.5	-13.0	0.1	24.8
6. Financial services (net)	14.2	19.0	29.1	36.8	34.0
7. Balance on current account	-19.6	-27.7	-40.4	-36.4	-8.5
8. Net capital movements	29.0	29.9	38.0	16.6	4.5
9. Foreign global debt	166.4	205.2	257.9	289.4	309.8
10. Foreign debt services	37.1	43.2	54.6	69.2	-
<i>Percentages</i>					
11. Interest payments as a percentage of exports of goods and services	17.4	19.9	26.4	38.3	35.0
12. Current account balance as percentage of gross national product	-2.8	-3.3	-4.3	-3.9	-0.9

Source: ECLAC, *Economic Survey of Latin America, 1983: Advance Summary*.

The fall in the net inflow of foreign capital to Latin America, combined with the very high remittances in respect of financial services, contributed for the second consecutive year to a net transfer of resources from the region to the rest of the world, amounting to nearly US\$ 50 billion during 1982-1983. Obviously, as a consequence of the smaller net capital inflow, foreign debt increase slowed down: 7% in 1983 as compared to 12% in 1982 and the high average figure of 23% during 1977-1981. Interest payments, however, which in 1977 represented 12.4% of exports of goods and services, have steadily increased, rising to triple that figure in 1982-1983. Furthermore, interest payments have also increased their proportion of total debt service payments from 35% in 1977-1978 to 58% in 1982 and a much higher figure in 1983, due to the postponement of most amortizations in that year.

But despite generalized devaluations and the implementation of other measures designed to stimulate exports, most of the adjustment has occurred in the form of a drop in imports, which fell 29% in 1983 after having fallen by 20% the year before.

This extraordinary fall in imports caused, and was caused by, a sharp contraction in economic

activity and other related indicators (see table 6). Latin America's GNP fell 3.3% in 1983, after having fallen 1% in 1982, while the per capita GNP fell by 5.6% in 1983 and was nearly 10% lower than the 1980 figure, reaching only the level attained as far back as 1977. Gross national income fell even more

Table 6
LATIN AMERICA:
INDICATORS OF COST OF ADJUSTMENT

	1976/1979	1980	1981	1982	1983
<i>1970 dollars</i>					
Real GNP per capita	930	1 007	997	965	911
Real GNP per capita	929	1 009	985	938	883
<i>Percentages</i>					
Change in consumer prices	50	53	61	86	130
Unemployment median ^a	7	7	7	9	10

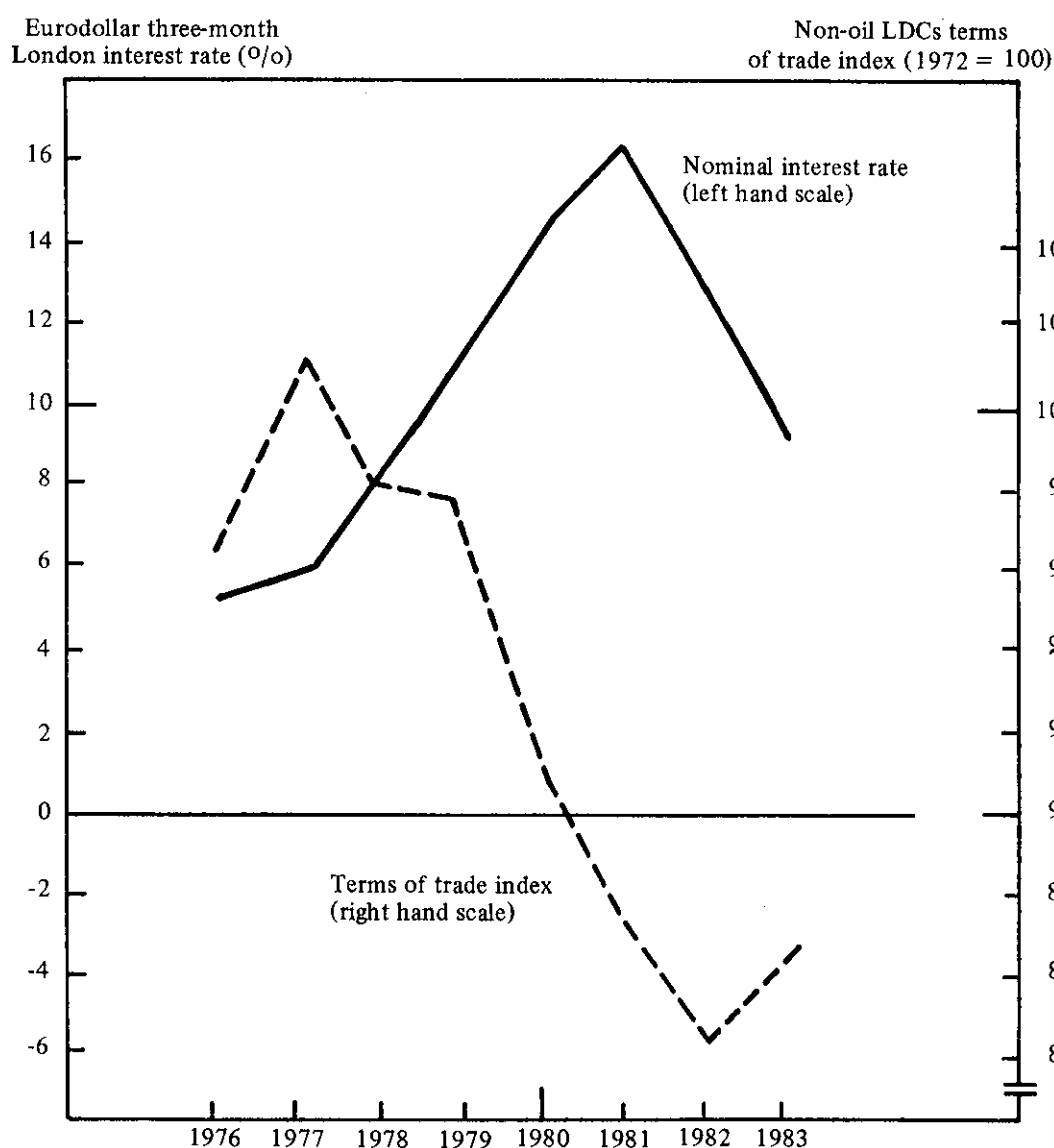
Source: ECLAC, *Economic Survey of Latin America, 1983: Advance Summary*.

