CEPAL

Review

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ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARIBBEAN

SANTIAGO, CHILE, APRIL 1989

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Notes and explanation of symbols

The following symbols are used in tables in the *Review:*
Three dots (...) indicate that data are not available or are not separately reported.
A dash (—) indicates that the amount is nil or negligible.
A blank space in a table means that the item in question is not applicable.
A minus sign (-) indicates a deficit or decrease, unless otherwise specified.
A point (.) is used to indicate decimals.
A slash (/) indicates a crop year or fiscal year, e.g., 1970/1971.
Use of a hyphen (-) between years, e.g., 1971-1973, indicates reference to the complete number of calendar years involved, including the beginning and end years.
Reference to "tons" mean metric tons, and to "dollars", United States dollars, unless otherwise stated.
Unless otherwise stated, references to annual rates of growth or variation signify compound annual rates.
Individual figures and percentages in tables do not necessarily add up to corresponding totals, because of rounding.

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CEPAL REVIEW No. 37

The conduct of Latin America's creditor banks

*Michael Mortimore**

The international crisis of indebtedness with transnational banks arose from a number of causes, of which the three main ones are the following: the negative repercussions of the world economic situation, the effects of the conduct of borrowers, and the consequences of the behaviour of the main transnational banks. The first two of these have been the subject of exhaustive analysis, but this has not been so in the case of the third cause, mainly because of the lack of concrete detailed information. This article sets forth the new ideas which emerged from the Interregional Project on Transnational Banks undertaken by the United Nations Centre on Transnational Corporations, the executing agency for which was the Joint ECLAC/CTC Unit on Transnational Corporations. This project was directed by the author of the present article.

It has been possible to define the consequences of the behaviour of the transnational banks more clearly on the basis of an analysis of the behaviour of these institutions both during the boom period of lending to the countries and during the period of debt restructuring. For this purpose, an analysis was made of the loan contracts signed by the transnational banks with six countries. The main banks which organized lending to developing countries through syndicated Eurocurrency credits were divided into three categories termed "leaders", "challengers" or "followers", depending on their conduct during the loan organization boom. This clearly showed the negative consequences of the predominant role played by the "leaders" during the formative period of the process of restructuring the debt with the transnational banks. This clearer idea of the behaviour of these banks, as a factor in the generation and spread of the debt crisis, permits a more realistic basis to be established for the sharing of the costs involved in the adjustment.

*Staff member of the Joint ECLAC/CTC Unit on Transnational Corporations.

The author wishes to express his gratitude to a number of persons who provided very useful comments on the English draft of the original report on the Interregional Project and to emphasize that they bear no responsibility for any errors which may remain. In particular, he wishes to express his thanks to Joseph Ramos, Robert Devlin, Fernando Fajnzylber, Alejandro Vera, Eugenio Lahera, Osvaldo Sunkel and Roberto Zahler of ECLAC; Karl Sauvant and Azizul Islam of the United Nations Centre on Transnational Corporations (UNCTC); Manuel Agosin of UNCTAD; Benny Widyono of the United Nations Regional Commissions Liaison Office; and Enrique de la Piedra, Marianne Scholte and an unnamed Canadian bank from outside of the United Nations system. The author would also like to thank the many participants in the ECLAC internal seminar held on the topic.

While it is recognized that debtor country behaviour and negative impacts from the international economic environment have also been basic factors behind the international debt crisis, these factors have been the subject of considerable analysis, especially by multilateral institutions such as the International Monetary Fund and World Bank. This article therefore focuses on transnational bank (TNB) behaviour, because of the scant attention it has received. The author was the co-ordinator of the United Nations Centre on Transnational Corporations (UNCTC) interregional project on TNBs which examined this subject.[1] The aim of this project was to analyse the behaviour of different categories of transnational banks during the boom in sovereign lending to developing countries and during the subsequent debt restructuring process. The project consisted of six country case studies[2] in which relevant information was collected from the loan contracts made with TNBs. That information provided the basis for a new appreciation of TNB behaviour during the boom in sovereign lending and the debt restructuring process which followed.

[1] See Michael, Mortimore, "Transnational Bank Behavior and the International Debt Crisis: Report of the UNCTC Interregional Project on Transnational Banks", September 1988, *mimeo.*

[2] The basic inputs for the case studies were the following: Eric Calcagno, *Los bancos transnacionales y el endeudamiento externo en la Argentina*, Cuadernos de la CEPAL series No. 56 (LC/G.1483-P), Santiago, Chile, November 1987, United Nations publication, Sales No. S.87.II.G.13; Alberto Couriel, "El Uruguay empobrecido: deuda externa y modelo neoliberal", November 1987, *mimeo*; Robert Devlin, *Transnational Banks and the External Finance of Latin America: the Experience of Peru* (E/CEPAL/G.1124), Santiago, Chile, December 1983, United Nations publication, Sales No. E.82.II.G.12; Robert Devlin and Michael Mortimore, *Los bancos transnacionales, el Estado y el endeudamiento externo en Bolivia*, Estudios e Informes de la CEPAL series No. 26 (E/CEPAL/G.1251) Santiago, Chile, June 1983, United Nations publication, Sales No. S.83.II.G.22; Jorge Luis Garay, "El papel de la banca comercial internacional en el endeudamiento externo público de Colombia, 1970-1983", August 1985, *mimeo*; Cristina Que Orbeta, "The Role of Transnational Banks in External Finance: the Philippine Experience", June 1986, *mimeo.*

I

TNB behaviour during the credit boom

It was found that, according to their size and general behaviour in organizing syndicated credits during the boom, the twenty-five principal TNB organizers of such credits could be classified into three groups: five *leaders* (Citicorp, Chase Manhattan, Bank America Corp., J.P. Morgan and Co. and Manufacturers Hanover): all North American banks which dominated the process of syndicating sovereign loans; ten *challengers* (Lloyds, Bank of Montreal, Bank of Tokyo, Bankers Trust, Chemical Bank, Canadian Imperial Bank of Commerce, Toronto Dominion Bank, Commerzbank A.G., Bank of Nova Scotia and Long Term Credit Bank): mainly smaller non-U.S. banks which actively competed with the leaders in the organization of syndicated credits; and ten *followers* (National Westminster, Deutsche Bank, Royal Bank of Canada, West Deutsche L.B., Dresdner Bank, Barclays Bank, Midland Bank Group, Credit Lyonnais, Industrial Bank of Japan and Banque Nationale de Paris): all large non-U.S. banks which, though active in the organizing of syndicated credits, were generally less active than both leaders and challengers. These categories provided an initial objective standard by which to distinguish the lending behaviour of the principal organizers of syndicated credits.

Based on existing literature on the subject, information from secondary sources and the original case studies carried out by the ECLAC/CTC Joint Unit, the hypothesis was advanced that a group of challengers, through price competition, had undercut the dominant position of the leaders in the syndicated loan market. Assuming that the different behaviour of distinct categories of TNBs would have varying impacts in debtor countries during both the credit boom and the debt restructuring period, it was decided to test the hypothesis by way of case studies in some of the more indebted developing countries. The findings demonstrated that while the original hypothesis was correct, TNB behaviour was considerably more complex than anticipated.

It was found that the top twenty-five organizers very much dominated the supply of syndicated credits in these countries. As may be seen from table 1, they organized between one-half and two-thirds of the value of those credits in the larger countries (Argentina, Philippines, Colombia and Peru) and about three-quarters of the total value in the smaller countries (Bolivia and Uruguay). If the amounts mobilized by the dominant organizers are scaled to a similar proportion of the total value for each country (37-47%), there is a sharp differentiation. While fifteen principal organizers were involved in Argentina and between five and 10 in the cases of the Philippines, Colombia and Peru, only two or three were involved for Bolivia and Uruguay. With regard to the category of the organizers, it can be appreciated that while the leaders and challengers organized similar amounts for these countries, their emphasis varied considerably in the sense that the leaders concentrated relatively more on Peru, Bolivia and Uruguay whereas the challengers organized relatively more in the cases of Argentina, the Philippines and Colombia. The followers occupied positions between those of the leaders and the challengers in most cases. This suggests that there were clearly different behaviour tendencies on the part of the different categories of banks.

The six case studies consisted of three which could be termed more price-competitive markets —that is, sovereign borrowers in which increased price competition by banks to place syndicated credits was coupled with increasing volumes of lending during the boom (the cases of Argentina, the Philippines and Colombia, as shown in figure 1)— and three which might be labelled riskier markets: that is, those in which such price competition did not exist or at least was not coupled with rising volumes of lending during the boom (the cases of Peru, Bolivia and Uruguay, shown in figure 2). The principal behavioural tendencies of the different categories of TNB organizers, by type of market, are summarized below.

Table 1

INTERREGIONAL PROJECT: RANKING OF PRINCIPAL ORGANIZERS OF SYNDICATED CREDITS IN CASES STUDIED, 1974-1982

(Rank values and millions of 1980 US dollars)

	Argentina	Philippines	Colombia	Peru	Bolivia	Uruguay	Total capital mobilized[a]
Leaders	**1 269.4**	**1 069.0**	**492.8**	**940.7**	**726.0**	**450.5**	**4 948.4**
Citicorp	1	1	-	4	2	1	1 493.9
Bank America	11	-	2	1	1	2	1 232.0
Manufactures Hanover	6	4	-	5	-	-	950.3
Chase Manhattan	-	2	-	3	-	-	812.3
J.P. Morgan and Co.	4	-	-	-	-	-	460.0
Challengers	**1 685.2**	**1 452.1**	**914.5**	**625.1**	**103.4**	**122.3**	**4 902.5**
Bank of Tokyo	3	6	3	7	-	-	827.3
Bank of Nova Scotia	8	10	5	-	-	-	781.1
Lloyds	2	5	-	-	-	-	652.9
Chemical	12	-	1	-	-	-	600.7
Bank of Montreal	9	3	-	-	-	-	530.5
Bankers Trust	-	8	-	-	-	-	440.2
Toronto Dominion	-	-	-	-	-	-	362.1
Canadian Imperial Bank of Commerce	7	-	-	-	-	-	295.7
Long Term Credit Bank	-	-	-	-	-	-	294.4
Commerzbank A.G.	-	-	-	-	-	-	117.6
Followers	**1 315.8**	**618.4**	**561.0**	**374.1**	**207.8**	**-**	**3 077.1**
Industrial B. of Japan	10	-	-	-	-	-	431.7
Credit Lyonnais	5	-	-	6	-	-	417.9
Dresdner	-	-	-	-	3	-	397.5
Barclays	-	-	-	-	-	-	378.2
West Deutsche LB	15	-	-	-	-	-	335.7
Royal Bank of Canada	-	-	-	-	-	-	302.3
Midland Group	-	-	-	-	-	-	262.6
National Westminster	-	-	-	-	-	-	207.7
Deutsche Bank	-	-	-	-	-	-	188.7
Banque Nat. de Paris	-	-	-	-	-	-	154.9
Number of principal organizers	15	10	5	7	3	2	17
Percentage capital mobilized by them[b]	39	43	37	37	48	47	40
Percentage capital mobilized by top 25	49	56	65	52	74	78	56

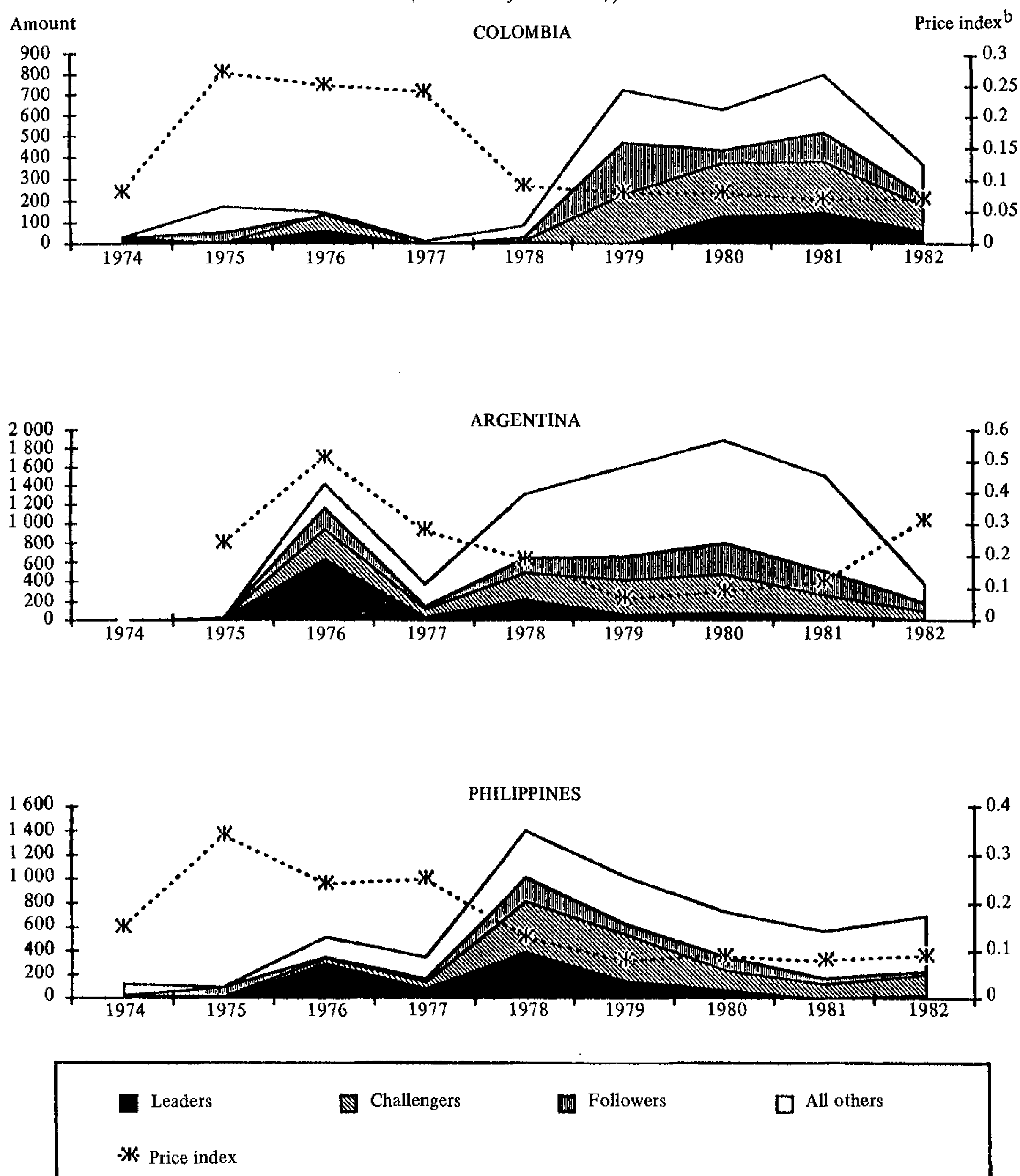
Source: ECLAC/CTC Joint Unit.
[a] Includes loans mobilized by these banks in all case studies.
[b] Includes only ranked banks.

The information from the case studies suggests that all categories of organizers, as well as other banks, were more active in the more price-competitive markets than in the riskier borrowers. In the first-named markets, such as Argentina, the Philippines and Colombia, the leaders, the challengers and the followers were all active in the organization of syndicated credits for the public sector or guaranteed by that sector, but the challengers were much more active than the leaders, who tended to vacate those markets as price competition stiffened and potential earnings shrank. The challengers continued to organize syndicated loans for public sector borrowers, compensating for lower earnings (fees, commissions and interest) by mobil-

Figure 1

CAPITAL MOBILIZED[a], BY CATEGORY OF BANK IN MORE PRICE-COMPETITIVE CASES (1974-1982)

(Millions of 1980 US$)



Source: ECLAC/CTC Joint Unit.

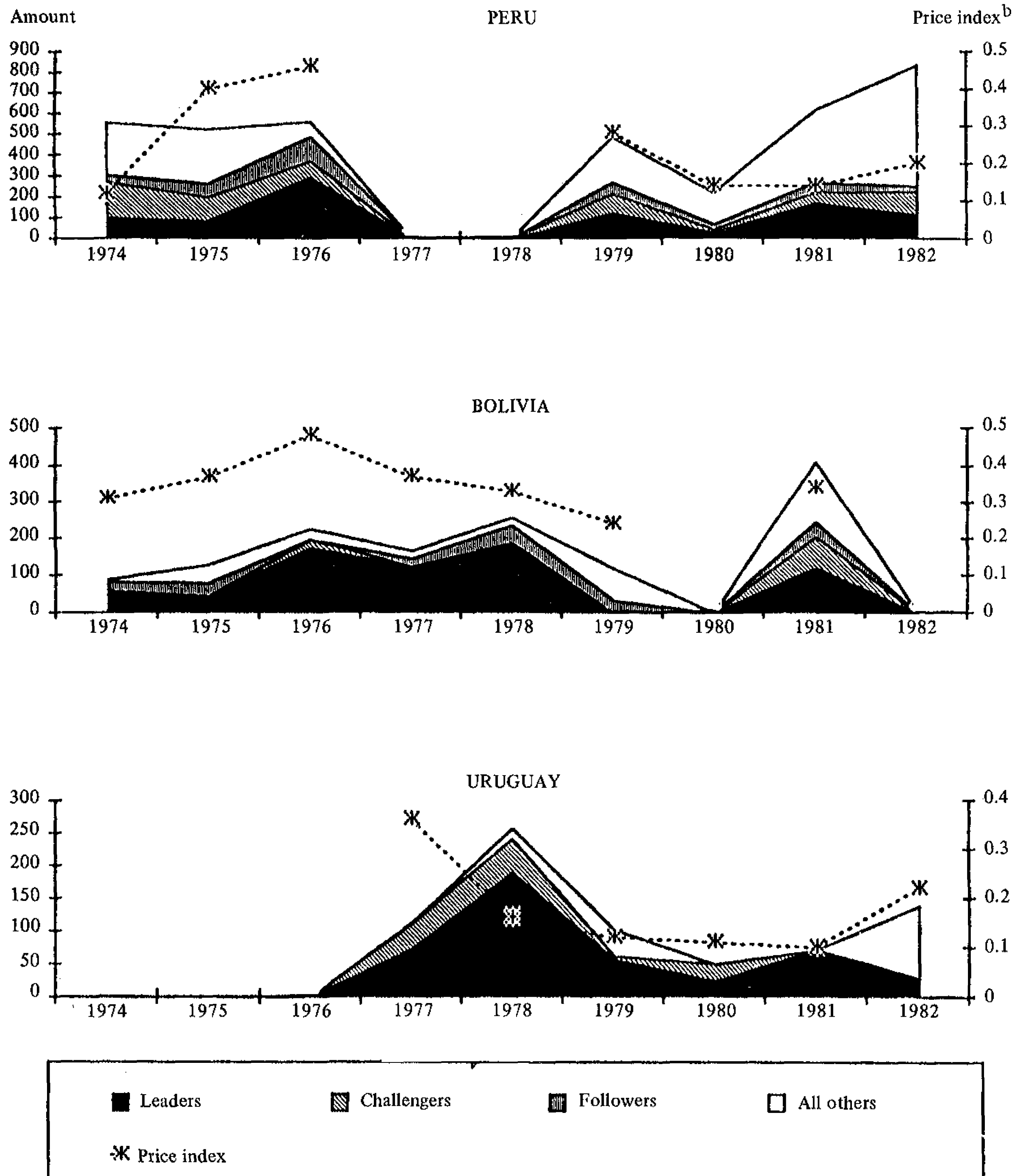
[a]According to this concept, the total value of the loans is assigned to the organizing bank (manager) or distributed equally among co-managers.

[b](Commission/Maturity + Spread)/Maturity.

Figure 2

CAPITAL MOBILIZED[a], BY CATEGORY OF BANK IN RISKIER CASES (1974-1982)

(Millions of 1980 US$)



Source: ECLAC/CTC Joint Unit.

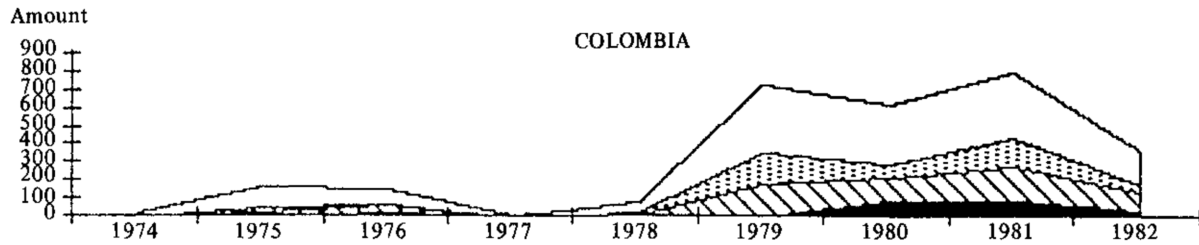
[a]According to this concept, the total value of the loan is assigned to the organizing bank (manager) or distributed equally among co-managers.

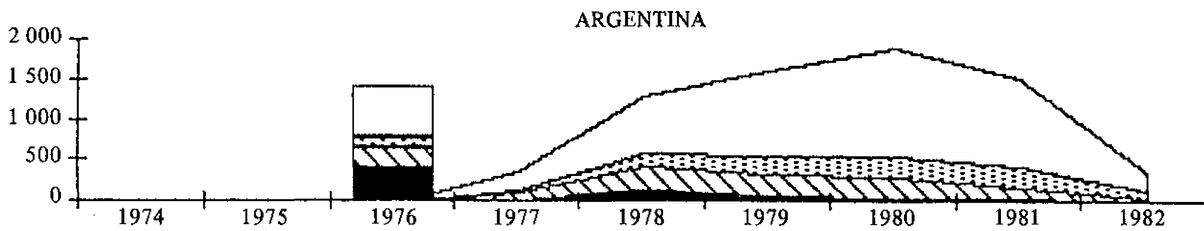
[b](Commission/Maturity + Spread)/Maturity.

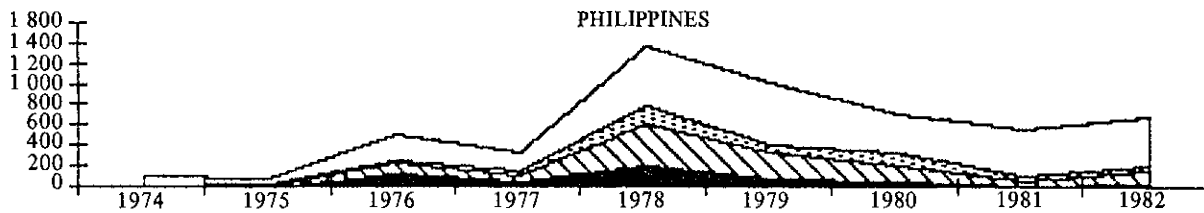
Figure 3

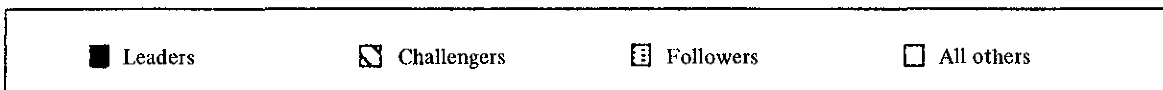
PARTICIPATION IN SYNDICATED CREDITS, BY CATEGORY OF BANK, IN THE MORE PRICE-COMPETITIVE CASES (1974-1986)

(Millions of 1980 US$)







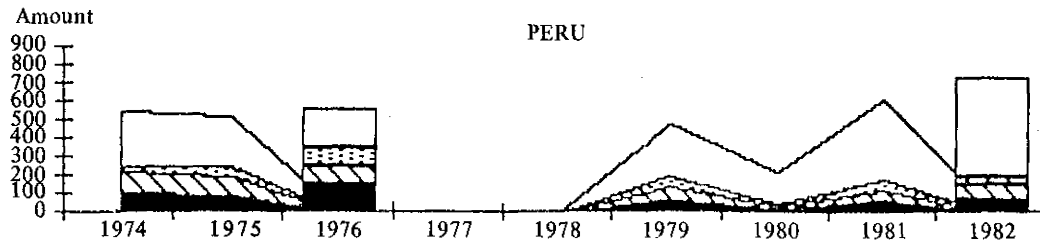


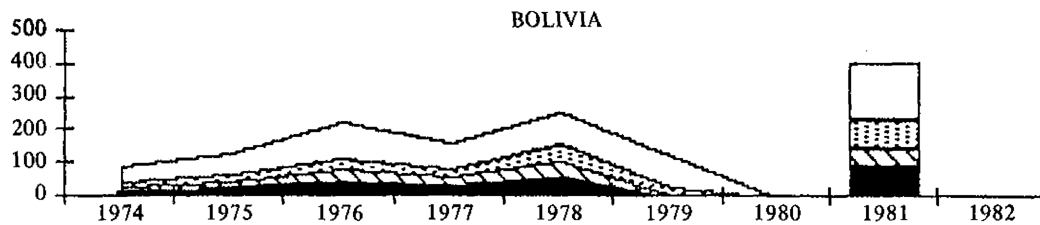
Source: ECLAC/CTC Joint Unit.

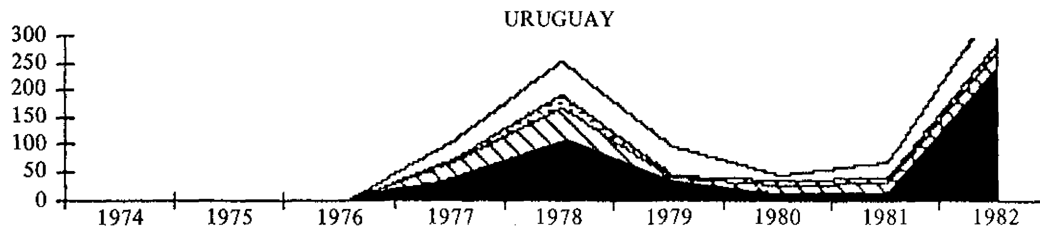
Figure 4

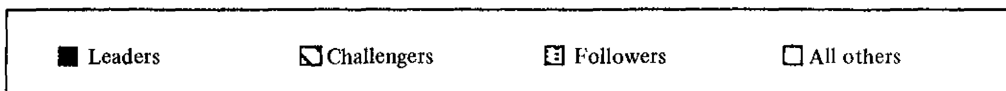
PARTICIPATION IN SYNDICATED CREDITS, BY CATEGORY OF BANK, IN THE RISKIER CASES (1974-1986)

(Millions of 1980 US$)









Source: ECLAC/CTC Joint Unit.

izing ever-increasing volumes. The leaders, however, tended to focus their attention on riskier (often unguaranteed) private sector borrowers in these countries, usually granting direct loans carrying a considerably steeper rate of interest. The followers, for their part, were active in differing degrees in both areas, but at levels lower than the challengers in organizing syndicated credits and lower than the leaders in placing direct loans with private sector borrowers. Other banks, particularly, banks entering the syndicated loan market for the first time, were increasingly the most important participants in the syndicated credits put together by the twenty-five principal organizers, in which interest earnings were severely reduced through heightened price competition. A comparison of figures 1 and 3 demonstrates the distinct behaviour of the leaders in organizing and participating in syndicated credits in the more price-competitive markets.

In the riskier markets, such as Peru, Bolivia and Uruguay, the leaders were very much more active than other banks in organizing and participating in syndicated credits to the public sector (or guaranteed by such), as well as —to a limited degree— in lending directly to private sector clients. During the boom the challengers were relatively inactive among these less creditworthy clients, while the followers, once again, demonstrated a bit of both types of behaviour, organizing more credits than the challengers but considerably less than the leaders in these riskier countries. Banks outside of the group of principal organizers were the major participants in those syndicated loans mobilized by leaders and, to a lesser extent, followers. In partial compensation for their much higher level of risk-taking, the leaders received high fees, commissions and interest earnings from these riskier clients. A comparison of figures 2 and 4 demonstrates that the leaders dominated the organization of credits for these markets and were the most prominent participants within the category of the top twenty-five organizers.

While it is clear that most of the principal organizers clearly overlent to major debtors during the boom, this common effect masks at least two distinct behavioural tendencies. The challengers overlent to the more creditworthy clients due to the competitive frenzy which took hold during the boom in sovereign lending. These banks tended to assume excessive exposure to potential insolvency due to "disaster myopia".[3] This means that because of competitive pressures which eroded the returns to lenders over time, many banks had to forego the collection of an uncertainty premium for accepting exposure to a major shock of low but unknown probability and/or to allow their capital positions to decline or their exposure to funding shocks in the interbank market to rise. This phenomenon represents a technical failure in risk estimation or creditworthiness evaluation which was converted into a systemic tendency, and it became particularly characteristic of the behaviour of challengers and new entrant banks. This behaviour stems primarily from what could be labelled a transactional perspective to sovereign lending: that is, to say, an urge to increase market share by way of ever-larger transactions with the more creditworthy of existing clients.

The leaders appear to have overlent for different reasons. Given their pronounced short-term profit orientation, these organizers felt compelled to move outside the confines of the public sector borrowers of their more creditworthy clients to place higher-return loans with significantly more risky clients, such as sovereign borrowers on the margin of the international market or unguaranteed private sector clients in the more price-competitive markets. In this respect, the leaders showed a greater tendency to become "loan pushers",[4] that is, they aggressively sold higher-priced loan packages to borrowers who were traditionally denied access to international credit markets altogether or who were at least denied such large amounts of funds. Although there had been no alteration in the risk characteristics which relegated them to the margin of international borrowing, these borrowers suddenly found the leaders acting like door-to-door salesmen attempting to persuade

[3]See J.M. Guttentag and R.J. Herring, "Disaster myopia in international banking", *Essays in International Finance*, No. 164, Princeton University, September 1986.

[4]W. Darity Jr., "Did the commercial banks push loans on the LDCs?", M.P. Caludon (ed.), *World Debt Crisis: International Lending on Trial*, Cambridge, Massachusetts, Ballinger Publishing Co., 1986. See also W. Darity Jr. and B. Horn, *The Loan Pushers*, New York, Ballinger, 1988. Also relevant is D. Dalamaide, *Debt Shock*, Garden City, N.Y., Doubleday and Co., Inc., 1984, p. 43, and A. Sampson, *op. cit.*, pp. 145-146.

Table 2

PRINCIPAL BEHAVIOURAL TENDENCIES OF TNBs, BY CATEGORY OF ORGANIZER/LENDER

Category of organizers/ lenders	Principal behavioural tendencies with regard to:			
	Competitive markets		Riskier borrowers	
	Organized	Placed or participated in	Organized	Placed or participated in
Leaders	1. Syndicated credits (for public sector)	1. Direct loans (to private sector) 2. Syndicated credits	1. Syndicated credits (for public sector)	1. Syndicated credits 2. Direct loans (to private sector)
Challengers	1. Syndicated credits (for public sector)	1. Syndicated credits		
Followers	1. Syndicated credits (for public sector)	1. Syndicated credits 2. Direct loans		1. Syndicated credits
Others		1. Syndicated credits		1. Syndicated credits

borrowers to take on hugh credits which they had not contemplated borrowing or, at least, not in such large volumes.[5] Because their income results more from *special* deals with riskier clients willing to pay higher fees, commissions and interest in order to gain access to the loan market, the leaders' behaviour can thus be considered relational in comparison to the transactional perspective of the challengers.

In sum, the principal behavioural tendencies of the major transnational banks during the credit boom can be crisply distinguished in terms of the disaster myopia demonstrated by the challengers in organizing syndicated loans in the more price-competitive markets and the loan-pushing characteristics of the leaders in organizing syndicated loans for the riskier sovereign clients or for unguaranteed private sector borrowers in the more price-competitive markets. The more transactional view of earnings taken by the challengers can be contrasted with the more relational perspective of the leaders. Furthermore, whereas the resultant risk concentration of the challengers can be qualified as excessive, that of most of the leaders falls more precisely into the category of sheer recklessness. In this sense, not only did TNB overlending contribute to the debt crisis, but different categories of organizers contributed in distinct manners to the creation of that crisis. A summary of the behavioural tendencies of different categories of TNBs during the boom is presented below (see table 2).

