

CEPAL

Review

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The external debt and the financial problems of Latin America*

*Carlos Massad***

The external debt is perhaps the most striking manifestation of the crisis through which the countries of Latin America are passing and is one of the problems whose solution is a necessary condition in order for these countries to be able to emerge from their present predicament.

The article begins by presenting some general data on the evolution of the total debt in the last decade to its present critical level equivalent to some 30% of the gross domestic product. It goes on to examine the reasons for this increase, dealing with them in terms of the increases in the supply of external credits and the demand for them, and placing particular emphasis in this respect on changes in relative domestic prices, exchange policy, excessive public and private spending, the rise in oil prices and its impact on international liquidity, etc. The author then goes on to deal with some consequences of the increase in the debt—such as restrictions on domestic policy, the transfer of resources abroad and external vulnerability—and the conditions on which this debt could be tolerable. These conditions are, essentially, the sustained growth of the world economy, continuity of the flow of external credit, and the expansion of exports, none of which are being fulfilled at present. He therefore suggests some emergency measures, including in particular the equitable renegotiation of the debt between debtors and creditors, an increase in the resources of the IMF and in its influence over creditor countries, and an increase in international liquidity, concluding that these measures, together with others in the medium term, are an urgent necessity at the present time.

*A preliminary version of this article was used by the author at the lecture he gave at the National Academy of Economics of Uruguay in May 1983.

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I Introduction

The external debt is a subject which is very much in fashion, and for this reason it is very dangerous: readers probably know just as much about it as the author, if not more. We all of us read, talk and are well informed on subjects of this type, and above all we sometimes hold very clear and well-defined ideas on them. I shall try to sum up these clear and well-defined ideas in order to give you the perspective at which my own experience and work have enabled me to arrive.

I shall refer first of all to the broad magnitudes involved in the financial problems of Latin America, then to the increase in the Latin American external debt and the reasons why this debt has gone up, after which I shall deal with the consequences of the increase in indebtedness and analyse the question of whether this debt is sustainable or not at its present level. Finally, I shall put forward some emergency and medium-term solutions at both the national and international levels and outline the prospects for the near future.

II The magnitudes involved

Let us first look at the magnitudes involved in the Latin American financial problem. It is well known that there is a sharp and growing deficit on the region's balance-of-payments current account, that is to say, essentially on our purchases from and sales to the exterior, plus payments in respect of interests and tourism. For 18 non-oil-exporting countries, this deficit, which was around US\$ 2 billion in 1970, kept within the range of 10 digits until 1978, when it came to some US\$ 8 billion, but the following year it rose to US\$ 14 billion, and in 1981 it reached a peak of US\$ 27 billion. In other words, over a period of 11 years the external deficit on the current account of the 18 non-oil-exporting

countries increased by a factor of 13, from US\$ 2 billion to US\$ 27 billion.

Income on the capital account helped to finance this deficit, however: although on the one hand there was a deficit on the current account, since Latin America was buying more than it was selling, on the other hand this was financed with net income on the capital account. This income was consistently greater than the deficit on current account, so that it was possible to pay off this deficit and still accumulate reserves. Thus, for example, whereas in 1970 there was a current account deficit of US\$ 2 100 million, the surplus on the capital account was US\$ 2 800 million, so that there were US\$ 700 million left to improve the reserve position of this group of countries. This situation continued until 1979, when the current account deficit came to US\$ 14 billion, whereas the capital account surplus was US\$ 17 800 million. In 1980 and 1981, but above all in 1982, however, the situation was completely reversed, and in these three years the accumulated current account deficit was almost US\$ 15 billion more than the net inflow of capital, thus meaning a loss of reserves by our countries, since only part of the current account deficit could be financed with capital income and the remainder had to be covered by making use of our own reserves. In 1982, for example, there was a current account deficit of US\$ 25 billion, whereas the capital account surplus was only US\$ 16 700 million: that is to say, in that year alone there was net depletion of the reserves by almost US\$ 9 billion.

This inflow of capital comes basically from two sources: on the one hand, from direct foreign investment, which does not generate indebtedness; and on the other hand, from medium- and long-term foreign loans, which are accounted as such in the balance of payments.

While the debt grew, foreign investment was becoming less and less substantial. There are many reasons for this: on the one hand, very good investment opportunities arose in other

countries, as for example in Asia (Korea, Taiwan, Singapore, and now also Thailand, *inter alia*); on the other hand, it must be recalled that between the mid-1960s and perhaps the mid-1970s in Latin America there was a wave of nationalizations in most of the countries, in which foreign investments were expropriated. In some cases these nationalizations took place on account of the excesses of investors, whereas in others the motives were different. But the mere fact that nationalization took place, whatever its cause and almost regardless of the compensation paid, led to the discouragement of new investment. Consequently, the inflow of capital was increasingly acquiring the nature of straightforward indebtedness.

In order to gain an idea of the level of the debt, it may be compared with the total product of the countries. Latin America's total debt is at the present moment something over US\$ 300 billion. In 1970, the total public and private short-, medium- and long-term external debt was equivalent to only a little under 12% of Latin America's gross domestic product, but towards the end of 1982 it was equivalent to around 30% of the product.

Furthermore, in proportion as the debt grew there was necessarily also an increase in the cost of servicing it, particularly as regards payments of interest, which grew for two reasons: because the level of indebtedness was rising, and also because interest rates rose sharply during this period. Expressed as a proportion of exports of goods and services, interest payments represented around 7% in 1970, but at the end of 1982 they came to almost 40%: that is to say, in 1982 it was necessary to use almost 40% of the resources obtained from our exports simply in order to pay the interest on the debt.