^a Median of annual average rates of urban unemployment in 10 selected Latin American countries.

than GNP, since for the third consecutive year the region's terms of trade deteriorated: phenomenon which occurred for six consecutive years in the case of the non-oil-exporting Latin American countries. Urban unemployment increased in almost all countries, while inflation soared to unprecedented high rates.

Perhaps the most illustrative way of perceiving the magnitude of what this adjustment process has meant for the region is to recognize that if GNP had continued to grow at one-half its average rate of growth between 1970-1980, Latin America would have obtained US\$ 150 billion in real terms at 1983 prices in additional GNP in 1981-1983. That

Figure 1
EVOLUTION OF TERMS OF TRADE OF NON-OIL-EXPORTING LDCs AND
NOMINAL INTEREST RATE



Source: IMF, *International Financial Statistics*, January 1984; *World Economic Outlook*, 1983.

amount is equivalent to nearly half the region's stock of foreign debt or to the GNP of Sweden or Switzerland.

Despite the important external sector adjustment policies adopted by Latin American countries in 1982 and 1983, the foreign exchange generated by this process and by voluntary lending was insufficient to cover external debt payments, and a number of countries found it impossible to pay not only the principal but in some cases even the interest. Most countries had to reschedule their external debt service and tried to reach agreements with the IMF and other foreign creditors to meet such debt service charges—not to mention repayment of loans coming due—while they have also had to reduce internal spending and apply austerity programmes that comply with IMF requirements.

Under present conditions it cannot be expected that the debt will continue to grow as in the past. The flow of liquid savings has been substantially reduced, and lenders are taking an extremely careful and selective attitude regarding international operations. In fact, as mentioned, the expansion of international lending in 1983 has been very much lower than the increase in interest payments to the exterior, so that the transfer of real resources from *debtors to creditors* has reached unprecedented levels even after allowing for debt renegotiation and for the fact that there are now considerable arrears in the interest and amortization payments of some debtor countries. While total international assets of banks reporting to the BIS grew by US\$ 22.3 billion in the first six months of 1983, as compared to US\$ 74 billion in the same period in 1982, bank lending to Latin America increased

US\$ 3.7 billion (US\$ 12 billion in the first half of 1982) and lending to all LDCs went up by US\$ 5.8 billion (US\$ 15 billion in the first half of 1982).

So, regardless of the transitory and externally caused nature of the present foreign payments deficits of Latin America, due mainly to unusually high foreign interest rates and unusually unfavourable terms of trade, financing is playing a very limited role in closing the external gap. Traditionally, through its conditional lending, the IMF generally included provisions to eliminate involuntary lending, offering financial resources in exchange. However, when the imbalances are very large, as they have been in 1982-1983, IMF resources are not sufficient and the Fund has been actively promoting the provision of additional funding from private lenders to complement its own very limited financing possibilities, in order to try to avoid payments crises.

As already mentioned, banks have reacted, at least until now, very conservatively, trying to reduce their exposure with LDCs. Available financing to those countries is now an extremely binding constraint. But in spite of the new circumstances, the IMF has reassumed an attitude similar to its traditional one of regarding causes of and cures for individual country balance-of-payments crises as if they were isolated phenomena. This time, however, the financial shortages have required an extremely restrictive and costly adjustment process, which has not been determined by the nature or causes of the imbalance but basically by available financing. The latter has overridden cost and benefit considerations, or—what amounts to the same thing—above some limited amount, the cost of financing has become infinite.

