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LATIN AMERICA'S DEBT: A REFORM PROPOSAL */

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INTRODUCTION

Rescue packages, rescheduling exercises, and IMF sponsored stabilization programs succeeded in preventing a major disruption of international financial markets, following the Latin American (L.A.) debt crisis of 1982. To consolidate this achievement, increasing consideration is being given to institutional reforms, at the national and international levels, designed to insure a healthy economic recovery of the heavily indebted L.A. countries.

What follows discusses the introduction of an insurance mechanism, in the context of a multi-year agreement between creditors and debtors. This mechanism is designed to insure debtor countries from adverse external shocks, conditioned on their attainment of satisfactory trade performance. The proposal builds on existing arrangements, economizes on official sources of funds, integrates the idea of a new export shortfall facility with that of an interest rate cap, and provides an explicit link between trade and finance. Before coming to it, we deal with some commonly asked questions about the origins of L.A.'s external difficulties and its prospects for recovery.

DISTINCT ORIGINS

The debt problems of L.A. countries today do not have a common origin. In fact, the diversity of economic experience in the region up to 1981/82 is enormous.

From an accounting point of view, net debt accumulation results from the sum of current account deficits with net capital outflows not compensated by direct investment inflows. Current account deficits are the most important factor, but they are by no means alone in explaining the surge of L.A. external indebtedness in the late seventies and early eighties. Consider the experience since 1979 of the seven L.A. countries currently with the highest debt levels: Brazil, Mexico, Venezuela, Argentina, Chile, Peru, and Colombia. For the group as a whole, the cumulative current account deficits since 1979 are responsible for about 2/3 of the increase

in their combined net external debt. The remaining 1/3 is accounted for by net capital outflows. Within the group, at one end you have the countries for which the debt is basically explained by the current account: Brazil, Colombia, Chile, and (since 1981) Peru. At the other end, there is Venezuela, which accumulated a sizable net external debt, while experiencing a surplus in its cumulative current account over the period. For Mexico and Argentina, current account deficits account for about 1/2 of the increase in external debt from 1979 to 1983.

Ignoring capital flight, and restricting attention only to the current account, the long-run consideration should first be made that it is perfectly normal for a developing country to run properly financed current account deficits. For these may simply reflect the existence of investment opportunities, which are not entirely tapped by domestic savings.

However, over the short-run, the deficits need not necessarily be associated either with a reduction in the real domestic savings rate or with an expansion of real investment. For national income, and hence, total domestic savings, may fall as a consequence of inadequate domestic pricing policies, such as overvalued exchange rates. These may make local firms unable to compete with cheaper foreign products, thus forcing a contraction of domestic output, employment, and savings. Furthermore, a temporary reduction of national income and savings below their potential value may also be caused by domestic supply shocks of a climatic or other nature.

But there are still other ways to obtain a deterioration in the current account, in the short-run. Worsening terms of trade cause an increase in the dollar value of domestic spending (which includes imports), relative to the dollar value of national output (which includes exports), even as the underlying real magnitudes remain constant. Increased real dollar interest rates reduce the value of national income and savings, out of a given domestic income, if the country is a net debtor to start with. Finally, for a given domestic spending level, national income and savings are reduced as exports fall on the

wake of a world recession or of external protectionism.

Thus, in principle, in the short-run, a deficit may result from excess domestic spending, wrong price policies, domestic supply shocks, adverse external shocks, or a combination thereof. An empirical examination is required to determine which of these reasons prevail in particular instances.

In the case of L.A. since 1978, an empirical analysis reveals a mixed picture. When 1981 is compared with 1978, the following facts stand out. The deterioration of Brazil's current account is entirely explained by adverse external shocks. In Colombia, external variables are responsible for about 1/2 of the deterioration, the other 1/2 resulting from an import bulge associated with an investment expansion. External variables account for about 1/3 of the current account deficit expansion in Chile and Argentina. The remaining 2/3 are due to a significant exchange rate overvaluation, which, in the case of Chile, was associated with a recovery of domestic investment levels. Terms of trade moved favorably to Peru, Mexico and Venezuela. The current account improvement of the latter is entirely accounted for by the oil market developments of the period. Domestic demand expansion, accompanied by import liberalization and some exchange rate overvaluation, are factors behind Peru's external accounts deterioration. A loss of trade competitiveness, caused by a lagging real exchange rate, underlies Mexico's current account deficit expansion in these years.