[5]A very revealing analysis of the door-to-door sales of syndicated loans to sovereign borrowers, by one of its practitioners, is contained in S.C. Gwynne, "Adventures in the loan trade", *Harpers'*, September 1983, p. 24.

Table 3

DEVELOPING COUNTRY DEBT RESTRUCTURING PACKAGES WITH TNBs, BY DEBTOR GROUP, 1980-1987*

(Billions of US dollars)

	1980-1982	1983	1984	1985	1986	1987	Total 1983-1987	Percentage distribution
I. **Restructuring**[a]	5.3	35.6	8.7	84.1	36.1	112.8	277.3	70
Mexico	-	20.2	-	48.7	-	43.7	112.6	28
Brazil	-	4.5	4.8	-	6.7	-	16.0	4
Major players: Non-OPEC[b]	5.3[c]	5.5	2.4	30.0	3.8	48.0	89.7	22
Major players: OPEC[d]	-	3.7	-	4.3	24.9[e]	21.1[f]	54.0	14
All others	4.5[c]	1.7	1.5	1.1	0.7	-	5.0	1
II. **New money**[g]	0.1	14.4	11.0	5.7	0.3	6.6	38.0	10
Mexico	-	5.0	3.8	-	-	5.0	13.8	3
Brazil	-	4.4	6.5	-	-	-	10.9	3
Major players: Non-OPEC[b]	0.1	4.4	0.7	5.5	-	1.6	12.2	3
Major players: OPEC[d]	-	0.4	-	0.2	0.3	-	0.9	...
All others	0.1	0.2	-	-	-	-	0.2	...
(Subtotal I + II)	(5.4)	(50.0)	(18.7)	(89.8)	(35.7)	(119.4)	(314.6)	(79)
(Mexico)	(-)	(25.2)	(3.8)	(48.7)	(-)	(48.7)	(126.4)	(32)
(Brazil)	(-)	(8.9)	(11.3)	(-)	(6.7)	(-)	(26.9)	(7)
(Major players: Non-OPEC)[b]	(5.4)	(9.9)	(3.1)	(35.5)	(3.1)	(49.6)	(101.2)	(26)
(Major players: OPEC)[c]	(-)	(4.1)	(-)	(4.5)	(25.2)[e]	(21.1)	(54.9)	(14)
(All others)	(-)	(1.9)	(1.5)	(1.1)	(0.7)	-	(5.2)	(1)
III. **Other facilities**[h]	0.2	22.4	16.9	7.1	28.1	8.3	82.8	21
Mexico	-	-	-	1.0	-	1.0	2.0	1
Brazil	-	15.8	15.1	-	24.1	-	55.0	14
Major players: Non-OPEC[b]	0.2	5.9	1.7	4.9	3.9	7.3	23.7	6
Major players: OPEC[d]	-	0.7	-	1.1	-	-	1.8	...
All others	...	0.1	0.1	0.1	0.1	-	0.4	...
(Total I + II + III)[i]	5.6	72.4	36.6	96.9	64.5	127.7	398.1	100
Mexico	-	25.2	3.8	49.7	-	49.7	128.4	32
Brazil	-	24.6	26.4	-	30.8	-	81.8	21
Major players: Non-OPEC[b]	5.6[c]	15.8	4.8	40.4[j]	7.7	56.9[k]	125.6	32
Major players: OPEC[d]	-	4.8	-	5.6	25.2[e]	21.1[f]	56.7	14
All others	...	2.0	1.6	1.2	0.8	-	5.6	1

Source: ECLAC/CTC Joint Unit on basis of information contained in Table II-3 of IBRD, *Developing Country Debt*, Washington, D.C., February, 1987, pp. XXVI-XXXI and updates.

*Organized by date of signature of agreement. The following agreements in principle are excluded: Honduras (1983, 1984 and 1987), Peru (1984), Zambia (1984), Costa Rica (1985), Cuba (1985), Congo (1986), Morocco (1986), Mozambique (1987) and Jamaica (1987).

[a] Consolidation of debt into new long-term obligations; includes arrears as well as future maturities.

[b] Includes Argentina, Chile, Cuba, Peru, Panama, Bolivia, Uruguay, Philippines, Morocco, Cote d'Ivoire, Turkey and Yugoslavia.

[c] Turkey accounted for US$2.3 billion in 1982.

[d] Ecuador, Nigeria and Venezuela.

[e] Venezuela accounted for US$21.2 billion in 1986 (already agreed to in principle in 1984).

[f] Venezuela.

[g] TNB loans arranged in conjunction with debt restructuring.

[h] Rollover or interim short-term financing of current maturities and/or maintenance of short-term credit lines.

[i] Debt rescheduling and new money packages are the essence of debt restructuring; the other facilities are considered incentives to keep negotiations progressing or to facilitate the implementation of an agreement. Although these other facilities are not here considered as debt restructuring *per se* they are included to provide a more complete picture of the debt restructuring process.

[j] Argentina accounted for US$13.4 billion in 1985.

[k] In 1987, Argentina, Chile and Philippines entered into restructuring agreements for US$29 500, US$12 490 and US$6 005 million respectively, plus new money and other facilities.

II

TNB behaviour during the crisis period

The debt restructuring process proved to be a surprise for most of the participants involved, in particular the principal TNB organizers and the major debtors, especially the riskier ones. The principal TNB organizers were undoubtedly astonished at how much control and influence they had over the debt restructuring process and how they were able to convert a declining power to negotiate into extraordinary benefits. The debtors, for their part, were most likely unfavourably surprised by the initial cohesion of the creditor bloc and the fact that debtors were obliged, at the beginning of the restructuring process, to assume virtually all the costs associated with the international debt crisis.

Table 3 shows that the TNB debt restructuring process was limited essentially to three principal instruments, namely, the reprogramming of original capital payments, the provision of new money (usually for the purpose of allowing debtors to remain current on their interest payments), and some other facilities, such as the rollover or interim short-term financing of current maturities and/or maintenance of short-term lines of credit. In most cases, these other facilities are more related to ongoing negotiations than to debt restructuring itself, although they are of critical importance to the comprehension of the situation of Brazil. If these other facilities are excluded it is evident that the debt restructuring process encompassed a clear pecking order, with Mexico and the non-OPEC major players[6] being the focus of TNB attention during the first years whereas the OPEC major players (essentially Venezuela) came to the fore in later years. Almost one-third of the restructuring package resources went to Mexico alone. Reprogrammed capital payments represented the backbone of the restructuring process and tended to become more prominent. New money became increasingly scarce, except for Mexico. All in all, the process was very lumpy and country-specific.

Table 4 clarifies the country-specificity of the TNB debt restructuring process as well as the negotiated costs involved. It can be seen that the TNB debt restructuring process fell into several clear phases. During phase 1, which may be called the forced adjustment phase, the debtors were charged punitive spreads and commissions for not being able to pay their TNB debt. Although relatively more new money was available during this phase, debt consolidation was limited to one or at most two years for the seven debtors which negotiated agreements during 1983-1984. The second phase brought with it a sharp improvement in the terms of the restructuring agreements as the amounts reprogrammed almost tripled, spreads tumbled, maturities lengthened, commissions disappeared, consolidation periods lengthened (although new money declined sharply), and more countries were incorporated into the process. The third phase witnessed similar improvements; however, now only five countries were included. Thus, although the terms of the restructuring process improved, it became more selective, including only the more pliant debtors with relatively larger exposures (excluding Brazil).

Previous experience with international debt crises did not prepare debtors for the debt restructuring process of the 1980s. Previously, creditors generally had little recourse if a sovereign borrower was unable to honour its commercial commitments due to unfavourable international economic factors. Creditors (usually bondholders) often formed national pressure groups and their government took up their cause in bilateral conversations with the debtor government, but the debtor's sovereign immunity protected it from suit or the execution of decisions of foreign tribunals. A new situation for the debt restructuring process of the 1980s, however,

[6] According to the definition used in the Interregional Project on Transnational Banks, major players were those developing countries which accounted for a minimum of 0.5% of the total value of syndicated loans during 1974-1977 or 1978-1982, according to information from the Organization for Economic Co-operation and Development (OECD), *Financial Market Trends*. Here the article refers only to those which signed restructuring agreements during 1983-1987.

Table 4

DEBT RESTRUCTURING AGREEMENTS FOR MAJOR PLAYERS* DURING 1981-1987

Date of signature[a]	Country	Agreement in principle[b]	Consolidation period[c]		Amounts involved			Spread[g]	Maturity		Commission[h]	Relative importance[i]
			Beginning date	Length (number months)	Amount reprogrammed[d]	New money facilities[e]	Other facilities[f]		Grace	Total		
IV.81	Bolivia I	VIII.80[j]	IV.81	24	451	-	-	2.19	2.5	5.3	1.13	49
VIII.81	Turkey I	...	...	...	100[k]	-	-	1.50	-	3.0	...	2
II.82	Peru I	...	I.80	24	350	-	-	1.50	2.0	4.0	1.00	16
III.82	Turkey II	...	VIII.79[l]	32	2 269[l]	-	-	1.75	2.0[m]	3.0[m]	...	54
	Pre-crisis subtotal			30	3 170	-	-	1.79	2.1	3.4	...	27
II.83	Brazil I	XII.82	I.83	12	4 800	4 400	15 675[n]	2.00	2.5	8.0	1.50	23
VII.83	Chile I	II.83	I.83	24	2 169	1 300	1 700[o]	2.13	4.0	8.0	1.25	92
VII.83	Uruguay I	III.83	I.83	24	575[p]	240	-	2.19	2.0	6.0	1.38	63
VII.83	Peru II	III.83	III.83	12	380	450	2 200[q]	2.25	3.0	8.0	1.25	29
VII.83	Nigeria I**	...	[r]	[r]	1 935	-	-	1.44	0.3	2.9	...	28
VIII.83	Mexico I	III.83	VIII.82	28	20 167	8 800[s]	[t]	1.81	4.0	8.0	1.00	65
X.83	Yugoslavia I	...	I.83	12	950	600	800[u]	1.81	3.0	6.0	...	109
X.83	Ecuador I**	VIII.83	XI.82	14	1 835	431	700	2.19	1.0	6.5	1.25	110
I.84	Chile II	VII.83	[v]	[v]	1 160[w]	780	1 700	2.13	4.0	8.0	1.25	39
I.84	Brazil II	XI.83	I.84	12	5 900	6 500	15 100[x]	2.00	5.0	9.0	1.00	27
V.84	Yugoslavia II	...	I.84	24	1 250	-	-	1.56	4.0	7.0	...	39
	Phase 1. Subtotal				41 121	23 501	37 875	1.88	3.6	7.7	1.20	41
III.85	Cote d'Ivoire I	...	XII.83	25	501	104	-	1.75	2.5	7.5	-	22
III.85	Mexico II	VIII.84	I.87	48	28 600[y]	-	-	1.00	-	14.0	-	78
V.85	Philippines I	...	X.83	22	5 885[z]	925	2 974	1.63	5.0	10.0	-	122
VIII.85	Mexico III	VIII.84	I.85	72	20 100[aa]	-	950[bb]	1.00	1.0	14.0	-	-
VIII.85	Argentina I	XII.84	I.82	48	14 200	3 700	3 100[cc]	1.38	3.0	11.0	-	78
X.85	Panama I	VI.85	I.85	24	652	60	190	1.38	3.5	12.0	-	34
XI.85	Chile III	VII.85	I.85	36	4 859	785[dd]	1 700	1.38[ee]	6.0	12.0	-	64
XII.85	Ecuador II**	XII.84	I.85	60	4 400	200	700	1.38[ff]	3.0	12.0	-	99
XII.85	Yugoslavia III	...	I.85	48	3 600	-	-	1.13	3.5	10.0	-	84
II.86	Morocco I	...	IX.83	24	538	-	610	1.75	3.0	7.0	-	14
II.86	Venezuela I**	V.85	I.83	72	21 172	-	-	1.13	-	12.5	-	130
VIII.86	Uruguay II	II.86	I.85	60	1 700[gg]	[hh]	-	1.50	3.0	12.0	-	76
IX.86	Brazil III	III.86	I.85	12	6 671	-	24 350[ii]	1.13	5.0	12.0	-	12
XII.86	Cote d'Ivoire II	...	I.86	48	691	-	-	1.63	3.0	12.0	-	23
XII.86	Morocco II	...	I.85	48	2 174	-	348	1.19	4.0	15.0	-	48
	Phase 2. Subtotal				115 743	5 774	34 922	1.18	1.5	12.7	-	58
IV.87	Mexico IV	X.86	[jj]	60	43 700	7 700	950[kk]	0.81	7.0	20	-	95
VI.87	Chile IV	II.87	I.88	48	4 695[ll]	-	1 700	1.00	6.0	15.5	-	39
VIII.87	Argentina II	IV.87	I.86	60	30 249[mm]	1 550	3 500[nn]	0.81	7.0	19.0	0.38[oo]	97
IX.87	Venezuela II**	III.87	I.82	84	20 422	-	-	0.88	-	13.0	-	86
IX.87	Philippines II	...	I.87	72	9 356	-[pp]	2 965	0.88	7.5	17.0	-	82
87	Mexico V	...	I.88	48	9 700[qq]	-	-	...	...	...	-	-
	Phase 3. Subtotal				118 122	9 250	9 115	0.84	5.6	17.9	-	88

Source: ECLAC/CTC Joint Unit, on basis of information contained in IBRD, *World Debt Tables, 1987-1988 Edition, Volume I. Analysis and Summary Tables*, Washington, D.C., January 1988, Table iv-3, pp. xxxvi-xlii, plus other national and international sources.

* Excludes Cuba, which does not participate in World Bank Debt Reporting System.

** Member of OPEC.

[a] The date that the new contract was signed (month, year). Note that the signing of the contract often took place much later than the agreement in principle, mainly due to the borrower's problems with the International Monetary Fund programme and the bank steering committee's problems in bringing all previous lenders into the new package.

[b] Based on newspaper reports.

[c] The period encompassing reprogrammed payments and arrears starting on date shown and running for the number of months indicated.

[d] Consolidation of debt into new long-term obligations; includes arrears as well as future maturities.

[e] Loans arranged in conjunction with debt restructuring. Sometimes considered as the reprogramming of interest payments.

[f] Maintenance of short-term trade or inter-bank lines of credit or rollover or interim financing of current maturities. These facilities are considered primarily as incentives for the borrower to continue negotiations or to implement an agreement.

[g] The margin over the base rate of interest (usually LIBOR). Where split rates were encountered a weighted average was calculated.

[h] Calculated as a percentage of the original value of agreement. Principal commissions included are management, agency and drawdown fees plus expenses where specified.

[i] This indicator shows the amount of reprogrammed debt plus new money facilities (excluding other facilities) in relation to outstanding bank debt at year-end previous to the new agreement.

[j] Date of first deferment agreement with TNBs.

[k] Third party reimbursement claims.

[l] Revision of terms of 1979 agreements, including new syndicated loan contracted in June of 1979.

[m] Number of years that original maturities were extended.

[n] Short-term credit maintenance. Furthermore, this agreement with TNBs was accompanied by credit for US$1.2 billion from the Bank for International Settlements (BIS) and US$1.9 billion from US Government Agencies (the Treasury and the Federal Reserve); these values are not included in the "other facilities" total.

[o] Short-term credit maintenance. Furthermore, this agreement with TNBs was accompanied by credit for US$300 million from BIS; it is not included in total for other facilities.

[p] Includes US$359 million in short-term non-trade-related credits.

[q] Includes payments deferred for a value of US$200 million.

[r] Two agreements (July and September) clearing away arrears on short-term letters of credit.

[s] A new money facility for US$3 800 million was obtanied (over 10 years with a 1.5% spread over LIBOR) in a separate agreement dated April 1984. It is included here to simplify the presentation of the relevant information.

[t] Interbank lines of credit (US$5 200 million) maintained through end-1986. This agreement was facilitated by a credit for US$900 million from the BIS and various credits from US Government Agencies which totalled US$2 900 million.

[u] Rollover of short-term debt for 1 year.

[v] Consolidates three separate agreements of January (US$1 160 million), June (US$780 million) and November (US$1 700 million).

[w] Short-term debt converted to medium-term.

[x] Includes rollover of short-term debt for US$15 675 million, maintenance of US$9 800 million trade-related lines of credit, plus restoration of interbank exposure to US$6 000 million.

[y] MYRA agreement which restructured loans rescheduled by 1983 agreement. Includes rescheduling of US$5 billion new money facility of 1983. This gave rise to repeated short-term rollover of US$950 million.

[z] Includes private sector debt for US$2 643 million.

[aa] MYRA agreement which restructured loans not included in 1983 agreement.

[bb] Deferment of first principal payment for rescheduled 1983 new money facility, as amended by March 1985 MYRA agreement.

[cc] This agreement was complemented by a bridge credit for US$500 million from the US Federal Reserve and other participating governments; it is not included in total.

[dd] Cofinancing operation of World Bank for US$300 million not included in total.

[ee] These rates also apply to outstanding portions of 1983 and 1984 agreements.

[ff] These rates also apply to outstanding portions of 1983 agreement.

[gg] Includes US$844 million in previously restructured debt.

[hh] Agreement includes cofinancing from World Bank.

[ii] Includes deferment of 1986 maturities for US$9 300 million.

[jj] This might be considered the first real "renegotiation agreement" because of its magnitude, the reduction of terms on previously restructured loans, the ex-post change in the spread for the 1983 and 1984 new money facilities, the growth contingency cofinancing (as well as regular cofinancing) of the World Bank, and the contingency investment support facility.

[kk] Restructuring of prepayment which was deferred since October 1985.

[ll] Reduction in terms of 1983-1984 new money facilities and 1983-1987 restructuring agreements as well as rescheduling of some original 1988-1991 maturities. Includes retiming element (interest paid once yearly only).

[mm] Restructuring of all principal maturities of pre-December 9, 1982 debt (maturing after December 31, 1985) for private sector borrowers is included.

[nn] Agreement facilitated by extension of maturity of loan for US$500 million placed previously by US Federal Reserve and other OECD Governments.

[oo] An incentive offered banks that signed up before a certain date.

[pp] Agreement included reduced spread for 1985 new money facility of US$925 million.

[qq] Restructuring of private sector debt.

resulted from statutes enacted in the United States and the United Kingdom during the 1976-1978 period which introduced a new *restricted* theory of sovereign immunity, one which allowed sovereign debtors to waive their immunity.[7] That soon became a standard feature of TNB loan contracts during the boom in sovereign lending. Excluding Colombia, which represents a special case in this field, over 80% of the total value of the contracts for which there was information (reviewed in the course of the Interregional Project on TNBs) were covered by such clauses. In unilateral fashion, the creditors changed the rules of the game and that had a strong impact on the definition of the debt restructuring process, apparently eliminating non-payment as a realistic alternative for debtors facing an unfavourable international economic conjuncture.

Another major innovation in the debt restructuring process for the 1980s was its essentially *private* nature and the control or influence over it which corresponded to the principal TNBs, especially the leaders (which had demonstrated the most imprudent lending behaviour during the boom). Debtors negotiated with multilateral institutions and in some instances with creditor national government agencies regarding their programmes for economic adjustment; however, they were told to speak directly to the bank steering committees as to how to handle upcoming payments on their TNB debt.[8] As may be seen from table 5, the bank steering committees for the six case studies, as well as those for the principal debtors, Mexico and Brazil, were dominated by the leader banks. A leader was the co-ordinating agent in all cases except that of Colombia (coincidentally the only major Latin American debtors not to restructure its debt). Citicorp was the co-ordinating agent in five cases and Bank America Corp. and Manufacturers Hanover in one case each. Even in the case of Colombia, the co-ordinating agent was a major U.S. bank (Chemical Bank). In terms of the nationality of the banks on the steering committees, United States banks usually filled one-half of the positions, a proportion which usually exceeded their exposure, even in the riskier cases. Although challengers were fairly well represented on the committees for Mexico and Brazil, they were under-represented in the other more price-competitive cases, where the leaders in fact occupied more positions than the challengers. Surprisingly, the challengers had more even representation with the leaders on the committees for the riskier cases, where their exposure was much smaller than the leaders. In other words, the leaders came to dominate the bank steering committees for the most important debtors and thereby exerted very strong influence over the debt restructuring process as a whole.

A third important novelty of the debt restructuring process of the 1980s was the initial unity or cohesion demonstrated by the creditor bloc of multilateral institutions and national governments. In practice, and given the much higher exposure of United States banks *vis-a-vis* any other single nationality of bank, this meant that the impact of the United States regulatory system had a significant extraterritorial effect on the debt restructuring process (see table 6). For example, the natural concern of United States officials to safeguard that country's financial system and the welfare of its banks had a negative impact on debtors[9] due to the fact that discretionary decision-making by regulators had allowed United States banks much liberty in respect of risk concentration, capital adequacy obligations and provisioning requirements, all of which meant that the parameters for the debt restructuring process were narrower for debtors and fewer possibilities existed for any form of debt relief. The United States regulators allowed the banks of that country (and especially the leaders who were the most exposed of all to carry

[7]W.T. John, "Sovereign immunity", *Sovereign Borrowers: Guidelines on Legal Negotiations with Commercial Lenders*, Butterworths, Uppsala, Sweden, Dag Hammarskjold Foundation, 1984.

[8]See the testimony of Mr. Donald Regan, Secretary of the U.S. Treasury, in *Hearings on International Debt*, Committee on Banking, Housing and Urban Affairs, U.S. Senate, 4 February 1983. Also see E.J. Frydl, and D.M. Sobol, "A perspective on the debt crisis, 1982-1987", *Seventy Third Annual Report*, Federal Reserve Bank of New York, May 1988.

[9]According to J. Sachs and H. Huizinga, in their "U.S. commercial banks and the developing-country debt crisis", *Brookings Papers on Economic Activity*, No. 2, 1987, p. 557: ..."the debt management strategy pursued by the United States and the official financial community since 1982 has been geared toward the protection of the large commercial banks, at least on a short-run accounting basis".

Table 5

TNB STEERING COMMITTEES FOR EIGHT HEAVILY INDEBTED COUNTRIES

Bank and group	Brazil (from secondary sources)	Mexico (from secondary sources)	Argentina (1985)[a]	Philippines (1983)	Colombia (1985)	Peru (1983)	Bolivia (1981)	Uruguay (1986)	Total: Members	Total: Co-ordinating agents
I. Leaders	5	5	5	5	4	3	3	3	33	7
Citicorp	xx	xx	xx	x	x	xx	x	x	x	5
Manufacturers Hanover	x	x	x	xx	x	x	x	x	8	1
Bank America	x	x[b]	x	x	x		xx	x	7	1
Chase Manhattan	x	x	x	x	x	x			6	
J.P. Morgan	x[b]	x	x	x					4	
II. Challengers	5	5	2	3	3	4	2	3	27	1
Bank of Tokyo	x	x	x	x	x	x		x	7	
Chemical Bank	x	x		x	xx	x			5	1
Bankers Trust	x	x			x	x	x		5	
Lloyds Bank	x[b]	x	x					x	4	
Bank of Montreal	x	x		x					3	
Bank of Nova Scotia						x	x	x	3	
III. Followers	2	1	3	3	5	3	1	1	19	-
Dresdner			x	x	x	x	x	x	6	
Credit Lyonnais	x		x			x			3	
Deutsche	x	x							2	
Barclays				x	x				2	
Royal Bank of Canada			x		x				2	
Indl. Bank of Japan					x				1	
Midland Group					x				1	
National Westminster						x			1	
Bank Nationale de Paris				x					1	
IV. Others on Steering Committees	2[b]		1	1	2	2	4	1	15	-
Total	14	13	11	12	14	12	10	8	94	8
Distribution by nationality										
United States (US)	7	7	5	6	7	6	7	3	48	8
Japan	1	1	1	2	2	1	-	1	9	-
Canada	1	1	1	1	1	1	1	1	8	-
United Kingdom (UK)	1	1	1	1	2	1	-	1	8	-
F.R. Germany (FRG)	1	1	1	1	1	1	1	1	8	-
France	1	1	1	1	1	1	-	-	6	-
Others	2	1	1	-	-	1	1	1		

Source: ECLAC/CTC Joint Unit.

[a] Years in brakets under name of country denote year of restructuring agreement from which committee structure was taken. In the body of the table, "xx" indicates that the bank was a co-ordinating agent, "x" that it was a member of committee.

[b] That it was co-chairman.

Table 6

LATIN AMERICA: EXPOSURE OF PRINCIPAL CREDITOR BANKING SYSTEMS AS OF END-1985

(Millions of US dollars)

Creditor \ Debtor	Brazil	Mexico	Argentina	Venezuela	Chile	Colombia	Peru	Others	Latin America
United States	**25 600**	**24 100**	**8 900**	**8 900**	**7 000**	**3 259**	**1 800**	**10 941**	**90 500**
Europe: 8 countries	**23 174**	**20 961**	**10 985**	**8 435**	**5 003**	**2 279**	**1 971**	**7 420**	**80 228**
(United Kingdom)	9 140	8 669	3 677	2 690	2 178	756	649	2 287	30 046
(France)	6 802	4 500	1 580	2 009	600*	600*	561	395	17 047
(Germany Federal Republic)	4 680	3 570	2 540	2 070	970	260	230	470	14 790
(Switzerland)	1 446	1 477	1 080	555	461	126	174	2 597	7 916
(Spain)	507	1 360	714	575	606	111	272	1 325	5 470
(Italy)*	439	1 365	704	496	173	16	70	76	3 339
(Belgium	160	20	690	40	15	410	15	270	1 620
Others	**13 759**	**15 481**	**5 738**	**5 707**	**2 789**	**1 492**	**547**	**1 236**	**46 349**
(Japan)*	8 200	10 000	4 300	3 650	1 400	1 000	400	780	29 730
(Canada)*	5 559	5 481	1 438	2 057	989	492	147	456	16 619
Total 11 countries	**62 533**	**60 542**	**25 623**	**23 042**	**14 792**	**7 030**	**4 318**	**19 597**	**217 077**

Source: Based on Central Bank data from listed countries, with exception of those marked by asterisks, which are estimates of Banking Analysis Limited (IBCA), London. Data published in Instituto de Relaciones Europeo-Latinoamericanas (IRELA), *Europa y la deuda externa de América Latina*, Dossier, No. 11, June 1987.

their loans to these major debtors at their original face value, by way of an accounting fiction in which the banks provided new money to those debtors to keep them current on interest payments (a key criterion of the United States regulatory system). In this way, the negotiations between United States banks and the United States regulators apparently had a more consequential impact on the debt restructuring process than did the negotiations between the bank steering committees and the debtors themselves.

Taken together, these novelties in the debt restructuring process of the 1980s had the effect of transferring to the debtors virtually all the costs associated with the international debt crisis, at least during its first phase. That phase, which has been described as one of forced adjustment for debtors, corresponded to the difficult 1982-1984 period, that is, the interim between Mexico's declaration of its inability to service its bank debt and the subsequent realization that adjustment was only feasible to the extent that it was accompanied by growth (as crystallized in the Baker initiative for dealing with the debt crisis). This was the phase in which the TNBs, especially the leaders, obtained the most benefits and the debtors shouldered the totality of the burden (including punitive spreads of around 2%) corresponding to the first restructuring agreements. The leaders' view of the debt crisis —which was that it was basically a liquidity problem— was generally accepted as *the* view of the crisis by the rest of the creditor bloc, that is, the multilateral institutions and national (especially United States) agencies.

In some cases the leaders also used their influence in the bank steering committees to obtain special advantages beyond the additional income from the punitive spreads. They were sometimes able to improve the security of their own loans to unguaranteed private sector borrowers by having them incorporated in one way or another into the debt restructuring agreements (thereby acquiring a State guarantee in an *ex post facto* manner) or by pressuring debtors to establish exchange rate guarantees or other special advantages. These restructuring agreements also had the effect of grouping all local debtors into one category and assigning overall debt service responsibility to the State. In this fashion, higher-risk clients which the leaders had presumably charged higher risk premiums were suddenly given the same legal status as the more creditworthy clients which challengers and others had charged very low risk premiums. In this sense, the leaders seem to have taken advantage of their management of the bank steering committees to gain particular advantages in terms of greater security for their riskier exposure and an improved income stream from fees and punitive interest rates. That increased income did not go primarily to strengthen capital or make loan loss provisions, however.[10] The leaders apparently misused the additional time given them through discretionary decision-making by United States regulators. Other banks, then experiencing good interest income from their reprogrammed exposures, tended to support the leaders' manner of dealing with the debt crisis. The leaders reached the high point of their control over the debt restructuring process during this phase, as their interpretation of the problem and their recommended solution were adopted by the creditor bloc as a whole. At the same time, however, it appeared evident that the huge forced adjustment made by the debtors seemed to serve more to strengthen the quarterly balances sheets of the leaders than to improve the medium-term economic prospects of the debtors themselves,[11] so that it prolonged the crisis rather than resolving it.

That point seemed to have been recognized during the second phase of the debt restructuring process (1985-1986), in that the recessionary adjustment strategy came to be viewed as self-defeating and important elements of the creditor bloc —multilateral institutions and some national authorities— came to hold the opinion

[10] *Ibid.*, p. 569. See also "Bank profitability 1980-1985: recent trends and structural features", *Financial Market Trends*, No. 38, November 1987.

[11] The adjustment of Latin America during 1982-1985, for example, has been found to be greater than the war reparations paid by Germany during 1925-1932 or by France during 1871-1875. See R. Devlin, "Economic restructuring in Latin America in the face of the foreign debt and the external transfer problem", *CEPAL Review*, No. 32 (LC/G.1473), Santiago, Chile, August 1987, pp. 75-102. See also ECLAC, *The Evolution of the External Debt Problem in Latin America and the Caribbean*, Estudios e Informes de la CEPAL series, No. 72 (LC/G.1487/Rev.1-P), Santiago, Chile, September 1988, United Nations publication, Sales No. S.88.II.G.10 and ECLAC, *External Debt in Latin America: Adjustment Policies and Renegotiation*, Boulder, Colorado, Lynne Rienner Publishers, Inc., 1985, Chapter 2.

that growth had to accompany adjustment, if the latter were to be positive and structural (rather than conjunctural) in nature. A new initiative emphasizing adjustment with growth was named after the United States Secretary of the Treasury, and was presented as the replacement for the previous perspective.[12] New roles were assigned to all the agents involved in the adjustment and debt restructuring processes. Responsible debtors were to receive more time and improved conditions for servicing their bank debt, as was manifested in the new multiyear rescheduling agreements which became more common thereafter.

The consequent reduced earnings (commissions disappeared and spreads fell appreciably) and longer-term commitments for creditors caused bank unity in the debt restructuring process to dissolve, however. The smaller banks and the regional United States banks with more limited exposure preferred not to get committed to providing new money facilities over medium-term horizon and they became increasingly interested in selling their debt at a discount in the secondary market. Non-United States banks, particularly some European ones with stronger capital bases, lower exposure, and more adequate loan loss provisions (as a consequence of more prudential bank supervision in those countries), increasingly sought other avenues due to the fact that the new money facility mechanisms whereby banks paid interest to themselves (in order to comply with the demands of the United States banks' regulatory environment) proved increasingly futile.[13] In this context, the major TNBs, especially the leaders which dominated the steering committees, found it more difficult to convince other banks to contribute to new money facilities and were less well-disposed themselves to increasing their own exposure as United States regulators became less tolerant with regard to discretionary decision-making favourable to the money-centre institutions. As a consequence, the TNBs were not able to mobilize anything like the US$20 billion in new money facilities expected of them as part of the Baker initiative, and their failure to do so caused dissatisfaction within the creditor bloc due to the fact that, by not fulfilling the role assigned them, the TNBs imperilled the efforts of the other creditors, especially the multilateral institutions.[14]

Although the creditor bloc unity was weakening and the situation for debtor countries tended to improve compared with the rigours of the forced adjustment phase, debtors demonstrating deviant behaviour —that is, those which did not maintain a dialogue with banks and multilateral institutions and did not make an effort to keep up-to-date in their interest payments— were dealt with harshly. Weaker, smaller, riskier debtors did not receive access to new money or other facilities on a scale comparable to their larger brethren unless they made exceptional concessions (as was the case of Uruguay). Peru and Bolivia (along with Nicaragua, Sudan and Zaire) were among the few debtors which fell into the value-impaired category of the United States regulatory system, obliging their United States creditors to take the inconvenient step of establishing allocated transfer risk reserves in respect of them. In general, during this second phase of the debt restructuring process the weakened creditor bloc unity and the dissatisfaction with the way the banks carried out the role assigned them resulted in a somewhat improved situation for those debtors which conformed to the rules of the game. The few debtors which did not conform were dealt with harshly by multilateral institutions and national agencies.