III

Adjustment and debt in the 1980s: options and limitations of existing tendencies, institutions and practices

1. *The international scenario*

Until the second half of 1980, developments in the foreign sector of the Latin American economy seemed perfectly under control. It is clear from the preceding sections that since the beginning of this decade shocks originating in policy actions or decisions in industrial countries and in the world economy have played a major role in the generation of external imbalances in the LDCs. In fact appropriate policy measures in the North are a crucial element for the viability of the actual adjustment processes taking place in the south. If the terms of trade in Latin America had been similar to those prevailing in 1980 (25% better) and if international interest rates had been similar to those obtained when the bulk of the foreign debt was contracted (on average four percentage points below present rates), the region would have had available US\$ 35 billion more in 1983. With these resources the region would have easily fulfilled its foreign payment obligations without having to reduce dramatically its imports nor needing additional foreign debt. In other words, if world trade and finance would only return to "normal" conditions, Latin America's foreign payments commitments could be satisfied without sacrificing its consumption levels or its growth possibilities.

Of course, policies in the LDCs have had a degree of responsibility in originating imbalances, but the correction of such policies, a responsibility of the LDCs' authorities, has already been carried out—in excess in many places—and has had a painful effect on both the domestic economy and its social fabric, raising skepticism about the ability of these countries to sustain the effort.

Current approaches to adjustment present two major problems: they maximize the global cost of the process and they are biased against debtor countries, which are bearing a dispro-

portionate share of the cost. There are four major aspects of the international economy where action is needed in order to reverse this situation.

First, high and volatile interest rates have a definite negative impact on the current crisis, for various reasons. As already mentioned, the debt service payments and terms of trade of the LDCs have been adversely affected. Interest payments exceed the cost of oil imports in non-oil LDCs. But interest rates have also helped to delay recovery in the North and have contributed, through capital inflows to the United States, to the strengthening of the value of the dollar *vis-à-vis* other currencies. This has affected the LDCs' competitiveness and increased the real cost of servicing the foreign debt, which is predominantly denominated in US dollars. In relation to this latter point, it has been estimated that if the non-oil LDCs' borrowing from commercial banks, which amounted to about US\$ 150 billion between 1979 and 1982, virtually all in terms of dollars, had been diversified to correspond broadly with the currency composition of their trade, the combined savings to these countries in terms of lower interest costs and exchange rate gains would have amounted to over US\$ 30 billion (see A. Mohl and D. Sobol, "Currency diversification and LDC debt", Federal Reserve Bank of New York, *Quarterly Review*, Autumn 1983, Volume 8, No. 3). Furthermore, high interest rates (together with overvalued Latin American currencies) have stimulated flights of capital to the United States which, according to private bank sources, reached US\$ 100 billion during 1980-1983, aggravating the region's debt problems.

Macroeconomic policies in industrial countries, and especially fiscal policy in the United States, bear major responsibility for the high and uncertain interest rate levels. Monetization and crowding-out effects of the fiscal deficit, expectations that the United State deficit is unlikely to

disappear even with a strong, long-lasting recovery (due to the fact that spending growth for both social and defence programmes will outpace the increase in tax revenues), and the fact that the industrial countries' public sector deficits are competing globally for a relatively weak flow of global savings are the major factors behind recent current interest rate levels and movements. Furthermore, the impact of international interest rates on LDCs is bigger than their effect on the average United States or United Kingdom citizen, since American or British borrowers can write off interest rate payments against taxes.

It should also be noted that banks' earnings depend not so much on the level of interest rates as on spreads, so that in principle, the soundness of the banking system would not be at stake and could even be enhanced if real interest rates could be reduced.

In summary, the advanced countries' responsibility for the levels and fluctuations of interest rates—one of the main determinants of current balance-of-payments crises and the highly costly and inefficient adjustment process in the LDCs—should be clearly recognized and action should be taken regarding fiscal and monetary policy mix, as well as on co-ordination of these and exchange rate policies among industrial countries.

The second international element to consider is that the actual adjustment process, based on generating trade surpluses in debtor countries, is being made extremely difficult and more costly due to the lack of sufficient foreign demand and protectionist tendencies in the North, which have affected both the LDCs' exports and their terms of trade.

On average, the LDCs' products account for only 3% of the industrial countries' market; this relative small share should leave ample scope for further expansion. However, relatively large shares for some specific products and protectionist measures against imports of many of these products suggest only moderate growth ahead. Although it should be noted that protectionist measures in OECD countries did not stem the dynamism of the most successful exporting countries in the late 1970s, the export environment in the next years will be much more competitive than in the last fifteen years. In addition to debtor countries' export promotion policies,

strong export growth will require not only a healthier world economy but also a restructuring process in the industrialized countries' economies, which is an essential aspect of international economic development to which national policies in both industrial and developing countries must make a positive contribution (see B.A. de Vries, "International Ramifications of the External Debt Situation", *AMEX Bank Review Special Papers* No. 8, November 1983).

