

CEPAL

Review

Executive Secretary
Norberto González

*Deputy Executive Secretary for
Economic and Social Development*
Gert Rosenthal

*Deputy Executive Secretary for
Co-operation and Support Services*
Robert T. Brown

Director of the Review
Raúl Prebisch

Technical Secretary
Adolfo Gurrieri

Deputy Secretary
Rosa Nielsen



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

CEPAL

Review

Santiago, Chile

Number 27

CONTENTS

| | |
|---|-----|
| Foreign policy and international financial negotiations: the external debt and the Cartagena Consensus. <i>Jorge Eduardo Navarrete</i> | 7 |
| External debt: Why don't our governments do the obvious? <i>Guillermo O'Donnell</i> | 27 |
| External debt and crisis: the decline of the orthodox procedures. <i>Robert Devlin</i> | 35 |
| The external debt of the Latin American countries. <i>Raúl Prebisch</i> | 53 |
| Latin America and integration: options in the crisis. <i>Guillermo Maldonado Lince</i> | 55 |
| Trade and equilibrium among the ALADI countries. <i>Jorge Torres Zorrilla and Eduardo Gana</i> | 69 |
| A two-front attack to overcome the payments crisis of developing countries. <i>Fábio R. Fiallo</i> | 79 |
| The imperfections of the capital market. <i>Eduardo Sarmiento</i> | 97 |
| The agriculture of Latin America: changes, trends and outlines of strategy. <i>Joint ECIACIFAO Agriculture Division</i> | 117 |
| On the role of small and medium-sized enterprises in the improvement of the production structure of developing countries. <i>Carlo Secchi</i> | 131 |
| Twenty-five years of the Inter-American Development Bank. <i>Felipe Herrera</i> | 143 |
| A sélection of addresses delivered at the Expert Meeting on Crisis and Development in Latin America and the Caribbean (Santiago, Chile, 29 April to 3 May 1985) | 153 |

Where do we stand?

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

*Guillermo O'Donnell**

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

*Senior Researcher of CEBRAP. Academic Director of the Kellogg Institute of the University of Notre Dame, and UNDP consultant.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

II

Can anything be done?

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

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

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

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

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

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

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

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

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

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