The 1987-1988 period witnessed a continued breakdown in creditor bloc unity and open disagreement among the banks, even among the leaders themselves. It might even come to be regarded as the adjustment phase for the TNBs themselves in the debt restructuring process. The new money facility for Mexico caused even the formerly docile English and Japanese banks to join the continental European ones is seeking

[12]See IMF, "International capital markets: developments and prospects", *IMF Occasional Paper*, No. 43, Washington, D.C., February 1986, p. 17; "Debt strategy must be flexible, Managing Director tells banks", *IMF Survey*, 2 June 1986, p. 165; and J. de Larosiere, "Progress on the international debt strategy", *Finance and Development*, vol. 24, No. 1, March 1987, p. 10.

[13]See Instituto de Relaciones Europeo-Latinoamericanas (IRELA), "Europa y la deuda externa de América Latina", Working Paper No. 11, Madrid, June 1987, and M.L. Williamson, "The role of banking regulation in Third World debt strategies", Working Paper, Overseas Development Council, May 1988.

[14]World Bank, *World Debt Tables, 1985-1986 Edition*, Washington, D.C., 1986, p. viii, and *World Debt Tables, 1986-1987 Edition*, Washington, D.C., 1987, p. xv-xvi.

new policy alternatives.[15] The Japanese government even came up with a new global proposal for tackling the international debt crisis at the economic summit in Toronto in 1988.[16] The United States manner of dealing with the crisis was increasingly ignored by virtually all participants and each one went his own way under the guise of a menu-approach to the crisis,[17] emphasizing debt sales in the secondary market or conversion to equity, bonds, goods, etc.

The TNBs' agreement in principle in October 1986 to give greatly improved conditions to Mexico, under pressure from the United States government, resulted in attempts by other debtors to obtain similar agreements (spreads of less than 1%, payments reprogrammed over 20 years with seven years' grace, reprogramming of previously reprogrammed credits, new money facility, contingency clauses, cofinancing element with World Bank). Brazil's attempt to obtain a similar deal without formal linkage to an IMF administered adjustment programme was rebuffed by the TNBs, and Brazil declared a moratorium in February of 1987. While the banks quickly came to agreement with other major player debtors such as Chile, Argentina, Venezuela and the Philippines, the impact of the Brazilian moratorium was so great, given the magnitude of the debt involved and the level of exposure of big United States banks, that the leaders had to take action.

Citicorp, the most exposed of the leaders, sprang into action by establishing additional loan loss provisions of the order of US$3 billion (bringing total provisions to the equivalent for about 25% of its exposure) —an initiative which destroyed the last fragments of leader solidarity as other banks such as Manufacturers Hanover, Chase Manhattan and Bank of America struggled to keep up.[18] Their balance sheets for 1987 showed the biggest losses since the Depression. Morgan set a precedent by designing a securitized bond scheme[19] aimed at helping Mexico capture a portion of the discount on its debt, as manifest in secondary market prices. United States regulations more and more seemed to favour the latter approach.

One very big problem facing the United States regulators was that although leaders were active as intermediaries in debt conversion schemes, they rarely dealt in their own debt. As smaller United States banks and regionals opted out of participation in new money facilities the leaders' share of the overall exposure of United States banks in troubled debtors was increasing.[20] Similarly, as non-United States banks became more active in debt conversion activities, the United States share of total bank exposure was going up, meaning that the debt crisis was again (as in 1982) concentrated in the hands of the banks which had been the most imprudent lenders during the credit boom and subsequently the most inflexible and intransigent of negotiators during the debt restructuring process.

Faced with increased resistance from creditor bloc governments and banks, and taking advantage of the new disunity among leader banks, United States regulators seem to be taking a new approach to the debt crisis in so far as it concerns United States banks. The aim apparently is to get the leaders to do something

[15]See M.L. Williamson, *op. cit.*, p. 20 and the IRELA document, *op. cit.*, p. 9.

[16]"Playing king of the hill at the Toronto summit", *Business Week*, 4 July 1988, p. 35. See also "The Miyazawa plan: any interest from debtors?, *The Economist*, 6 August 1988, p. 64.

[17]See World Bank, Debt Management and Financial Advisory Services Department, *The Market-Based Menu Approach*, Washington, D.C., 1988.

[18]"Banks slither on the city slick", *The Economist*, 30 May 1987, p. 77.

[19]See "Mexico's swap gamble", *South*, March, 1988, p. 21 and "Sanity at last on Third World debt", *Fortune*, February 1988, p. 8. See also Andrew Quale Jr., "New Approaches to the Management and Disposition by U.S. Banks of their LDC Debt: Debt/Equity Conversion and the Mexican Debt Securitization and Collateralization Scheme", paper presented to seminar on debt-equity swaps held in Caracas, Venezuela, 27-29 April 1988, pp. 37-47. Finally, it might be recalled that Citicorp in 1987 had made Mexico a different kind of offer, one firmly rejected by the Mexicans. Citicorp's chairman described it in the following manner: "Obviously, our most attractive investment is in ourselves. I said to the Mexicans, when I was talking about putting some equity in —if they'd let me increase the capital of Citicorp in Mexico by a hundred million dollars, because you really are investing in something that you know". See "Citicorps Reed outlines path on Third World loans", *The Wall Street Journal*, 28 May 1987.

[20]See B.A. Bennett and G.C. Zimmerman, "U.S. banks' exposure to developing countries: an examination of recent trends", *Economic Review*, No. 2, Federal Reserve Bank of San Francisco, Spring, 1985, pp. 14 and 19-20. The share of the Baker 15 debtor countries in the overall outstanding international loans of U.S. banks rose from 25.9 to 31.3% between 1982 and 1986. The share of the nine money centre banks in U.S. bank exposure to the troubled debtors increased from 56.4 to 62.7% over the same period.

regarding their loan loss reserves and their still huge country exposures. The U.S. Federal Reserve revised equity conversion regulations by no longer limiting non-financial investments to the purchase of equity in firms being privatized by debtor governments and extending the period such investments can be held.[21] Accounting issues concerning the "contagion" of the rest of a bank's portfolio by the dealing-off of a portion at a discount have also apparently been resolved.[22] Furthermore, an international agreement on capital adequacy standards seems to set a definite time frame (until 1992) for debt conversion activity. As of 1992, only 1.5% of the new 8% reserve capital/asset ratio can correspond to loan loss reserves. Presently, such reserves account for some 4% in the case of most of the leaders.[23] In other words, it appears that something is now being done by United States regulators. Tax benefits for banks which write down their loans to realistic levels, similar to other major creditor countries, would undoubtly speed up the process. If such actions motivate leader banks to deal off significant portions of their troubled debtor exposure,[24] the material basis for the TNB adjustment stage will have been firmly established. If they do not, the international debt crisis may be transformed into a national crisis, at least from the perspective of the creditor banks involved.

In a similar manner to debtor country behaviour and the negative impacts of the international economic environment, TNB behaviour is also a fundamental causal factor in the creation of the international debt crisis. The responsibility of TNBs in overlending to developing countries during the boom and in not contributing sufficiently to a solution by way of the debt restructuring process was not borne uniformly by all banks, either by category or nationality. Clearly the leaders —all United States money centre institutions— bear much more responsibility in terms of their imprudent lending during the boom and their intransigence in the face of all reasonable solutions to the international debt crisis which implied losses for them. Now leader unity has broken down and more positive leader initiatives, like Morgan's securitized bond scheme for Mexico, will hopefully replace the heretofore short-sighted policies of banks like Citicorp. Apparently, United States regulators have finally realized that there is no way of avoiding losses for these banks commensurate with their part in the creation of the crisis. Nonetheless, policy guidelines are still clearly needed.[25]

[21] See "Amendment to Regulation K", *Federal Reserve Bulletin*, vol. 74, No. 4, April 1988, p. 232.

[22] According to the American Institute of Certified Public Accountants (AICPA), *Practice Bulletin*, October 1987.

[23] "Cooke's medicine: kill or cure?", *Euromoney*, July 1988, pp. 34 and 51.

[24] Newspaper reports are split over the impact of the new policies, as can be appreciated from the following articles: "Big banks shift from 3d World", *The New York Times*, 28 July 1988 and "Banks step up Third World debt disposal - New York institutions lag the pace, however", *The Wall Street Journal*, 26 July 1988.

[25] As a *Business Week* editorial put it: "The banks, whose lending practices contributed to the crisis, must not be allowed to wriggle off the hook" (July 25, 1988, p. 84).

CEPAL REVIEW No. 37

Options for tackling the external debt problem

*Robert Devlin**

This paper will briefly overview the current situation of debtors and creditors and evaluate some of the difficult issues concerning the international management of Latin America's payment problems. Section 1 of the paper itemizes the achievements and setbacks in the international debt management programme since 1982 and finds that while the creditor countries have, on balance, done reasonably well for themselves over the last few years, the debtor countries in contrast have found themselves in a crisis of deepening proportions. Section 2 explores the reasons for the debtors' poor economic performance; it points out that in many instances it is difficult to isolate the question of the quality of domestic effort to adjust from the perverse effect of an adverse external environment, and in particular, from the outward net transfer of financial resources from the debtor countries to the creditor countries. Indeed, Section 3 concludes that if there is any generalized cause for the poor performance of the region, it is the half-hearted international public policy that has been in place since 1982, which has given priority to an outward transfer of resources instead of supporting efficient socioeconomic restructuring in Latin America. Section 4 argues that to correct this tendency, there must be a much more ambitious production of international public goods designed to ensure new credit and reduce the external debt of Latin America in volumes that are macroeconomically significant. It is concluded that in the absence of this, more debtors in the region will opt for unilateral limits on their debt service, and that moreover, if the debtor countries display more sophistication in the deployment of this technique, self-designed debt-relief can support sustained economic growth.

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I

The current situation

1. *Searching for progress*

Looking to the North, one sees the OECD economies out of recession, and indeed enjoying one of the longest periods of non-inflationary economic expansion in their modern history.[1] A highly decentralized international lender-of-last-resort facility (composed of the IMF, World Bank, Bank for International Settlements, OECD central banks, treasuries, export credit agencies, and the private banks themselves) has proved its effectiveness in averting the destabilizing defaults in Latin America that threatened to emerge from the systemic payments crisis of that region.[2] Thus, in the middle of the worst financial crisis since the 1930s, private banks have generally performed remarkably well. For example, throughout the crisis years of 1982-1986 the international earnings of United States banks remained buoyant, and indeed their overall growth of net income accelerated as these institutions diversified into new profit opportunities at home (table 1). Negative earnings manifested themselves only in 1987, on account of the first large-scale allocation of reserves against possible losses on the Latin

[1] During 1983-1988 growth of GNP in the industrialized countries averaged 3.5% per annum. Given the voters' preference for continuity in the political leadership of the North, this rate of growth would seem to be satisfactory. However, as Sidney Dell remarked to the author, the performance is not satisfactory when viewed from the needs of an interdependent world: OECD economic growth has been highly volatile, uncertain as to its sustainability, and has imparted relatively little buoyancy to the debtor's terms of trade. The growth rate is calculated from data in IMF, *World Economic Outlook*, Washington, D.C., Advance Copy, 25 September 1988, p. 71.

[2] For an analysis of these international facilities see Philip Wellons, *Passing the Buck* (Boston: Harvard Business School Press, 1987), Chapter 7. For an analysis of how these facilities were applied during the Latin American crisis see ECLAC, *External Debt in Latin America* (Boulder, Colorado: Lynne Rienner Publishers, 1985), chapter 3 and ECLAC, *The evolution of the external debt problem in Latin America and the Caribbean*, Estudios e Informes de la CEPAL series, No. 72 (LC/G.1487/Rev.1-P), Santiago, Chile, 1988, United Nations publication, Sales No.: E.88.II.G.10, chapter I.

Table 1

UNITED STATES BANKING: SELECTED INDICATORS

(Percentage of total average assets)

	1980	1981	1982	1983	1984	1985	1986	1987
Net interest revenue	**2.8**	**2.8**	3.1	3.3	3.4	3.6	3.6	3.4
Money centre banks	2.4	2.4	2.8	2.9	3.1	3.2	3.2	2.9
Regional banks	3.4	3.3	3.4	3.7	3.9	4.1	4.0	3.0
Net income	**0.62**	**0.59**	**0.59**	0.67	0.65	0.66	0.67	-0.31
Money centre banks	0.51	0.52	0.54	0.64	0.60	0.69	0.70	-0.65
Regional banks	0.76	0.67	0.66	0.69	0.70	0.64	0.65	0.01
International Earnings	-	-	-	-	-	-	-	-
Money centre banks	0.27	0.30	0.32	0.29	0.27	0.26	0.22	-1.33
Regional banks	-	-	-	-	-	-	-	-

Source: ECLAC, on the basis of data in Thomas Hanley *et.al., A Review of Bank Performance* (various editions) New York: Salomon Brothers.

American portfolio.[3] The industry, however, rebounded in the first half of 1988, reporting a strong recovery of earnings.[4]

Moreover, behind this strong earnings performance an impressive "growth-oriented adjustment" of the banks' loan portfolio in Latin America is underway. Again the United States banks are illustrative: by March 1988, they had reduced their absolute exposure in the region by 12% with respect to June 1982 (table 2), while doubling their primary capital, all of which enabled them to cut in half their Latin American loan-to-capital ratio, from a precarious 124% to a much more manageable 58% (table 3). United States money centre banks now have 25-30% of their LDC portfolio backed by loan loss reserves, while many United States regional and continental European banks have a corresponding coverage of 50% or more (table 4).[5] In sum, the international management of the payments difficulties in Latin America has helped the bankers to convert a situation which was originally, for them, a severe "crisis" into something more akin to a "problem". Indeed, the success of the bankers' adjustment is reflected in signs of complacency in financial circles about the Latin American situation: in the view of some experts, a refusal to pay by any one of the major debtors —Brazil, Mexico, Argentina or Venezuela— would not now create undue stress in the world banking system.[6]

The creditors' diagnosis of the problem in Latin America is also certainly more realistic now than it was at the outset. Gone are the rosy scenarios about a short-term liquidity crisis; most creditors now recognize that the problem in Latin America is structural, because time-consuming internal economic and social transformations are needed in most debtor countries to competitively produce and sell the tradeable goods required to generate foreign exchange for normal servicing of the debt. Likewise, there is now recognition that protracted belt tightening in the debtor

[3] The increase in loan loss reserves was induced by actions of Citibank, which raised reserves by US$3 billion in the second quarter of 1987. For competitive reasons, most other United States banks with Latin American exposure copied Citibank to one degree or another. Consequently, United States banks reported US$11 billion in losses in the second quarter, which represented the industry's worst performance since the 1930s. See ECLAC, "Economic Survey of the United States of America", Washington Office, 24 August 1988, p. 29, published later as *Economic Survey of the United States, 1987* (LC/G.1477; LC/WAS/L.3/Rev.1), Santiago, Chile, February 1989.

[4] See Thomas Hanley *et al., Developing Country Exposures —Have Investors Recognized the Degree of Progress Made by Money Center Banks?,* New York, Salomon Brothers, 21 July 1988, p. 2.

[5] For the situation of European banks, see Gunner Wiegand, *Western Europe and the Latin American Debt Crisis,* Working Paper No. 12, Madrid, 1988, p. 20.

[6] *Daily Telegraph* (U.K.), "Time to Break the Cycle of Third World Debt", 30 August 1988.

Table 2

EXPOSURE OF UNITED STATES BANKS IN LATIN AMERICA

	Millions of dollars									Annual growth rates (total exposure)		
	June 1982			December 1987			March 1988					
	Top 9	Rest	Total	Top 9	Rest	Total	Top 9	Rest	Total	1986	1987	March 88/ June 82
Latin America	48 714	33 368	82 082	49 757	24 720	74 477	49 015	23 116	72 311	-3.0	-5.4	-11.9
Oil-exporting countries	23 567	17 285	40 852	20 699	12 446	33 145	20 066	11 621	31 867	-6.0	-6.7	-22.0
Bolivia	231	137	368	39	24	63	38	20	58	-13.6	-29.2	-84.2
Ecuador	1 257	910	2 167	1 137	650	1 787	1 119	586	1 705	3.1	-11.4	-21.3
Mexico	13 602	11 619	25 221	13 396	9 002	22 398	12 848	8 240	21 088	-3.7	-4.9	-16.4
Peru	1 330	1 017	2 347	441	400	841	390	392	782	-23.2	-27.4	-66.7
Venezuela	7 147	3 602	10 749	5 686	2 370	8 056	5 671	2 383	8 054	-10.8	-7.8	-25.1
Non-oil-exporting countries	25 147	16 083	41 230	29 058	12 274	41 332	28 949	11 495	40 444	-0.3	-4.2	-1.9
Argentina	5 595	3 212	8 807	6 709	2 521	9 230	6 766	2 452	9 218	3.5	2.0	4.7
Brazil	12 336	8 179	20 515	15 763	6 507	22 270	15 754	5 986	21 740	0.2	-5.7	6.0
Colombia	2 075	961	3 036	1 398	675	2 073	1 350	700	2 050	-15.0	-3.8	-32.5
Costa Rica	221	259	480	178	139	317	176	133	309	-5.2	-20.6	-25.6
Chile	3 314	2 761	6 075	3 907	1 964	5 871	3 841	1 778	5 619	0.1	-6.1	-7.5
El Salvador	53	16	69	8	41	49	6	46	52	12.2	-10.9	-24.6
Guatemala	96	53	149	29	19	48	29	12	41	-32.4	4.3	-72.5
Honduras	139	64	203	42	64	106	36	68	104	-9.3	-	-48.8
Nicaragua	257	168	425	13	30	43	13	28	41	-26.7	-34.8	-90.3
Paraguay	299	28	327	60	17	77	58	12	70	-37.4	-28.0	-78.6
Dominican Republic	338	108	446	263	80	343	263	82	345	-6.6	-14.0	-22.6
Uruguay	424	274	698	688	217	905	657	198	855	0.8	1.8	22.5

Source: ECLAC, on the basis of United States Federal Financial Institutions Examination Council, *Statistical Release,* various numbers.

Table 3

UNITED STATES BANKING: LATIN AMERICAN EXPOSURE AS A PERCENTAGE OF PRIMARY CAPITAL

	June 1982			March 1988		
	Top 9	Rest	Total	Top 9	Rest	Total
Latin America	**180.0**	**85.4**	**124.0**	**96.7**	**31.8**	**57.7**
Oil-exporters	87.1	44.2	61.8	40.2	16.1	25.7
Non-oil-exporters	93.0	41.2	62.2	56.5	15.7	32.0
Memo Item:						
Primary capital[a]	27.1	39.1	66.2	51.5	77.7	129.1

Source: ECLAC, on the basis of data from the United States Federal Financial Institutions Examination Council, *Statistical Release*, various numbers.
[a] Billions of dollars.

Table 4

UNITED STATES BANKING: RESERVES SET ASIDE ON LDC PORTFOLIO

(Millions of dollars)

	Reserving 1987			Total estimated reserves	Percentage of LDC portfolio
	II quarter	IV quarter	Total		
Money centre banks					
Bankers Trust	700	-	700	1 000	25
Chase Manhattan	1 600	-	1 600	2 000	25
Chemical Bank	1 100	-	1 100	1 360	25
Citicorp	3 000	-	3 000	3 325	25
Manufacturers Hanover	1 700	-	1 700	1 787	25
J.P. Morgan and Co.	850	-	850	1 330	25
Republic N.Y. Corp.	100	10	110	200	40
Bank of Boston Corp.	300	200	500	430[a]	55[a]
First Chicago	780	240	1 020	1 132	39
Selected regional banks					
Bank of New England	97	100	197	192[a]	75[a]
Midlantic Corp.	30	25	55	54[a]	63[a]
Mellon Bank	290	180	470	621[a]	45[a]
Banc One Corp.	53	-	53	7	67
NBD Bancorp.	54	-	54	106	50
Sovran Financial	-	-	-	44	45
First Union Corp.	25	-	25	28	49
First Republic Bank	275	-	275	350	26
Bank America Corp.	1 100	-	1 100	2 004	20
First Interestate	500	180	680	612[a]	54[a]
Security Pacific	558	350	908	980[a]	54[a]
Wells Fargo	550	39	589	850[a]	50[a]
First Wachovia Corp.	50	31	81	55	60

Source: ECLAC, on the basis of data in Thomas Hanley and others, *A Review of Bank Performance: 1988 Edition*, New York, Salomon Brothers, 1988.
[a] Medium and long-term loans.

countries is counterproductive: in order to politically legitimize necessary reforms and to raise the mass of domestic savings available for investment and debt service, countries clearly must achieve a sustained expansion of their economies.

The more realistic diagnosis has also led to more realistic responses. Some banks, recognizing that the "time" implicit in the restructuring process erodes some of the present value of the income stream of their assets in Latin America, began in 1987 to more aggressively adjust downward the valuation of their loans in the region.[7] Moreover, the devaluation of assets has sometimes resulted in relief for the debtors as banks now show an increasing willingness to accept formal debt reduction schemes through direct or indirect participation in debt-equity swaps,[8] the purchase of below market interest rate exit bonds,[9] the conversion of debt into bonds at a discount,[10] direct buybacks,[11] etc.

The new diagnosis likewise has induced better responses from the multilateral lenders. The recognition of the structural problem has brought the World Bank from the background of the international debt strategy to the centre of the playing field.[12] Meanwhile, the IMF has accommodated to the new realities by extending its adjustment programmes to up to four years, lengthening the period of review of its performance criteria to six months, as well as creating a new expanded contingency financing facility.

Turning South, one finds that the crisis has coincided with some positive changes in Latin America. There are today thirteen democratic governments in the region compared to only four in the late 1970s.[13] On the economic front, the severity of the crisis in Latin America has certainly broken the back of the dogmatism sometimes attached to import substitution development strategies and so-called inward-looking development. Indeed, one senses the emergence of a new pragmatism in the formulation of development policy. While eschewing some of the more simplistic prescriptions for economic liberalization emanating from the North, the achievement of international competitiveness is now a central preoccupation of the authorities of the region. Most countries are manifestly eager to learn the art of producing and selling for highly competitive international markets. The popular notion of the State as the handmaiden of development also has undergone reassessment; there is a general awareness that government resources are inefficiently deployed and that private initiative offers more potential for development.[14]

Good intentions obviously are not enough. However, while Latin America's efforts to alter the direction of its development policy and restore creditworthiness do not warrant

[7] At the beginning of 1988 this process further intensified. In April-June 1988 the largest United States banks had loan charge-offs of US$0.9 billion, up from US$0.6 billion in the first quarter of the year. See T. Hanley and others, *op. cit.*, p. 2.

[8] Debt/equity swaps in Argentina, Brazil, Chile and Mexico totalled US$5 billion in 1987. Peter Truell, "Cutting Losses", *Wall Street Journal*, 23 September 1988, Supplement, p. 10 R.

[9] In the 1988 debt rescheduling of Brazil roughly 100 banks suscribed to exit bonds amounting to about US$1 billion. The bonds carried a 6% interest rate for 25 years.

[10] Early in 1988 Mexico converted US$3.67 billion of commercial bank debt into US$2.56 billion of bonds, which represented a 30% discount. The bonds had a single 20-year maturity and carried an interest rate of 1.63% over LIBOR. The principal of the bond was secured by the government's purchase of a 20-year United States Treasury zero-coupon bond for an amount equivalent to the outstanding Mexican government bonds.

[11] In March 1988 Bolivia arranged to buy back US$318 million of its public commercial bank debt —nearly 50% of the total with these lenders— at a price of 11 cents on the dollar. The resources for the buyback arrangement came from OECD countries. The operation was facilitated by the establishment of a special escrow account in the IMF for the depositing of OECD contributions. Meanwhile, in mid-1988 Chile negotiated with its banks an arrangement to use up to US$500 million of its international reserves to buy back bank debt at a discount. In November 1988 Chile bought back US$299 of bank debt at 56 cents on the dollar.

[12] The most recent manifestation of this was the willingness of the World Bank to sponsor a restructuring loan for the Government of Argentina even though the Argentine economic authorities could not reach prior terms with the IMF for a standby agreement. See Stephen Fidler, "World Bank Agrees Argentine Loan", *Financial Times*, 26 September 1988.

[13] The four democratic governments in the 1970s were Colombia, Costa Rica, the Dominican Republic and Venezuela. It should be added that Ecuador's democratic institutions were restored in April 1979.

[14] Commercial bankers recognize the emergence of this new consensus in the region. See, for instance, John Reed, "New Money in New Ways", *International Economy*, October/November 1987, p. 50.

unreserved applause, it would be equally unfair to ignore the great adjustments that have actually been undertaken and the sacrifices they have involved. Between 1982 and 1988 the region transferred US$179 billion to its creditor countries.[15] Moreover, that outward net transfer of resources from Latin America was policy-induced, for it was made possible only because the region rapidly converted a long-standing trade deficit —averaging nearly US$2 billion per annum in 1978-1981— into a massive trade surplus that averaged US$26 billion per annum in 1982-1988. The trade surpluses, in turn, could not have come about without exchange rate devaluations, adjustments of domestic interest rates, fiscal correction (including the selling off of State enterprises), compression of real wages, etc.[16] Also, the domestic effort must be evaluated in the light of an unhelpful external environment. Aside from protectionism, exports have been hindered by historically low average unit prices, which have caused the value of exports to expand by only a small fraction of the recorded growth of export volume (table 5).

Table 5

LATIN AMERICA: EXPORTS OF GOODS

(Index, 1980 = 100)

	Value			Volume			Variation[a]
	Annual averages		1988[b]	Annual averages		1988[b]	Value / Volume
	1978-1981	1982-1987		1978-1981	1982-1987		
Latin America	**85**	**99**	**115**	**96**	**126**	**156**	**52.7**
Oil-exporters	82	95	87	95	125	152	50.5
Bolivia	86	70	56	99	74	69	(73.7)
Ecuador	87	95	89	102	128	159	35.7
Mexico	81	131	134	93	181	228	65.2
Peru	81	75	68	98	94	71	(180.5)
Venezuela	82	70	54	104	85	106	(79.8)
Non-oil-exporters	**88**	**103**	**139**	**98**	**127**	**159**	**57.8**
Argentina	97	94	94	114	124	131	...
Brazil	89	119	166	95	144	197	65.3
Colombia	86	103	150	95	114	174	99.0
Costa Rica	95	97	120	107	114	121	32.3
Chile	79	87	146	93	130	158	23.1
El Salvador	88	66	59	96	79	78	(141.2)
Guatemala	84	71	73	91	83	83	(176.1)
Haiti	76	93	83	85	112	82	70.4
Honduras	89	92	115	95	96	106	309.1
Nicaragua	123	76	48	144	87	45	(102.3)
Panama	...	...	...	...	...	...	...
Paraguay	96	136	251	93	132	239	99.5
Dominican Republic	96	80	85	103	103	107	...
Uruguay	89	102	130	97	121	130	59.1

Source: Calculated from data of ECLAC Division of Statistics and Quantitative Analysis.
[a] Variation between annual average of 1978-1981 and 1982-1987. Numbers in parenthesis refer to cases where both value and volume declined over the two periods.
[b] 1988 data estimate from ECLAC, *Preliminary Overview of the Latin American Economy*, (LC/G.1536), Santiago, Chile, January 1989, table 8.

[15] See ECLAC, *Preliminary Overview of the Latin American Economy, 1988* (LC/G.1536), Santiago, Chile, 3 January 1989, table 15.

[16] For a detailed analysis of the process of adjustment in Latin America, see Andrés Bianchi, Robert Devlin and Joseph Ramos, "El Proceso de Ajuste en la América Latina", *El Trimestre Económico*, vol. LIV, No. 216, October/December 1987.

Table 6

15 BAKER PLAN COUNTRIES: MEDIUM-TERM BANK CREDITS, 1986-1988[a]

(Millions of dollars)

	1986	1987	January-August 1988
Total	**483**	**10 004**	**6 250**
Argentina	17	2 110	-
Bolivia	-	-	-
Brazil	-	-	5 200
Chile	-	-[a]	-
Colombia	201	87	1 000
Cote d'Ivoire	-	-	-
Ecuador	220	32;(300)[b]	-
Mexico	-	7 700	-
Morocco	-	25	50
Nigeria	-	-	-
Peru	-	-	-
Philippines	-	-	-
Uruguay	45	-	-
Venezuela	-	30	-
Yugoslavia	-	20	-

Source: OECD, *Financial Statistics Monthly*, various numbers, Paris, and ECLAC, Economic Development Division.
[a]In a rescheduling in 1987 Chile secured a "retiming" of its interest payments which saved the country about US$450 million in 1988.
[b]Cancelled.

2. *Itemizing the setbacks*

While there have been signs of progress on some fronts, there have also been setbacks of major importance. In the last six years, the North has lost export markets,[17] and hence jobs and GNP growth, due to a reduced capacity to import in Latin America. OECD firms with direct investments in Latin America have not been able to escape the crisis; their profitability has fallen and corporate uncertainties in Latin America are certainly up.[18] United States banks, which are those with the greatest exposure in Latin America, have lost ground in the international race for dominance of financial markets: expansion into a world of financial liberalization is a capital-intensive endeavour, and the time and resources United States banks must allocate to propping up their slumping Latin American portfolio has clearly put them at a competitive disadvantage. Moreover, although it is difficult to prove definite links, it is also suspected that the increased supply of illicit drugs from Latin America is at least partially linked to shortages of foreign exchange in the region.

The North may also have suffered a serious erosion of the value of its "goodwill" in Latin America. On the one hand, creditors have repeatedly failed to keep their promises of new financing for the debtors; most recently the Baker Plan's 1985 commitment to mobilize US$20 billion of new bank finance and US$9 billion of official loans over three years has remained unfulfilled. Multilateral net disbursements to the region have declined rather than increased, while private bank loans have been few and far between, and heavily concentrated in the hands of only a lucky few within the so-called Baker 15 (tables 6 and 7).

[17]One study has shown that by 1985 United States exports to Latin America were 28% below levels recorded in 1981 and 47% below the potential export level. The latter is defined as maintenance of a constant export share *vis-à-vis* GDP. See Joint Economic Committee, United States Congress, "Trade Deficits, Foreign Debt and Sagging Growth", Washington, D.C., September 1986, table 6.

[18]For example, rates of return on United States direct investment in Latin America declined from an average of 17% in 1980-1981 to 6% in 1982-1985. See United Nations Centre on Transnational Corporations, *Transnational Corporations in World Development: Trends and Prospects* (ST/CTC/89), New York, 1988, United Nations publication, Sales No. 88.II.A.7, p. 82.