Although developments in 1983 and forecasts for 1984 indicate a recovery from the 1982 world recession, and despite the increase in imports into the United States, the international transmission of the recovery is working less well than in the past. The growth of world trade exceeded the growth of world output by a sizeable margin in the two-year period following the 1975 recession, as it has on average throughout the postwar period. For 1983-1984, in contrast, the excess of trade over output growth is likely to be negligible or non-existent, the main reasons for this being the slower available financing, due to the debt problem and the proliferation of protectionist measures. To this should be added the restrictions imposed on imports by heavily indebted LDCs.

In a dynamic, expanding economy, traditional prescriptions for a single country to adjust by increasing exports and restricting imports have some rational basis. However, since every export is someone else's import, a "composition fallacy" may occur when a generalized crisis takes place. As the IMF has leverage with respect to deficit countries which are in need of financial resources but not with respect to surplus countries (or reserve currency countries whether in surplus or deficit), the burden of adjustment is thrown upon deficit non-reserve currency countries. This fact increases the cost of adjustment for those countries, and reduces the efficiency of certain policy measures, especially when the world economy is not growing at a rapid pace.

Availability and stability of foreign financing is the third international factor which requires urgent policy measures.

As mentioned in section II, bank lending to LDCs, and especially to Latin America, grew at extraordinarily high rates during the 1970s. In hindsight, although in some countries investment rates, and GNP and export growth rates,

were high, development strategies based on foreign saving had very weak foundations. Excessive reliance on short-term loans created a serious imbalance between the maturity structure of investment and the debt, increasing the countries' vulnerability to debt servicing problems. Foreign finance in some cases took the place of domestic savings, stimulating consumption. The overabundance of foreign exchange contributed to overvalued exchange rates, putting a brake on export dynamism. Also, attempts to maintain activity levels in the face of the oil shocks, and the fact that high United States interest rates and domestic exchange rate expectations of depreciation stimulated speculative private capital outflows, were all factors that helped to partially offset the value of bank lending and to militate against its efficient use.

The private banks' initial reaction to debt servicing problems in the 1980s was not only to try to reduce their exposure with the LDCs, which by mid-1983 was over US\$ 330 billion, but also to charge additional commissions and fees in the rescheduling schemes (which only very recently have tended to diminish slightly), that have added an extra cost on already high interest rates. It is evident that because of their aggressive loan policies, together with less than adequate project evaluation and their lack of awareness of the country and commercial risks involved, banks bear a share of responsibility in the gestation of the current balance-of-payments crisis. They tend to argue that due to the very competitive supply side of the market in the 1970s, spreads were low and provisions insufficient to cope with generalized payments crises. However, their current behaviour of trying to suddenly block the access of "problem" countries to financial markets and to impose rescheduling procedures that have increased financial costs substantially is helping to augment external imbalances, throwing practically all the adjustment cost burden on the debtor countries.

Together with higher financial costs, bank lending has declined and there is little reason to expect it will increase in the near future, except under forceful IMF pressure. However, as real interest rates will probably diminish only slightly and very slowly, if at all, huge and costly trade surpluses of the debtor countries are still not

sufficient to close the foreign exchange gap, and countries will require additional loans. The only sources available would be the advanced countries' governments, which are themselves under severe budget constraints, and multilateral institutions which, even if they increased their capital and lending capacity to what seems reasonable limits, will still fall short of required needs. Therefore, although efforts should be strengthened to ensure that the IBRD and IMF play a major role, directly and indirectly, in international financing it appears that no solution to the LDCs' debt problem will be viable unless it includes a reduction of the real burden of debt.

A final element in the international scenario, that has not been sufficiently incorporated in current approaches to adjustment policies, is related to the extent to which both through trade and finance, countries and regions tend to be interrelated.

As the world has become more interdependent, actions by a group of countries are bound to affect the rest, positively or negatively. Actions in the same direction by most or by all countries will reinforce each other, producing on any individual country an effect substantially larger than the one that would have been forthcoming from that country's policies by themselves. The growing interdependence is likewise reflected in the fact that if a country takes adjustment measures to reduce a deficit at a time when surplus countries are applying expansionary policies, the result will be a faster and smoother adjustment process at substantially reduced economic and social cost. However, that is not what is happening at present. Thus, a reduction in expenditures in a deficit country, with the aim of freeing additional resources for use in the tradeable goods sector, will be defeated in its purpose if the rest of the world is also compressing domestic demand because of, say anti-inflationary policies. The case of import protection is even more clear: policies to promote the exports of deficit countries will be defeated if the rest of the world prevents those exports from finding markets. Similarly, if one country devalues its currency to produce a reduction in the external sector gap, it may achieve its purpose. But if many countries producing similar commodities devalue at the same time, the result may not be adjustment, but merely a reduction in the prices of the exports of

those countries, and a worsening in their terms of trade which might even increase the imbalance.