The figures thus show that the debt grew rapidly and that its cost is high. We must now ask ourselves why the debt increased: what happened in those 12 or 13 years to make it grow so rapidly.

III

Why the debt increased

Let us classify the reasons for the increase in the debt under two traditional categories of economic analysis: demand and supply. First of all we will see what happened on the demand side to cause the growth of the debt, and then what reasons there were on the supply side for its increase.

1. *The reasons on the demand side*

Various reasons of different types may be mentioned on the demand side: the first to be referred to are the domestic policies or events which increased real domestic interest rates, for when these rates increase, there is a greater incentive to seek loans abroad. Consequently, any element which helps to bring about an increase in real domestic interest rates automatically results in a greater incentive to seek loans abroad.

a) *The anti-inflation campaign and economic changes*

The first element to be noted here is the struggle against inflation. Practically all the countries of the region carried on an active campaign against inflation during this period. Such a struggle naturally means, among other things, a relatively restrictive monetary policy, and this in turn brings about an increase in interest rates.

At the same time, during this period most of the countries of the region embarked on policies of profound economic change in which they reviewed their tariffs or financial systems, general incentives, systems of taxation, social security, etc.

These policies of change not only have long-term effects, but also certain short-term effects which may also involve costs. Thus, for example, a policy of change normally brings about variations in relative prices, which are the indicators used by the economy in allocating its resources.

In the case of those goods whose relative prices rise, the situation is often resolved by way

of external trade. If there is a greater demand for certain products which causes their relative price to rise, then this rise will probably be attenuated by way of external trade, because a sufficient amount of those products will be imported to satisfy demand or at least relieve the excess demand generated. In the case of a drop in relative prices, however, which would represent a sign that resources should be taken away from that activity and transferred to others where the prices are more favourable, the effect does not take place as rapidly, since the normal reaction of enterprises is not to immediately reduce their activities, but rather to ask for loans from the banking system in order in this way to overcome what they consider to be a temporary unfavourable situation, although in reality it may be a question of a longer-term change in relative prices in the country.

As enterprises approach the banking system, this system will respond—if they have appropriate guarantees—by granting them credit, and in this way the demand for credit will be increased. On the other hand, those enterprises whose relative prices are increasing will also want to expand and will then exert pressure on the banking system too, so that an abrupt change in relative prices in an economy normally brings with it an acceleration in the demand for credit, that is to say, greater pressure on the banking system. This pressure in turn will have the result of causing a rise in interest rates within the context of a given monetary policy. Indeed, it may be noted that it is precisely in those countries where there has been the biggest effort to make changes that there have also been the biggest rises in real interest rates. When such higher real domestic interest rates exist, this naturally constitutes a strong incentive to seek loans abroad, where rates are more favourable.

In this way, policies aimed at economic change tend, in the short term, to increase the demand for credit and to generate high domestic interest rates.

b) *The link between financial and non-financial enterprises*

Within this same field, we must consider the fact that in certain cases a link is formed between the bank and the enterprise making use of credit; the enterprise obtains credit in preference to other enterprises, and it can therefore work with relatively smaller capital in relation to its debt. In other words, the enterprise risks very little: the smaller the capital is in relation to the debt, the smaller the amount risked by the enterprise, and if it is only risking a small amount, then it will be willing to pay higher interest rates in order to procure financing to keep in business, even at difficult times. Thus the fact that there is a link between the banking system and the production sector gives rise to an incentive to enterprises to accept higher interest rates than they would otherwise be willing to agree to. As is only natural, this once again generates higher domestic interest rates and incentives for seeking loans abroad.

c) *Exchange policy*

Another important element in this picture is exchange policy. If, in a country suffering from inflation, the exchange rate is fixed at a certain nominal rate and remains stable while inflation continues, what will happen is that the nominal domestic rates, which are already high because of inflation, will be converted into high real interest rates in dollar terms. For example, if there is a fixed exchange rate for the dollar, with inflation of 20% and an interest rate of 25%, this means that the real rate of interest, measured in terms of national currency, is only 5%, whereas its equivalent in terms of dollars would be 25%, because the exchange rate for the dollar is fixed. Consequently, if it is possible to obtain loans abroad in dollars at an interest rate of 12%, this would be equivalent to paying only half the domestic rate and hence, in an economy suffering from inflation, the fact of keeping the exchange rate stable for a long period is a further incentive to seek loans abroad, because the dollar interest is lower than the domestic real interest rate.

All these elements help to increase the

domestic real interest rate and tend to generate an incentive to seek loans abroad.

d) *Excessive public sector spending*

A second set of elements which explains the demand for external indebtedness is linked with the elimination of restrictions on expenditure. Here, the orthodox or classic case is that in which the government spends more than its income. The following is a typical example: there is a fiscal deficit financed by the Central Bank; the excess monetary emission generates an excess of money supply over demand; and this excess of money supply is manifested in the rest of the markets through excess demand for goods and securities. The excess demand for goods corresponds to a deficit on the current account of the balance of payments, while the excess demand for securities has its counterpart in an outflow of capital from the country, so that in turn it is reflected in a deficit on the capital account of the balance of payments. A global deficit is thus produced which the authorities have to finance. Excessive public spending, then, financed by emission by the Central Bank, means a loss of foreign exchange and the State has to go outside the country, normally through the Central Bank, in order to obtain the resources needed to finance this deficit. This is where the phenomenon known in the United States as 'crowding out' takes place: that is to say, when the State goes out looking for loans it pushes the private sector aside into a corner and the latter sector is not able to obtain the credits it needs. Such is the traditional or orthodox case.