Table 7

IMF, WORLD BANK AND IDB: NET TRANSFERS TO LATIN AMERICA

(Billions of dollars)

	1980	1981	1982	1983	1984	1985	1986	1987
1. **Net disbursements**	**2.3**	**2.7**	**4.0**	**8.8**	**7.4**	**5.3**	**4.4**	**2.1**
IMF	-0.1	0.1	1.2	5.7	3.3	1.5	0.2	-0.5
World Bank	1.2	1.3	1.4	1.7	2.1	1.9	2.7	1.6
IDB	1.2	1.3	1.4	1.4	2.0	1.9	1.5	1.0
2. **Interest charges**	**1.0**	**1.2**	**1.3**	**1.7**	**2.2**	**2.7**	**3.6**	**4.0**
IMF	0.1	0.1	0.1	0.3	0.6	0.9	0.9	0.8
World Bank	0.6	0.7	0.8	0.9	1.0	1.1	1.7	2.1
IDB	0.3	0.4	0.4	0.5	0.6	0.7	1.0	1.1
3. **Net transfers** (1-2)[a]	**1.1**	**1.5**	**2.8**	**7.2**	**5.2**	**2.6**	**0.7**	**-1.9**
IMF	-0.2	-	1.2	5.4	2.7	0.6	-0.8	-1.3
World Bank	0.5	0.6	0.6	0.8	1.1	0.8	1.0	-0.5
IDB	0.8	0.9	1.0	1.0	1.4	1.2	0.5	-0.1

Source: Calculated from data provided by SELA.
[a] May not sum properly due to rounding.

Table 8

LATIN AMERICA: PARTICIPATION IN MULTILATERAL ADJUSTMENT PROGRAMMES

	IMF		World Bank	
	1982-1983	1987	1982-1983	1987
Total	13	6	1	9
Oil-exporters	3	2	-	3
Bolivia	-	x	-	x
Ecuador	x	-	-	x
Mexico	x	x	-	x
Peru	x	-	-	-
Venezuela	-	-	-	-
Non-oil-exporters	10	4	1	6
Argentina	x	x[a]	-	x
Brazil	x	-[b]	x	x
Colombia	-	-	-	x
Costa Rica	x	x	-	x
Chile	x	x	-	x
El Salvador	-	-	-	-
Guatemala	x	-	-	-
Haiti	x	-	-	-
Honduras	x	-	-	-
Nicaragua	-	-	-	-
Panama	x	-	-	-
Paraguay	-	-	-	-
Dominican Republic	x	-	-	-
Uruguay	x	x	-	x

Source: ECLAC, Ecominic Development Division, based on the respective institution's data.
[a] "Out", at least transitorily in 1988.
[b] "In" in 1988.

Table 9

GROSS DOMESTIC SAVINGS AND INVESTMENT IN LATIN AMERICA[a]

	Savings Index 1980 = 100		Investment Index 1980 = 100	
	1978-1982	1982-1987	1978-1981	1982-1987
Latin America	96	107	94	73
Oil-exporters	...	...	...	...
Bolivia	91	57	129	64
Ecuador	92	114	93	74
Mexico	94	113	92	69
Peru	95	79	89	80
Venezuela	107	83	117	74
Non-oil-exporters	...	...	...	...
Argentina	112	104	88	51
Brazil	90	110	91	78
Colombia	97	113	99	110
Costa Rica	103	184	85	70
Chile	82	122	90	57
El Salvador	85	74	134	85
Guatemala	94	98	117	77
Haiti	91	150	96	107
Honduras	101	83	98	63
Nicaragua	...	...	93	134
Panama	80	100	94	86
Paraguay	83	69	93	85
Dominican Republic	107	151	92	95
Uruguay	123	155	91	50

Source: Calculated from data of ECLAC, Division of Statistics and Quantitative Analysis.
[a]Market prices and 1980 dollars.

Meanwhile, the IMF's credibility has been further tarnished over the last few years because its programmes continue to be associated with economic recession; this has caused more countries to distance themselves from the Fund exactly when in principle the need for its guidance is greater than ever (table 8). The 1988 Toronto Summit's priority attention to Africa's debt problem, contrasting with the continued inertia on the Latin American front, was also not very helpful.[19] Finally, the United States administration's often unconstructive approach to the Inter-American Development Bank's problems has been a severe source of contention in hemispheric relations.

The setbacks for Latin America since the outbreak of the crisis have been very dramatic. Who would have imagined back in 1982 that by 1988 Latin America's per capita gross domestic product would be nearly 7% below the 1980 figure?[20] While domestic savings have been higher than ever before, since 1982 the region's domestic investment —vital to any serious campaign to make Latin America's goods and services more internationally competitive— has been 22% below the average annual level recorded in 1978-1981 (table 9). On a per capita basis the investment performance has been even worse: in 1987 such outlays were the highest of the six years of the crisis, yet even so per capita investment in that year was the lowest since

[19]The scheme for African debtors allows creditor governments to write off one third of the debts, or cut interest rates by half or 3.5 percentage points, or lengthen the amortization period to 25 years. The plan has been criticized as not being radical enough for these problem debtors. See *Financial Times*, "Africa's debt burden", 30 September 1988, p. 18.

[20]ECLAC, *Preliminary Overview . . .*, *op. cit.*, table 3.

1971![21] Inflation has increased spectacularly in Latin America; the regional average was nearly 500% in 1988, with rates reaching three digits for two countries (Argentina and Brazil) and four digits for another two (Nicaragua and Peru). Real wages have for the most part been depressed, while official unemployment is disturbingly high.[22] Although the social repercussions of the crisis are hard to quantify, there are studies which suggest an important deterioration on many fronts and confirm what the casual observer senses when visiting almost any Latin American capital city.[23]

Finally, the evolution of the debt burden indicators has not been entirely encouraging. After seven years of costly adjustments the region's debt-to-export ratio in 1988 (339%) was 60% higher than in 1980. On the other hand, the interest/exports ratio had fallen to 28% by 1988, and although that was still extremely burdensome, it was nevertheless the lowest level recorded since 1981 (table 10).

Table 10

LATIN AMERICA: EXTERNAL DEBT

	Debt[a]	Debt export		Debt/GDP		Interest exports		Arrears	
	1988[b]	1981	1988[b]	1981	1988	1981	1988[b]	1987	Sept.1988
Latin America	**401.4**	**247**	**339**	**46**	**53**	**28**	**28**	**x**	**x**
Oil-exporters	159.2	220	343	...	...	23	28	x	x
Bolivia	3.9	348	595	...	...	35	35	x	x
Ecuador	10.5	202	388	51	80	23	33	x	x
Mexico	96.7	259	339	52	62	29	29	-	-
Peru	16.2	239	442	45	70	24	22	x	x
Venezuela	31.9	160	290	56	49	13	26	-	-
Non-oil-exporters	**242.1**	**273**	**337**	...	...	**34**	**28**	**x**	**x**
Argentina	56.8	329	541	55	81	36	40	-	x
Brazil	114.6	313	321	39	42	40	30	x	-
Colombia	15.9	199	218	24	33	22	21	-	-
Costa Rica	4.1	229	260	90	108	28	20	x	x
Chile	19.1	311	236	73	74	39	23	-	-
Cuba	(5.7)[c]	...	...	...	...	...	...	x	x
El Salvador	1.9	174	185	...	...	8	10	-	-
Guatemala	2.8	96	225	...	...	8	13	x	x
Haiti	0.8	155	276	...	...	3	7	...	x
Honduras	3.2	180	290	...	...	14	14	x	x
Nicaragua	6.7	464	2 068	...	...	37	103	x	x
Panama	4.2	92	...	...	...	...	...	-	x
Paraguay	2.2	171	324	...	...	15	12	x	x
Dominican Republic	3.8	168	220	...	...	19	13	x	x
Uruguay	6.1	183	354	51	97	13	23	-	-

Source: ECLAC, Economic Development Division.
[a] Billions of dollars.
[b] ECLAC, *Preliminary Overview of the Latin American Economy, 1988* (LC/G.1536), Santiago, Chile, January 1989.
[c] Excluded from totals. Represents debt with so-called market countries in 1987.

[21] ECLAC, Division of Statistics and Quantitative Analysis.
[22] Data from ECLAC, *Preliminary Overview ..., op. cit.*
[23] World Bank, "Poverty in Latin America: The Impact of Depression", Washington, D.C., 1986.

II

Why the skewed distribution of costs between creditors and debtors?

The review of the situation since 1982 suggests some improvements, but also points to serious setbacks for the creditor and debtor countries alike. Yet the review also highlights a distribution of benefits and costs that is clearly skewed against the debtor countries. In effect, thanks to a growth-oriented adjustment, private banks now only have a problem in Latin America; the countries of the region, in contrast, have a development crisis of ever deepening proportions. Why?

Impatient creditors often point to: i) bad economic policies in the debtor countries, coupled with their excessive debt accumulation in the 1970s; and ii) an unwillingness in the 1980s to make and persist with the hard economic decisions needed to turn the Latin American economies around. Moreover, there often exists by implication the notion that if creditors provide comprehensive relief for the debtors this will raise moral hazard, as well as giving rise to a tendency to abuse the degrees of freedom won thanks to the relaxation of the efforts to restructure the region's economies and make them more competitive internationally.

The debtors, on the other hand, tend to focus on the harsh external environment and the weight of the outward transfer of resources.[24] The argument is by now well developed. Expenditure switching policies normally take a great deal of time to work their way through the economies, especially in structurally uncompetitive ones. Thus, the large trade surplus needed to effectively service debts at high real rates of interest can be achieved in the short term only with a disproportionate amount of import compression and domestic economic recession. Moreover, since it is inherently difficult for developing countries to quickly raise domestic savings (especially during an economic slowdown), the outward transfer of resources tends to have its counterpart in reduced investment and social expenditure, which is counterproductive, because it hampers economic restructuring and future capacity to service debts. Furthermore, the changing of relative prices for the purpose of making an external transfer tends to aggravate inflationary pressures. This situation is complicated by the fact that debt servicing is largely the responsibility of the public sector, giving rise to an internal budgetary transfer problem. As demonstrated even in the United States, tax and public expenditure decisions belong in extremely delicate political terrain. If there is no broad domestic political consensus to accept a decisive increase in taxes and a lowering of public expenditure to accommodate the transfer, the State must mobilize the necessary resources through an inflationary tax. This is a risky strategy that can easily degenerate into hyperinflation.[25]

As in most polarizing issues, the truth probably lies in between the extremes of the arguments of the two groups. To overcome the development crisis and put Latin American debtors back on track, adequate and sustained internal effort is unquestionably a necessary first step in a successful restructuring process. Thus far the internal efforts have been of varying intensity and duration in the region, but such efforts have certainly been made. As mentioned earlier, domestic policy has induced a transfer of resources to the creditor countries of US$179

[24] For a more complete analysis see ECLAC, *Restrictions on Sustained Development in Latin America and the Caribbean and the Requisites for Overcoming Them* (LC/G.1488(SES.22/3)/ Rev. 1), Santiago, Chile, 9 February 1988. The study that helped to shift the analytical focus of the debt debate to the question of the transfer problem is Helmut Reisen and Axel Van Trotsenberg, *The Budgetary and Transfer Problem.* Paris, Organization for Economic Co-operation and Development (OECD), 1988.

[25] An analysis of the complex relationship between debt service and inflation can be found in Rudiger Dornbusch, "Debt, Inflation and Growth: The Case of Argentina", Washington, D.C., International Monetary Fund, 16 February 1988.

billion, or more than 4% of GDP per annum. To illustrate the magnitude of the transfer, suffice it to recall that this exceeds the outward net transfer forced on defeated Germany under the 1919 Treaty of Versailles (2.5%) and defeated France under the 1871 Treaty of Frankfurt (2.3%).[26] The debtors also deserve some patience from the creditor countries: to turn around a development strategy that worked reasonably well for 50-odd years is much more than a six-year project.[27] In addition, the economic transformation is being attempted simultaneously with a fragile transition to political democracy. A peripatetic course might be a likely feature of any process of economic transformation built on a very weak and emerging institutional framework.

Moreover, it is always difficult to isolate the contribution made to economic recovery by domestic efforts from the effects of the external environment. If that environment had been clearly supportive of the debtors' efforts to adjust and restructure, one could more comfortably point an accusing finger at lack of serious domestic effort. But in most respects the external environment has been extremely unsupportive of Latin America's adjustment policies. Of critical importance in this regard is the fact that the region's adjustment process has been badly underfinanced from the outset of the crisis.[28] Indeed, whether it be the formula of 7% annual expansion of bank lending that emerged in 1982, or the Baker Plan's 2 1/2% per annum formula, financing volumes have not satisfied the modest targets that the creditors have variously committed themselves to.[29] Underfinancing for the debtors translates into overtransferring of resources to creditors. The transfer problem is therefore a real one that has undermined the efficiency of the debtor countries' policies for adjustment and restructuring.

III

The most conspicuous weak link: half-hearted international public policy

A systemic debt crisis is a collective problem. In these circumstances, negative externalities emanating from the private market are notoriously indiscriminating, drawing into the problem prudent and imprudent lenders/borrowers alike, and even passing serious costs onto those not even remotely involved in the problem.[30] Moreover, rational individual responses to the situation can be very damaging to the collective good and escalate the costs for all. Hence the need for public intervention in the marketplace, first, to stabilize private expectations, and second to assist in restructuring the market agents (borrowers, lenders or both) in a way that is functional to the renewed solvency of the system

[26] See Bianchi, Devlin and Ramos, *op. cit.*, p. 891.

[27] The per capita GDP in Latin America grew by a respectable 3% per annum over 1950-1980.

[28] Ground has focussed on this issue. Conventional criteria suggest that the transitory components of external shocks should be financed. However, according to Ground's estimates, the external finance made available to Latin America over 1982-1985 covered only 37%, 25%, 36%, and 16% of the respective transitory components of the adverse external shocks in that period. See Richard Ground, "The origin and magnitude of the recessionary adjustment in Latin America", *CEPAL Review*, No. 30 (LC/G.1441), Santiago, Chile, December 1986, p. 72.

[29] When the crisis first broke out, private banks, in conjunction with the IMF, committed themselves to an annual expansion of 7% in their credit exposure in the region. The actual expansion in the first round of reschedulings came closer to 6% and fell dramatically thereafter. Then, in September 1985, Secretary Baker of the United States Treasury established a new target for bank credit expansion of 2 1/2% per annum for 3 years. This goal was not fulfilled; indeed, the response of the banks was to begin a sustained reduction of their exposure in the region. Moreover, the slack was not picked up by multilateral and bilateral lenders.

[30] Colombia is a good illustration of this problem: with a debt-to-export ratio of only a little over 2:1 and a debt-to-GDP ratio of 34%, it has had tremendous difficulty securing fresh credit from the private banks.

and to global recovery with minimum social disruption. Given the opportunities for "free riding" when externalities exist, and its adverse effects on the efficiency of any institutional arrangement, effective public solutions often are to varying degrees coercive in nature.[31] All these principles are usually put into practice when severe financial strain emerges in the domestic markets of the creditor countries.[32]

The international debt crisis that emerged in 1982 has in fact been subject to international public management.[33] Yet, the effectiveness of the latter as an instrument in the promotion of global prosperity and development in an interdependent world has been severely limited. This is because the international debt management strategy has not evolved much beyond a lender-of-last-resort function designed to keep the Northern banking system stable. Indeed, with time it has become increasingly obvious that it is the sporadic threat of a destabilizing default, rather than the sustained requirements of financing economic restructuring in the debtor country, that brings forth new credits. The faster the banks have strengthened their balance sheets, the tighter external financing has become. Meanwhile, however, official lenders have not been given the means to pick up the slack; indeed, they are aggravating the problem as the net flow of resources from these institutions has now turned negative (table 7).

The latest phase of the international debt strategy —the so-called Market Menu Approach— does not rectify the situation. To the extent that it represents a public policy initiative at all, it repeats the basic flaw of the earlier stages: the day to day mechanics of a supposedly multilateral debt management programme remain biased toward the narrow objective of securing an orderly adjustment of private financial portfolios in the North.

The initial phase of the debt management strategy was characterized by a "holding action" designed to enable the international financial system to avoid accounting losses via commercially priced reschedulings and new money packages. Now, the latest phase is primarily oriented to the gradual adjustment of the banks' asset values and enhanced risk diversification through schemes involving debt swaps and securitization. As for the macroeconomic issue of finance to support economic reforms, investment, growth and restored creditworthiness in the debtor countries, it largely remains a passive residual to this process. It is in this sense that the Market Menu is basically a private creditors' menu.

As ECLAC has shown in a recent study, from the perspective of the debtors' macroeconomic needs the Market Menu may list some interesting "appetizers', but the "main entrées" simply are not there.[34] The market-based approach of the menu relies on the principle of voluntary responses from the individual creditors, with little more than moral support from their governments. However, conventional market financing is procyclical in nature and therefore new capital will be unlikely to flow spontaneously to Latin America in a macroeconomically significant volume as long as potential creditors see big discounts of 50% or more on existing debt.

As for the new and more exotic instruments designed around portfolio adjustments, their natural development will be only gradual. It is well known that private markets operate at the margin and each new instrument must start small even under favourable circumstances.[35] In Latin America advance is further slowed by complex free rider and international legal, tax and accounting problems in the market, as well as many institutional investors' lack of

[31] Detailed analysis of the problems of collective action and public goods can be found in James Buchanan, *The Demand and Supply of Public Goods*, Chicago, Rand McNally and Co., 1968, chapter 5.

[32] The collective nature of the problem even manifests itself in isolated payments crises of individual firms. Because of this, bankruptcy laws often impose collective solutions upon a firm's creditors. See Thomas Jackson, *The Logic and Limits of Bankruptcy Law*, Cambridge, Mass., Harvard University Press, 1986.

[33] By now the nature of the co-ordinated policies of the IMF, OECD Central Banks and Treasuries with the creditor banks and debtor governments is so well known that it is not necessary to summarize it here. If desired, however, details may be found in ECLAC, *External Debt in Latin America, op.cit.*, pp. 47-86.

[34] ECLAC, *The Evolution of the ..., op. cit.*, chapter II.

[35] See Mahesh Kotecha, "Repackaging Third World Debt", *Standard and Poor's International Credit Week*, August 1987, p. 9 and Kenneth Telljohann, "Analytical Framework", *Prospects for Securitization of Less Developed Country Loan*, New York, Salomon Brothers, June 1987, p. 11.

familiarity with the region. There are also demand constraints in Latin America as questions of sovereignty and monetary control limit the potential expansion of some of the creditors' preferred instruments in the market menu.[36]

Another consideration is that the bulk of the proposed debt reduction instruments in the menu act on the principal. Since countries are not amortizing debt anyway, the immediate impact of the transaction on the balance of payments is indirect, in the form of reduced interest payments; hence relief will be marginal until the cumulative scope of the reduction of the principal becomes very large.[37] The menu also has the serious drawback that voluntary market transactions are effected only sporadically, making it difficult to predict the timing of conversions, their distribution among the different countries, the amount of relief for the balance of payments, and the effectiveness of the conversion with respect to the support of a domestic programme for economic reform and restructuring.

In sum, when left to their own devices, private markets naturally unwind from a large debt overhang only slowly. The amount of debt swapped and converted at a discount into other types of assets will undoubtedly rise markedly in the years ahead.[38] Yet for the immediate future the Market Menu Approach —at least as currently formulated— will only chip away at the corners of the region's problems because it does not address the urgent central macroeconomic issue of today: how to finance in a sustained and predictable way the economic reforms and new investments that Latin America will need to initiate growth now and begin to restore its capacity to service foreign debts. From the standpoint of a collective economic problem and collective solutions, the Market Menu Approach therefore clearly represents unambitious public policy. Indeed, in some essential ways the market menu seems to have thrust us back to the 1930s, when debtor countries and private creditors groped inefficiently for 20 years for a way to unwind from the debt overhang of that period.[39]

IV
Where do we go from here?

The Latin American debt problem should be viewed in its proper context, as a collective international problem: at a time when private sources of credit for Latin America have collapsed, the reliance on voluntary private "micro" responses from the menu to resolve a systemic macroeconomic financial problem promises to delay the adjustment of both debtor and creditor countries and raise costs for the

[36] "Negative side effects" are particularly complex in the popular debt-equity swaps. See Group of Thirty, *Finance for Developing Countries*, New York, 1987.

[37] As an illustration, the original goal of the Mexican-Morgan Guaranty bond operation of early 1988 was to convert US$20 billion of debt. If this goal had been attained at an average (rather optimistic) discount of 40%, something of the order of US$350 million of net interest payments would have been saved. While this type of operation had many merits, including the banks' formal recognition of market discounts, its significance as a vehicle for macroeconomic financing is less apparent in view of the US$7 billion interest burden with the private lenders. In any event, as mentioned in footnote 10, the banks' reception to the plan was less enthusiastic than had originally been hoped for. A detailed analysis of the Mexican bond offer can be found in Kenneth Telljohann and Richard Buckholz, *The Mexican Bond Exchange Offer*, New York, Salomon Brothers, January 1988.

[38] The volume of secondary market trading in 1987 is estimated to have been about US$12 billion. Some expect that figure to rise to US$25 billion in 1988. To put these figures in perspective it must be remembered that they include considerable double counting and therefore do not mirror actual debt conversions. The figures also are still small relative to the estimated US$300-350 billion of problem LDC debt in the international commercial banking system. See Richard Lawrence, "Banker Proposes Solution to Argentina, Brazilian Debt", *Journal of Commerce*, 28 September 1988 and Eugenio Lahera, *La conversión de la deuda externa: antecedentes, evolución y perspectivas* (LC/R.614), UNDP/ECLAC Project "Finance for Development", Santiago, Chile, ECLAC, September 1987.

[39] For a good review of the portfolio adjustments of debtors and creditors in the 1930s and 1940s, see Marilyn Skiles, *Latin American International Loan Defaults in the 1930s:* Lessons for the 1980s?, Federal Reserve Bank of New York, Research Paper No. 8812, April 1988.

international community as a whole. The systemic aspects of the problem give theoretical and practical support to the idea that there is a need for more aggressive production of international public goods designed to accelerate the adjustment of debtor and creditor countries alike, as well as to ensure that costs are distributed in such a way that they can be paid for out of future growth of the global economic system.

The reason why the proposal for a multilateral debt conversion facility has repeatedly appeared in the debate about debt, and will not go away despite rather heated rejections by the leaders of the international debt strategy, is that it is the most complete expression of the systemic nature of the debt problem in the Western Hemisphere and the social efficacy of a collective solution.[40] Obviously, many of the details of such a complex facility, as well as auxiliary regulatory, accounting and tax measures, need to be refined, but the basic thrust of the proposed initiative —an orderly and macroeconomically significant reduction of the present value of debt in return for orderly adjustment of economic policy— is in the best spirit of good public economic policy-making in an interdependent world. As an interim step to negotiating such a complex facility, one could envision —under the auspices of IMF-approved exchange restrictions within the context of an official standby programme— an immediate temporary freezing of interest payments (with forced capitalization of the difference) at levels consistent with specified targets of investment and growth in the debtor economies.

A less ambitious public policy could consist simply of the approval of *ad hoc* public guarantees on bank loans and market debt reduction instruments, coupled with supportive modification of tax and accounting rules for the banks. This could grant the credit enhancement needed to bring a volume of conversions and buybacks sufficient to generate rapid and significant balance-of-payments financing for the debtor countries. Bolivia's recent debt buyback at 11 cents on the dollar is a good example of how ambitious intervention by the international public sector can bring about a quick and substantial reduction of the debt overhang.

Ad hoc guarantees, while more effective than the hands-off approach of the current Market Menu, are not without their drawbacks, however. On the one hand, the distribution of relief among countries may be arbitrarily based on political factors, while the timing of that relief remains uncertain. On the other, since *ad hoc* arrangements tackle free rider problems and other negative externalities only in a piecemeal fashion, their cumulative cost over the medium term could be actually more than a full-fledged debt reduction facility today.

Should Latin America promote these and other collective international initiatives? Certainly yes. Should Latin America bank its future development on the imminent emergence of comprehensive public initiatives? Probably not. Collective solutions for a large number of individual economic agents are notoriously difficult to organize when customs, traditions, legal standards, strategies and economic circumstances differ. To act collectively, there must be a common sense of extreme stress. This sense of stress existed in Northern financial circles in 1982 when virtually all national banking systems were vulnerable to defaults in Latin America; this explains the amazingly quick and extraordinarily tight global co-ordination among the creditors to avoid default in the early

[40] In the contemporary debate early proposals were made by Peter Kenen and Richard Weinert. Kenen proposed conversion at a discount, while Weinert proposed conversion at par with below-market interest rates, on the grounds that this would spread the banks' losses over time. See Peter Kenen, "A Bailout for the banks", *The New York Times*, March 1983 and Richard Weinert "Banks and bankruptcy", *Foreign Policy*, No. 50, Second Quarter, 1983, pp. 128-149. Kenen has recently updated and expanded his proposal. See Peter Kenen, "A Proposal for Reducing the Debt Burden of Developing Countries", Princeton, New Jersey, Princeton University, March 1987. Other people proposing a global debt conversion facility are: John La Falce, "Third World Debt Crises: the Urgent Need to Confront Reality", *Congressional Record*, Washington, D.C., vol. 133, No. 34, 5 March 1987; Don Pease, "A Congressional Plan to Solve the Debt Problem", *International Economy*, March/April 1988, pp. 98-105; James Robinson, "A Comprehensive Agenda for LDC Debt and World Trade Growth", London, American Express Bank, March 1988; Percy Mistry, "Third World Debt", May 1987; and Arjun Sengupta, "A Proposal for a Debt Adjustment Facility", Washington, D.C., IMF, 8 March 1988.

years of the crisis.[41] However, as the banks' vulnerability to default has receded, and as interest in Latin America's markets has become increasingly overshadowed by developments in vibrant Asia, as well as in the emerging new Common Market of Europe and the free trade area of North America, even that limited co-ordination has broken down into an extremely muddled approach, where each creditor is now increasingly set free to cut its own deal. Indeed, in most respects the so-called Market Menu legitimizes the serious *de facto* breakdown in co-ordination among creditors and their governments and multilateral agencies.[42]

Collective solutions also typically have immediate costs, whereas the benefits are spread out more gradually. Serious financial and external adjustment problems limit the United States' ability to respond to difficulties in the hemisphere with new money, at least on the scale that we had become accustomed to in the 1950s and 1960s. Meanwhile, it remains to be seen to what degree Japan and Europe will be willing to fill the financial void in the region, and whether this can be done without creating serious conflict over the traditional distribution of political spheres of influence.

New public initiatives therefore could be very slow in emerging, or else they could be of insufficient scale to tackle the development crisis in the region. But this does not mean that the Market Menu is the only game in town. Indeed, the debtors have gradually developed their own menu of options which includes various types of moratoria on debt service payments. Notwithstanding recent developments in Brazil, more than half of the countries in Latin America are now deploying this latter approach (table 10). It is also important to remember that most of the recent debt restructurings carried out under the official Market Menu have evolved out of concessions by the creditors, designed to either coax a country out of a moratorium, or prevent it from entering one.[43] Moreover, these agreements can represent more than a temporary respite from a threat of future moratorium only to the degree that they adequately address the underlying capacity to pay of the debtor. So far, only the recent Bolivian agreement would unequivocally fall into this category.

The debtors' menu of options should not be underestimated. In the past an organized formal or informal threat to impose full or partial limits on payments has proven difficult partly because of the lack of internal consensus on what to do about the outward net transfer of resources. It is possible to observe, however, a series of interesting shifts in political alliances in a number of important debtor countries which suggest that that consensus may now be emerging in more countries as we move into the seventh year of the development crisis of the region.

In addition, the debtor countries will gradually learn the secrets of how to sustain growth in a state of full or partial moratorium. Most earlier limits on payments evolved out of the force of events, set off by a poor domestic economic policy, or were mistakenly conceived as an end in and of itself, which only served to stimulate self-defeating populism. Now, however, there are signs of greater sophistication. Perhaps because of some recent bad experiences, more countries seem to realize that, in order to be a successful instrument for economic recovery, a temporary moratorium must evolve out of a coherent economic programme designed to vigorously correct internal and external disequilibria. Furthermore, the limit on payments must be partial and conciliatory in nature, with lines of communication to the creditors kept open and

[41] The co-ordination was so good that Latin Americans began to perceive the formation of a creditors' cartel. See OAS, "Desarrollo Integral y Democracia en América Latina y el Caribe: Ideas y Agenda para la Acción", Washington, D.C., 28 September 1987, p. 23.

[42] The breakdown of the cartel reflects itself in the growing disputes among all parties in the creditor bloc about how to share responsibilities in the management of the debt issue. Serious public disagreements have broken out among the private banks, between the banks, their governments and the multilateral lenders, among the creditor governments, between the creditor governments and multilateral lenders, and even between the World Bank and IMF (over the recent World Bank loan programme in Argentina, mentioned in footnote 12). For an analysis of the breakdown of the creditor co-ordination, see ECLAC, *The Evolution of the ...*, *op. cit.*

[43] This manifested itself clearly during the fourth round of reschedulings. See ECLAC, *Economic Survey of Latin America and the Caribbean, 1987: Advance Summary* (LC/G.1511), Santiago, Chile, pp. 42-60.

constructive proposals offered to them for resolving the problem in a context compatible with an explicit growth-oriented economic reform programme of the debtor country. To the extent that debt service is forcibly rechannelled into a coherent and sustainable economic programme and gratuitous conflict is avoided, the country enhances the possibility of eventually winning a more realistic settlement on the outstanding debt.

V
Conclusions

We have seen that the outward transfer of resources from Latin America hinders adjustment, growth and economic restructuring through its aggravation of either the foreign exchange constraint, the savings/fiscal constraint, or both. In the absence of systematic payment guarantees from the creditor governments, the voluntary market options in the Menu Approach promise to reduce that transfer burden only gradually over a long haul and with a high degree of uncertainty regarding the amount and timing of relief, as well as its distribution among the debtors. In the meantime, the external finance requirements for supporting macroeconomic programmes of growth and restructuring remain unsatisfied. It is thus no surprise that there are very few countries in Latin America which have so far been able to sustain a process of adequate growth with price stability.

An international strategy for growth and reconstruction which benefits only a few problem debtors is clearly a half-hearted international public policy. Yet, it could be unproductive for the debtor countries of Latin America to sit back and wait for the creditor governments to rescue them from their plight with more ambitious international public initiatives. We have seen that collective solutions to a systemic problem emerge more out of a sense of urgency than a sense of good will. As long as the Northern financial systems can successfully adjust to the debt overhang with minimum public assistance, and as long as the economic problems of the region do not provoke open manifestations of political radicalization in the debtor countries, it will be difficult for a comprehensive public policy response to emerge from the heterogeneous bloc of creditor countries. Clearly, then, the solution to Latin America's crisis of debt and development must, more than ever, come from "inside" the region. This approach is moreover aided today by the serious cracks and disputes that have been developing in the creditors' negotiating bloc, coupled with the lessening importance of the Latin American portfolio in the global economy, because this state of affairs affords more freedom to the debtor countries regarding the formulation of policies designed to lower the outward transfer of resources.

Countries undoubtedly will want to approach the reduction of this transfer in different ways. A minority of countries will find it appropriate to work entirely within the official framework of the Market Menu Approach, periodically rescheduling debts on commercial terms, seeking involuntary loans and participating in debt reduction schemes voluntarily sanctioned by the creditors. Other countries, however, will decide, or be forced by events, to limit the transfer through a partial or total stoppage of payments. In some cases the limit (or threat of a limit) on debt service will be a very transitory bargaining tactic designed to achieve more favourable conditions within the officially sanctioned debt management scheme, but in others it will be a longer-term policy stance designed to force the creditors to share in the costs of a medium-term programme of economic growth and restructuring.[44] A prolonged partial or full moratorium will, of

[44] There are various ways a moratorium can be established. For some techniques that draw partially on the experience of the 1930s, see ECLAC, *ibid.*

course, drive down secondary market prices of the debt to the floor and thereby give the countries more leverage in establishing the pace and discounted terms of eventual debt settlements.[45]

As for co-operation among the debtor countries of the region, past experience suggests that this can be only of very limited scope in view of the heterogeneous conditions of the borrowers. However, as the common stress of the development crisis intensifies, the barriers standing in the way of regional co-operation may be overcome, bringing forth more effective joint initiatives to reduce the net outward transfer of resources.