Excessive reliance on adjustment delays the North's recovery since the LDCs' markets for the industrial countries' exports are no longer of marginal importance. Added to the above-mentioned composition fallacy, implicit in regional export promotion within a stagnant world economy, is the fact that import cutbacks in the LDCs help to feed the recessionary tendencies in the rest of the world, delaying economic recovery in those same countries. According to Professor Koren, President of the Austrian National Bank, around 20% of world trade is affected by difficulties in deficit countries. Given this situation, it is no longer reasonable to impose economic policy conditions on many countries simultaneously while at the same time expecting them to raise their exports and lower their imports. If many countries were to meet those conditions at one and the same time, the system could not function (BIS press review, 27 October 1983). Up to August 1983, United Kingdom exports to Latin America fell by 35% relative to the same period in 1982, and some calculations indicate that the fall in United States merchandise exports to Latin America accounted for over 40% of the total decline in that country's exports in 1982 and was responsible for the loss of 250 000 jobs in the United States in areas where unemployment was generally higher than the United States average (see S. Dhar, "United States trade with Latin America: consequences of financing constraints", Federal Reserve Bank of New York, *Quarterly Review*, Autumn 1983, Vol. 8, No. 3).

On the financial side, it has been estimated that the LDCs' debt exposure of the major private banks amounts to more than twice their capital and that the annual interest owed to such banks by the LDCs is more than the banks' total profits (see R. Wienert, "Banks and Bankruptcy" *Foreign Policy*, No. 50, Spring 1983).

Consequently, the present approaches to adjustment which throw the burden basically on deficit countries and are strongly biased in the direction of recessionary policies should be complemented by trade liberalization policies in the advanced countries and a major new role for financing through debt rescheduling on better conditions, with higher net capital inflows to LDCs. This is in the interests of both North and

South, not only through its effects on higher global output and trade growth but also because it minimizes the possible impact of partial or generalized default on the international banking system and its consequent effects on an even deeper and more prolonged world depression.

2. Adjustment policies at the country level

Current adjustment policies in the LDCs have been inspired by the traditional IMF approach implemented in the 1950s and 1960s with the aim of improving debtor countries' trade balances. Section II showed that an extraordinary effort has been made by most Latin American countries, with huge economic and social costs. Although trade balance improvement has been impressive it has not been sufficient to generate the re-sources needed to fill the foreign exchange gap. That is why most countries have had to rechedule their foreign debt and still need higher capital inflows and/or a reduction in the real value of debt service in order to "finance" interest payments.

The adjustment experience during the 1980s has revived the discussion regarding its efficacy as well as the question of its sharing of the burden among debtor and creditor countries. The Latin American case reveals that certain old criticisms of traditional policies have solid bases and should receive more attention from multilateral organizations and advanced countries. In addition, however, developments in the 1970s and the changes that have taken place in international, regional and local scenarios have given rise to new, non-traditional issues and problems which should also be incorporated in the analysis and discussion aimed at seeking policies that will allow for more efficient and equitable adjustment processes.

Adjustment policies recently implemented in Latin America show a clear recessionary bias. Improvement in the trade balance has been achieved essentially through lowering imports and diminishing the countries' standard of living, rather than by increasing exports. In other words, the reduction in aggregate demand tends to outweigh the change in output composition, while supply-oriented policies have proven particularly ineffective. The world recession and the increasing protectionism of the 1980s have con-

tributed to this situation as well as the fact that outward-looking policies, when implemented globally, are less efficient (as is implicit in current policy prescriptions) than when applied by a single "small" country.

However, it seems that the traditional approach, applied rather homogeneously to a number of quite different country cases, which assumes that current account problems are derived from excess demand for goods, blurs the basic fact that financial service payments are the major component of the current account deficit. Therefore, given that debt was acquired through time and that interest rates are now extremely high, policy prescriptions aimed at reducing "excess spending behaviour" and attempting to solve a "stock" problem with traditional instruments based on generating an excess supply of goods focus attention on issues and variables that, although related to the problem, are not the most efficient ways of dealing with it.

Furthermore, as mentioned in section 1, when restrictive fiscal and monetary policies are implemented and devaluation takes place, the exportable and import substitution sectors tend to respond slowly, while imports and economic growth slow down or are reduced rather quickly and non-tradeables supply, facing a scale effect that in the short run is much more important than the relative price effect, tends to stagnate or even to fall. From a development perspective, traditional adjustment measures present a further problem, since the recessionary impact—given the fact that people will attempt to maintain current levels of consumption—tends to fall more heavily on investment. Finally, inflation associated with devaluation, together with a decrease in real wages and increases in unemployment, generates a regressive domestic distribution of the burden of adjustment, in addition to the costs incurred through the impact of stabilization policies.