e) *Excessive private sector spending*

It also seems appropriate, however, to briefly analyse some non-traditional or what we might call heterodox cases, where the 'crowding out' takes place in the opposite direction: here, it is the private sector which crowds out the public sector. Let us look at an example. Suppose that for some reason the private sector decides to increase its expenditure and finds possibilities of financing this increased expenditure abroad. The increase in private spending will then be reflected in a deficit on the current account, since

the private sector seeks to buy more goods than are available in the market and must therefore import the additional goods. A deficit is caused on the current account, and this is automatically financed because the private sector itself seeks the necessary financing for its excess spending abroad. It might happen, however, that not all this financing goes to buy imported goods, but part of it is also used to buy domestic products, so that in this case part of the financing obtained would cover the current account, while the rest would increase the country's reserves.

Thus, through excessive private spending, a phenomenon of current account imbalance and external indebtedness is created which is identical to that occurring in the case of the public sector. Where there are possibilities of financing it abroad, excessive private sector spending can be just as dangerous as excessive public sector spending financed from the resources of the Central Bank.

The increase in the external debt in order to finance private spending will be reflected in the statistics, and it is probably to be expected that in those countries where the increase in the debt was due above all to excessive private spending, the external debt or the increase in it will be fundamentally of a private nature. In contrast, in those countries where the increased expenditure was due basically to excessive public spending, it is the Central Bank or the government itself which will have to seek financing, and consequently the external debt or the increase in it will be mainly of a public nature. If we look at the statistics of those countries which observe 'good conduct' in fiscal matters in the traditional sense of maintaining a relatively balanced budget, but where there is excessive private spending, we will mainly find an increase in the external debt of the private sector, whereas in those cases where the fiscal deficit predominates, it will be seen that the increase in indebtedness is essentially public.

In cases where there is an imbalance on the current account due to an increase in private expenditure financed from inflows of capital, then if part of these dollars is not used to finance import but to finance domestic expenditure, the prices of the so-called 'non-tradeable' goods will tend to go up, meaning that in reality the exchange rate is lagging behind. We thus observe

that there is an increase in the debt and that, by lagging behind, the exchange rate accentuates the current account imbalance. We then have a phenomenon where excessive private spending, financed by indebtedness which increases the reserves but leaves the exchange rate lagging behind, will again increase the imbalance on current account.

2. *Reasons on the supply side*

Let us leave aside at this point the reasons on the demand side which explain the indebtedness and look for a moment at the reasons on the supply side which show how this high indebtedness was able to take place.

The elements on the supply side are basically linked with the two 'impacts' of the oil price rises. These two great increases, in 1973-1974 and in 1978-1979, generated enormous surpluses on the accounts of the oil-exporting countries. These surpluses affected both the supply of funds and the demand for them. On the one hand, they generated a supply of funds, since the oil-exporting countries, especially those of the Middle East, have a great preference for liquidity in their holdings of foreign assets and they have preferred to put their liquid resources in bank accounts rather than in other types of investments, especially at the beginning of this process. At the same time that these countries were depositing these resources in the banking system, however, the oil-importing countries needed to finance their accounts, which had been unbalanced by the deficit.

There were thus simultaneous increases in both the supply of funds in the international field and in the demand for them. The oil-exporting countries deposited these resources in the private banking system operating at the international level, and this system expanded with striking speed. For a moment, it seemed that the system would not be capable of achieving the so-called 'recycling', that is to say, the reallocation of the funds from the oil-exporting countries to the oil-importing countries, yet this recycling grew between 1970 and 1981 at an annual rate of 20%. Almost all the available indicators, whether regarding the total assets of the international private banking system, its external as-

sets or its foreign exchange assets, show growth rate averages of 20% per year.

The surplus accumulated by the oil-exporting countries between 1974 and 1981 came to US\$ 433 billion, while the total net external assets of the banks reporting to the Bank for International Settlements in Basle are of the order of one million dollars.

With these resources, the Euromarkets expanded rapidly, at an average of 20% per year; the European banks expanded by 18%, the Eurocurrency market by 19%, the total assets of

the banks reporting to the Bank for International Settlements in Basle by 21.5%, etc.; all these rates of similar magnitude point to an unprecedented expansion in external financing.

Thus, on the one hand, our countries found themselves needing more resources, while on the other hand they had greater resources available to them: indeed, many foreign banks offered loans even when traditionally they would have taken the opposite view. This custom was reversed in the following years, however.

IV

The consequences of the increase in indebtedness

Let us now look at the consequences of the increase in indebtedness, the main figures for which we gave earlier. In order to analyse them, we should perhaps think in terms of an enterprise facing its banker. Let us assume that it is a solvent enterprise dealing with a banker with whom it has been working for many years, but that it now has a relatively high level of indebtedness. It is possible that in these circumstances the banker may say that before the enterprise undertakes new investments or expansion programmes, it should inform him in detail regarding its situation, because since it has quite a high level of indebtedness it is compromising a high proportion of the bank's resources, so that the bank is beginning to take a very close interest in the enterprise's evolution and risks.

