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Introduction: Internal debt, external debt and economic transformation

The topics of internal debt, external debt and the process of adjustment and economic transformation have special features which distinguish them from each other. But they also have important interrelationships, often obscure, which must be studied with care. This issue of the *CEPAL Review* takes up these three topics, with emphasis on their interrelationships.

The Latin American experience of the last 15 years has demonstrated the risks of rapid financial deregulation. When this deregulation occurred swiftly (Chile, Argentina and Uruguay), the financial system experienced real domestic interest rates far in excess of any reasonable figure.

Before deregulation, interest rates in the domestic financial systems were low or even negative in real terms. This led, *inter alia,* to a situation in which debt owed to the financial system was a very large component in the assets of enterprises. But capital, another important component in such assets, usually represented a relatively low proportion thereof. Certain fiscal policies helped to accentuate this phenomenon by allowing interest payments to be treated as costs, thus reducing profits and therefore profits taxes, and by forbidding similar treatment of the dividends paid to shareholders and other holders of the capital.

This situation was sustainable as long as interest rates remained very low or negative in real terms. But when the financial system began to experience high interest rates, the existing debt entailed interest payments incompatible with the regular income of the enterprises. They were then forced, firstly, to refinance their payments of interest and even of capital to the financial system, and then to freeze them, with the result that the investment portfolios of financial institutions became less secure or even irrecoverable.

When at the same time the level of economic activity declined, both the costs and the incomes of enterprises were affected, and they were forced to transfer the problem to the financial system.

This process was not synchronous in all enterprises or in all sectors of the economy, but as time passed it was clearly becoming more widespread. Accordingly, the institutions of the financial system did not all perceive the problem in the same way at the same time, although sooner or later the system itself was affected: the level of debt at the higher interest rates became unsustainable and action by the State in support of the financial system inevitable.

The first three articles in this issue, prepared as part of the Joint Project UNDP/ECLAC "Implications for Latin America of the International Monetary and Financial System", consider the topic of internal debt from a general standpoint and in terms of two specific cases: Colombia and Peru. It is of particular interest to analyse the positions of these two countries, for in general terms they are two of the best known cases in the Latin American region.

For a long time Colombia maintained stable economic policies with no abrupt changes in the degree of control or in the openness of the financial system. These stable policies helped to limit the scope of the problem and prevent the widespread financial difficulties encountered in the countries of the Southern Cone. In Peru enterprises succeeded in transferring to the rest of the economy a substantial part of their financial difficulties; the problem thus produced a very sharp drop in real wages and in fiscal revenue rather than declines in production and increases in unemployment.

The risks of rapid financial deregulation were demonstrated with particular sharpness when this deregulation was combined with equally rapid financial openness. Although deregulation coincided with high domestic interest rates, openness offered the possibility of avoiding them, at least partially, by incurring foreign debt, for interest rates in the international financial markets were moderate and in some cases negative in the currencies of their countries of origin. Accordingly, the assets of governments, enterprises and private individuals began to show an increasing proportion of direct or indirect external debt. This process stimulated rapid expansion in the international financial markets. When the years of the lean cows arrived, in other words when the growth in the world economy came to a halt, when interest rates in the international markets rose and the terms of trade deteriorated, it became impossible for the region to continue the normal servicing of its external debt.

In the debtor countries government support for enterprises and private individuals was not sufficient to cope with the external debt. This support might have been sufficient if the responsibility for the foreign debt had not ultimately fallen, for contractual reasons or through international pressure, on the governments of the debtor countries themselves. When these governments accepted responsibility for the foreign debt, they were also forced to apply the brake to their national economies, thus aggravating the problem of domestic debt. The suspension of the flows of external financing was followed by several rounds of renegotiation which managed merely to defer the problem.

Three articles in this number of the *Review* deal with external debt. The first of them, prepared in ECLAC's Division of Economic Development, takes up the important topic of economic transformation in the light of the limitations imposed by the transfer of resources abroad occasioned by the debt. The second article, revised and updated specifically for this issue from a work produced by the Latin American Economic System (SELA), studies the possibility of converting the external debt into capital and draws attention to the difficulties and problems of such conversion. The third article, prepared in ECLAC's Mexico City Office, studies the external debt of the Central American countries, which have perhaps received less attention because their absolute levels of debt do not seem high, although some of them have the highest figures for external debt in proportion to their product or population.

Faced both with an unsustainable domestic debt situation and with a foreign debt which cannot be regularly serviced, the debtor countries are being forced to adopt policies of economic adjustment and transformation to deal with the situation. In the case of domestic debt the financial system and the debtors must improve the make-up of their assets, increasing capital in proportion to debt; it is also necessary to allocate resources more efficiently and to stimulate saving to underpin rapid capital accumulation. In the case of the external debt, as well as generating the resources for repayment it is important to transform these resources into currencies acceptable to the creditors; the emphasis must therefore be on the production of internationally marketable goods and services, which often requires changes in the production structure and not merely in profit incentives.

How can these adjustments and this transformation be achieved? This question has arisen persistently in recent years. The traditional methods were devised mainly to deal with isolated cases, so that when they are given general application they acquire a clear recessionary bias which must be corrected.

The last two articles in this issue of the *Review*, prepared as part of the project on "Macroeconomic policies and the adjustment process in Latin America" which is being implemented by ECLAC in collaboration with the Netherlands, deal with the topic of adjustment. The first of them does so on the basis of the Latin American experience, emphasizing both the internal rigidities of the economies and the need to consider the problem of adjustment from a global perspective. The second and last article views the problem from an opposite perspective, taking the existing theoretical focuses and setting them against the Latin American situation in order to determine whether they are applicable thereto.

Thus these articles examine three interrelated topics: internal debt, external debt and the process of adjustment and transformation. They indicate two fundamental lessons. The first is that stable policies are more important than the ideal policies which certain fashionable models seek to carry to extremes. The stability of policies depends not only on their intrinsic quality but also on the political support which they obtain; if this support is to be sufficiently broad, the policies will have to guarantee a fair distribution of costs and benefits among all population groups and across frontiers. The second lesson is that policies cannot be analysed as if each of them pursued a goal separate from the goals pursued by the others. A policy of high interest rates which succeeds in increasing saving and reducing the external deficit can be destroyed by its harmful effects on the financial system as a whole. An exchange policy devised to restrain inflation can heap imbalances on the external sector which cause it to explode with greater force. An adjustment policy designed to reduce the external deficit of a small country can prove counterproductive if many other countries apply it at the same time; or it can prove completely useless if the policies of the bigger countries do not leave it sufficient room for manoeuvre. Economic policies must therefore be considered carefully as a whole, both in the case of a single country and in the case of the entire international community.

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