The above-mentioned factors, traditionally associated with "orthodox" adjustment policies, have been amplified not only by the international scenario of the 1980s, especially the world recession, terms of trade deterioration and higher interest rates, but also by inconsistencies associated with new phenomena, which tend to exacerbate economic fluctuations and recessionary effects. The amount of adjustment required has

been amplified by the fact that the trade balance has had to improve not only to cover higher debt service payments but also to try to compensate for the smaller net lending due to the procyclical behaviour of the commercial banks. This "over-adjustment" tends to be self-defeating since, as relative price changes prove less effective for reducing deficits, forcing additional emphasis on restrictive measures, these excessive restrictions damage the economic system as a whole and tend to increase the risks of lending as seen by the creditors.

In a number of countries, a similar situation to what has happened internationally in relation to debt service capacity, has occurred domestically. Much of the "debt" problem is originated not only by the lack of foreign exchange but also by the fact domestic residents, firms and persons, have been unable to service their *domestic* debt. This situation, associated with inefficient resource allocation in previous years, has been exacerbated by the "microeconomic" effects of the adjustment policies that are being implemented. Falling sales and increasing taxes and financial costs—the importance of the latter in the structure of production costs having increased enormously—squeeze firms' profits as well as consumers' ability to pay, shaking the soundness of domestic financial systems and increasing the cost of the adjustment process as a whole. The need for recovery of the economy, so that domestic illiquidity and/or insolvency is eliminated (a necessary condition for servicing the foreign debt) is contradicted by the recessionary effect of the adjustment policies being actually implemented.

Closely related to the internal debt issue is the fact that in a number of countries in the region, especially those which engaged in unrestricted liberalization cum stabilization programmes, domestic real interest rates have reached excessively high levels and experienced extremely sharp movements. While those developments may have been justified on the basis of events taking place in the credit markets, their consequences for other aspects of the economy would have required a closer look, and actions, to deal with events affecting those rates so as to achieve better results in overall objectives of economic policy. Similarly, the extraordinary inflow of foreign capital and anti-inflationary policies

based on exchange rate management, together with tendencies to integrate the goods markets into the world economy by lowering barriers to trade, generated in many cases grossly overvalued exchange rates which stimulated, in the wake of the world recession, huge private capital outflows outside the region. In summary, the behaviour of certain variables, namely exchange and interest rates, as well as real wages, foreign debt and asset prices, as "outliers" has enormously complicated and increased the cost of adjustment policies, since much more drastic changes in relative prices are required which, furthermore, may end up to being in contradiction with the overall desired results.

The behaviour of asset prices merits special consideration in some Latin American economies. In the late 1970s and to a certain extent up to the present, real and financial asset prices soared, without adequate capital accumulation effort having taken place, creating a "bubble effect" which stimulated private expenditure. As the cost of domestic financing was higher than that of foreign financing, funding private sector excess spending abroad became a profitable way to circumvent the tight domestic credit or money markets. In many cases this was the main domestic cause of the external imbalance. However, the traditional approach to adjustment assumes that it is the public sector deficit which is the principal element behind excess spending, and higher prices for public sector services, lower govern-

ment spending, higher taxes, etc., are therefore felt to be called for. Obviously, under these circumstances, although the trade balance will improve, distortions created in the domestic economy, together with an unnecessary fall in investment as compared to the desired reduction in consumption, help to increase still further the costs associated with the current adjustment.

Finally, in more general terms, since the slower growth rates in industrial countries and the higher real interest rates in international markets, as well as the smaller increase in the foreign financing available to LDCs will probably prevail for quite a long time, it would be desirable that the adjustment process in debtor countries should be guided not so much by short-run financial or balance-of-payments considerations, but rather by long-run development objectives. This requires—together with the attempt to minimize and better distribute the adjustment cost in the short run—appropriate "intervened" (as opposed to automatic) adjustment. In particular, policies aiming at increasing the flexibility of the domestic structure of debtor economies are called for. In this respect, it seems that the recent experience of some of the Asian NICs, particularly Taiwan and to a smaller extent Korea, which have been able to rely less on debt, to increase and diversify exports to both advanced and oil-exporting countries, and to substitute imports more efficiently, rather than reduce them could be quite illuminating.

IV

Final comments and conclusions. A new proposal

The economic size of the developing world, and its linkages both through trade and finance with the industrial countries, indicate the need to give higher priority to a global international approach to the balance-of-payments problems of LDCs. Even though adjustment is required, the prevailing approach considers countries on a case-by-case basis and tends to minimize the effects of the world economic stagnation on LDCs' recovery and to overlook the impact of their adjustment on the advanced countries' levels of

exports and activity. Also, the characteristics of the world economy today are quite different from those prevailing in the 1950s and 1960s. They require from the international community, and especially from the IMF, a new approach to old problems. Recent experience shows, however, that apart from the IMF's role in leading efforts to obtain additional financing no major effort is being made in that direction; the implementation of traditional ideas and standard policies in the new international scenario is increas-

ing the burden placed on LDCs by problems which urgently require a more efficient and equitable solution than the one currently being pursued. These considerations, together with the fact that developments that have occurred outside the LDCs' policies and responsibilities have played a major role in the actual crisis, mean that there is now an even greater need for financing than during the renegotiation processes that have been taking place since August 1982.