From the point of view of a country, this means that certain restrictions on domestic policies come into being through the mere fact of having a large debt which has to be continually renewed. We may recall in passing that debts now have much shorter maturities than they had ten years ago, because they are mainly from private and not official sources. Ten years ago, most of the Latin American debt — perhaps 80% of the total — came from institutions like the World Bank, the Inter-American Development Bank, AID, etc.: all official institutions which loan for long periods at fixed interest

rates. Now, however, the relationship has been completely reversed: 80% of the debt is with private institutions which, by their very nature, loan for shorter periods and at floating interest rates whose consequences we shall analyse later.

1. *The restrictions on domestic policy*

In the first place, the level of the debt imposes certain restrictions on domestic policy. Obviously, it is not possible to apply whatever policy one likes: the policies must be such as to make possible the regular renewal of at least the level of credit already received, and this imposes restrictions on monetary, exchange and interest rate policies; it is not that these restrictions are directly imposed by the creditor banks, but they result from the force of circumstances, since the banks are looking at certain indicators to decide whether the economic management of a country will allow it to pay its commitments or not: if these indicators give a negative answer to this question, the bank will become very reluctant to renew its commitments and will begin to demand payment or increase the guarantees requested, just as it would do if it were dealing with an enterprise; in contrast, if these indicators give favourable answers, the bank will probably prove to be quite willing to grant new credits, to renew existing ones, etc. It is worth repeating that it is not a question of the bank

making direct demands to the authorities, but rather that the banks take into account the way certain indicators are evolving. For example, if the international reserves are going down, this is a bad sign to the bank, and if a country has a very large debt it can therefore hardly apply policies which involve the reduction of its reserves. The banks also consider the situation of the balance-of-payments current account: if this shows much of a deficit, it will be more difficult to renew credits or obtain new ones. In short, countries must seek policies which do not give rise to excessively large deficits on their current accounts. These are just a few examples, since the range of possibilities is very wide. At all events, the main point which I wish to bring out is that a high level of indebtedness, by its very nature, imposes restrictions on domestic policies and it is only possible to apply those which cause the indicators of solvency examined with such care by the banks to move in favourable directions which will make it possible to renew credits or obtain new ones.

2. *The real transfer of resources to the exterior*

A second consequence of a large debt is that it makes a real transfer of resources to the exterior a definite probability. Asking for loans means obtaining more resources than one possesses; a country which asks for loans does so in order to spend more than it has. In this way, a loan from abroad means a real transfer of resources from the exterior to the debtor country. At the same time, however, when the debt is paid back to the exterior the real transfer of resources is reversed. Transferring real resources means having fewer shoes, less clothing, less food: it is not something vague but something very concrete and effective; transferring real resources to the exterior means sending abroad assets which are then no longer available for consumption within the country, just as assets were *received* from the exterior when a loan was obtained. The developing countries are traditionally recipients of capital, however, and by the nature of their development they are in a position to offer better investment conditions or terms than others, so that for a very long time they will be receiving net capital from the ex-

terior, that is to say, real resources which are added to their own, in order to keep up levels of consumption and investment.

When the debt becomes very high, a country runs the imminent risk that the debt will have to be reduced, and this means that there will have to be domestic restrictions in order to send to the exterior the real resources with which the debt is paid.

Furthermore, the higher the debt, the higher too will be the interest, and this forms part of the current payments of a country, so that the greater the debt, the greater the probability will be of a deficit on current account due to the interest payments, and consequently there will also be greater probability that it will not be possible to obtain as many loans as before and that it will be necessary to transfer resources to the exterior. To take an example, let us assume that the external debt of a country is equal to its national product, that this product is growing at a rate of 5% per year, and that the real interest on the debt is also 5% per year; this would mean that the country would have to pay to the exterior real resources equivalent to the entire growth of its economy for ever, since these are payments of interest and not of capital.

3. *A new source of external vulnerability*

Furthermore, and as a consequence of the rapid growth of the debt, this has been contracted for shorter terms, because the commercial banks lend for shorter periods than AID or IDB, and also at higher costs, because they must not only cover their costs but also make a profit. Since the debt is for a shorter term and is more costly, this increases the possibility of a real transfer of resources to the exterior when the countries have to pay interest or pay back the capital of the debt itself. What makes the situation even more complex, however, is that the interest on private debts is not fixed like that on loans from IDB or AID, but floating, that is to say, it is usually varied every three or six months in line with the market. This means that the effects of the interest rate do not fall only on new loans. When a rate is fixed—9%, for example—and afterwards the rate is raised to 10%, this does not increase the rate on existing loans, which remains at 9%, since the rate of 10% is

only applied to new loans obtained. When the rate is floating, however, a rise in it from 9% to 10% means that the latter rate will be applied to the entire debt, and not only to the new debt contracted. Since nowadays practically 80% of the Latin American external debt is subject to floating interest rates, this means that a rise in the rate from 9% to 10% involves an extra expense of US\$ 2 400 million for Latin America as a whole.

In addition, however, the fact that the entire debt is subject to floating interest rates constitutes a new way for the international transmission of imbalances. The traditional ways in which international imbalances are transmitted are very well known. When the United States is going through a recession, for example, the prices of commodity exports fall even though those of the developing countries' imports keep on rising, and the deterioration in the terms of trade means that we receive less for our exports, so that the imbalance is transmitted to our economy through the terms of trade.

During a recession, the imports of the developed countries often go down, which means that our exports go down too. Thus, the effects of the international recession are also transferred to our economies through the volume of exports.