In sum, the classic market mechanism for resolving a debt overhang —default— was temporarily suspended by the unprecedented international debt management strategy of the early 1980s. However, as we move through the seventh year of the region's debt servicing difficulties, some of the classic market dynamics of the 1930s seem to be taking hold. Private credit markets have failed and do not discriminate well among the debtors, while new credit is withheld regardless of the countries' economic policies and capacity to pay. Just as in the 1930s, some countries in Latin America are normally servicing their foreign debt without much refinancing, but most are not. Trading of debt paper has accelerated, and secondary market prices reflect large discounts. Some of the debtors' economies manage to overcome the external constraints, while others do not. This is clearly a very unsatisfactory solution to the debt overhang, with unnecessary costs for debtors and creditors alike. However, it is the only realistic option until there is more far-sighted political leadership in the creditor countries.

[45] Again, this is what happened in the 1930s. Indeed, some countries stopped debt service to accumulate resources for a buyback of debt at very low market prices. See M. Skiles, *op.cit.*

CEPAL REVIEW No. 37

Latin America's prospects in the financial markets

*Alfred J. Watkins**

Since the onset of the debt crisis, officials in both creditor and debtor nations have declared that commercial banks would resume making new loans to developing country borrowers once the debtors completed their macroeconomic adjustments and restored their creditworthiness. However, the commercial banks' long-term business interests may no longer coincide with Latin America's debt service and investment requirements.

During the 1970s, virtually every financial market development damaged the commercial banks' domestic business opportunities and enhanced Latin America's access to external financial resources. In both the United States and Japan, the banks shifted their lending operations to developing countries, whose appetite for external financial resources rescued the banks from the threat of stagnation.

The 1980s have been entirely different. Virtually every evolutionary trend and regulatory development in the financial markets during this decade has reduced the Latin American countries' access to external financial resources. Moreover, many of the changes that are expected to unfold during the remainder of this decade and the early part of the 1990s will increase the cost of making syndicated loans to Latin America at the same time that they offer banks a broad array of new profit-making opportunities within developed country markets. Consequently, it is unlikely that commercial bank growth strategies and Latin America's external capital requirement will once again coincide anytime soon.

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Introduction

The financial market innovations of the 1980s opened new vistas for most international borrowers and lenders. New techniques of financial market intermediation reduced costs for borrowers and increased returns for lenders. For the first time, national currencies and national boundaries were not significant barriers to cross-border capital flows. With the globalization, integration, and deregulation of various financial markets, borrowers could compare borrowing costs in different locations and raise funds in the financial centre and currency that offered the lowest price at any particular moment. If that particular currency and interest rate structure was not optimal, currency and interest rate swaps —along with other financial engineering techniques— could improve the match between assets and liabilities. Meanwhile, increased competition among lenders, both in different financial centres and within each centre, ensured that borrowers would enjoy maximum access to the full range of innovations and that borrowing costs would be pared to the bone.

The benefits of this financial revolution have largely bypassed Latin America. Except for an occasional concerted lending package —generally arranged under the threat of a debt service moratorium or some other financial crisis— the financial markets stopped supplying Latin America with external capital. Several factors account for this reluctance, not the least of which is the region's large external debt and the associated decline in creditworthiness. But several important trends associated with the globalization, integration and liberalization of the international financial markets have also been important.

For most of this decade, a rising fraction of the world's financial resources flowed through the securities markets. The syndicated loan market, where Latin American sovereign borrowers raised the vast majority of their external funds during the 1970s, had fallen out of favour with international borrowers and lenders, at least until recently. Simultaneously, new financial market regulations in many of the traditional creditor countries gave banks an opportunity to offer their developed country customers a much broader array of financial services

and to offer their traditional commercial banking services to a wider range of developed country customers. This made it relatively more costly for banks to stay in the syndicated loan business. Not surprisingly, syndicated loans to developing countries —including those that did not experience severe debt servicing difficulties— were no longer viewed as an important profit centre for many commercial banks.

Compounding these problems is the fact that for a variety of reasons having little or nothing to do with Latin America's financial problems, United States banks have been retreating from the international lending arena. They have stopped increasing their exposure, not just to developing countries with external debt problems, but to countries in virtually every region of the globe, developed and developing alike. Since United States banks were in the forefront of lending to Latin America during the 1970s, their eclipse by Japanese banks and general retreat from international lending can be expected to have profound ramifications for Latin America. More specifically, if Latin America's traditional source of external capital is becoming more insular while new entrants into the international lending arena are focusing their attentions elsewhere, Latin American borrowers may want to reassess their growth and debt management strategies. At the very least, the region may need to start looking east, rather than north, for financial assistance.

This article explores these issues in greater detail. It begins with a description of the financial market structure of the 1970s and the factors prompting United States and Japanese banks to jump into the international lending arena with such enthusiasm and vigor. As the discussion will show, the large current account surpluses of the Organization of Petroleum Exporting Countries (OPEC) had a much smaller impact on the growth of syndicated commercial bank loans to developing countries than is generally recognized. Instead, two less frequently discussed factors proved to be of much greater importance. The first was the regulatory environment confronting commercial banks in most creditor countries. The second was the decline in developed country economic growth rates. In tandem, these changes presented commercial banks with a strategic choice between domestic stagnation and international expansion based on rapidly rising volumes of syndicated loans to developing country borrowers. Not surprisingly, most commercial banks selected the latter option.

The second section explains how virtually every financial innovation and regulatory development during the 1980s reduced the region's access to international capital. In addition, it suggests that many of the financial market changes that are expected to occur during the remainder of this decade and the early part of the 1990s —especially the changing structure of domestic bank regulations in the United States and Japan and the emergence of a unified European market in 1992— will reduce the likelihood that commercial bank growth strategies and Latin America's external capital requirement will coincide anytime soon. The final section explores the strategic implications of these financial market innovations for Latin America's economic growth and debt management strategies.

I

International capital markets in the 1970s

In retrospect, it is clear that the 1970s were an anomaly. Almost without exception, every evolutionary trend and revolutionary development in the international capital markets seemed to channel additional capital towards Latin America. This section analyses some of the more important forces at work during the decade in order to show how they affected bank lending decisions and, more importantly, to explain why the region is unlikely to witness such a favourable constellation of forces

in the foreseeable future. The discussion begins by demonstrating that the link between the first oil shock and the growth of syndicated lending to Latin America is more complex than is generally realized. Among the additional variables that need to be considered are: a) the emergence of a two-tier international capital market; b) the impact of domestic bank regulations and international capital controls on the international lending volumes of United States banks; and c) the impact of rapidly increasing government budget deficits and dramatically slower domestic economic growth rates on the decision of Japanese banks to enter the international lending arena.

1. *OPEC and international capital flows*

The 1973 oil shock radically transformed the patterns of international capital flows. According to traditional historical accounts, OPEC current account surpluses flooded the banking system with liquidity and induced the banks to start making syndicated loans to developing country borrowers (Makin, 1984; Cohen, 1986). Unfortunately, this stylized version of events does not stand up well to either empirical or theoretical scrutiny.

From the banking industry's perspective, the main impact of the first oil shock was the dramatic redistribution of wealth from oil consumers to oil producers, not a sudden surge in banking system liquidity. This redistribution was reflected in the banking system's ledger, where the accounts of oil producers were credited and the accounts of oil consumers were debited. But since this bookkeeping transaction amounted to nothing more than a transfer of banking assets from one depositor to another, there is little theoretical justification for suggesting that OPEC surpluses actually increased the international banking system's overall liquidity.

The available empirical evidence supports this hypothesis. Following the 1974 failures of the Franklin National Bank in the United States and the Herstatt Bank in Europe, many commercial banks withdrew their funds from the Euromarkets, generating an overall decline in international liquidity. Consequently, United States banks financed their Euromarket lending operations, not by tapping the excess liquidity of OPEC depositors, but by transferring deposits from their domestic offices to their London branches (D'Arista, 1979). Thus, it was United States oil consumers, not Middle Eastern oil producers, who played a major role in maintaining the liquidity of the Euromarkets in the immediate aftermath of the first oil shock.

The pattern of interest rate spreads also suggests that many other factors besides OPEC surpluses affected the banking industry's willingness to accelerate their lending to Latin America. For example, if the banking industry were truly faced with excess liquidity, as the traditional history suggests, Latin American borrowers should have paid low spreads when OPEC surpluses were greatest and higher spreads as those surpluses diminished. In fact, just the opposite pattern prevailed. Latin American borrowers were charged high spreads in 1974 and 1975 when OPEC surpluses and, more importantly, OPEC deposits in the commercial banking system, were at their peak. Conversely, the spreads began to decline in 1977, at about the time that OPEC surpluses were declining and OPEC *borrowing* from the commercial banking system was beginning to accelerate. Clearly, additional factors governed the pace and volume of commercial bank flows to Latin America during this period.

2. *The two-tier international capital market*

One of the most important of these additional factors was the 600% growth of the Euromarkets during this decade (Cohen, 1986; Mendelsohn, 1980; Versluysen, 1981). In percentage terms, the growth of syndicated bank loans outstripped the growth of external bond offerings, especially in the post-1977 period (table 1). Nevertheless, every segment of the international financial market experienced rapid growth. More significantly, the financial markets were not the least bit reluctant to do business with developing country borrowers. Of the US$774 billion supplied by the international financial markets between 1973 and 1981, developing countries received US$236 billion, or approximately one third of the total (table 2).

Table 1

TOTAL FUNDS RAISED ON INTERNATIONAL FINANCIAL MARKETS

(Billions of US dollars)

	External bonds	Syndicated Eurocredits	Total
1973	8.6	20.9	29.5
1974	8.8	28.5	37.3
1975	19.7	20.6	40.3
1976	33.7	27.8	61.5
1977	34.9	33.8	68.7
1978	35.8	74.2	110.0
1979	37.3	79.1	116.4
1980	38.0	79.9	117.9
1981	47.8	145.3	193.1
Total	**264.6**	**510.1**	**774.7**

Source: Organization for Economic Co-operation and Development, 1982: "The medium-term Eurocredit market in 1978-1981", *Financial Market Trends*, No. 21, March, p. 5.

Table 2

BORROWING IN INTERNATIONAL CAPITAL MARKETS

(Billions of US dollars)

	External bonds	Syndicated Eurocredits	Total
	Developed:		
1973	6.5	13.9	20.4
1974	7.1	20.5	27.6
1975	16.3	9.5	25.8
1976	27.8	12.7	40.5
1977	26.9	16.1	43.0
1978	26.6	35.7	62.3
1979	30.4	29.0	59.4
1980	32.0	41.1	73.1
1981	39.2	90.1	129.3
Total	**212.8**	**268.6**	**481.4**
	Developing:		
1973	1.2	7.2	8.4
1974	.9	8.0	8.9
1975	.7	10.9	11.6
1976	2.0	14.2	16.2
1977	4.1	17.8	21.9
1978	5.3	34.2	39.5
1979	3.0	41.6	44.6
1980	1.8	34.5	36.3
1981	3.4	45.1	48.5
Total	**22.4**	**213.5**	**235.9**

Source: Organization for Economic Co-operation and Development, 1980: "Access by developing countries to international financial markets", *Financial Market Trends*, No. 13, February, p. 92, and 1982: "The market for external bond issues, 1973-1981", *Financial Market Trends*, No. 22, June, p. 20.

Despite the rapid growth in all segments of the financial markets and the apparent ease with which developing country borrowers obtained external financial resources, not all borrowers enjoyed equal access to every segment of the international financial markets. Nevertheless, during the 1970s, even the financial market's discriminatory practices worked to ensure that developing countries would have ample supplies of external financial resources. Simply stated, a two-tier international capital market emerged as early as the mid-1970s. In the upper tier were public and private borrowers from developed countries. Because of their high credit rating, these borrowers were able to obtain approximately 50% of their total external funds in the international bond market. The lower tier, by comparison, was inhabited by public and private sector borrowers from developing countries. Because these borrowers were perceived as less creditworthy, their only source of external financing was the commercial banking system, which generally supplied over 90% of their needs.

This two-tier market evolved out of a complex series of events. One crucial factor was the widespread stagflation in the Organization for Economic Co-operation and Development (OECD) area following the 1973 oil price shock. The resulting slowdown in OECD growth rates led to a steep decline in the private sector's demand for capital. Within the United States, for example, commercial and industrial bank loans declined by US$13 billion between 1974 and 1976 (D'Arista, 1976). This slowdown was not confined to the United States. As table 2 indicates, Eurocurrency bank borrowings by industrial country borrowers also declined sharply between 1974 and 1976.

At the same time, however, many of these industrial countries needed to finance sharply higher oil-induced current account deficits. Since they had relatively little external debt, high reserves and strong credit ratings, they had ready access to the international bond markets. Thus, at the same time that their bank borrowing declined by 40%, their borrowing in the international bond markets rose by US$20 billion, or 400% (United States Senate, 1977).

Because many of the top-rated public and private sector customers in developed countries

were deserting the banking system and raising funds directly in the securities markets, the banks needed to find new customers. In view of their sharply rising current account deficits, non-oil developing countries were more than willing to come to the banks' rescue. As a result, increased commercial bank loans to developing countries between 1974 and 1976 offset most of the decline in commercial bank lending to OECD borrowers.

This basic theme was repeated a number of times throughout the remainder of the decade: every time financial market developments militated against a growth of commercial bank loans to OECD borrowers, an equal and opposite reaction elsewhere in the financial system encouraged the banks to expand their lending operations to less developed countries (LDCs) instead. For example, the Federal Reserve Board's October 1979 decision to tighten the United States money supply is generally considered to be the first in a long series of events leading to the eventual outbreak of the debt crisis. A little noted side-effect, however, was that the Federal Reserve Board's action also encouraged United States banks to continue lending to Latin America.

As the OECD secretariat noted at the time, the Federal Reserve Board's October 1979 announcement "contained an 8% reserve requirement on increases in bank-managed liabilities, including Euro-dollar borrowings, loans made by foreign offices of Federal Reserve member banks to United States residents, and assets sold by member banks to related foreign offices; it did not affect, however, foreign lending by overseas branches of United States banks" (OECD, 1980, p. 2). In other words, in an attempt to control the domestic supply of credit, the Federal Reserve Board not only slowed the growth of the United States money supply but also tried to prevent commercial banks from counteracting its tight money policy by importing foreign funds for lending inside the United States. But since the Federal Reserve Board was only interested in restraining United States credit, it did not restrict bank lending to non-United States residents. Not surprisingly, United States banks responded by looking outside the United States for new business. Since OECD borrowers were still raising funds directly in the securities markets, banks had little choice but to increase their loans to LDC borrowers.

As this analysis suggests, banks started lending to Latin America, not because they were enthralled with the region's economic prospects *per se*, but because many of their better, more traditional customers were borrowing money elsewhere. A more detailed examination of the forces propelling United States and Japanese banks into the international lending arena will help to clarify this point.

3. *Origins of United States bank lending to LDCs*

The origin of United States bank lending to LDCs can be traced to 1969, when a combination of rising interest rates inside the United States and restrictions on the interest rate that United States commercial banks could pay depositors sparked a large-scale outflow of funds from the United States banking system (Wojnilower, 1980; Melton, 1977). However, United States banks quickly discovered a way to replace their lost deposits and circumvent the interest rate ceilings. They simply instructed their overseas branches to raise funds in the Euromarkets —where the interest rate they could pay depositors was not restricted by United States banking regulations— and lend the proceeds to the United States head office. Approximately US$13 billion entered the United States this way in 1969 (D'Arista, 1976).

However, when the 1970 recession reduced the United States domestic demand for loanable funds, United States banks repaid their overseas branches. This left the overseas offices with a surplus of funds and a shortage of borrowers. Compounding their problem was the fact that many OECD countries began prohibiting their residents from borrowing Eurodollars. These restrictions were designed to prevent residents from speculating against the dollar by borrowing dollars in the Euromarkets, converting them to local currency, and then waiting for the dollar to fall. By preventing these speculative flows, European central banks hoped to regain control over their domestic money supply.

However, these restrictions also meant that commercial banks were barred from making Euro-dollar loans to their best customers, United

States multinational corporations. Looking around, the banks settled on the next available group of borrowers —the developing countries. As a result, Eurocurrency bank lending to LDCs in the years preceding the first oil shock rose from a scant US$300 million in 1970 to US$7 billion in 1973. As a percent of total new credits extended by the Eurocurrency banks, loans to LDCs rose from 6.3% in 1970 to 20.7% in 1973 (D'Arista, 1979).

Syndicated loans to LDCs also became one of the most lucrative growth arenas open to United States commercial banks. According to data compiled by the United States Senate (1977), the domestic earnings of 13 large United States banks remained relatively stagnant between 1970 and 1976 (table 3). Those earnings were also quite sensitive to the ups and downs of the business cycle. Their international earnings, by comparison, rose much more rapidly and seemed quite impervious to the business cycle.

Table 3

DOMESTIC AND INTERNATIONAL EARNINGS OF UNITED STATES BANKS

(Billions of US dollars)

	International earnings	Domestic earnings
1970	177.3	884.4
1971	245.3	865.4
1972	337.0	858.9
1973	477.5	918.5
1974	616.3	1 014.5
1975	835.9	918.0
1976	886.2	905.2

Source: United States Senate, 1977: *International Debt, the Banks, and United States Foreign Policy*, a staff report prepared for the use of the Subcommittee on Foreign Economic Policy of the Committee on Foreign Relations, 95th Congress, first session, August.

4. *Origins of Japanese bank lending to the LDCs*

In Japan, the initial impetus for LDC lending had less to do with capital controls preventing commercial bank lending and much more to do with declining domestic growth rates and rising government budget deficits. As a result, "Banks [were] faced with a decline in loan demand from domestic corporations. Hence the search for good borrowers [brought] expansion into foreign markets" (Suzuki, 1986, p. 15). Consequently, the new motto in Japanese banking circles became "low growth and internationalization" (Guttman, 1987, p. 1258).

The post-war period preceding the first oil shock has been dubbed the "Japanese miracle". The Japanese economy expanded at an annual average rate of 10% between 1950 and 1973 and experienced its first recession only in 1974. However, in retrospect, the Japanese miracle actually ended in as early as 1971 or 1972, when the yen was revalued by 16% and many of Japan's capital intensive, heavy industrial sectors suddenly became uncompetitive (Lincoln, 1988, p. 216).

This slowdown in domestic growth rates had a serious destabilizing impact on the Japanese financial system. Since most Japanese corporations did not realize that the economy had entered a new era of permanently slower growth, they continued investing as if the old growth rates would continue indefinitely. With the onset of the 1974 recession, however, overcapacity became a serious problem. Real fixed investment declined at a 1% annual pace from 1974 to 1978, down from the 16% annual average rate of increase recorded between 1950 and 1973 (Lincoln, 1988, p. 43).

Because Japanese corporations had traditionally relied on commercial banks to supply the vast majority of their non-internally generated funds, the sharp drop in investment deprived commercial banks of their most lucrative and dynamic market. From 1965 to 1973, for example, private financial intermediaries, consisting primarily of commercial banks, supplied nearly three quarters of all the funds raised in the Japanese capital markets. By 1980, that share had declined to around 50% (Suzuki, 1986, p. 40). In other words, Japanese banks were supplying a declining share of funds to a stagnant market.

At about the same time, Japanese government budget deficits began increasing dramatically. During the "miracle" phase of Japanese post-war history, government surpluses averaged 1.9% of gross national product, thereby allowing Japan to finance its high growth rates without resorting to foreign borrowing. However, by 1972, leading members of the Japanese

ruling party started calling for a policy of deficit-financed spending for "social overhead capital and social security" (Lincoln, 1988, p. 22). Unfortunately, the government was as unprepared for the recession as the corporate sector. As the economic downturn gathered strength, the modest deficits forecast in the ruling party's economic platform started rising uncontrollably. Annual budget deficits rose to more than one trillion yen in the early 1970s and passed the 5 trillion yen mark in 1975. The deficits continued soaring, eventually reaching 14 trillion yen in 1981. In the wake of these deficits, the central government's outstanding debt rose from 8% of gross national product (GDP) in the late 1960s to 33% by late 1981 (Sakakibara, 1984), and its share of annual credit flows rose from 18% in the 1960s to 46.8% in 1980-1981 (Guttman, 1987, p. 1258).

Rather than offsetting the corporate sector's declining demand for loanable funds, the rapid increase in the government's budget deficits compounded the banking industry's problems. In order to minimize the government's debt servicing costs, the Ministry of Finance initially began issuing bonds at artificially low interest rates and requiring commercial banks to purchase a large portion of each issue. Since the Bank of Japan repurchased most of these bonds at par within one year as part of its efforts to increase the money supply in tandem with the economy's rapid growth, holding comparatively small quantities of government bonds was relatively painless and risk-free for the commercial banks. By the mid-1970s, however, this comfortable arrangement began to fall apart. As government deficits increased, the banks were forced to purchase rapidly increasing quantities of bonds. Meanwhile, as the slowdown in economic growth reduced the need for rapid money supply growth, the Bank of Japan halted its bond repurchase programme. Consequently, the share of low-interest government bonds in bank portfolios increased dramatically.

When the banks balked at purchasing more low-interest bonds, the Ministry of Finance started selling short-term bonds to the public at market rates of interest. Unfortunately for the banks, this generated a *de facto* short-term money market and prompted Japanese corporations to start managing their liquid assets more aggressively (Yoshitomi, 1985, p. 10). Rather than keeping their idle cash in low-yielding commercial bank accounts, they began investing in the newly emerging government securities market.

This combination of declining corporate investment and rising budget deficits squeezed bank profits from both the asset and liability side of the balance sheet. Simply put, the emergence of a short-term money market hastened the disappearance of the banks' low-cost deposit base while the decline in corporate investment kept loan demand stagnant. Not surprisingly, bank profitability plunged, with return on equity at Japan's city banks falling from 24% in 1974 to 15% in 1979 (Lincoln, 1988, p. 167). This prompted one Japanese banker to note:

> "Business has been sluggish in three ways. One has been the narrowing margin between the cost of our funds and the yields on our new loans... Second is that corporate treasurers... have been trying very hard to reduce their bank borrowings so that the banks have been unable to expand their lending. So the total volume of our lending was doomed to stay on a plateau while our interest rate margins were narrowing all the time. In addition to that, our business with the structurally depressed industries underwent a deterioration in quality... This brought an additional burden to the banks" (Bronte, 1979, p. 15).

Like their United States counterparts, Japanese commercial banks saw international lending as an antidote to declining domestic profit margins. During the late 1960s and early 1970s, the Ministry of Finance had allowed Japanese banks to make tentative forays into the international lending arena. However, Japanese banks were forced to retreat from the international markets when the Japanese economy ran current account deficits in the aftermath of the oil and food price shocks of 1972-1974. It is interesting to note in this respect that the withdrawal of Japanese banks from international lending during this period intensified the liquidity pressures in the Euromarkets, suggesting once again that the link between OPEC surpluses and the liquidity of the Euromarkets is more tenuous than is generally recognized.

However, these prohibitions on international lending were removed in 1977, shortly after the Japanese current account returned to surplus. As far as the Japanese banks were concerned, this new freedom could not have come at a better time. In the face of stagnant business demand and rising costs, international lending was seen as the easiest way to restore profitability. Thus, the removal of capital controls precipitated the "unrestricted entry of Japan's 13 city banks into the international lending arena... Suddenly, the competition became very rough as the city banks scrambled to establish a foothold in the newly opened market... The city banks moved immediately to take advantage of their new freedom in the international sector. Their cumulative overseas portfolios mushroomed by at the rate of about US$1 billion a month" (*The Economist*, 1984, p. 18).

For Latin American borrowers, these developments also represented the best possible news. The rapid influx of Japanese banks, along with the continuing entry of United States regional banks into the international lending arena, ensured a steady supply of fresh bank financing for each new round of syndicated lending. As a result, the liquidity of the Euromarkets increased steadily between 1977 and 1979, despite the fact that both OPEC current account surpluses and OPEC's deposits in the commercial banking system were not rising nearly as rapidly (Mattione, 1985, chapter 2; Sternlight, 1984). This additional liquidity was quickly translated into improved borrowing terms for developing country debtors. For example, spreads paid by LDC borrowers for syndicated loans declined sharply after 1977, even while their borrowing volumes increased and OPEC surpluses decreased. Between end-1977 and end-1979, the spread paid by developing countries fell by more than 70 basis points to approximately half the 1977 level. At the same time, the differential in the spread paid by top-rated OECD borrowers and typical developing country borrowers fell by two thirds, from 62 basis points at end-1977 to only 17 basis points at end-1979 (OECD, 1982a, p. 28).

II

Capital market developments in the 1980s

Compared to the previous decade when virtually every development in the international capital markets seemed to favour Latin America, most financial market developments during the 1980s appear to be depriving the region of external financial support. Consequently, while the region's debt service payments remain high, its ability to finance those payments with new inflows of external capital, as opposed to an outward transfer of real resources, remains seriously impaired.

One thing is certain, however. Latin America's recent inability to obtain financial assistance cannot be blamed on the stagnation of the international capital markets. The markets have been remarkably buoyant in recent years. Net bank and bond financing rose from US$130 billion to US$245 billion between 1983 and 1986 (table 4). That buoyancy continued in 1987, as the annual flow of net bank and bond financing rose to US$315 billion (Bank for International Settlements (BIS), 1988, p. 109). Nevertheless, these were precisely the years when Latin America's gross capital inflows plunged to practically zero and its net resource transfers reached all-time highs. Several evolutionary trends within the financial markets account for the discrepancy between the rapid growth of the international capital markets and the stagnation of capital flows to Latin America.

One of the most significant trends is the dramatic shift in the mode of international financial intermediation. During the 1970s, more than two thirds of all international capital flows moved through the commercial banking system, where the two-tier capital market provided Latin America with an ample supply of external credit. However, as the data in table 4

Table 4

ESTIMATED LENDING IN INTERNATIONAL MARKETS[a]

(Billions of dollars)

	1980	1981	1982	1983	1984	1985	1986	1987
Net bank lending	160.0	165.0	95.0	85.0	90.0	105.0	165.0	255.0
Net bond financing	28.0	36.5	58.5	59.0	83.0	125.0	156.0	104.0
Bank plus bond	188.0	201.5	153.5	144.0	173.0	230.0	321.0	359.0
Double counting[b]	8.0	6.5	8.5	14.0	28.0	55.0	76.0	44.0
Net bank and bond	180.0	195.0	145.0	130.0	145.0	175.0	245.0	315.0

Source: Bank for International Settlements, 1985: *Fifty-fifth Annual Report*; 1987: *Fifty-seventh Annual Report*; 1988: *Fifty-eighth Annual Report.*

[a] Up to 1983, the reporting area consists of the G-10 countries, Luxembourg, Austria, Denmark, Ireland, and the offshore branches of United States banks in the Bahamas, Panama, the Cayman Islands, Hong Kong, and Singapore. As of 1984, the reporting area was expanded to include Finland, Norway, Spain, the branches of non-United States banks operating in the Bahamas, the Cayman Islands, Hong Kong and Singapore and all offshore units in Bahrain and the Netherlands Antilles.

[b] Double counting refers to bonds purchased by commercial banks for their own investment account.

reveal, annual flows of new bank lending declined by close to 50% during the first half of the 1980s, while net bond financing more than tripled. As a result, the most rapidly growing sector of the international capital markets was precisely the one that had traditionally been closed to developing countries.

A second evolutionary trend is the growing insularity of international capital flows. Although the capital markets were growing rapidly and becoming more international in scope, a diminishing share of these flows went to developing countries. In 1981, for example, 40% of net bank lending and 5% of international bond issues went to borrowers located outside the Bank for International Settlements (BIS) reporting area. During 1987, however, only slightly more than 1% of total bond finance and 10% of bank flows left the BIS area (BIS, 1988, p. 123).

In line with this development, Japanese residents became the largest consumers of commercial bank credit, despite the country's sizeable current account surplus and its status as the world's largest creditor nation. For example, Japanese residents borrowed US$72 billion from the international commercial banking system in 1987, up from approximately US$59 billion the year before. United States residents, by comparison, borrowed only US$45 billion in 1987 and less than US$20 billion the previous year (BIS, 1988; pp. 70, 72). Thus, if Latin America has been having problems attracting an adequate supply of international credit, it would appear that its chief competitor at the bank loan window has been Japan, not the United States.

Japan's status as the largest commercial bank borrower as well as the world's largest creditor is not a statistical anomaly. On the contrary, it is directly related to the way that Japanese investors have chosen to accumulate foreign assets. Simply stated, over the past three or four years, Japan's gross foreign investments have exceeded the country's current account surplus (table 5). The gap between the volume of Japan's long term investments and its cumulative current account surpluses has been financed primarily by commercial bank borrowing.

This process is highlighted in table 5. As can be seen, Japan's US$37 billion net investment surplus in 1983 consisted of a US$68 billion surplus in its long-term portfolio and a US$31 billion deficit in short-term assets, primarily loans from the international banking system. By 1986, that surplus in the long-term portion of Japan's portfolio had increased to US$283 billion. However, this US$215 billion increase was far greater than the country's cumulative current account surplus. Most of that difference was financed with short-term bank loans, thereby providing the commercial banking system with more than enough loan demand to offset any decline in lending volume to Latin America.

Table 5

JAPAN: NET INVESTMENT POSITION BY TYPE OF ASSETS[a]

(Millions of US dollars)

	1983	1984	1985	1986
Long term	68 100	115 962	178 969	283 800
Private sector	61 500	108 208	172 682	272 512
Direct investments	27 800	33 463	39 231	51 557
Trade credits	17 900	22 800	23 472	31 959
Loans	28 000	39 335	45 659	68 012
Securities	(13 800)	10 497	60 901	114 322
Other	1 500	2 113	3 419	6 662
Government	6 700	7 754	6 287	11 288
Short term	(30 800)	(41 616)	(49 148)	(103 449)
Private sector	(49 600)	(61 139)	(68 232)	(133 971)
Monetary movements	(35 200)	(52 536)	(61 265)	(127 450)
Other	(14 400)	(8 603)	(6 967)	(6 521)
Government sector	18 800	19 523	19 084	30 522
Monetary movements	21 800	23 671	23 093	36 191
Other	(3 100)	(4 148)	(4 009)	(5 669)
Memo item:				
Current account	20 800	35 000	49 200	85 800

Source: For 1983 data, Bank of Tokyo, 1985: "Japan's external assets and liabilities", *Tokyo Financial Review*, March. For remaining years, Japan Economic Institute, 1986: "Japan's role in world financial Markets", *Japan Economic Institute Report*, No. 42A, November 14, and 1987: "Japan still the world's top net creditor nation", *Japan Economic Institute Report*, No. 21B, June 5.
[a] Figures in parentheses denote deficits.

A third, and more recent, evolutionary development is the almost total collapse of the floating rate note (FRN) segment of the international capital markets and the simultaneous revival of commercial bank lending.[1] From a peak of US$55.9 billion in 1985 and a respectable US$47.8 billion in 1986, the volume of newly issued floating rate notes fell to US$12 billion in 1987 (BIS: 1988, p. 126). Meanwhile, the pace of international bank lending increased from a rather lackluster US$55 billion in the first half of 1986 to US$110 billion in the second half of 1986, US$135 billion during the first half of 1987 and US$120 billion in the second half of that year.

These two trends are not unrelated. Syndicated lending revived precisely because floating rate notes and commercial bank loans are close substitutes. For LDC borrowers, however, these trends are simply one more illustration of how virtually every financial development in the 1980s worked to inhibit the flow of funds to developing countries. Simply stated, even though Latin America's financial problems did not cause the collapse of the floating rate note market and despite the fact that the region never used these instruments to raise much capital, Latin America can expect to notice several adverse effects from its collapse.