COMMON EXTERNAL SHOCKS

This diversity of experience does not imply that the macroeconomic policy problems of L.A. are specific to each country, and that no generalization applies to the region as a whole.

The reason why such diverse countries all face a common debt problem today was the association of very severe current and capital account shocks in 1982. World recession, interest rate increases, and terms of trade deterioration fell upon

oil and non-oil exporting countries alike. Thus, the purchasing power of exports fell by 6 per cent for the region as a whole, while the ratio of total interest payments to exports of goods and services rose from 26 per cent in 1981 to 38 per cent in 1982. This was accompanied by a cessation of voluntary bank lending to the region, in some cases aggravated by capital flight. Thus, net capital inflows fell from \$37.9 billion in 1981 to \$16.7 billion in 1982.

Rescue packages, forced reschedulings, and interest arrearages followed as a consequence. This process was accompanied by sometimes massive exchange rate devaluations and dramatic domestic spending cuts, as it can be visualized in the accompanying table.

DOMESTIC ADJUSTMENT

In terms of the balance-of-payments, the pay-offs of these austerity measures have been quite high. The turn-arounds of the current accounts of some countries have been nothing short of spectacular. Mexico, in particular, managed to transform a current account deficit of \$13.9 billion in 1981 into a current account surplus of \$5.3 billion in 1983. Venezuela went from a \$3.4 billion deficit in 1982 to a \$5.0 billion surplus in 1983. Chile succeeded in cutting by nearly 3/4 in 1983 its \$4.2 billion deficit of 1981. Brazil and Argentina slashed their external deficits by about 1/2 from 1981 to 1983. Modest improvements were also obtained by Peru and Colombia.

But this gives too optimistic a picture of what has been accomplished so far. The reason being that there are two distinct ways to improve the external accounts of a country. Enhanced competitiveness is one; domestic recession is the other. A country may succeed in exporting more and importing less because of the competitive strength of its export and import substituting industries. Or else because shrinking domestic sales induce local firms to buy fewer intermediate imports abroad, while forcing them to temporarily dump their products in external markets. Unfortunately, a significant part of the L.A. external success in

1983 was achieved at the cost of domestic output contraction. Hence, part of the external gains will last only as long as the recession does.

EXPORT-LED RECOVERY?

Recent studies have suggested that L.A. countries can now count on an export-led recovery. But, in some L.A. countries, inflation is still rampant and needs to be set under control, before growth can resume. Apart from that, for the region as a whole, the success of any export drive will depend on the sustainability of the present world recovery. Also, what is at stake for the resumption of GDP growth in L.A. is not how much is exported, but how much foreign exchange is left over to acquire imports, after payment of debt service. This is so, because, overall, L.A. imports have now been reduced to essential items, which will necessarily need to expand, accompanying a general economic recovery.

In the case of Brazil, I have calculated the foreign exchange requirements for the resumption of historically normal GDP growth rates over the next five years¹. Assumptions are a constant dollar interest rate and a dollar inflation of 5 per cent per year. Roughly speaking, under historically normal import coefficients, I found these foreign exchange requirements to be that the dollar value of exports grow no less than 12 per cent per year, and that the external debt grow no less than 5 per cent per year, which is the assumed rate of world inflation. Roughly equivalent results for debt expansion are obtained by Ernesto Zedillo, in the case of Mexico².

These requirements do not seem very stringent, but it does not follow that L.A. recovery is around the corner.

1/ See Edmar Bacha, "External shocks and growth prospects: the case of Brazil, 1973-1989". New York: UNCTAD, unpublished ms., June 1984.

2/ See Ernesto Zedillo, "Mexico's recent balance of payments experience and prospects for growth". New York: UNCTAD, unpublished ms., June 1984.