When the developed countries are applying a restrictive monetary policy, interest rates go up, and a higher rate of interest tends to bring about a reduction in investments in our countries, so that, because of the smaller expenditure brought about by high international interest rates, this is another way in which part of the recession is transferred to our economies. When there is a recession in the United States, the exchange rate of the dollar improves with respect to other currencies, and as our currencies are normally linked to the dollar this constitutes a kind of revaluation through which international imbalances are also transmitted to our economies.

Now, however, with the floating interest

rates which affect the whole of the debt, there is a new and non-traditional way for the international transmission of imbalances, namely, through movements in interest rates. When interest rates rise in the United States because that country is applying a restrictive monetary policy, two things happen at once: the United States economy is slowed down, so that all the other traditional effects already mentioned take place, yet at the same time interest rates rise, thus directly increasing the interest payments on current account. Consequently, interest rates not only have an indirect effect through the spending of the economy, but also a direct effect through the current account imbalance caused by the need to make larger interest payments.

4. Another new source of vulnerability

Given the importance of the external debt and its level, there is another non-traditional mechanism for the transmission of international imbalances: deterioration in the portfolios of banks in the exterior. Let us suppose, for example, that there is a recession in the United States; this leads to a deterioration in the portfolios of the banks of that country, so that they are much more reluctant to lend money and thus reduce the level of their loans. A country with a high level of indebtedness, however, has to pay high interest rates which it needs to finance, and it must renew its credits in order at least to keep up the level of its debt, yet it is precisely at this time that the banks become reluctant to lend, when interest rates are simultaneously rising because of the external recession. Thus, at one and the same time there is a deterioration in the terms of trade, all the other traditional ways of transmitting imbalances make themselves felt, and moreover the non-traditional methods of transmission of imbalances, which operate through the deterioration of the bank portfolios with consequent forced reduction of their lending activities, also come into action, leading to contraction in the international financial system.

V

Is the present level of indebtedness sustainable?

After looking at all these negative aspects, it would seem appropriate to analyse the question of whether the present level of indebtedness of Latin America can be sustained or not. I shall then suggest what could be done to deal with the situation. For the moment, however, it is worth stopping at this point to determine under what conditions the level of Latin American external indebtedness can be sustained.

1. *The growth rate of the world economy*

The first condition in order for this level to be sustainable is that the world economy should recover, that is to say, that it should have a steady growth rate. Indeed, the National Security Council of the United States estimates that if the economies of the OECD countries grew at a rate of 4.2% per year, the problem of the external debt would be perfectly bearable for the debtor countries taken as a whole. Naturally, there are cases where the difficulties in doing so would be greater, but taking the countries as a whole, a sustained 4.2% growth rate by the OECD countries would make it possible to face up to this level of indebtedness because it would mean higher prices for exports, bigger exports for the debtor countries, lower interest rates, etc.

2. *The level of external real interest rates*

The second condition is that interest rates should go down in real terms to their traditional level. If we look at the last few decades in the United States and Europe, we see that real interest rates were between 1% and 2%, with the exception of Japan, where real rates were higher because of the great productivity of that country's economy. Economies cannot resist long periods in which real interest rates are much over 1% or 2%, because in such an event the depositors in banks would be the owners of the entire national wealth within the relatively short space of three or four generations; since interest keeps building up, after less than a century a million dollars would be turned into a thousand

million dollars if the interest rate were 7% per year. Real interest rates, which were quite low in the past, are now of the order of 7%, which is an absolutely abnormal level. Thus, if the growth rate of the world economy were between 4% and 5% and real external interest rates were more than 1% or 2%, the debt would be perfectly sustainable.

3. *Continuity in the flow of external credit*

A third condition is that the flow of bank credit should be relatively continuous and not interrupted. Another problem arises here, because numerous banks which are relatively small by international standards have entered the field of international financing and are operating behind the big banks or in conjunction with them. These small banks entered this field because there was great liquidity in the system and this enabled them to find a safety valve for their resources, but they do not have the capacity to evaluate clients in other countries; they lack a team of experts who can maintain an updated view of the economies of other countries and of individual foreign clients, so that they have to rely on the judgement and criteria of the big banks. The small banks are also weak, however, and a small error in their portfolio can mean very serious difficulties for them, so that they go in together behind the big banks and also leave the field together at the first sign of difficulties. The big banks, which have their own teams for evaluating the situation, do not display such erratic reactions, or at any rate would have fewer reasons to do so, whereas the smaller banks enter and leave the field *en masse*. This attitude causes difficulties with regard to the flow of bank credit resources, and in particular it causes serious difficulties in the present renegotiation of the debt. The banking system shows a strong gregarious instinct, acting together one way or another. Thus, it acted in one direction between 1975 and 1981, and in the opposite direction in 1982.

4. *The expansion of exports*

Another necessary condition is that there should be a steady expansion of the exports of debtor countries. If the economies of the other countries in the world are growing, this will enable exports to be expanded, but in order to do this it is necessary to have production capacity. In other words, it is necessary to have made intelligent use of the resources obtained through domestic saving and indebtedness. It cannot, however, be asserted that these resources have been intelligently used in all cases. In reality, when we look closely into the matter we find that in various cases external saving was used as a substitute for domestic saving instead of being a complement to it: that is to say, external saving led to a reduction of domestic saving. Investment did not grow as much as it should have done with these resources, so that not all countries are in a position to increase their exports, even if the world were to grow at a sufficient rate to absorb them.