During the mid-1980s, United States commercial banks raised large amounts of capital by issuing perpetual floating rate notes —i.e., floating interest rate securities with no fixed maturity date. As the OECD noted recently:

For banks, the availability of a broad market in FRNs —where the banks have raised funds exceeding US$100 billion during the 1985-1986 period— has meant the possibility of securing a better matching of assets and liabilities both in terms of interest rates and maturities. [In addition], the introduction of long-term floating-rate instruments which can be assimilated to capital for supervisory purposes —e.g. perpetual FRNs in the form of subordinated debt— has provided banks with a badly-needed opportunity

[1] For a description of floating rate notes, see BIS, 1986, Levich, 1987.

to raise capital-like funds and to strengthen their balances sheet (OECD, 1987a, p. 52).

However, the demise of floating rate notes will make it more costly for banks to raise additional capital. This, in turn, should make banks even more reluctant to extend new loans, write-off a portion of their existing claims or take other actions that might reduce the region's net resource transfer. In addition, since commercial bank loans and FRNs are close substitutes, the collapse of the floating rate note market has provided commercial banks with a new and rapidly increasing pool of top-rated borrowers. And since the banks began lending to Latin America precisely because many of their best customers were raising funds directly in the securities markets, the return of these valued customers will reduce the need for many banks to maintain close business relationships with Latin America. Again, as the OECD noted, "Activity on the syndicated credit market has strengthened significantly since the middle of last year....[While sovereign borrowing remains modest by past standards, the market has accommodated with remarkable speed and efficiency a growing volume of corporate demand" (OECD, 1987b, p. 50).

Obviously, these developments do not bode well for Latin America. When securitized lending was in fashion earlier in the decade, Latin American borrowers were unable to raise funds in this segment of the market. But now that the securities sector is in the midst of a contraction and many top-rated borrowers are turning to the syndicated loan market, Latin America will once again find itself at the end of the credit queue. Moreover, it stands to reason that if the region had difficulty obtaining loans when the international markets were buoyant and robust, it is unlikely to fare better now that one of the banks' major sources of capital has disappeared.

The impact of these adverse developments within the international financial markets themselves will be reinforced by the new regulatory and business climate in individual banking centres that will confront United States, European and Japanese banks during the remainder of the 1980s and the early part of the 1990s. Unlike the previous decade, the net effect of these changes will be to raise the opportunity cost of doing business in Latin America, thus making the commercial banks even more interested in focusing their capital and managerial resources closer to home. These developments have already induced United States banks to retreat from the international lending arena. Additional changes scheduled to take effect during the next few years can be expected to reinforce these trends and induce similar shifts in the international lending policies of Japanese and European banks.

1. *The retreat of United States commercial banks in the 1980s*

In view of Latin America's recent problems obtaining new commercial bank loans, it is tempting to argue that the banks' refusal to lend is motivated primarily by the region's existing debt overhang. In fact, United States banks have shown a greater willingness to lend to Latin American borrowers than to borrowers in almost any other region. According to official United States banking data, the growth of United States bank loans to Latin America and the Caribbean —excluding Ecuador and Venezuela, which are listed in the OPEC category— levelled off in 1983 and 1984, rising during those two years at an annual rate of only US$1.5 billion (table 6). This was down significantly from the US$8.6 billion annual average increase registered between end-1977 and end-1982, but no other region, developed or developing, increased its loans from United States banks at a faster rate (Bennett and Zimmerman, 1988). Moreover, between end-1982 and end-1987, United States bank exposure to Latin America declined by just under US$6 billion, compared to a combined US$21 billion decline in exposure to the developed countries, including both members and non-members of the Group of Ten.

As these statistics indicate, Latin America's efforts to obtain new loans were hampered not only by the region's structural overindebtedness but by what appears to be a general retreat of United States banks from the international lending arena. Part of this retreat undoubtedly reflects the decision of smaller banks to focus on lending opportunities closer to home. However, the retreat was not confined solely to this segment of the United States banking industry. Many of the larger regional and multinational banks that could be expected to have a longer-

term commitment to the international financial markets also stopped increasing their international exposure and slowed the growth of their balance sheets.

One of the most impressive signs of their retreat is the relative decline of United States money centre and large regional banks. In 1980, for example, Dai-Ichi Kangyo Bank, at number 10, was the only Japanese bank to rank among the top 10 in the *Euromoney* list of banks ranked by assets. By 1987, however, Japanese banks occupied all five of the top five slots and eight of the top 10 positions. Citicorp, at number 10, was the only United States bank to remain in the top tier. Japanese banks filled five of the next 10 slots; United States banks filled none. Indeed, only four United States banks —Citicorp, Chase Manhattan, Bank of America and Chemical— even ranked in the top 50, compared to 20 Japanese banks.

Besides their commanding presence in the *Euromoney* tables, 12 Japanese banks are among the 25 largest banks operating in the United Kingdom, where they account for 31% of all the international liabilities booked in London, up from 13% as recently as 1981. Japanese banks also account for 8.4% of all commercial bank loans outstanding in the United States. They underwrote US$18 billion, or 50%, of all United States municipal bonds issued in 1986 and control five of the 11 largest banks comprising 13% of the total banking market in California (*Far Eastern Economic Review*, 1987, p. 86; Stokes, 1988, p. 247).

More telling than these relative rankings is the absolute size of the consolidated assets controlled by banks chartered in different countries. In 1980, for example, only two United States banks —Citicorp and Bank of America— and two French banks —Crédit Agricole and Banque National De Paris— had assets of more than US$100 billion. The average assets of the top 10 United States banks and the top 10 Japanese banks were approximately equal, at US$54.9 billion and US$58.6 billion respectively. In 1987, Citicorp was the only United States bank with assets of more than US$100 billion. Meanwhile, 16 Japanese, three German, five French, two British and two Swiss banks occupied this once-elite group.

2. *United States bank regulations and United States bank lending in the 1980s*

The relative stagnation of United States banks and the phenomenal growth of Japanese banks did not occur in a vacuum. For Japanese banks, the yen's rise since February 1985 is partially responsible for their rapid growth during the past two years. Similarly, the rapid growth of Japan's exports gave Japanese banks a built-in advantage in the realm of trade financing. Nevertheless, these factors explain only part of the story. Japanese banks also increased their relative standing in the *Euromoney* 500 list between 1982 and 1984 when the yen was declin-

Table 6

UNITED STATES BANK EXPOSURE BY REGION[a]

(Billions of dollars)

	G-10 and Switzerland	Non-G-10 developed	Eastern Europe	OPEC	Latin America	Asia	Total
1981	150.1	32.1	7.3	22.4	62.8	27.5	320.4
1982	161.9	38.0	5.9	24.3	70.6	32.7	351.6
1983	164.3	41.3	5.2	25.0	71.1	33.2	359.3
1984	147.0	39.0	4.6	22.9	73.7	29.6	332.2
1985	144.0	34.5	4.2	20.0	69.7	26.5	311.8
1986	144.2	30.1	3.6	17.4	68.2	22.2	296.8
1987	152.3	26.6	3.2	14.6	64.8	19.4	290.8

Source: Federal Financial Institutions Examination Council, *Country Exposure Lending Survey*, various years.

[a] Exposure data is adjusted for guarantees and indirect borrowing. Totals do not add due to the exclusion of data for Africa, offshore banking centres, and international and regional organizations.

ing. And changing currency value and rising export volumes cannot explain the entry of so many comparatively unknown Japanese banks into top positions in the list of the world's largest banks. Conversely, the debt problems of Latin America and Eastern Europe cannot account for the relative stagnation of United States banks. Japanese and European banks had equal, if not greater, exposures to these two financially-troubled regions. And yet international debt problems only seem to have affected the growth of United States banks.

What seems to be inhibiting United States banks is an adverse profit and regulatory environment. As a result, United States banks are discovering that it is in their best interest to slow their total asset growth in general and their international lending profile in particular. Obviously, this makes it more difficult for Latin American borrowers to obtain external financial support. In many respects, this is one of the most striking differences between the global financial environment of the 1970s an that of the 1980s.

i) *Rising capital costs.* During the 1970s, rapid asset growth was the key to increased commercial bank profitability, especially during periods when interest rate spreads were declining. By sponsoring new loan syndications and making the syndication fees immediately into profits, banks could maintain, and even increase, their gross profit margins. However, this strategy could succeed only if banks were generating increasing amounts of syndication fees which, in turn, required generating increasing amounts of syndicated loans. During the 1970s, in other words, the profit and growth strategies of the banks were congruent with the financial needs of developing countries.

Helping to sustain this symbiotic relationship were the generally lax capital requirements placed on the largest United States banks. Money centre banks and regional banks with more than US$1 billion of assets entered the 1970s with capital asset ratios of slightly less than 6%. By 1981, that ratio had fallen to 3.9% for money centre banks and 4.6% for the large regional banks (New York Federal Reserve Bank Staff, 1987, p. 15). These declining ratios allowed the money centre and regional banks to increase their return on equity from approximately 11% during the early 1970s to more than 13% in 1981, despite increased competition, declining interest rate spreads and generally lower syndication fees.

United States banks came under increased pressure to raise their capital asset ratios after 1983 when Congress authorized the Federal Reserve Board to establish minimum capital standards for the largest bank holding companies. In the wake of these stricter standards, United States banks raised more than US$58 billion of additional capital since end-1982 (table 7). However, since the banks' return on assets has not increased appreciably, bank profitability, as measured by return on equity, has been stagnant at best, and declining in many cases (Salomon Brothers, 1987, pp. 56-57).

Adding to the banks' woes is the fact that their cost of capital is much higher than that of their domestic investment bank and Japanese commercial bank rivals (New York Federal Reserve Bank Staff, 1987; Mead and Gluck, 1987, p. 270). This puts United States banks at a severe competitive disadvantage. On the one hand, they need higher loan spreads and return on assets merely to break even. As the New York

Table 7

UNITED STATES BANK CAPITAL[a]

(Billions of dollars)

	1982	1983	1984	1985	1986	1987
All reporting banks	70.6	79.3	92.2	105.4	116.1	129.2
Top nine	29.0	31.5	36.7	42.3	46.7	51.5
Next fifteen[a]	13.5	14.9	18.1	20.6	22.0	23.9
All other	28.1	33.0	37.4	42.5	47.4	53.8

Source: Federal Financial Institutions Examination Council, *Country Exposure Lending Survey*, various years.
[a]Bank mergers during the second half of 1987 reduced the "next fifteen" category to 13 banks by end-1987.

Federal Reserve Bank explained in a recent study of bank profitability, "The hurdle rate of return for capital to be invested in new projects at large banks (especially at multinational) has had to be *quite* high on average in this decade, well above the rate of return on existing capital as measured by bank returns on equity and far above the rate of return demanded by the market for corporate business in general" (emphasis in original) (New York Federal Reserve Bank Staff, 1987; p. 31). And yet at the same time that they must generate higher rates of return, United States banks are finding that the more highly leveraged Japanese banks are offering to make loans at much lower spreads.

ii) *The growth of off-balance-sheet assets.* In an effort to increase their gross profits, and thus their return on equity, United States banks have been searching for less capital-intensive operating procedures. To an increasing extent, this means that syndicated loans have been falling out of favour while so-called fee-generating, off-balance-sheet financial services such as letters of credit, currency swaps and interest rate swaps are gaining prominence. According to the United States Federal Deposit Insurance Corporation, for example, off-balance-sheet items have been one of the most rapidly growing lines of business for United States commercial banks (Chessen, 1987, p. 4). They totalled less than US$250 billion in 1980, or 250% of the banking system's total capital. By 1987, the value of all off-balance-sheet items had risen to approximately US$2.3 trillion, or more than 1 300% of bank capital. In line with these estimates, the New York Federal Reserve Bank notes, "money center holding companies seem to be earning an increasing share of their profits from non-lending-related activities. The primary difference between one set of estimates and another is the pace of this change. For example, before loan loss provisions, favourable assumptions suggest that lending-related activities' share of pre-tax profits fell from about 85% of the total in 1980 to about 65% in 1984 and 1985. Less favourable assumptions suggest that the loan-related share of profits fell from about 65% in 1980 to about 35% in 1984 and 1985" (Proctor, 1987, p. 242).

From the banks' perspective, the advantage of this shift away from syndicated loans is that they are not required to hold capital against off-balance-sheet items. On the other hand, because new loans require additional capital, their effect on return on equity is more ambiguous. As a result, the link between bank profitability and Latin America's financial requirements has become more tenuous. But of course this is just one more illustration of how the dominant commercial banking trends in the 1980s worked against the region and would have done so even if there were no debt crisis.

iii) *New bank regulations.* These competitive pressures and trends in the banks' preferred mode of doing business have spawned a number of proposed revisions, as well as actual changes, in United States bank regulations. In all likelihood, these will make banks even more reluctant to provide additional financial support to developing countries. For example, one proposal would expand the opportunities for banks to earn fee income. Under current rules, commercial banks are legally forbidden to engage in many of the most lucrative fee-generating financial activities such as underwriting corporate stocks, bonds and commercial paper. The primary legal barriers are the depression-era Glass-Steagall Act separating investment banking from commercial banking and the Bank Holding Act restricting the sorts of financial services corporations that bank holding companies can own (Jackson and Cohen, 1986; Jackson, 1987; D'Arista, 1986).

Several proposals, including one sponsored by New York Federal Reserve Bank President Gerald Corrigan (1987), would allow commercial banks to engage in a variety of previously forbidden securities-related activities. However, in order to exploit these new opportunities, banks will have to raise large amounts of capital. Given the demise of the floating rate note market and the depressed price of most bank stocks, raising the additional capital needed to enter the investment banking field could prove to be both expensive and difficult. Therefore, banks will probably be extremely reluctant to divert whatever scarce capital they do have away from investment banking activities simply so that more will be available to support syndicated lending to highly indebted countries.

Ironically, the proliferation of United States bank failures could also discourage banks from providing additional financial assistance to Latin

America. Two banking rules and practices are crucial to understanding how this process may operate. First, under current United States rules and regulations, banks are restricted from conducting business in more than one state. Second, rather than closing an insolvent bank and paying off the insured depositors, the Federal Deposit Insurance Corporation (FDIC) —the United States government agency that insures depositors against losses resulting from bank failures— usually tries to sell bankrupt commercial banks to healthier financial institutions. As a condition of the sale, the FDIC often guarantees that it will absorb all current and at least some future losses in the failed bank's loan portfolio. However, in an effort to encourage additional banks to bid for the failed bank's assets, thereby reducing the government's cost of liquidating the insolvent bank, commercial banks located in one state are permitted to acquire insolvent banks in a different state. This waiver of the prohibition against interstate banking offers banks a golden opportunity to establish a multistate network of branches and loan offices.

Many United States banks are now putting their capital as well as their managerial time and expertise into acquiring insolvent banks and competing aggressively for the profitable lending business that the failed banks were too weak to pursue. As a result, the expansion plans of many of the healthiest regional banks no longer require the rapid growth of lending volumes to Latin America. For the moment at least, all the expansion they can afford is available in domestic markets. Moreover, since the United States government absorbs all the losses in the insolvent bank's portfolio, acquiring an insolvent bank would appear to be a relatively risk-free route to expansion. Certainly, it is less risky than making new loans to Latin America. Not surprisingly, a number of regional and money centre banks have concluded that purchasing insolvent banks is a more profitable and safer way to deploy their available capital. Since there is no shortage of failing banks, this process can be expected to continue for some time —as will the bank's reluctance to return to the developing country syndicated loan market.

3. *Regulatory pressures on European and Japanese banks*

Until recently, the international expansion plans of Japanese and European banks were not affected by the same factors that hobbled their United States counterparts. However, within the next few years, this situation will change dramatically, closing off still more avenues of financial support for Latin America. Two pending regulatory changes merit special attention.

i) *Capital adequacy standards*. The first is the new minimum capital standards schedule to take effect in 1992 (Bardos, 1987; Board of Governors, 1988; Osborn and Evans, 1988). Under the terms of this 11-nation proposal, commercial banks will have to maintain capital equal to at least 8% of their risk-adjusted assets. However, this simple and seemingly modest-sounding proposal contains several dramatic changes in current capital adequacy standards. Among other things, it mandates that at least half of each bank's total capital —its so-called tier one capital— must consist of shareholders' equity. In addition, the proposal limits the amount of loan loss reserves that can be included in the remaining, or tier two, portion of total capital. The proposal also requires each bank to maintain capital against all of its off-balance-sheet assets.

Finally, the capital guidelines place all assets into various risk categories. Assets that have a lower risk weighting require less capital than assets with a higher risk weighting. While the precise details of this risk-weigthing procedure are not of interest here, it is sufficient to note that loans to developing countries are in the highest risk-weigthing category, along with loans to most private sector borrowers within the BIS area. Thus, when all is said and done, the new capital guidelines will require the banks to raise one dollar of capital whenever they increase their LDC exposure by US$12. At least half of this additional capital must be in the form of shareholders' equity.

ii) *Europe 1992*. Under the terms of another proposal recently adopted by the European Economic Community (EEC), all barriers to international commerce within the EEC will be

eliminated in 1992 (Bellanger, 1988; Commission of the European Communities, 1988; Hale, 1988). Once these barriers have been dismantled, any corporation doing business in one country will be entitled to expand into any other country within the EEC. This unlimited freedom of expansion pertains to bank as well as non-bank corporations. Thus, according to the European Parliament's "second Banking Directive", any bank licensed to do business in one European country can engage in any acceptable banking activity anywhere within the EEC. The definition of "acceptable" includes the full range of investment and commercial banking services. Moreover, the provisions of the Second Banking Directive will generally apply to United States and Japanese banks that already have at least one office within the EEC.

iii) *Consequences.* At this early date, it is difficult to predict with any degree of certainty precisely how the new capital adequacy guidelines and European deregulation moves will influence commercial bank attitudes towards making new loans to Latin America. However, a number of tentative conclusions are possible, all of which suggest additional reasons why commercial banks will become even less interested than they are today in providing balance-of-payment support for developing countries.

According to preliminary analysis, the new capital guidelines can be expected to retard the planned expansion of most commercial banks, at least initially. The United States investment banking firm of Goldman Sachs estimates that 14 large United States banks, including Manufacturers Hanover, Bankers Trust, Irving Bank, Continental Illinois, Security Pacific and First Republic, will have to raise approximately US$14 billion of additional capital by the end of 1992 if they are to comply with the new capital guidelines. This estimate assumes that the affected banks do not expand their balance sheets between now and the end of 1992. In addition, United States banks will need at least US$20 billion of additional capital to replace the after-tax value of the shareholders' equity that would be consumed by writing down their LDC loans to 50% of their current face value. Combining just these two items, it would appear that United States banks will need between US$14 billion and US$34 billion of additional capital to finance their current loan portfolios (Hale, 1988, p. 108; General Accounting Office, 1988).

Japanese banks could face similar pressures, although the precise impact of the capital guidelines on their expansion plans is still subject to considerable speculation and uncertainty. However, one widely quoted and respected study by the Nomura Research Institute estimates that Japanese banks will have to slow their asset growth from 7 to 8% per year, down from the 12 to 13% annual growth registered during the past 10 years, if they hope to limit their new capital raising requirements to 7 trillion yen to 8 trillion yen (approximately US$50 billion to US$60 billion assuming and exchange rate of 130 yen to the dollar) (Wagstyl, 1988).

In view of these additional capital requirements, it is difficult to envision either United States banks or Japanese banks raising still more capital so they can expand their exposure to developing countries. Preliminary indications are that this will certainly be true for Japanese banks. For example, Japanese banks are expected to become more active in their domestic consumer lending market where there is less international competition, and profits, at least for the moment, are higher. This would also give them an integral role in financing Japan's transition from an export-led economy to one that places greater emphasis on internal demand. Loans to mid-size domestic corporations are also expected to increase (Osborne and Evans, 1988).

Finally, when Japanese banks do venture overseas, it is expected that they will focus their efforts on the United States market, where the continued popularity of leveraged buyouts, junk bond financing, and other merger-related transactions offers much higher yields. In this respect, it is important to point out that under the capital guidelines, the capital needed to purchase a junk bond issued by a United States corporation will be equal to the capital needed to make a syndicated loan to Latin America. But since loans to Latin America currently carry a spread of 13/16 over the London interbank offered rate (LIBOR) while junk bonds are yielding at least 400 to 500 basis points above LIBOR, it is not difficult to see why a profit maximizing bank will always prefer the latter.

Just as the new capital requirements are expected to make commercial banks less eager to

expand their Latin American exposure, Europe's forthcoming financial deregulation could also increase the banks' opportunity cost of doing business in developing countries. For example, according to the current conventional wisdom, large European banks will have to start merging with each other if they want to survive and prosper in the post-1992 era. "The question is not whether to buy, but to buy. The number of deals will be staggering", explained one close observer of the European banking scene (Phillips, 1988, p. 54). Acquiring other banks, however, will require vast amounts of capital. As one European banker said recently, "Capital is the number one issue of the moment. It's vital first for banks to finance natural business growth at home —which they are not doing at present— and secondly to finance acquisitions" (Shale, 1988, p. 72). In addition, the 1992 deregulation is expected to spark a large number of mergers among European non-bank corporations (Fairlamb, 1988). The commercial banks hope to provide financing for many of these mergers as well. As a result, European banks, like their United States counterparts, are expected to place much greater emphasis on domestic business opportunities as well as on defending their established niches from the competitive encroachments of rival banks. In this environment, it is highly unlikely that any bank will conclude that adding more Latin American loans to its portfolio will strengthen its competitive position within Europe. Moreover, when European banks do look overseas, they will be more likely to focus their attention on the United States which absorbs 10% of Europe's exports, than on Latin America, which purchases less than 3% of the EEC's exports. In other words, Latin America can expect to become an increasingly irrelevant factor in Europe's medium-term trade and financial plans.

III

Conclusions

Since the onset of the debt crisis more than six years ago, officials in both creditor and debtor nations have operated on the assumption that commercial banks would start making new loans to developing country borrowers once the debtors completed their macroeconomic adjustments and restored their creditworthiness. As this paper has demonstrated, however, life may not be this simple. A comparison of the factors that induced banks to begin lending to developing countries in the 1970s with the conditions prevailing during the 1980s and likely to prevail in the 1990s suggests that the commercial banks' long-term business interests may no longer coincide with Latin America's debt service and investment requirements.

How should Latin American political and economic officials respond to the strategic challenge posed by these new facts of life? Several answers immediately come to mind. First, and perhaps foremost, debtor nations will have to rely to a much greater extent than before on internally generated savings. So far, the response to the disappearance of external savings has been a sharp decline in investment. In order to protect Latin America's long-term growth potential, this process will have to be reversed.

Secondly the World Bank and Inter-American Development Bank should also consider how they could respond to this challenge. Should they attempt to fill the financial gap left by the retreat of the commercial banks by increasing their own disbursements? If the answer is yes, how will this decision affect their own credit rating, and hence their own long-term ability to assist the region? Alternatively, should they reduce their own lending on the grounds that without sufficient burden sharing by the commercial banks, structural adjustment will be much more difficult, and therefore much less likely to succeed? There are no easy or obvious answers.

Finally, if commercial banks cannot be induced to put sufficient new funds into debtor

nations, then debtor nations may want to consider looking for ways to harness the strategic interest of the commercial banks to the goal of debt relief. This may not be as difficult as it might first appear. In terms of United States banks, for example, generally accepted accounting practices dictate that banks must establish loan loss reserves only if they believe that they will be unable to collect the outstanding principal. Reserves are generally not required if a bank merely reduces its interest rate on an existing loan.

At a time when United States commercial banks are under increasing pressure to raise additional capital and at a time when their loan loss reserves will no longer be counted as tier one capital, interest rate concessions, rather than making new loans or forgiving part of the outstanding principal, may prove to be in the best interests of both creditors and debtors. From the banks' perspective, new loans require additional capital and write-downs consume existing capital. But since it could be argued that interest rate concessions increase the probability that banks will eventually be able recover their outstanding claims, United States bank regulations would probably allow banks to convert their existing loan loss reserves back into tier one capital. At least one member of the United States Congress has already made this argument (Pease, 1988). Thus, in the wake of interest rate concessions, debtors would reduce their net resource transfers while banks strengthen their capital base and obtain the resources which they need to expand into what they see as more strategically important lines of business.

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CEPAL REVIEW No. 37

Criticisms and suggestions on the cross-conditionality of the IMF and the World Bank

Patricio Meller

In order to make the problem of external debt compatible with that of the economic growth of Latin American countries, the adoption of a "growth-oriented adjustment" strategy has been suggested. Since both the International Monetary Fund and the World Bank are called upon to play an important role in this strategy, there is a need to review and co-ordinate the conditionalities imposed by both institutions. This need is related to the fact that the current deficits in the balance of payments of the Latin American countries are structural, and therefore must be dealt with in the long term; on the other hand, it has been proven repeatedly that short-term macroeconomic adjustment affects the pattern of long-term growth.

Given this interaction, it becomes necessary to co-ordinate the economic programmes sponsored by the Fund and the Bank. Moreover, in practice, the Bank adjustment programmes have generally been applied in a context in which a Fund programme is already in operation. Hence it is difficult to isolate the effects of each institution's programme. The need for uniformity and consistency within and between them lead to the subject of cross-conditionality.

It would seem appropriate for Latin American economists to formulate their suggestions and proposals *a priori*, rather than expressing their criticisms *a posteriori*, concerning the nature and components of the type of cross-conditionality that may soon be put into effect, which will probably have more serious effects than did the one imposed by the IMF in recent years.

This article makes a contribution to the criticism of this cross-conditionality and to the formulation of some alternative proposals.

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At Bretton Woods (1944) it was stipulated that the key concern of the International Monetary Fund (IMF) would be the short-term adjustment problem faced by a country experiencing an external imbalance; on the other hand, the World Bank would be oriented toward long-term goals, such as promoting economic growth and development. This differentiation of roles has caused a crisis in the 1980s. There is a consensus that the deficits in the balance of payments of Latin American countries (and of developing countries in general) are structural and therefore must be dealt with on the long term. It has been proven, however, that short-term macroeconomic adjustment affects the future pattern of growth. In other words, economic conditions have an impact on what happens in the long run; likewise, in order to solve problems related to these conditions, a broader time perspective is needed. In view of the interaction between the short term and the long term, there must be some degree of co-ordination among the economic programmes proposed by the IMF and the World Bank. In practice, World Bank adjustment programmes generally have been applied in a context where an IMF programme is already in operation. Consequently, it is difficult to isolate the effects of each institution's programme. The need for uniformity and consistency within each and between the two leads to the subject of *cross-conditionality.*

Latin American economists have repeatedly asserted their criticisms of, and disagreements with IMF conditionality.[1] However, it is probable that the adoption of a "growth-oriented adjustment" strategy will confront Latin American countries in the near future with a cross-conditionality imposed by the Fund and the Bank. It would seem wise, then, for the economists of the region to formulate their suggestions and proposals *a priori*, rather than expressing their criticisms *a posteriori*, regarding the nature and components of this cross-conditionality, whose elements certainly require an analysis of the above-mentioned strategy.

[1]Bibliographical references on this subject: Bacha (1983), Buira (1983), Ground (1984), Killick (1984), David (1985). For a more recent review, see SELA (1986), Marshall (1987), Meller (1988), Pastor (1987).

The purpose of this work is to examine the problems involved in these topics. In the first section, the new role of the IMF and the World Bank in the external debt problem of Latin America will be discussed. The second section will deal with the various elements linked to the strategy of "growth-oriented adjustment" and the (possible) cross-conditionality to which it would be subject. The third section explores some proposals for modifying the conditionalities of these institutions, taking into consideration recent concerns in the region.

I

The Latin American foreign debt and the new roles of the fund and the Bank

1. *The new role of the International Monetary Fund*

In response to the virtual collapse of the international financial system in 1982 owing to the problem of the Latin American foreign debt, the International Monetary Fund (IMF) has performed an important role of intermediary between debtor nations and creditor banks. The Fund organized and co-ordinated complex packages of financial resources from very diverse sources, which helped to confront the insufficiencies of external liquidity of many countries of the region in 1982-1985. In that period the IMF also significantly increased the volume of loans committed from its own resources.

In assuming this role of intermediary, the IMF has imposed conditions on both debtors and creditors. Debtors have had to adopt adjustment programmes that include the *total* payment of debt servicing. Similarly, creditor banks have had to supply, "not very voluntarily", additional loans in order to bolster the packages put together by the Fund, in which its contributions were merely one of the components.

It should be remembered that the basic function assigned originally to the IMF consists of providing loans to countries that are experiencing external payments difficulties related to current economic conditions; i.e., the Fund's role is fundamentally short term and centred on the deficit in balance-of-payments *flows*. As Bacha notes (1985), when the IMF assumed the role of intermediary in the Latin American debt problem, it was showing a specific concern for a long-term *stock* problem. Underlying this proposal is the basic idea that the Latin American foreign debt and its prompt servicing is *not* due to a temporary lack of liquidity, but to a *critical* problem of stock imbalance.

Nevertheless, this new role of intermediary presents the IMF with new difficulties (Bacha, 1986). Consider the case of a debtor country that cannot comply with the economic adjustment programme. If the IMF decides to suspend the programme, this will cause an economic crisis in the debtor country, which, without the Fund's seal of approval, will be unable to obtain external resources. In other words, the signing of an economic programme with the IMF provides indispensable external credibility to the country's economic programme.[2] The suspension of the programme inevitably raises questions about how the Fund could have proposed a non-viable economic programme, questions which cannot help but discredit the Fund itself. On the other hand, if the IMF maintains the flow of loans, despite the failure to meet the goals, it is also risking a loss of external credibility as an international supervisory agency.

2. *The problem of asymmetry*

There is an asymmetrical situation with regard to the problem of external imbalance, depending on whether the country is industrialized or less developed (LDC). The IMF has been unable to

[2]In some cases the signing of an economic programme with the IMF also provides a certain domestic credibility. In others, it may become a triggering factor in domestic instability.

convince the industrialized countries to apply a consistent, uniform economic programme that promotes international financial stability and world growth.

Moreover, although the external imbalance and the fiscal deficit of the United States economy have been at the core of the world economy's unsatisfactory functioning in recent years, the IMF can do nothing to surmount them. How would the United States government and people react if the Fund suggested that they reduce the size of their fiscal deficit from 4% to 2% (of the GDP) within one year? A quantitatively similar and sometimes even greater demand is stipulated in most of the standby arrangements signed by Latin American countries with the IMF.

The maintenance of a stable world economic and financial system today depends essentially on the policies applied by the industrialized nations. Sometimes, not only is there an asymmetry in the conditionality —the latter applying only to LDCs— but as a result the IMF cannot even fulfil its main function. It has become a mere spectator and commentator with regard to world economic trends, unable to influence or alter their course (Miller, 1986). Given this inability to convince the industrialized nations to modify their policies, the IMF (and the World Bank) should at least be concerned with the probable effects on the functioning of the world economy and on the LDCs (Please, 1987).

Indeed, if the industrialized nations apply policies that adversely affect the world economy, the LDCs are going to suffer the consequences;[3] hence they had best be warned, so that they can use the appropriate tools to try to neutralize the impact. They must be aware, then, that however restrictive the conditionality imposed on the LDCs either to eliminate the external imbalances or to ensure continued flows of debt servicing, it would not lead to an orderly growth of the world economy, which primarily depends on the policies of the industrialized nations.[4]

This international asymmetry entails another basic problem. The fact that there are countries with a trade deficit necessarily implies that others are accumulating a surplus. Then why, in view of the existing imbalance, should only those with a deficit bear the brunt of adjustment? The obvious answer would be that only the countries with a trade deficit face problems of financial liquidity; and this is what leads Latin American governments to turn to the IMF. However, this need not be so. Already in the 1940s, when the creation of the IMF and the World Bank was being discussed, Keynes advocated symmetry in the distribution of the costs of adjustment.