In the case of Brazil, for example, results are very sensitive to assumptions regarding the behavior of external variables. This is a country from which capital flight did not take place, hence, under current international arrangements, a reversal of its present capital account tightness depends entirely either on a sudden reestablishment of Brazil's creditworthiness in international financial markets, or on massive capital transfers from other sources. What we will more likely be witnessing is a continuation, ad nauseam, of the current rescheduling exercises. In the latter context, the growth prospects of the country will be by and large dictated by the availability of foreign exchange. Brazil's imports are currently very compressed; in 1983, the GDP share of goods and non-factor services imports was less than 9 per cent. But most of these were essential imports. Hence, it would take a very large fall of GDP if the need arrived to further compress imports. Interest rates are a obvious threat, as each one per cent increase in them costs Brazil about \$700 million dollars annually. Thus, the current export expansion will fail to lead a recovery, if international interest rates continue to go up. Independently of this, exports will not do the trick if their expansion (when measured against the very low 1982 base) is immediately taken as a sign of less need for fresh money, under the annual rescheduling exercises.

Other L.A. countries are even more dependent than Brazil on the vagaries of a few commodity markets. Their current accounts are also deeply affected by interest rate variations, while external financing depends almost entirely on the annual rescheduling exercises, as financial markets are closed for all L.A. countries, even those, like Colombia, with relatively low debt ratios.

Thus, even though our base forecast is for L.A. recovery, the conclusion is that currently there is too much uncertainty in the international scenario to permit the highly indebted L.A. countries to adequately plan their growth strategies.

A NEW DEAL

It is a fact that this uncertainty affect all countries, both developed and developing. L.A., however, is a special case, because there is a deal to be made.

The region faces a situation which is highly specific of sovereign debtors which are constrained by the availability of foreign exchange. Currently, the social worth of each additional dollar for the region is many times higher than its observed market value. Moreover, the costs of domestic adjustment have already been very significant. Hence, the social and political pressures on L.A. governments will be enormous to maintain imports and delay interest payments, if the external environment prevents the region from recovering. However, if an adequate insurance mechanism against external shocks is provided, these countries would have a strong incentive to remain punctual in their debt payments, in order to continue enjoying the benefits of an open international trade and payments system.

Banks and governments in the creditor countries, on the other hand, are anxious to avoid the disruption of international markets, which would result from the accumulation of significant postponed interest payments on the L.A. debt. They should, thus, be willing to provide the insurance mechanism that L.A. requires, as this would considerably lessen the risks of such a disruption.

INSURANCE MECHANISM

The mechanism would be a multi-year agreement between creditors and debtors, designed to ensure that, starting from an adequate initial base, the volume of imports of the debtor countries may grow at rates sufficiently high for these countries to resume their past trend GDP growth rates. For the purpose of illustration, suppose that net capital inflows other than bank loans exactly compensate the necessary build-up of international reserves. Then, the volume of imports will depend on the simplified expression:

$$\frac{\text{dollar value of exports} + \text{fresh bank money} - \text{interest payments}}{\text{unit dollar value of imports}}$$

To implement the mechanism, targets for the provision of fresh bank money would be established for a multi-year period, on the basis of export volume targets, on one hand, and forecasts of interest rates and export and import prices, on the other. Fresh money would be provided by a cap on interest rates. The difference between market and capped interest rates would be capitalized, at market rates, according to previously agreed amortization schedules. For example, in the case of Brazil, a rough estimate is that the volume of fresh money would need to correspond to about one-half of the interest bill over the 1985-89 period.

Next the assurance would be provided that the volume of fresh money would vary inversely with the value of exports and directly with the level of market interest rates, so as to always meet the import target. These variations in fresh money volume would be obtained by varying the level of the cap, in response to unanticipated variations in export volume or the terms of trade.

CONDITIONALITY CLAUSES

Attention should be given to two problems, namely, adequate incentives for the debtor countries to do their best to expand exports, and eligibility requirements to restrict the number of countries applying for the insurance mechanism.