It is also necessary to take into account the marked protectionist trends observed in almost all countries of the world. Although governments try to resist protectionist pressures, the combination of unemployment and external imbalances in the OECD countries causes these pressures to be successful. In recent years world trade has practically stagnated, and in reality for at least the past year world trade has been going down, in terms of both volume and prices, for the first time in a great many years.

Unfortunately, protectionist tendencies in countries are not easy to reverse. Once established, a series of vested interests are created in connection with them: those of the workers and owners of the enterprises receiving protection, the enterprises connected with them, the interests of the geographical areas where these are located, etc. This makes it very difficult to do away with protectionist measures once they have been adopted.

5. *Fulfilment of the conditions*

As a result of the world recession, these four conditions which are necessary in order for the external debt to be sustainable in a normal manner are not being fulfilled. Unfortunately, the

world economy is not growing, or else is only doing so very slowly. The gross national product of the industrialized countries as a whole, which grew by 1.3% in 1980 and 1.2% in 1981, shrank by 0.3% in 1982, and while in 1983 some growth is hoped for, this is at present nothing but a hope, so that it is clear that the world economy is not growing at the rate of 4% or 5% which would be needed in order to make the present level of indebtedness bearable.

Furthermore, there has been an important change in the surplus/deficit distribution in the world. With the failure of the oil cartel, the oil-exporting countries have ceased to register big surpluses; it will be recalled that they had accumulated almost US\$ 500 billion in surpluses which they were mostly keeping on deposit in the banking system. Now, however, these countries have a deficit: the figures show that in 1982, for example, the oil-exporting countries had a deficit of US\$ 2 billion on their external accounts, and a deficit of US\$ 27 billion is expected for 1983, so that these countries will no longer be making extra contributions to world liquidity. In 1982, the industrial countries registered a deficit of US\$ 1 400 million, while the non-oil-exporting developing countries showed a deficit of US\$ 87 billion. For 1983, the industrial countries expect a surplus, thus changing the current account situation, but these countries are much less inclined than the oil-exporting countries to keep their resources in liquid form in the banks. It is therefore improbable that the latter can expect additional liquid resources, and it is also consequently improbable that the international financial system will grow again at the rates at which it had been expanding. Indeed, in the last few months of 1982, the international financial system showed a slight decline in its figures, instead of growth.

As a result of the world recession (trade stagnation and protectionism were already referred to earlier), world trade declined in terms of volume by 2.5% in 1982, and by 4% in terms of unit values. It may be noted that up to 1981 it had grown steadily. Real interest rates, for their part, have risen from 1% or 2% to around 7%.

In short, it is becoming increasingly difficult to export; real interest rates are rising in the exterior; and domestic and foreign bank

portfolios are deteriorating so that the supply of external credit is shrinking. One set of figures serves to illustrate the importance of several of these factors for the Latin American countries: if the terms of trade had kept the levels they had in 1965-1969 and interest rates had not varied from the average level of 1978, then the current account deficit of the 18 main Latin American non-oil-exporting countries would have gone down from the US\$ 25 billion which it reached at the end of 1982 to only US\$ 1 billion. Of course, if the terms of trade and interest rates

had been different, then many other things would have been different too. This calculation at least gives us an order of magnitude by which to appreciate the importance of the figures involved, however.

This set of factors means that, because of its form, maturities and amounts of interest payments, the present level of indebtedness is not sustainable and demands priority attention on the part of Ministers of Finance and Presidents of Central Banks.

VI

How is the problem to be faced?

A problem of the magnitude, scope and complexity of the present one does not admit of simple or rapid solutions. On the contrary, it calls for action on various planes and for the adoption of measures whose effects will take place at different moments in time. Any orderly solution of the problem of indebtedness calls, in the first place, for the adoption of certain emergency measures which will give time for the measures of a more definitive nature to come into effect.

1. *Emergency actions*

a) *Renegotiation of the debt*

Many countries have initiated action designed to reprogramme, refinance or renegotiate (however one wishes to call it) their commitments in respect of the external debt which fall due in the next twelve months or two years. Through such action, in agreement with creditors, it is hoped to reduce the amortization burden on the balance of payments during the next year or two years. It is spread out over the future, with some period of grace, because it is expected that the conditions of the national and world economy will be more favourable in the years to come.

The first experiences of renegotiation show a marked increase in the cost of the renegotiated debt. This increase is based on the

argument that the risk for the creditor has increased. In reality, however, it may be asserted that such risk has perhaps even gone down, since the renegotiations have been accompanied by sharp increases in the guarantees provided by the debtor countries, at the demand of the creditor institutions. Furthermore, the real option which the creditor has is not the choice between obtaining punctual payment or renegotiating, but rather the choice between renegotiating or not collecting the amounts due at all. This situation is not due to the ill will of the debtors, but to the material impossibility of paying in the manner originally agreed. The initial cost of the credit already included a certain 'risk premium', in line with the normal conditions of the credit market. Consequently, when the risk materializes the debtors should content themselves with the premium which has already been paid, and not increase the cost of the credit still further with higher spreads, flat surcharges, etc.