The countries with trade surpluses have to permit access to the exports of deficit countries, so that they are able to generate the foreign exchange necessary for financing the deficit. This is exactly what the United States has recommended recently to Japan. In order to alleviate the burden of adjustment linked to the United States external imbalance, Japan has declared that it is willing to increase its imports from the United States and "voluntarily" reduce its exports to that market.

In sum, the Fund is facing a number of dilemmas in fulfilling its function of supervising the orderly, stable growth of the world economy. How can the IMF influence the economic policies of the industrialized nations? How can it have an influence on countries that do not need loans from it? How can it suggest changes in the policies of countries with a trade surplus? (Kenen, 1987). The overall problem seems to be associated with the concession of the appropriate mechanisms so that the IMF can have a *symmetrical* influence on the industrialized nations and on the less developed countries, or on the surplus and deficit countries, so as to promote a more equitable distribution of the costs of adjustment where external imbalances exist. For example, the IMF could rely upon various mechanisms to induce trade surplus countries to facilitate access to the exports of deficit countries.

3. *The new role of the World Bank*

In the 1970s, the global perception of the World Bank (Annis, 1986; Feinberg and others, 1986) was that in the LDCs the benefits of greater

[3]The impact of the hike in the real international interest rate in the 1980s has been quantitatively around 50% of the total amount of interest paid by Latin America during the 1982-1986 period; see Meller (1988).

[4]The LDC economies are a mere appendix to the industrialized economies. In the LDC economies what happens in the industrialized economies is expanded cyclically.

growth did not reach the poor, thus invalidating the "trickle-down" theory. The growth-oriented redistribution approach, which suggested that in the LDCs it is possible to achieve redistribution without sacrificing growth, was then tried. The alleviation and/or elimination of poverty became the conceptual focus of the Bank, and actually became a moral goal. This new approach took the form of credits for investment projects that directly benefited specific poor groups.

In the 1980s a change in the focal point of the Bank's efforts has taken place. A negative view of LDC institutionality and economic policies has arisen. It is said that *poor and unsound policies and weak and corrupted institutions* prevail in them. Since the level of investment depends, among other factors, on the global economic context, the conclusion is drawn that in many countries the prevailing policies and institutions introduce an enormous mass of distortions. Consequently, it is very difficult for the World Bank to find viable investment projects to which it can grant financing. Within this framework, the institution has created new lines of credit aimed at supporting countries that must undertake structural adjustments in order to resolve external imbalances rather than financing specific projects.[5] The content of such programmes is the basis of the Bank's new conditionality. Its purpose is to boost the general efficiency of the economy by establishing suitable incentives, a goal which assumes changes in trade and price policies, the size and structure of the State and the role that the government plays in the economy.

The Bank's current view is that the most common distortions in the LDCs (Michalopoulos, 1987) are price controls, very differentiated incentives among tradeable goods, a subsidized interest rate, credit control and obstacles to the mobility of the labour factor and to the adjustment of real wages. Improved efficiency in the allocation of resources and in productivity can be attained through the removal of price controls, the liberalization of the external sector and the lifting of prevailing regulations in factor markets. The latter policy, in the case of the capital market, improves the allocation of credit and therefore of investment, while the deregulation of the job market results in a more efficient allocation of labour.

On the other hand, given the serious external imbalance, it is important for the LDCs to increase their production of tradeable goods. According to the World Bank, this requires a stable macroeconomic context, which provides an appropriate exchange rate and a structure of incentives that is neutral with respect to production for the domestic or external market. This neutrality demands, in turn, a complete rationalization and liberalization of foreign trade, which suggests the elimination of quantitative restrictions and non-tariff barriers on imports, together with tariff reductions, the establishment of equal (and low) tariffs and the lowering, and abolition if possible of export taxes. It is not advisable to apply sequentially the liberalization of imports after exports have been expanded and the country has acquired enough international reserves; it is preferable to do all this simultaneously. In addition, it is recommended that incentives be increased in order to attract foreign investment, avoiding discriminatory treatment between national and foreign enterprises. Finally, a complete re-evaluation of the government's role as owner or operator of public enterprises is suggested, with various alternatives for denationalizing and privatizing being presented (Michalopoulos, 1987; various World Bank internal reports).

These economic reforms would thus be far-reaching. It should be noted that IMF conditionality —although it may be strict, inappropriate and imperfect— interferes or intervenes considerably less in internal affairs than any such as the above which might be imposed by the Bank. The conditionality of the Fund, oriented as it is toward reducing external and domestic imbalances, uses a conceptual framework based on budget restrictions. On the other hand, that of the World Bank, based on the liberalization of markets and the external sector, deregulation and privatization, requires a conceptual framework of dynamic growth strategies in an imperfect world of "second best". There is no firm and consistent theoretical (or empirical) basis for such an exercise (Helleiner, 1986; Sachs, 1986).

[5]In 1980 only four of the credit operations of the World Bank were oriented toward sectoral or structural adjustment, for a total amount of US$370 million. In 1987, there were 31 operations of this type, and their total amount came to cover US$4.1 billion.

Other doubts about this possible conditionality (Annis, 1986; Feinberg and others, 1986) put stress on how biased the Bank's view of the LDCs is. The Bank shows a marked hostility toward government intervention and public enterprises, since they are indiscriminately considered to be obstacles to growth. Government interventions in the growth of the economy are always "bad" and introduce distortions; it is therefore necessary to reduce its degree of involvement. Public enterprises are inefficient by definition; that is why privatization *per se* leads to an increase in efficiency and prosperity. Public bureaucrats are always viewed as inept and corrupt, and private businessmen as efficient and honest.

The existing evidence in Latin America in these matters suggests that reality is not so black and white, but a great deal more complex. Likewise, structural adjustment lending (SAL) programmes are quite ambitious and include a package of economic reforms that implies a clear interference in the development strategy, the management of economic policies and the evolution of distribution and redistribution patterns. In most Latin American countries this interference is considered to be simply intolerable.

In short, it would be better for the World Bank to resume the approach that it advocated in the 1970s —which gave priority to alleviating and eliminating poverty—, while avoiding making the same mistakes. It is true that the LDCs have to undertake structural reforms, but there is much uncertainty about the most appropriate sequence and rate of application. On the other hand, each case is different and depends on the initial conditions and on political feasibility. Thus, it is vital that the decisions remain in the hands of the governments.

As for the debt problem, until 1984 the Bank maintained a passive attitude, which to a certain extent responded to the prevailing view in the industrialized nations that the lack of liquidity was only temporary. Given the persistence of the problem and the paucity of external credit alternatives, the LDCs increased their demand for the credit resources that were idle and stagnating in the Bank. Since 1985, the Bank has adopted a more active attitude, upon perceiving that the debt problem has an adverse effect on LDC growth, which in turn leads primarily to difficulties in finding viable investment projects.

The Baker initiative or plan consolidates this more active role. On the one hand, the IMF suffered a major institutional deterioration during the costly adjustment process of 1982-1985, and a different international institution was then needed to replace it; on the other hand, there was an important change of emphasis in the perception of the debt problem, when concern began to be expressed about the growth of debtor countries during the adjustment period.

The World Bank has performed a significant role for some Latin American debtor countries (Chile, Colombia, Mexico and Panama) as a catalyst or backer of new loans from international private banking; in other words, the fact that it provides loans or backing has facilitated the concession of commercial bank loans. In this sense, international private banking would like the Bank to go much further and expand its backing to either existing loans or any future flow. Obviously, the institution resists this type of pressure, and any bank which grants a loan for investment must therefore assume the risks involved in the operation (Feinberg and Bacha, 1987).

II

Growth-oriented adjustment

This strategy corresponds to an earlier regional proposal. In light of the experience of the many programmes signed by Latin American countries with the IMF, for some time there has been fairly widespread agreement that they reduce the external imbalance, but at a high domestic cost. Furthermore, they do not lead the economy down the road to stable, high and viable growth, since they do not produce the structural changes required.

Today, everyone speaks of "growth-oriented adjustment". However, there are serious disagreements over the package of economic policies required for implementing this strategy.

1. *Possible conflict between adjustment and growth*

A macroeconomic adjustment programme may require a significant decrease in the fiscal deficit and a decline in the rate of increase of domestic credit. The reduction of the fiscal deficit may imply, in turn, a hike in the taxes on all economic agents, including exporters, and a cutback in public spending, which would also affect public investment. On the other hand, a contraction in domestic credit erodes the financial resources available for sustaining investment. Consequently, the previous macroeconomic programme, geared toward inducing adjustment, would not be a positive stimulus for growth; i.e., there would be some degree of *trade-off* between adjustment and growth.

However, it is possible to argue that macroeconomic adjustment is a prerequisite to a sustained, long-term growth. A stable macroeconomic environment, that is, one that is free of imbalances (domestic or external) and that has stable economic regulations, encourages and motivates the economic agents to adopt a long-term perspective.

2. *(Possible) cross-conditionality between the Fund and the World Bank*

There are two distinctive elements that provide the conceptual frame of reference used implicitly or explicitly in the elaboration of a possible cross-conditionality between the two institutions. They are the "multilateralist" view prevailing in the 1980s and the successful growth experience of Asian exporter countries.

The "multilateralist" view prevailing in the period prior to 1980 held that international economic *co-operation* could play an important role in promoting world prosperity and development. The prevailing view today in industrialized nations and international organizations is very different (Dadzie, 1987). According to this view, the economic difficulties experienced recently are the result of inappropriate domestic policies in the LDCs and in industrialized nations. The solution would then consist of applying the "appropriate and correct" (macroeconomic) policies, and introducing structural adjustments oriented toward increasing the flexibility of the economy in order to enable a more efficient allocation of resources. Each country has to "put its house in order" and adjust its economy in response to possible exogenous changes in external variables. From the standpoint of development, this serves to facilitate trade and financial flows; what is crucial is *not* the improvement of the international setting but the establishment, in each economy, of adequate incentives so that the private sector becomes the engine of growth. The interdependence of the world economy has become so complex that even a co-ordinated action by the governments of the industrialized nations cannot alter the sequence of events.

On the other hand, using the successful growth experience of Asian exporter countries as a reference, it is foreseeable that the new Fund-World Bank *cross-conditionality* will suggest to the LDCs that they adopt a development strategy based on export promotion ("outward development"). It should be noted that most Latin American economists, as well as ECLAC, agree with this. The key disagreement lies, however, in the package of economic policies needed to implement the strategy.

In short, the economic framework of *cross-conditionality* would be based on the following principles: application of "responsible, appropriate and correct" macroeconomic policies (such as monetary and fiscal policies); motivation and augmentation of savings and investment; boost in the production of tradeable goods and, in particular, export promotion, and establishment of a more appropriate structure of incentives in the local economy.

At this level of generalities, it is very difficult for any economist to disagree. Who could oppose responsible, appropriate, correct and adequate policies?[6] Then why have the LDC governments not decided to apply them? The commonplace answer is that the most appropriate, correct and

[6] Only an irresponsible, incorrect or inadequate economist could disagree.

responsible economic programme is not obvious in the economies of a "second best" world, with their imperfections, distortions and political and economic pressures, and in countries whose governments are dedicated to very disparate objectives (greater growth, lower inflation, less unemployment, more equitable distribution of income, alleviation of poverty and reduction of the external imbalance), among which there are trade-offs of unknown but severe proportions, especially in a dynamic context.

The growth-oriented adjustment strategy based on the promotion of exports, implicit or explicit in the (possible) *cross-conditionality* between the Fund and the World bank, would contain the following elements (Guitián, 1981 and 1987; Krueger, 1978; Balassa and others, 1986; Michalopoulos, 1987):

i) Liberalization of markets and the external sector. The central component of the latter is import liberalization.

ii) Granting of incentives to expand exports, such as devaluing local currency, maintaining a stable real exchange rate and cutting export taxes.

iii) Transformation of the private sector —national or foreign— into an engine of economic growth, which is often a euphemism for the privatization of public enterprises.

iv) Enforcement of stable, permanent economic regulations, hand-in-hand with less government intervention in the economy and, in connection with the previous point, a reduction in the size of the State in the economy.

3. *Review of the Asian experience*

It would seem that there are very different interpretations of the policies used in the successful Asian export experience.

Sachs (1987) has examined the series of policies applied by Japan in the period (1950-1973) in which the country reached one of the highest annual average rates of economic growth.

i) *Exchange rate policy.* The government held absolute control over foreign exchange, and exporters had to surrender all foreign exchange generated. Public bureaucrats allocated the foreign currency among the various sectors and enterprises, without subjecting them to specific norms. During the 1950-1964 period, official foreign currency was not granted for tourism.

ii) *Capital account.* The government was the only economic agent that could request external credit; foreign investment was subject to strong controls, and the entry of multinational corporations controlled mainly by foreigners was not permitted.

iii) *Interest rate.* The real interest rate was low and subject to a maximum ceiling; the granting of credit was discretionary.

iv) *Incentives for exporters.* Overseas sales were promoted, not through the import liberalization mechanism but through specific fiscal incentives (subsidies and tax exemptions), which were extended to exports with natural comparative advantages.

In short, according to the above-mentioned author, the Japanese export experience was based neither on free trade nor on a freely operating market mechanism, indeed it was not at all outside the sphere of government influence.

It should be noted that in several Latin American countries an economic programme apparently similar to that described was applied. Why, then, were the results not similar? Possible answers are: there is no single economic formula to achieve a given objective, in this case export promotion; or rather, the same formula, applied to different economies and under different world economic conditions, can produce different results. In our judgement, however, during the 1950-1970 period in most Latin American countries the incentives were biased against exports (permanently overvalued local currency, high import barriers, etc.), and there was even a certain pessimism about export potential.

As for the non-Japanese Asian strategy, which was also successful, Sachs points out that export promotion is the engine of economic growth, but that it is not equivalent to mere import liberalization. The latter is not a prerequisite to export promotion either. The same can be said of the "pure" role of the market and the State in the economy. In Korea, the authorities promote the formation of large commercial businesses that distribute export products; and although there is no equivalent to the Japanese MITI (famous for its guidelines for future export areas), the government puts pressure on the major export firms and interacts with them, playing an active and important role.

In sum, the package of economic policies produced by the successful Asian export promotion strategy is unlike that contemplated in the "liberalization and deregulation" associated with (possible) cross-conditionality.

4. *Some difficulties with a (possible) cross-conditionality*

The economic programme suggested by the proposed cross-conditionality between the IMF and the World Bank would supposedly result in growth-oriented adjustment, thereby enhancing the prosperity of the country that accepts it. This leads to a dual paradox (Streeten, 1987). On the one hand, if the economic programme associated with cross-conditionality benefits those that implement it, then why do governments not apply it *motu propio*? Why is it necessary to put pressure on them to do so through cross-conditionality? (Sachs, 1987). On the other hand, if that economic programme is really so good, why do the countries that decide to apply it not pay for the advice, receiving an "award" in exchange (access to credit)?

Streeten lists 10 reasons to explain this dual paradox. Their key elements are: i) the short-term costs involved in this strategy can be very high, and ii) there may be serious disagreements between international institutions and countries over the functioning of the economy and perceptions and expectations about future changes. Regardless of these explanations, the first part of the dual paradox deals with the central problem of the conditionality of multilateral institutions. There is something in its components that makes it unattractive to the countries in need of external financing. In fact, if there are credit alternatives other than those represented by multilateral institutions, they will be preferred, although their cost may be higher (as was evident at the end of the 1970s). This calls into question the role of multilateral institutions which may eventually become mere lenders of last resort. In that context, one of the conclusions of the case study by Killick (1984) is that the traditional IMF adjustment programmes have a greater probability of success when the local government really agrees to apply them. Summing up, it seems to be vital to increase the dialogue between the different parties, in other words, countries and multilateral institutions.

The possibility of cross-conditionality has given rise to several doubts. In the first place, a basic discrepancy is noted with regard to the growth-oriented adjustment strategy recommended by both institutions. This would basically advocate that the LDC involved achieve an equilibrium in the balance of payments that is compatible with the flows of payments for servicing its foreign debt and with the amount of new loans received; in that scheme, the rate of economic growth of the country is obtained as a residual. However, according to the Fishlow (1987), the view of the new growth-oriented adjustment strategy must be different. The goal is to ensure an adequate minimum level of growth, determining the volume of external resources needed by the LDC; what is obtained as a residual, then, is the flow of external loans. The crucial question then becomes: from where will these resources come?

In the second place, there is no theoretical model that describes the transition from a situation of imbalance to one of balance, particularly when that process includes defining the opportune moment and time sequence of structural reforms (trade opening, financial opening, market liberalization, lifting of economic regulations, etc.). The dynamics of the change in the presence of imbalanced markets is very difficult to describe, and there is simply no theoretical model of how to do it (Helleiner, 1986). Nevertheless, in a context in which imperfections and distortions predominate, it is foreseeable that cross-conditionality will systematically suggest the use of price incentives and the liberalization of everything that can be liberalized. This global approach can be defended only if it is applied judiciously and flexibly, but as a universal rule it is not valid or acceptable either politically or economically (Helleiner, 1986).

In the third place, it can be presumed that cross-conditionality impedes the negotiating process of each country with multilateral institutions, since it can conclude one negotiation only when it has concluded the others (Lizano and Charpentier, 1986). This would be similar to trying to solve a model of simultaneous equations with variable (and sometimes not clearly convergent) parameters, at the precise moment

when the country is urgently in need of external loans.

The following line of argument suggests the reasons for the establishment of *cross-conditionality.* The two types of *conditionality* of the IMF and the World Bank are supposedly a coherent, consistent and complementary policy framework; for growth-oriented adjustment to succeed, then, the programme must be applied as a whole. In order to guarantee that it is implemented effectively, it is advisable to have a mechanism like *cross-conditionality.* From the countries' viewpoint, its existence would deeply affect the socio-political stability of their governments, since compliance or non-compliance with various elements of the cross-conditionality would affect practically the *entire* flow of external loans obtained by the country. In the presence of a *cross-conditionality* between the IMF and the World Bank, the LDCs would then avoid having to resort to those international institutions to request credit; if they did so, they would be exposed to a delicate factor of political, economic and social instability.

Finally, the development strategy, the size and type of growth and other socioeconomic objectives are the main components of that at times vague concept, of national sovereignty. The degree of susceptibility of a country will be affected when there is an obvious intrusion into key economic and political areas, such as liberalization, deregulation, privatization and foreign investment. Suggesting and urging the adoption of an economic programme in terms of its impact on the balance of payments is a very narrow objective. Furthermore, the criterion for evaluating the success of that programme cannot be limited to how well it is able to cover the payment of debt servicing (Miller, 1986), but must take into account its impact on growth and on other socioeconomic objectives of a redistributive nature.

5. *The distribution problem*

From the country's point of view, achieving adjustment in a situation of external imbalance is a public good that supposedly benefits all its economic agents. Then why do they all not co-operate and make sacrifices to obtain it? How can the costs of the adjustment be distributed equitably? What is, from this angle, the most appropriate economic policy package? A similar set of questions is applicable in the case of the growth-oriented adjustment strategy; in this situation, it could be adduced that those who make sacrifices today will benefit tomorrow by greater growth. However, this reasoning raises many questions. What are the guarantees that those who make the greatest relative sacrifice in the present will really be compensated? Will that compensation be greater for those who have made the most sacrifices? How can the sacrifice of present well-being be compared to a potential future benefit? What compensation should be given to those who have been unemployed for a long time in order to facilitate the present adjustment, in view of the economic, psychological and social costs they have paid?

6. *Financing of the strategy*

Without a doubt, the basic problem of a growth-oriented adjustment strategy is that it demands a larger volume of resources over a longer period of time. This is because, in the case of Latin American economies, the strategy requires the introduction of deep-seated changes. The central goal —to expand aggregate supply, primarily of tradeable goods, in the medium and long term— assumes the mobilization of more resources than that of traditional IMF short-term adjustment programmes, which have been oriented toward reducing aggregate demand (Sengupta, 1987). On the other hand, external financial resources are essential in the early years of the application of the growth-oriented adjustment strategy, to avoid further reduction in per capita consumption. It is difficult to carry out a package of structural reforms in a context where the deterioration of an already depressed level of consumption is proposed. In a democratic régime, this lacks political viability.

In view of the prevailing international economic situation and the problems mentioned, the Latin American countries face very unfavourable prospects. A possible scenario is that international banking may not provide significant amounts of new medium-term loans. It is probable, in fact, that commercial banking may be largely concentrated on the financing (short-term credit) of foreign trade operations.

Moreover, it may be assumed that the resources from foreign investment and the possible aid from the governments of the industrialized countries will fall short of the needs of the strategy in question.

Two alternatives would then remain. The first would be to increase the amount of credit resources from IMF and the World Bank through, among other mechanisms, greater support from the member governments of those institutions, improved use of special drawing rights (SDR) by the Fund or an increase in the proportional amount of the Bank credits in relation to its assets (on this subject, see SELA 1986, and the 1987 report of the Group of 24). If this formula were applied, both international institutions would assume in the middle term a predominant role for the Latin American countries; hence the importance of an open and broad discussion on cross-conditionality. The second alternative would consist of a substantial reduction in the negative flow of financial resources from Latin America. In other words, it is practically impossible to reconcile the application of a growth-oriented adjustment strategy with the payment of foreign debt servicing in the presence of a declining (and rationed) supply of external credit. Thus, the flow of resources allocated by Latin American countries to debt servicing must be curtailed.

III

Some final proposals

This work has been oriented toward examining some general but crucial aspects of the problems linked to the conditionality of the IMF and the World Bank and its probable —and perhaps even imminent— application in the region. In an initial phase, it is possible to formulate only a few tentative suggestions about the direction that the analysis should take. In a later stage, the analysis must deal in greater depth with the basic principles and components of a conditionality that takes into account the interests of the Latin American countries.

The economists of the industrialized world have played a crucial role in defining the rules of the game and in the type of conditionality promoted by both institutions; supposedly, the views and vested interests of these countries will have an important impact on the final result. However, the IMF and the World Bank have not been rigid, unchanging institutions throughout the passage of time.[7] Moreover, as Keynes argues, the power of ideas in relation to that of vested interests should not be underestimated. Latin American economists must concentrate, then, on formulating proposals to reform the existing and potential conditionalities of multilateral institutions which are more acceptable and beneficial to the interests of the region. The recent articles of Edmar Bacha (1983, 1985, 1986, 1987) provide a guideline for the type of research that must be promoted in the region.

The following is a brief list of proposals:

1. The transfer of resources from Latin America to the exterior in an amount equivalent to 4% of the gross domestic product (GDP) is completely incompatible with the growth-oriented adjustment strategy. The countries of the region cannot continue to maintain a negative flow of resources of that magnitude. This means that a definitive solution to the problem of the Latin American foreign debt, which at this point is essentially a political rather than economic issue, cannot be deferred. However, as Dornbusch has observed, today, unlike what happened in the 1920s and 1930s, the problem has been insistently considered to be a basically economic one.[8] It is high time to apply some of the many solutions that have been suggested.[9]

[7] Guitián (1981) and de Vries (1986) examine the growth and changes experienced by the IMF. Annis (1986) and Feinberg, *et al.* (1986) do the same for the World Bank.

[8] Quoted in Miller (1986), p. 84.

[9] On this subject, see Ffrench-Davis and Feinberg (1986); Massad (1986); de Carmoy (1987).

2. The conditionalities promoted by international institutions have to be reviewed and readjusted so as not to impose on the countries excessive adjustment costs or technico-ideological solutions incompatible with the majority preferences of their citizens.

For an IMF or World Bank programme to be acceptable and viable, the goal of correcting the imbalance in the balance of payments must be subject to the obtention of at least a minimal growth rate compatible with the country's supply of resources and progress toward redistributive social goals. Adjustment processes and structural reforms involve high costs for the poor; unfortunately, the same occurs with "non-adjustment." The basic problem lies in how to redistribute equitably the sacrifices involved in the adjustment.

New loans from the IMF and World Bank must not be used to repay the foreign debt, since in that case they would not be used for financing the growth-oriented adjustment strategy. Moreover, it is advisable for both institutions to defer the payment of amortizations and the servicing of loans during a certain period while the countries introduce the changes required by the adjustments and structural reforms.

On the one hand, if in a given country the Fund and the World Bank are going to operate simultaneously, it is reasonable to expect that the conditionalities promoted by these institutions be uniform and consistent. On the other hand, the host country has to be able to express an opinion and have an influence on the type of cross-conditionality that will be applied to it. In any case, it must be explicitly stipulated in each of the agreements that a cross conditionality neither exists nor is in force.

3. The main guidelines for IMF conditionality would be the following:[10]

a) Reverse conditionality. The adjustment programme must be designed by the borrowing country, taking into account the existing external restriction. Thus, the homogeneous and uniform programmes of the IMF would be replaced by "home-made", "fitted" adjustment programmes. This proposal is probably more significant for the small countries than for the larger ones, since the latter have a greater bargaining power.

Now let us look at this conditionality from an operational standpoint. A country presents the IMF with its adjustment programme and a request for credit. IMF experts review the consistency and viability of the programme. If serious disagreements arise over its feasibility, the Executive Director is called in to settle them. The final result probably consists of a compromise solution between the adjustment programme submitted by the country and the observations suggested by the IMF experts. But what is crucial about this process is the point of departure of the negotiations, since the final result commonly depends on the initial terms of the discussion.

b) Conditionality that takes into account variables of the real sector of the economy. In order to put a ceiling on the domestic cost of adjustment, it could be stipulated that when given levels are exceeded in the decline in the product or the increase in the unemployment rate, the country will be provided with further increases in external credit. The programme signed by Mexico in 1985 contained a clause of this type.

Thus, Bacha (1987) suggests that the financial-budgetary exercises traditionally carried out by the Fund be complemented by national feasible economic growth rate exercises, from which will evolve, as a residual, the volume of financial resources necessary for supporting a given rate of expansion of the product.

The identification of that minimum rate (consistent with adjustment), which can be used as a point of reference for all countries, can cause some difficulties. The zero figure always holds great attraction, inasmuch as it could be asserted that zero growth in per capita income means that the current levels at least do not deteriorate. But this would mean applying a stricter criterion to those countries that have a higher rate, which would make no sense.[11]

[10]See Group of 24 (1987); Bacha (1985) and (1987); SELA (1986).

[11]The application of the "rule of two", i.e., dividing by two the average value of the country's economic growth rate for the last five years, is probably a less discriminatory criterion. This "rule of two" would have a precedent in the financial exercises of the Fund, which would use it in order to determine the level of fiscal deficit that must be reached by the (Latin American) countries in order to implement the adjustment programme (Bacha, 1987).

c) Conditionality at two levels. In this case, it is suggested that a distinction be made between the external variables (those linked to the balance of payments and international reserves), measured in foreign currency, and internal variables (fiscal deficit, domestic credit, inflation), measured in local currency. The priority conditionality for the IMF would be that corresponding to the variables expressed in foreign currency; the domestic goals would then be relaxed when the external goals have been met (Bacha, 1985).

Spraos (1986) suggests a more extreme option. IMF conditionality must be centred on a single goal, the balance of payments, and later using only indicators (targets, in this case) linked directly to external accounts. Bacha (1987) feels, from a pragmatic standpoint, that it is more feasible to achieve a modification in IMF conditionality toward a conditionality at two levels, as previously indicated, which attempts to eliminate a considerable part of the existing conditionality. From the perspective of the countries, conditionality at two levels would substantially fulfil a very similar function to that of the one centred exclusively on the balance-of-payments objective.[12]

d) Consistency between the level of external variables and the minimum goal of economic growth stipulated. This level has to take into account: i) an adequate expansion of domestic credit (probably with one quota that is lower and another that is higher), so as to maintain enough liquidity to sustain the desired level of growth; ii) a fiscal deficit that ensures the essential levels of public investment and social spending for achieving the objectives of economic growth and alleviation of poverty and redistribution of prosperity.

e) Expansion of the compensatory financing facility (CFF) in order to cover a major proportion of the drop in exports and consider possible variations in the international interest rate. The impact of the fluctuations of this variable has acquired great importance for Latin American debtor countries. It would probably be more logical for access to the CFF programme to be related not to the quota that each country contributes to the Fund, but to the amount generated by the external maladjustment (associated with the fall in exports or the increase in the interest rate).[13]

4. The Bank should consider the following criteria in the design of its conditionality.[14]

a) Return to its foremost objective of the 1960s and 1970s, that is, eradication of poverty and redistributive growth. In terms of adjustment programmes, conditionality must specifically consider: i) alternative strategies that minimize social costs; ii) compensation mechanisms that cushion the impact on the poorest groups; iii) mechanisms that distribute equitably the sacrifices of adjustment, and iv) specification of the distributive impact of different alternatives.

The above has not been resolved either theoretically or empirically. Thus, it must become a priority objective within the World Bank research programme. The UNICEF approach of "adjustment with a human face" (Cornia, Jolly and Stewart, 1987) points out the urgency of protecting the maintenance of minimum nutritional levels for children and of meeting the basic needs of other vulnerable groups. In this sense, it is suggested that during the process of adjustment, the progress not only of the balance of payments and inflation, but also of the nutritional state and meeting of the basic needs of the

[12]Spraos (1986) raises an additional problem with respect to the indicators (targets) included in the conditionality, which are the frames of reference for determining the performance (or non-performance) of the agreed adjustment programme. Should they be linked to the policy *goals* or *instruments*? The IMF uses as a criterion the level of the instruments. Thus it is supposedly possible to discern when the non-performance of an adjustment programme is caused by endogenous or exogenous factors; a country would be responsible only when it does not meet the goals of a programme that is under its control (Kenen, 1987). But how can those cases in which the governments do not retain total control over the instruments be distinguished? Spraos also points out some of the difficulties involved in the use of instruments as *targets*: i) there must be a stable and very well-defined relationship between the policy instrument and the objective for which it is being used; ii) there is not always an operationalization of the instrument which indicates that it is the best; this is illustrated by the various types of M_1 used to tie in to the concept of money; iii) the instrument selected has to be the only one that can alter the value of the objective variable in the direction desired. Obviously, it is difficult for all of these requirements to be met in the real world.

[13]Other proposals by the Group of 24 (1987) are that: i) the IMF should not set precise quantitative goals, but ranges of goals for crucial variables; and ii) CFF programmes must definitively replace standby loans.

[14]See Helleiner (1986); Feinberg, *et al.* (1986); Feinberg and Bacha (1987).

most vulnerable and lowest income groups should be subject to constant scrutiny. The experience of Great Britain during the Second World War shows that it is feasible to make both nutritional concerns and progress in the adjustment programme compatible, even during extremely pressing times.

b) Maintenance, whenever possible, of the recently prevailing relative weight of loans for specific investment projects. Within these, it seems advisable to favour those which generate the most jobs; for example, loans to medium and small businesses, or loans for the labour-intensive construction of low-cost housing (with a maximum of square metres).

c) In relation to structural adjustment loans, the Bank should concentrate on those of a sectoral nature. From the political standpoint, structural adjustment loans (SAL) involve smaller amounts of resources than those associated with the reforms included in their conditionality. On the other hand, some loans oriented toward sectoral adjustments do not require the application (or consistency) of a macroeconomic programme with the IMF; this is the case of those that are set up to improve nutritional status or human capital or to strengthen the energy policy or the infrastructure of a country.

d) Support for an export promotion strategy, about which there is a high level of consensus. In the modern interdependent world, the external sector plays a crucial role for small and medium-sized countries (categories that include all Latin American nations). In order to stimulate overseas, sales, the following are suggested, among other measures: i) maintaining a stable exchange control, under which local currency is permanently (for a reasonably long period of time, i.e., 10 to 15 years) slightly undervalued; ii) eliminating all the obstacles to the importation of inputs used in exports. It would also be appropriate to use a direct export subsidy mechanism (for marginal and/or new exports) for an initial period of no less than five years, which would decrease and eventually be eliminated. This mechanism is justified by arguments similar to those supporting the protection of infant industries. This type of measure, which is especially oriented toward the export sector, is undoubtedly preferable to the unrestricted, indiscriminate liberalization of imports.