Both problems can be solved, through adequate conditionality clauses, the implementation of which would be supervised by an international organization. First, as long as this insurance mechanism applies, a debt covenant would insure that debtor countries do not have access to alternative sources of hard currency finance. Second, strict export performance clauses would be set, against the background of anticipated growth rates of world trade. A waiver would apply only if the supervising international organization determined that the causes of an eventual export

shortfall were beyond the debtor country's control. Such waiver would be necessary for the provision of additional fresh money, in the form of a temporary lowering of the capped interest rate.

These conditions seem sufficiently restrictive to guarantee that only debtor countries which are actually constrained by the availability of foreign exchange would apply for the insurance. Others would prefer to reestablish their financial creditworthiness on their own. Also, the provisions are such that only countries with high debt service ratios would be interested in the facility, as fresh money would be provided through interest rate capitalization.

The conditionality system also introduces an element of symmetry between creditors and debtors, and a link between trade and finance. The faster exports from debtor to creditor countries grow, the less need there will be for fresh money. Thus, a countervailing influence is introduced against protectionist trends in industrial countries markets.

The proposal builds on existing institutions, and on suggestions which are already been discussed by the international community, such as a new compensatory facility for export shortfalls, an interest rate cap, and multi-year reschedulings. Finally, the suggested mechanism economizes on the use of official bilateral and multilateral loans, since fresh money is generated by capitalizing mostly private bank interest. Official funds can thus continue to be provided internationally on basis other than a country's past debt to private banks.

A further question may arise, relating to the establishment of conditions on domestic variables, such as budget deficits and money supply.

There can be little disagreement that budget deficits in L.A. generally are too high, and that money supply consequently is frequently out of control. These problems need to be solved, to guarantee a healthy economic expansion, in L.A. as elsewhere. However, all needed reforms cannot be implemented at once; and, in

the case of L.A., the balance of payments is the problem which mostly concern the international community. If this premise is accepted, the recent L.A. experience shows how tenuous can be the relationship between the balance of payments and domestic phenomena, such as budget deficits and inflation rates, at least in the short-run. The target for the Mexican government budget deficit in 1983 was supposedly set to be consistent with a current account deficit of 4 billion dollars. The target budget deficit was met with exactitude, but the current account displayed a surplus of 5.5 billion dollars. More dramatic was the case of Brazil, which had a trade performance better than targeted in 1983. However, its IMF program had to be suspended for most of the year, because the country did not come close to meeting the domestic performance criteria of the program.

Furthermore, such domestic criteria too often tend to become highly politicized, as they involve conflicting interest group pressures in each country. In some cases, international organizations may be welcome to play a useful broker or cathartic role among warring domestic factions, but at least in L.A. the record is not very encouraging. It seems to be politically wiser to induce domestic austerity indirectly, through the establishment of strict conditions on trade performance.

Time has probably come to give more thought to direct balance of payments conditionality, whenever it is found, on economic and political grounds, to be a superior instrument of adjustment.

A final point needs to be made. The mechanism is designed to help promoting a positive solution to the debt crisis. It provides debtor countries with the assurance of additional financing, in case external shocks prevent them from adequately adjusting to a situation of reduced capital transfers from abroad. However, it cannot do miracles. A growth enhancing solution to the debt crisis ultimately depends on the adoption of sound economic policies, in creditor and debtor countries alike, associated with alternative forms of voluntarily transferring capital from the former to the latter.

SUMMARY

The argument can be summarized as follows:

. The origins of current balance of payments difficulties are different for each L.A. country. The reason why such diverse countries all face a common debt problem today was the association of very severe current and capital account shocks in 1982.

. Rescue packages, forced reschedulings, and interest arrearages were accompanied by sometimes massive exchange rate devaluations and dramatic domestic spending cuts in the region, in 1982 and 1983.

. The external accounts of most L.A. countries turned around in 1983, at the cost of a profound recession. The prospects for economic recovery are very sensitive to assumptions regarding the behavior of external variables. Currently, there is too much uncertainty in the international scene, to permit the highly indebted L.A. countries to adequately plan their growth strategies.

. The social and political pressures on L.A. governments will be enormous to maintain imports and delay interest payments, if the external environment prevents the region from recovering. However, if an adequate insurance mechanism against external shocks is provided, these countries would have a strong incentive to remain current on their debt payments, in order to continue enjoying the benefits of an open international trade and payments system.