The adjustment and "overadjustment" of most debtor countries in the past eighteen months has been impressive. In spite of the huge economic and social costs incurred in terms of losses in output and higher inflation and unemployment, however, trade surpluses have not been sufficient to compensate for interest payments and smaller inflows of capital. The monetary authorities and governments in industrial countries, together with the IMF and private banks, have helped by rescheduling and consolidating existing debt.

These results, and the magnitude of the problems yet to be solved, indicate that the current approach to adjustment and the efforts made in that connection by all the principal participants have so far succeeded, at high and not equitably shared costs, in something important but limited: buying time. It is doubtful, however, whether the present arrangements have bought enough time for all the countries concerned or can be used to buy much more in the future.

Private bankers, especially the smaller ones, are displeased with what they perceive as "arm twisting" and increasing official interference in their business, although many of them would appreciate being bailed out by their monetary authorities. The IMF's credibility has been shaken by the many breakdown in its programmes. The industrial countries' concern about eventual tax increases and trade competition from abroad is reducing their governments' policy options. Last but not least, although it is true that "there is no such thing as a painless adjustment", the question is whether, over the longer term, the current adjustment policies in debtor countries, which tend to maximize cost in terms of output and employment losses and lower investment, will be worth the economic and social costs incurred. Many of the developing countries are concluding that adjustment cannot go on for much longer

and are pressing for a much more equitable and development-oriented solution to current problems. Furthermore, they correctly argue that over the longer term improved creditworthiness must be based on growth in output and exports and not on reduction of economic activity.

As already mentioned, economic recovery as well as lower protectionism and interest rates in industrial countries would obviously help. However, it seems that even if developments in the world economy go in the right direction, neither their speed nor their foreseeable magnitude will be sufficient to induce urgently needed growth in debtor countries. Furthermore, as most of these countries start from such high debt burdens they probably cannot return to normal market borrowing for some years to come. Therefore, together with a healthier international economy, there is need for new loans and adequate growth of official development assistance so as to allow domestic policy changes to be appropriately and more smoothly accomplished.

As lending banks view their exposure with debtor countries as too high by today's standards, and given that the external financial constraint on LDCs is the most pressing one, no solution during the near future seems feasible without a fall in the real debt burden. In this context, a number of proposals in relation to the debt problem have been advanced, which include special treatment of both amortization and interest payments. (Most of these proposals are contained in M. Guerguil, "The international financial crisis: diagnoses and prescriptions", to appear in *CEPAL Review* No. 24.) They range from outright purchases of the loans by governments or official institutions to the establishment of long grace periods and guarantee schemes which would give both lenders and borrowers time to alleviate their problems, while the most extreme ones consist of exchanging real assets for debt.

The main problems regarding the adoption of most of these schemes are the political implications involved in the capital losses associated with them. Although most of the debt problem is one of temporary illiquidity and not of fundamental insolvency, and in spite of recent and current emergency actions, many LDCs will not be able to service their debt, and therefore its level must be reduced. Someone has to make good the losses. In industrial countries the possibilities are

reduced to savers or depositors taxpayers, or the banks' shareholders.

Banks will have to keep lending to debtor countries because otherwise they will not even receive interest, or they might have to lower interest rates and/or commissions and fees in future (unavoidable) reschedulings, thus reducing their earnings. A certain amount of money is likely to be lost, and one possibility is that it will have to be written off by the creditors and spread over time, so as to preserve confidence in the banking system. At the other extreme, some proposals suggest that it is the LDCs which should make up for the capital loss, in addition to current losses in output and employment, by exchanging part of the outstanding debt for shares in firms that their governments control (L.A. Metzler, *Financial Times*, 14 December 1983). A whole range of "intermediate" proposals have been suggested, including a major role for SDRs (D. Avramovic, "The debt problem of developing countries at end-1982", *Aussenwirtschaft*, March 1983); reconversion of currencies as loans are rescheduled (M. Zombanakis, *Financial Times*, 9 November 1983); and stabilizing the real value of debt in terms of dollars (S. Brittan, "World debt: a suggestion", *Financial Times*, 29 September 1983).

Some of these ideas could not be considered seriously in the atmosphere of emergency which has prevailed until recently, when the restoration of confidence in the banking system and avoiding defaults by Third World countries had overwhelming importance. But now is the time for all parties concerned (especially governments, monetary authorities and commercial banks in industrialized countries, all of which share the responsibility and ought to share the debt burden) to study these proposals and act appropriately.