The renegotiation will lead the creditor banks to take a great interest in the domestic policies of the country concerned, because it is important for them to know whether such policies will ensure that the debt can eventually be paid off promptly on normal terms. This is where the real restrictions on domestic policies appear when the debt is large, as already noted. It is worth adding that in normal relations between debtors and creditors, when the former

cannot pay their debts as scheduled an agreement is reached which lightens the burden of the debt for the debtor, thus sharing the problem with the creditor. In the present circumstances there is no machinery for achieving such an objective, although such machinery existed in the past, before the Second World War, when most of the external debt took the form of bonds sold on the London and New York markets. If the debtors ran into difficulties, the price of the bonds fell and the debtors could buy back the bonds they had issued (i.e., their debt) at a fraction of their original value, so that the burden of the debt was shared between creditors and debtors. Bank portfolios, however, cannot easily be bought and sold on the market, and this type of machinery for sharing the burden of the debt has consequently disappeared.

In short, renegotiation is the first emergency action to be taken, but it should be subject to a warning: neither creditors nor debtors should take an exaggerated attitude as regards the cost of the debt.

- b) *Expansion of the resources of the International Monetary Fund and the need for an even-handed attitude by it to both creditors and debtors*

A second type of emergency action consists of the expansion of the International Monetary Fund, which has just increased its regular resources by 47.5%, representing the addition of some US\$ 15 billion to the resources which it has available for lending. This sum, however, is insignificant compared with the magnitude of the problem, so that if the Fund does not act in other ways also, it will very soon find itself without resources once again. The International Monetary Fund is an absolutely essential institution in this process, and in my opinion it has played a key role in completing or helping to complete the renegotiations which have been effected so far. The Managing Director of the Fund has personally seen to it that the banks agree to assemble the additional resources needed to make up what each country requires to finance its needs.

This situation means that the Fund must take into account the fact that there are limits to

the policies which a country can adopt in order to make its programme acceptable. Here, there is a certain bias in the situation: in the present circumstances I consider that the Fund is not in a position to apply the same pressure to creditor countries as to debtors, so that there is a recessive bias in the Fund's policy. If it could apply the same pressure to creditor countries, it would tell them that they must apply expansive policies in order to make the world economy grow and permit an increase in the trade of the developing countries, especially Latin America. If this could be done, the burden of adjusting the Latin American economy to the new situation would be considerably lightened. In my personal opinion, the International Monetary Fund needs to seek extra resources quickly and to find some system which will enable it to exert pressure on the creditor countries in the same way that it exerts it on debtors. I consider that much still remains to be done in this respect.

- c) *The growth of world liquidity*

When we look at the figures, we see that the world's international reserves are going down. In the case of Latin America, its gross reserves went down by US\$ 12 billion in a little over one year, without counting the changes in the price of gold. The world as a whole has lost an even larger sum and continues to lose reserves, so that a substantial additional allocation of Special Drawing Rights would be justified from every point of view. These Rights were created precisely in order to supplement international liquidity at a time when the other sources of liquidity were not capable of satisfying requirements. Today they are clearly not capable of doing so either, and in my opinion there is therefore every justification for issuing Special Drawing Rights. The argument originally given for not continuing to issue them was that the banking system was growing so rapidly that it could take care of all financing needs, but this is no longer the case. The growth of the banking system has been paralysed, and there therefore does not seem to be any convincing argument against an additional allocation of Special Drawing Rights.

This would solve many problems. Firstly, it

would raise the level of world liquidity to support the continued expansion of trade; secondly, it would tend to redistribute the debt payment burden since, to the extent that a country receives as a 'gift' a certain amount of resources, it is being permitted to transfer fewer real resources in order to pay its external debt. Furthermore, it is my understanding that increasing the amount of Special Drawing Rights does not require special legislation in any country, including the United States, where it does not even need to be submitted to Congress, as is required in the case of an increase in the International Monetary Fund quotas.

It is well worth supporting the studies which are being embarked upon at this moment in the Fund to consider the possibility of making a fresh issue of Special Drawing Rights.

2. *Medium-term solutions*

a) *At the national level*

Let us now look at the medium-term solutions and the panorama offered by the future. These medium-term solutions call for action at both the national and the regional and international levels.

At the national level, I consider that the coming year will witness policies aimed at promoting the growth of exports and import substitution. This is one way of assigning more resources to the so-called tradeable goods sector and thus accumulating greater resources for reducing the debt in relative terms. In reality the objective should not necessarily be to reduce the level of the debt in absolute terms, but an effort should be made to reduce it as regards its relative magnitude with respect to exports and the national product, which are the indicators most commonly used in this respect.

b) *At the regional level*

A second element which will probably make its appearance in national policies will be the use as far as possible of the regional markets and the regional and subregional integration agreements. This represents a still unexplored field which could be used for the common bene-

fit of all the countries. In order to do this, it will be necessary to strengthen the regional co-operation machinery in both its trade and financial aspects. This topic is quite well known and has been studied by various bodies, so that it is not appropriate to consider it in detail here. Moreover, there is evidence that some subregional bodies are already acting in this direction.

At the regional level, a further expansion of the Inter-American Development Bank, its regular capital and its additional funds would be particularly important. There are some difficulties standing in the way of expanding the regular capital of the Bank, but it is to be hoped that these will be overcome and that the countries which have encountered problems in this respect will be able to eliminate the restrictions limiting its growth.

c) *At the international level*

At the international level, I believe that the expansion of the International Monetary Fund would be an extremely favourable element, provided that this expansion was much greater than recently agreed upon: US\$ 15 billion is a drop in the ocean compared with the present financial difficulties; probably the size of the Fund ought to be doubled, or more than doubled, yet so far it is only being increased by 47.5%.