. The mechanism would be a multi-year agreement between creditors and debtors, ensuring that the volume of imports of the debtor countries may grow at rates sufficiently high for these countries to resume their past trend GDP growth rates.

. Fresh money would be provided by a variable cap on interest rates. The difference between market and capped interest rates would

be capitalized, according to previously agreed amortization schedules. The level of the cap would vary in response to unanticipated variations in export volumes or the terms of trade.

. An international organization would supervise the implementation of conditionality clauses on the debtor countries' balance of payments. First, a debt covenant would be established barring the access of debtor countries to alternative sources of hard currency finance. Second, export performance criteria would be set, against the background of anticipated growth rates of world trade. A waiver would apply only if the supervising international organization determined that the causes of an eventual export shortfall were beyond the debtor country's control.

. Conditions on domestic variables, such as the budget deficit and money supply, would not necessarily be set, if, on economic and political grounds, it was found that direct balance of payments conditionality was a superior instrument of adjustment.

TABLE 1

LATIN AMERICA: EXTERNAL SHOCKS, BALANCE OF PAYMENTS, DOMESTIC ADJUSTMENT AND OUTPUT COSTS

	1981	1982	1983		
<u>External Shocks</u> ⁽¹⁾ ...					
Purchasing power of exports of goods (percentage change from previous year)					
All L.A.	- .9	-6.0			- .7
(Oil exporters)	(.3)	(-3.8)			(-2.8)
(Non-oil exporters)	(-3.9)	(-8.8)			(9.6)
Ratio of total interest payments to exports of goods and services					
All L.A.	.26	.38			.35
(Oil exporters)	(.22)	(.31)			(.32)
(Non-oil exporters)	(.31)	(.46)			(.38)
Net capital inflows (US\$ billions)					
All L.A.	\$37.9	\$16.7			\$3.2
(Oil exporters)	(\$12.9)	(-\$ 1.6)			(-\$6.7)
(Non-oil exporters)	(\$25.0)	(\$18.3)			(\$9.9)
<u>Balance of Payments</u> ⁽¹⁾					
<u>Performance</u>					
Current account balances (US\$ billions)					
All L.A.	-\$40.3	-\$36.3			-\$6.1
(Oil exporters)	(-\$12.8)	(-\$ 9.5)			(\$9.3)
(Non-oil exporters)	(-\$27.5)	(-\$26.8)			(-\$15.4)
<u>Adjustment efforts in 1983...</u>	<u>Argentina</u>	<u>Brazil</u>	<u>Chile</u>	<u>Mexico</u>	<u>Venezuela</u>
(percentage changes from peak values in the 1980-82 period)					
• Real domestic spending cuts ⁽²⁾	-6.3	-12.7	-30.3	-11.7	-11.7
• Real effective exchange rate devaluations ⁽³⁾	-34.7	-23.7	-17.8	-23.4	-35.2
<u>Domestic output costs</u> ...					
(percentage changes from peak values in the 1980-82 period) ⁽²⁾					
• GDP contraction	-8.6	-5.2	-16.2	-5.0	-4.8

(1) Source: United Nations Economic Commission for Latin America Economic Survey of Latin America, 1983: Advance Summary. Santiago, Chile: ECLA, March 1984.

(2) For Argentina, variations are measured from 1981 to the 3rd quarter of 1983. For Brazil, from 1980 to 1983. For Chile, from 1981 to the 2nd quarter of 1983. For Mexico, from 1981 to 1983. For Venezuela, from 1982 to 1983. Original sources: Central Bank of Argentina, Vargas Foundation, Central Bank of Chile, Bank of Mexico, Central Bank of Venezuela. The Brazilian figures are the author's estimates, based on preliminary data from Vargas Foundation. For Mexico and Venezuela, the same deflator is assumed to apply for domestic spending and GDP.

(3) For Argentina, Chile and Mexico, variations are measured from 1981 to 1983. For Brazil, from 1982 to 1983. For Venezuela, from 1982 to March 1984.
Source: Morgan Guaranty.

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