As indicated above, the fact that interest rates are substantially higher than their previous long-term average, and that these higher rates apply to the bulk of the external debt of the LDCs, compounds debt service payment difficulties. For Latin America as a whole, amortization and interest payments of medium and long-term debt after renegotiation absorb more than 50% of exports of goods and services, and more than 60% in the case of five countries of the region. A change of one percentage point in external inter-

est rates represents US\$ 2.8 billion per year: a sum equivalent to roughly 3% of the total exports of the region.

Lenders are normally willing to reprogramme or refinance amortization payments, but there are very few cases where this willingness extends to cover interest payments. A reduction in interest payments below market rates would reduce the operational income of the lending institutions without a corresponding reduction in operating costs.

Interest rates are not under the control of borrowers or lenders. They are a result of macroeconomic policies, and since these policies are not stable, interest rates cannot be expected to stabilize in the short run. Furthermore, the level of such rates in real terms is now five or six times higher than the longer-term (10 or 20 years) averages.

But if interest rates cannot be stabilized at normal levels, interest payments can be. A new proposal in this respect is as follows (C. Massad, "Una proposición para la solución de los pagos por intereses" (mimeo), ECLAC, November 1983).

- a) A "reference" rate in real terms would be established at a level similar to the long-term average international real interest rates plus normal spreads.
- b) Original debtors could pay interest in their own currencies to their Central Bank, at the originally agreed market rates.
- c) The Central Banks would pay creditors interest up to a maximum equal to the reference rate. The difference, if positive, would be accumulated in special accounts at the Central Bank of the debtor country and credited to the original creditors.
- d) If negative, the difference would be paid to the creditors by the Central Bank, drawing against the funds accumulated in the special accounts, in so far as there remain resources accumulated in the accounts. Such resources would accumulate when the market rates exceed the reference rate and would disaccumulate in the opposite case.
- e) The Central Bank would assume the exchange risk, but not the commercial risk.
- f) In their own accounts, creditors could present the amounts accumulated in the special accounts of the Central Bank as credits guaranteed by the Central Bank involved.

- g) The system would operate as long as there are resources accumulated in the special accounts.
- h) The scheme would be applied to debt outstanding as of a given date.

This proposal could make a very substantial contribution to strengthening the portfolio of creditor banks and to normalizing the situation in financial markets. Of course, the liquidity problem involved for creditors (banks pay interest at the going rate but would only get them back over time) could be taken care of with the support of their own monetary authority. It would be a minimum contribution to the solution of a problem in which all parties involved bear some responsibility.

Two aspects of the proposal require global agreements: one is the necessary support of national monetary authorities of creditor countries to creditor institutions; the other is that of the general characteristic of the system and the general conditions for its application. The IMF could lead the effort to achieve such agreements. The proposal does not require setting up new institutions, nor does it call for asset transfers among creditors or between them and international organizations. The proposal also provides a simple mechanism for interest subsidization, if desired: funds put at the disposal of Central Banks could be used to reduce the amounts accumulated in the special account.

Other aspects, such as the precise scope of the system, rates and spread involved, funds accumulated in the special account and not fully drawn before payment of the debt, etc., are matters of negotiation, but it would be easy to propose some possible options if needed.

Finally, the scheme could run parallel to the rescheduling of debt amortization payments and need not interfere with it.

It is very probable that after the emergency debtor countries will still find serious constraints that will limit the scope for expansionary policies

and will complicate the aim of achieving growth rates similar to those observed in the 1970s. The most important constraint will be external financing. In general, it will not be easy for governments or Central Banks of advanced countries or for official multilateral institutions to compensate for the expected smaller rate of increase in private bank lending. Improved financial management by LDCs, such as diversifying the currency composition of debt and using new financial tools and techniques, will be needed to optimize the use of the limited foreign finance available. In addition to this, it seems that the relatively smaller amount of financial credits will have to be compensated by resource transfers from industrial countries in other forms, mainly direct foreign investment, whose share in the 1970s diminished abruptly in favour of bank credits; new thinking is needed in this area also, so as to avoid the mistakes of the past.

On the internal front, adjustment and policy measures in debtor countries should be designed and implemented with a longer time horizon than is currently being used. Greater reliance on domestic saving, and efficient resource allocation aimed at increasing employment and the rate of growth of output and exports are required. Recent experience in Latin America as well as in some countries in South-East Asia suggests that much more attention than in the past should be given to "macroprice management", i.e., exchange rate, interest rate and wage policies. Consistent policies in these areas may contribute decisively to increasing saving and allocating investment more efficiently. This, together with adequate pricing policies and reforms aimed at increasing market and management flexibility, in a joint effort by the government and the private sector, should contribute decisively to put those countries on a higher growth path based on a dynamic tradeable sector (for export production and import substitution), which at the same time can be induced to use labour-intensive technologies.