The expansion of the World Bank would also be very favourable, provided that the Bank eliminates or ceases to apply a principle which it has been using in recent years: namely, the 'principle of graduality' whereby, in proportion as the per capita income of a country rises, that country ceases to be eligible for obtaining World Bank loans.

One of the important elements for the future is that there should be a change in the composition of the external liabilities of the countries. In other words, instead of having so much debt from private sources, as they do now, the countries should have more external investment and less external debt, while there should be relatively more debt from official sources and consequently less from private sources. An external liability structure in which there is relatively more investment and loans from official sources

offers much greater stability for the total financial resources and the total portfolio of external liabilities of the countries. Changes in interest rates would not then affect them so much, since official loans normally carry a fixed interest rate, and a problem of instability would thus be relieved. At the same time, foreign investment should behave in keeping with the economic cycles, that is to say, when a country suffers economic difficulties it should not have to pay profits to the exterior. Thus, remittances of profits on investments would be smaller when the economic situation was unfavourable, and greater when it was favourable, or at least incentives could be established to encourage this approach, which would help to relieve the external financing problem instead of complicating it.

3. *New instruments for co-operation*

Generally speaking, probably what is needed are not new institutions for co-operation, but merely new instruments for it. In this respect, I should like to mention first of all the question of exchange systems. It would be desirable that exchange rates should not float as much as they do now, but should be more 'viscous' as Giscard D'Estaing called them or 'guided' as Carlos Sanaguinetti suggested. These two terms imply an exchange system which does not fluctuate sharply or erratically in the world but has some degree of inertia, so that these fluctuations do not discourage the allocation of resources to activities connected with international trade.

In the case of Latin America, consideration could be given to new instruments of co-operation such as the possibility of establishing a common unit of account for the payment of services. Let us assume that the countries agree to establish a unit of account with a well-defined physical existence with which they could make their payments in respect of tourism, for example, with these payments being settled among the countries at the end of a certain length of

time. Each country would issue its own units of account, and each one would treat them as though they were foreign exchange, subject to the same restrictions and regulations. At the end of a certain length of time, such as three or six months, there would be a settlement of accounts in respect of these resources and only the outstanding differences would be paid in foreign exchange. This could save a really considerable volume of foreign exchange resources and consequently relieve the pressure on the reserves.

Furthermore, it is necessary to exchange financial information, for the countries know little or nothing about what is happening in other countries. The result of this is, for example, that at a given moment a country decides to come on the market with a bond issue on the same day that this is being done by another country, thus causing a drop in the price of the bonds and an increase in the cost for the issuer. If they had exchanged information they would simply have come to an agreement not to come on to the market at the same time. The manner of negotiation or renegotiation with the exterior could also be known by the countries, so that after a prior exchange of information they can each negotiate their own situation with fuller knowledge of the circumstances. Thus, some formula for the exchange of information could be extremely useful for all. Thought could also be given to the possibility of coming on to external markets not as individual banks, but perhaps as multinational enterprises. Why not form multinational enterprises in the financial field which can come on to international financial markets in that form instead of doing so, as happens at present, as individual banks which have much less capital, much less backing and run much greater risks because they are linked to the fate of a single country? In contrast, if multinational enterprises were formed, they would have behind them a group of countries which could diversify the risk much better.

VII

The future prospects

After taking due account of the nature of the possible short and medium-term solutions, I consider that in looking forward to the future we must have in mind one important concept: austerity. I have the impression that, in view of our level of imbalance, our level of indebtedness and the likelihood of a slow recovery of the world economy, our countries must necessarily look forward to a period of austerity. The way out of this problem will not be rapid, but slow and difficult. It is necessary to increase domestic saving, and in order to do this public and private consumption must suffer, in order to leave a margin for the growth of production in the area of tradeable goods and take advantage of the prospects of an eventual recovery of the world economy. The need for efficiency in the allocation of resources and in the social evaluation of projects will, I believe, become quite painfully evident. The more difficulties there are in a family, the greater care is exercised in the use of resources, and the same occurs with an enterprise or a country. This implies obligations and responsibilities not only for the government but also for each and every one of the citizens.

Finally, more austerity also calls for great concern to ensure the social distribution of the burden. If austerity and demands for effort and sacrifice are imposed in a manner which lacks equity, they will not be sustainable: they could be maintained for six months or a year, but finally the countries would not accept a type of austerity which only affects some citizens but not all.

In the final analysis, however, I am optimistic. Latin America has gone through difficult times in the past; we may recall that this is not the first crisis faced by the world economy. There was another very great crisis in the 1930s, and although it is true that the circumstances were different, that crisis left some lessons for us. It began at the end of 1929, yet in 1939, at the beginning of the war, unemployment in the industrialized countries was still very great. In 1941, when the United States entered the war, unemployment in that country was still running at 14% of the labour force although ten years had passed by then. We have learnt more now than we knew then, and we have other institutions, so that it will not be ten years this time, but even so the time needed to emerge from this problem must be reckoned in years rather than months.

Fortunately, signs of recovery of the world economy are already to be glimpsed. They are neither very marked nor very brilliant or dramatic, but they are nevertheless there. Order books are growing in the United States, stocks are dropping and have probably reached their lowest level, while housing construction is beginning to show some recovery. These are positive symptoms: of course they do not herald an easy or triumphant outcome, but they do represent an incentive for setting about the inevitable task of austere and equitable sacrifice so necessary for supporting us in our present difficulties.