It is obvious that the private sector responds positively to the appropriate economic incentives; consequently, by applying the criteria described, it can be transformed into a vital agent for the expansion of Latin American exports. On the other hand, although the private sector and the market mechanism play a key role, government action is still indispensable in a number of aspects. It is responsible, in fact, for establishing a propitious global context; providing the basic infrastructure and motivating the human capital formation adequate for development; encouraging and, in some cases, initiating certain types of activity that, owing to their externalities and economies of scale, do not attract the private sector in the beginning. Although they may be transferred *a posteriori*; promoting active trade policies, through bilateral or multilateral agreements and through embassies that provide the pertinent information, etc.

In order for there to be success in the current competitive international world, nobody can be excluded; on the contrary, all the economic agents of a country must push the cart of the economy in the same direction. The, somewhat obvious moral is that the Latin American countries necessarily have to establish and operate a mixed economy, in which both the private sector and the State play important roles. The polar systems with values of 0 or 1 for the economic roles of the private and public sectors —no matter which one is assigned the 0 or the 1— are doomed to failure. Nevertheless, each country has to define the optimal combination for itself.

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Options for regional integration

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This article analyses one of the fundamental categories of ECLAC thinking: the economic integration of Latin America and the Caribbean. It suggests a different approach to Latin American integration, taking into account past experiences and current circumstances within and outside the region. In accordance with this view, integration must become a political strategy for Latin Americans. This would mean involving the largest possible number of social actors in the task, especially the democratic political community, thereby strengthening the possibility of bringing their democratic principles to fruition. Hence integration would become a part of national aspirations and political movements.

This concept seeks to overcome two obstacles of paramount importance that have affected integration in the past three decades, namely, the focus on trade on the one hand, and, on the other, the contradiction between changing national policies and the policies required by an integrated Latin America. The key purpose is to create real and permanent interdependencies among the countries of the region. If this goal is met, trade will be a symptom that these interdependencies exist and are being consolidated, as distinct from the impression given by indecisive, unstable efforts which easily bow under the stress produced by crises originating in the external sector.

The article addresses three issues —in the corresponding three chapters— which are to a large extent interrelated: the potentials and limitations of integration and co-operation; some recent initiatives; and policy, strategy and action proposals.

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I

Potentials and limitations of integration and co-operation

1. *Proposals and dilemmas*

Historically, subregional integration processes in Latin America and the Caribbean have arisen as a response to the problems of external constraint and the need to generate bases for a sustained, efficient development. In the nearly three decades that these initiatives have been under way, there has been a notable change in the economic, political and social structures of the countries of the region, but many of the dilemmas which caused those problems remain and have even intensified.

In the structure of Latin American exports, commodities continue to represent a high proportion —around 80% of the total—, an their prices, in relation to manufactures, are constantly deteriorating on international markets. Thus it becomes increasingly difficult to import the goods the region needs for its development and at the same time maintain a trade balance based on growing quantities of exports of commodities, since the upswing in their supply causes further reductions in their relative prices.

In recent years, this structural situation —which has been the lot of the region— has worsened and there are no signs of any improvement in the offing. Despite the longstanding debate on the validity of the phenomenon of deteriorating terms of trade of commodities compared to manufactures, there are few today who would still argue that it makes no difference to a country's development whether it exports one category of products or another.[1] Manufactures exports have become an

[1]The verification of persistent deterioration in the terms of trade leads to admitting the need to promote the production and export of manufactures and the policies that favour them, such as differentiated tariffs, which protect final products more than their inputs.

explicit objective of the bulk of the foreign trade strategies used by developing countries.

At the same time, a restructuring of the international division of labour is taking shape. This is the result of the incorporation of microelectronics and automation into the productive processes, revolutionary discoveries in the field of genetic engineering and other similar techniques. These real changes in the forms of production should set the direction for the coming transformations in the productive systems of Latin American and Caribbean countries. It should be added that technological changes contribute to depressing the prices of the region's raw materials for export, generating cheaper substitute products and reducing the physical content of inputs in finished products, through the "miniaturization" of most of their mechanical and, in particular, electronic components.

The heterogeneity of the Latin American and Caribbean countries and their dissimilar degrees of industrialization, mean that the strategies for adapting to these new conditions will be different as well. In certain cases, it will be enough to return to developing the productive system. In others, however, it will be necessary to apply more deep-seated corrective measures.

2. *The potential role of economic integration*

In the early days of integration, it was relatively simple to identify its role. The countries were just beginning the systematic development of their industrial apparatus, and hence almost no one questioned the need for industrialization. The size of domestic markets defined the type of productive activities which could be implanted autonomously and those which, owing to their economies of scale, exceeded national capacities.

Today, the size of manufacturing plants continues to play a decisive role in arriving at competitive costs in certain branches of the economy; however, the "gigantism"[2] which prevailed until the 1970s tends to be out-performed by smaller, more versatile plants. The automobile industry is still an exception to this trend.

This does not mean that all countries, even under today's conditions, can agree to the establishment of industries such as iron and steel, petrochemicals, aluminium, some mass produced capital goods or advanced electronics. The main limiting factor resides in the technological and productive capability of the economy as a whole to strengthen manufacturing enterprises and give them the necessary support infrastructure. In general, there is no infrastructure in the countries of the region capable of sustaining autonomous development. The main deficiency lies in the scientific and technological system, and its capacity to collaborate in the continual modernization and transformation of the productive apparatus using technologies which involve mental ability, as opposed to unskilled labour.

Shifting from an international specialization based on labour-intensive activities to one with greater technological content is neither simple nor automatic. An increase in resources for scientific and technological development and innovation must be combined with a strong system for the training and advanced preparation of highly specialized personnel.

Traditionally, most of the labour-saving technological processes, and the automated equipment which performs a similar function, have been imported from the industrialized countries. This results in a wide occupational and balance-of-payments gap, in view of the high cost of these technologies and equipment and the fact that they displace labour. An expanded market, resulting from an effective integration process, can help create the conditions for a technological and productive development which is more in harmony with an active participation in the international economy. It can also permit joint investments that require broad bases of economic support. It is clear that integration does not guarantee success in a project of this sort, but it does make a task which would be nearly impossible if undertaken in isolation feasible for the great majority of nations.

In the complex framework of deep-rooted changes in the international economy —derived

[2] For example, blast furnaces in the iron and steel industry with an annual unit capacity of 3 to 4 million tons of cast iron, automated "transfer" equipment for mass production parts, for supertankers and bulk carriers of more than 300 000 tons.

above all from scientific and technological progress and the "internationalization" of productive processes— the notion of an expanded market differs from the traditional concept, in which expansion was primarily understood to be the result of multilateral tariff liberalization and the elimination of non-tariff barriers. Such an approach is inappropriate to the realities described. The expanded market is perceived as a way of closely intertwining the economies with their operators —whether public or private—, where the core element is the governments' capacity to co-operate in promoting various production schemes and shared investment initiatives. These include tariff relief mechanisms and the elimination of other trade barriers, but the central aspect is the creation of a solid, stable interdependence.

In this task, regional co-operation will become another essential factor. The scientific and technological development described involves forms of co-ordinated action which will strengthen the various country capacities and open the way to the generation and spread of appropriate technologies. In addition, co-operation will allow for the acquisition of certain technologies which are almost always marketed on the basis of monopolistic supplies, and where aggregate negotiating capacity can be a determining factor in obtaining them and establishing appropriate prices.

In short, the economic and productive evolution of recent years requires different understanding of integration and co-operation than in the past. Some instruments, especially those relating to tariffs, become relatively less important in this new understanding, as a more stable, overall economic interdependence is sought. Likewise, the heterogeneity of the region makes it necessary to move forward in various fields and through various mechanisms, or through subregional groups to collaborate on specific projects of common interest.

3. *The international function of regional unity*

In order to make it possible to develop an efficient, dynamic productive system, integration functions must be combined just as vigorously with functions aiming at achieving a less vulnerable and dependent participation in the international economy. The international crisis of recent years has once again brought into focus that in international relations there has been a rise in the use of pressure and force as rules of coexistence. The protectionism of the developed countries, practised by the main trading partners of the region, makes it vital to create a negotiating capacity to neutralize the disastrous effects of these actions on the main export items.

Just as unity is a prerequisite for developing a strategy to modernize and vitalize the productive system, it is also a necessary condition for organizing and exercising an internationally credible, effective negotiating capacity. This assumes that industrialization, agricultural development and, in general, the development of the productive system —including related services—, are based primarily on the regional or subregional market, depending on the case. The selection is not dogmatic. In the current state of the international economy, it corresponds to the conviction that it is more feasible for the region to take advantage of the prospects of joint domestic markets as a way of increasing national and regional autonomy, or in other words, heightening the degrees of freedom to choose a development strategy that permits greater control over resources and productive structures and qualitatively changes the way they are incorporated into the world economy.

4. *Obstacles to integration*

In the Latin American integration schemes —the Latin American Integration Association (ALADI), the Central American Common Market (CACM) and the Andean Group—, the larger countries did not join ranks in support of common, long-term objectives and the most effective instruments and institutions for achieving them.

In LAFTA/ALADI, Argentina, Brazil and Mexico have gone through different stages in evaluating the importance of an effective integration process. It has been only recently that the Governments of Argentina and Brazil have shown a deeper commitment to creating a real economic interdependence between their

countries, with an initially bilateral orientation. The Andean Group, headed originally by Chile and Colombia, was disrupted by the withdrawal of Chile and the loss of conviction about the Group's true role in regional integration. It should be remembered that this scheme arose from the need to invigorate a process —LAFTA— that had begun to languish long before the end of its ten years of operation. Finally, the Central American Common Market —which achieved substantial trade development but which is currently involved in conflicts and serious tensions— has suffered grave setbacks, and the leadership exercised by the larger countries of the subregion has flagged.

Generally speaking, the governments' political backing of integration has been one of words rather than deeds. This explains why neither public sector operators nor State enterprises have become participants in this initiative. Private businessmen for their part, have been only marginally involved. Civil communities and their means of expression, including political parties, have not become committed to these processes either. Most of the various sectors of the community have been unable to see the advantages of integration. This is because enough progress has not been made on the issues that most directly benefit the general population, such as freedom of movement and access to work among the member countries of the same scheme, or on other conventions having a similar purpose, such as education and technical training, validation of diplomas, etc.

Aside from the need for leadership from the largest countries in each subregional scheme —and the fact that it is necessary to turn these processes into a national political strategy—, it would be advantageous for integration to be more selective and for the goals to be pinpointed clearly so as to choose the most appropriate instruments to meet the objectives.

Although tariffs are still important today in creating or diverting international trade flows, non-tariff restrictions, exchange rate parities, loans and financing mechanisms, State purchases, clearing arrangements, stipulated domestic remittances by transnational corporations and many other factors related to product quality, transport, marketing techniques, etc., are also important. If the purpose of integration is to generate stable economic ties among the member countries of a scheme, it will be essential first to define the nature and closeness of the ties desired and then to adapt the instruments to that objective.

On the other hand, it should be noted that governments strongly resist making proposals for multilateral machinery. This is because it is difficult to specify long-term objectives, in view of the economic crisis, and because there is a tendency, for the same reason, to avoid making commitments that will be complicated to fulfil. Under current conditions, the dilemma between multilateralism and bilateralism is more theoretical than real. The vast majority of the governments of the region are in no position to assume the risks of complying with more wide-ranging obligations whose results are uncertain. This does not mean that subregional integration schemes should stop seeking the elements of collective union that are the very essence of their purpose.[3]

5. *The benefits of integration*

The subject of the costs and benefits of integration is certainly one of the most controversial and difficult to separate from a merely theoretical plane or from subjective assessments. The increase in trade relations —which, as mentioned above, was considerable until the onset of the economic crisis— was not homogeneous, and some countries had persistent trade imbalances with the other members of the same integration scheme. Likewise, trade protected by tariff preferences did not represent a very big share of trade within a scheme, except in the Central American Common Market, where tariff concessions operated more effectively. This meant that, in most cases, the diversion of trade to member countries did not entail higher costs for the importer, if the normal customs tariffs for third countries were applied to the goods. In ALADI it is estimated that, in 1985, only 33% of the trade was carried out under some tariff

[3] For more information on this subject, see ECLAC, "Multilateralismo y bilateralismo en la ALADI" (LC/R.564), Santiago, Chile, 9 February 1987.

preference system, which is equivalent to approximately 4.6% of its total international trade.

The costs and benefits of integration must be discussed in the context of the existing diverse strategies and institutional constraints. Thus, to the extent that countries are willing to support a given level of inefficient industrial or manufacturing production, it becomes clearer that a customs union among countries can serve to reduce the excess cost of industrial production among the members through three channels: comparative advantages within the region or the union, economies of scale in production and an increase in diversity for consumers. Whether society intrinsically values industrial protection or the existing power relations make protection an inevitable result of the political process is of little importance. What is really important is that, if industrial protection and inefficiency are inevitable, then a customs union may very well reduce the costs of this protection.[4]

It should be noted that this way of looking at the costs and benefits of integration does not include the basic factors in the imperfect international markets of goods and services, namely, economic and political blocs, increasingly managed trade and transnationalization and internationalization of world relations. Accordingly, the increased capacity to negotiate and support joint positions, which reinforces economic and political unity, must be assessed in its true dimensions. The theory of the behaviour of customs unions and free trade zones, which is mainly based on the existence of competitive and open international markets, has been discredited by a reality that shows, now more than ever, that these conditions never existed.

On the other hand, the list of co-operation measures made feasible by the existence of subregional integration schemes would be a long one. Initiatives in the joint exploitation of shared natural resources, such as binational hydroelectric resources, the Energy Co-operation Programme for Central American and Caribbean countries, signed in San José by Mexico and Venezuela, and the Action Committees of the Latin American Economic System (SELA), would have encountered great difficulty in crystallizing had it not been for the knowledge and the linkages resulting from integration efforts in the region.[5]

Subregional integration schemes have generally tended to concentrate mainly on aspects of reciprocal trade and its financing. Some, however, ventured into other areas, such as the programming of branches of production, electrical interconnection, transport facilitation, culture and, to a lesser degree, technological development. Thus there is plenty of room for applying contributions of these processes to the development of the subregions, and especially for enhancing their presence in the international economy.

Finally, integration has a political dimension that is closely linked to the governments' ideas and their specific political strategies.Through unity, the rebirth of democracy in most of the countries can find considerable support and enrichment.

The conclusion that may be drawn from the above analysis is that integration is a complex process with political, economic and social dimensions, which must be relevant to each country's views and variants on the integral development of society. Integration is therefore a means by which to co-operate in achieving the domestic objectives of a society and to make viable its more equitable, dynamic participation in the international economy.

[4] Rudiger Dornbusch, "Los costos y beneficios de la integración económica regional", *Estudios*, year IV, No. 19, Córdoba, Argentina, July-September 1981.

[5] For a detailed description of co-operation initiatives, see *Integración y cooperación regionales en los años ochenta*, Estudios e Informes de la CEPAL, No. 8, Santiago, Chile, 1982.

II

Some recent initiatives

1. *Brief summary of past events*

When integration processes first began, national planning was an important tool of the economic policies of the countries of the region. Through it, most of them received reasonable guidelines on the objectives and goals to be reached —globally and sectorally—, which made it feasible to promote various joint projects.

By the mid-1970s, planning lost ground in the conduct of economic policies. Meanwhile, neo-liberal trends were gaining acceptance and in some cases were pushed to their extreme. This transitional phase in economic management slowed down efforts towards integration, contributing to its growing weakness. An outcome of this situation was the review and modification of some basic agreements, such as the First Protocol Amending the Cartagena Agreement (Arequipa, 1979) and the new Montevideo Treaty of 1980. These conceptual readjustments were based on the growing disparity between national policies and the multilateral policies issuing from each integration scheme.

Since 1982, when the serious problem of foreign debt exploded, another adverse condition has arisen. The countries have begun to act primarily in response to conjunctural situations and have been faced with the adjustment policies recommended by the International Monetary Fund (IMF), which further weakens integration efforts. This crisis, however, although obviously negative, has had positive effects on the main concepts behind integration. A large majority of countries confirm that it is not just a problem of whether they can service the debt or not, but that the elements of the crisis are more extensive. This reveals the weaknesses of industrialization processes and the need to promote a general re-adaptation of the productive apparatus. As will be seen further on, this is one of the key ideas of the Integration and Economic Co-operation Programme (PICE) and of several protocols signed by Argentina and Brazil.

In addition, in national societies, the negative effects of recent authoritarian governments and of the existing strong ties with developed countries continue to be felt. Nevertheless, important events have also occurred recently which may help make integration and co-operation efforts viable again. A way of solving the Central American conflict has been found in the Esquipulas II accords, which have the decided backing of the Contadora and Support Groups. There is a renewed regional political will being expressed systematically in recent times. This attitude may make it possible for the Central American integration process to be rebuilt gradually, the Andean Group to resume a dynamic pace in its activities, the Latin American Integration Association (ALADI) to gradually become an authentic regional forum for the trade and payments of the region, and the Latin American Economic System (SELA) to succeed in formulating and consolidating the many endeavours developing within it.

In sum, reviewing what has been occurring in integration processes, it is evident that there is a close correlation between past events and the prevailing political setting. It can also be seen that this setting, perhaps for the first time, is now more favourable to unity.

2. *The current situation*

The predominance of democratic processes has created a different environment, characterized by the existence of a new regional diplomacy, with frequent, direct dialogue at the ministerial and presidential levels. This does not mean that integration and co-operation have surmounted all the difficulties to become the panacea that will cure the ills of the uncertain economic situation which affects all countries to a greater or lesser degree.

The current status of integration and co-operation processes must be examined with a critical eye, beginning with the recognition that they are still far from having a decisive impact on national political projects, combining rationally and harmoniously with the orientations and policies of each country.

The conflict of interests is probably still the greatest difficulty. For many countries ceding part of a market to a neighbour amounts to endangering their own security. For example, trade deficits with the industrialized countries or South-east Asia are less important, while deficits with countries within the region, especially with a country belonging to the same integration scheme are serious political problems. Overcoming this rigid view is an especially important challenge for governments, political parties, intellectuals, workers, businesses and the competent international organizations. Integration and co-operation must be understood not just as the sum of the greatest number of sales operations possible. A concept based on a true, ongoing interdependence among countries is preferable to such a "Phoenician" view. The task is neither easy nor short-term, but it cannot be deferred.

Within this general framework, the most promising recent initiatives have been the Regional Round of Negotiations, the Protocol Amending the Cartagena Agreement, some bilateral agreements and the agreement on "Procedures for the establishment of a firm and lasting peace in Central America".

a) *Regional Round of Negotiations*

After a long period of deliberations and technical analyses —which took much longer than expected—, the Third Meeting of the Council of Ministers of the Latin American Integration Association (ALADI) adopted, in March 1987, a normative framework within which the process would be developed. This framework contains at least two advances that should be pointed out. One is the strengthening of the Regional Tariff Preference (RTP), and the other —of greater importance— is the Trade Recovery and Expansion Programme (resolution 15 (III)). The ministerial agreements are weak, however, in that they make only a marginal analysis of the problem of financing and payments. Yet in precisely this area there is an obvious bind which does not allow for the building of a dynamic trade co-operation scheme, such as the one required by the prevailing circumstances.

RTP is important because it is the multilateral mechanism *par excellence* of the Association. The tariff cutbacks that have been achieved are slowly approaching levels capable of generating trade. In any event, agreements must be reached on new and considerable extensions in order to attain the goal. The core problem, however, is the number of exceptions, which in practice make this instrument inoperative and discredit its multilateral character. A unique aspect of the Association is that RTP applies only to those countries which enforce it. By late 1987, nearly all the countries had complied with this procedure.

The Trade Recovery and Expansion Programme is without doubt one of the most ambitious goals promoted by ALADI. The main idea is to grant a wide margin of preference —on the average, around 60%—, so as to divert to the regional market 30% of the countries' imports from the rest of the world.

The lists submitted by the 10 countries —Bolivia excluded itself voluntarily— indicate an intraregional trade potential of around US$12 billion. If 50% of that potential were to be realized intra-ALADI trade would increase from the US$7.658 billion which it averaged in 1984-1985 to US$13.8 billion, representing an 80% growth.

The basic scheme seems simple, but during the negotiating process initiated in April 1987 many problems were detected whose solution is still uncertain. The current difficulties are certainly surmountable, but they require deep-seated changes in the willingness to negotiate and in negotiation styles and procedures. The regional political environment and the ministerial resolution mentioned above are a step in this direction. Nevertheless, no progress has apparently been made yet in inculcating a different negotiating attitude, oriented toward new regional interdependence instead of merely promoting trade deals that may be short-lived.

Any attempt to reactivate long-term trade requires payment and financing mechanisms to promote and stimulate the expanding trade.

Notably little progress has been made in this direction. The Andean peso and the "gaucho" —whose norms have not yet been determined— are important steps, but are not enough to reverse the historical trend toward favouring trade with third countries, to the detriment of the Latin American market potential.

b) *Protocol Amending the Cartagena Agreement*

The crisis in Andean integration had its origin primarily in intra-subregional trade. The problem stemmed from various sources: sudden changes in exchange rate policies; the application of recessive adjustment policies; extreme concentration on trade between Colombia and Venezuela and the limitation of the import capacity of both. The servicing of the subregion's high foreign debt serves as a backdrop.

The recent Protocol (decision 217 of May 1987), which required long, hard negotiations, sets forth solutions for trade problems. It creates a temporary system of managed trade, based on annual, global and product quotas. They cannot be lower than 30% of the average annual value of corresponding imports from member countries in the period 1980-1985. Limits per country and express modalities of application for Bolivia and Ecuador are set.

The major innovations involve agricultural and industrial development, economic and social co-operation, institutional aspects and decision 24, on a common system of foreign investment. The modification of the latter is one of the most controversial aspects of the Protocol, since it has always been associated with the very essence of the agreement. There remains, however, the possibility of a future re-examination of some of these basic principles, which essentially attempt to preserve the benefits of the process for member countries.

c) *The Argentine-Brazilian agreement*

The Integration and Economic Co-operation Programme (PICE) and the series of protocols that have been signed to implement it have given a renewed thrust to bilateral relations and have produced effects that may help invigorate the process of Latin American unity.

During 1987, the pace of political co-operation that began in mid-1986 was maintained. More than 20 protocols were signed, covering dissimilar and complex areas. They deal with capital goods, biotechnology, nuclear energy, transport, money supply —the "gaucho"— and various cultural aspects. It is difficult, however, to find indicators that can be used to assess the real degree of interrelationships being developed. In this context, agreements on nuclear issues and the resulting detente, and advances in aircraft manufacturing or progress in biotechnology, are aimed at producing long-term results.

The Investment Fund Rules and Regulations were approved in the second half of 1987, which has delayed the investment process required for the execution of several protocols, especially the one concerning capital goods. An *ad hoc* working group is trying to resolve the problems and cost of transport, particularly in the case of wheat. The technical and administrative phase for the building of the Pichi-Picun-Leufú hydroelectric plant has been completed and the financial part having to do with opening it is being negotiated. In communications, an interconnected system is being formed through the use of digital networks.

The protocol on capital goods has made remarkable progress in respect of negotiated items. Including the second section of the common list, nearly 30% of the projected goal was met (600 items in total and 190 already incorporated) for the programmed four-year period. This shows significant progress, although in some cases only specific products within other, broader categories are involved. For Argentina, this has meant a net generation of exports, but these are chiefly mass-produced goods, basically machine tools for small- and medium-scale producers, who normally do not represent a high volume of demand.

This protocol has evolved past the easy stage which allowed for the inclusion of products in the common list by agreement among all producers. In order to continue to move forward in 1988, goods which will affect business interests must be included. In cases where there is a certain parallelism in the countries' industrialization processes, achieving a trade opening will be a complex task.

As a negative factor, it should be mentioned that there has been no progress in public sector purchases, not only because of the complexity of the subject, but also because PETROBRAS for example —which is the source of the greatest demand—, has only one registry of local suppliers. Yacimientos Petrolíferos Fiscales (YPF), on the Argentine side, still has not organized a list of suppliers. Circumstances exogenous to the protocol are slowing down its implementation and impeding full use of its potential.

Finally, it is noteworthy that Partial Scope Agreement No. 1 has become an excellent negotiating framework in trade matters. Tariff preferences have been expanded, barriers and other measures having the same effect have been eliminated and many new products have been incorporated. Nevertheless, problems with non-compliance have limited the trade of some agricultural products. Both governments will undertake an evaluation of this instrument in order to determine the necessary corrective measures.

Finally, it should be remembered that, although the agreement is bilateral, Uruguay has participated actively in its political structuring, making it possible to formalize specific agreements among the three countries.

d) *Economic co-operation with Central America*[6]

The following are some of the elements of the current Latin American scene which indicate the dimensions of the task that the region must face as a whole:

i) The deterioration of the external sector is alarming, in terms of the magnitude and growth rate of the debt and of the continuing deficit in the trade balance of every Central American country. Between 1980 and 1986, the foreign debt rose from around US$7 billion to more than US$17 billion, and a deficit of over US$10 billion accumulated in the trade balance during the period. Until 1987, the subregion was unable to recover the export levels attained at the beginning of the decade.

ii) This deterioration is even more pronounced in the trade among the countries themselves. Particularly noticeable is the drop in the trade of industrial and manufactured goods. Exports within the subregion, which represented 25% of total exports in 1980, fell to 10% in 1986. The intra-subregional debt exceeds US$720 million.

iii) The deterioration of the external sector is centred in Nicaragua and El Salvador. Nicaragua accounts for more than one third of the total external debt and trade balance deficit accumulated in the last six years, and 77% of the intra-subregional debt. For its part, El Salvador accounts for one third of the total trade debt accumulated by the subregion. This makes both economies "bottlenecks" for the economic reactivation of the whole area. It has thus become an urgent need to solve the structural problems of these countries, both nationally and subregionally.

iv) On another plane, the political, war-related and economic crises have created a massive intraregional displacement of families with few or no economic resources. This highly sensitive issue of immense social magnitude affects every country of the region, placing a heavy burden on their economies.

In light of these facts and consistent with the views expressed by the eight Latin American presidents in Acapulco, there is a pressing need to take steps toward solving the problems of foreign debt, intra-subregional trade recovery and refugees.

To deal with the global *foreign debt,* combining the efforts of Central American countries with those of the rest of Latin America is the fundamental line of action, particularly *vis-à-vis* the industrialized nations and international financial institutions.

The intraregional debt requires new external resources for the payment of a part of the outstanding balance. This effort is estimated —as a preliminary working hypothesis— at approximately US$250 million for the upcoming three-year period, along with a renegotiation of the balance, and requires strong, united support from Latin American countries and the international community. One option, which could come from the Latin American countries themselves, would be to

[6]The text that is presented next was elaborated before the preparation, at the request of Secretary General of the United Nations, of the special plan of economic co-operation for Central America.

provide goods payable on the long term under clearly concessional conditions.

The *reactivation of trade flows* among Central American countries would be a factor in promoting the improvement of the regional economy. A fundamental element would be the re-establishment of the productive capacity to export of the countries suffering the worst economic decline, and the financing of exports —or imports— at various stages. The increase in industrial exports would help to recover 58% of the level lost in intraregional exports.

Trade reactivation and foreign debt management —global or intraregional— will not last without the recovery of the most damaged economies of the region. This in turn implies the stabilization and reorganization of the main macro-economic variables. A programme for Nicaragua would require around US$400 million —a figure that, for the moment, must also be considered as a working hypothesis— in order to re-establish productive capacity and halt inflation through an influx of consumer goods. In the case of El Salvador, the figure would be lower, in view of the external financial support which it already receives.

These steps are precisely aimed at revitalizing the integration scheme and overcoming some of the serious obstacles that confront its member nations. This must be combined with the co-ordination and unification of efforts not only to deal with the debt problem but also to promote exports and Latin American and international economic co-operation.

The subject of *refugees and displaced persons* is a serious social problem, which undoubtedly has had severe economic repercussions. The main recipient country is the United States. Mexico provides asylum for around 200 000 refugees, chiefly from El Salvador, Guatemala and Nicaragua. The problem also exists in Costa Rica. There are no relatively reliable statistics concerning this important issue, but there is a common recognition that it is significant and represents a political priority for the subregion.

The solution to this problem must combine direct assistance in food, health and education with efforts related to the "repatriation" of refugee groups. It is necessary to give them the means to exercise their productive capabilities, whereby they plough back resources into the national economies of the subregion. According to preliminary studies, nearly US$250 million would be required to begin to solve the problem.

III

Some policy, strategy and action proposals

1. *The political and geopolitical dimension*

It has been noted repeatedly —and justifiably— that in their most concrete expression regional integration and co-operation have the support of only the few governments and private business sectors directly involved. This reality, which largely explains the fragility of these processes in Latin America and the Caribbean, must be the point of departure in the pursuit of more participatory, open systems.

Efforts to involve the main economic, political and social agents in initiatives for greater unity and linkage among the participating nations should specify their objectives. In the present situation, the traditional results expected of economic integration and co-operation must be complemented by achievements in areas that are important to the people themselves.

The guarantee of democracy, the attainment of a lasting, stable peace and the channeling of a political pluralism toward the building of regional unity are values that would provide integration with a different and more profound dimension. At the same time, they can facilitate the incorporation of these processes into the aspirations and concerns of most of the national populations.

a) *Guaranteeing democracy*

Regional socio-economic heterogeneity means that a large dose of pluralism and pragmatism are needed in the conception and application of political strategies and schemes. Democracy in the national setting —and its extension to the region and subregion— can help to formulate an appropriate response. The essential elements of democracy should be used to shape more united, co-operative schemes among the countries of the region as concerted political efforts become easier.

Thus, for example, political agreements, essentially linked to democratic processes, have facilitated personal contacts among heads of State or among the highest ministerial officials. As a result of this new style of diplomacy, there has been an important change in the way in which regional problems have traditionally been addressed. Several cases illustrate this change. Among them are the many meetings of the Presidents of Argentina, Brazil and Uruguay; the contacts among the Central American Presidents and the meeting of the Presidents of the group of eight countries members of the Permanent Mechanism for Consultation and Policy Co-ordination held in Acapulco from 27 to 29 November 1987.

A difficult but fundamental task facing the region is to convert the integration and co-operation schemes into processes whereby concerted political efforts are increasingly undertaken. This will undoubtedly contribute to their reinforcement and consolidation, while serving as a mainstay for the democratic régimes of Latin America and the Caribbean.

b) *Concerted geopolitical efforts*

As history shows, the effects of geopolitical tensions have not only weakened relations among the countries of the region, but also have undermined the very foundations of national development. In fact, military spending more than doubled during the 1973-1982 period.[7] In eight of the 21 countries of Latin America about which there is information on the functional distribution of public sector expenditures, defence spending exceeded spending on health; in three it was greater than spending on education and in two was higher than the sum total of education and health spending.[8] In Central America —as in other nations of the region— military spending openly competes with resources for social and economic development.

The real potential for conflict in the region is found, as a general rule, in the border disputes among neighbouring countries. The discovery of collective formulas to deal with these situations ought to reduce the escalating arms race, since nationalist sentiments often hinder an objective evaluation of the cost-benefit ratio of such territorial disputes. Sometimes, this leads governments to spend more on arms than the object under dispute is actually worth, thus motivating neighbouring countries to arm themselves further. Nevertheless, the powerful political and economic interests outside the region which contribute to the often artificial tensions, cannot be ignored.

From another angle, bilateral tensions and conflicts not only have an impact on the linkages among the countries involved, but also tend to slow down or immobilize regional integration and co-operation initiatives, as could be seen recently in Central America. How can integration and co-operation contribute to a positive change in this situation? The following are some suggestions in this direction:

i) Regional unity, through integration, could be encouraged as a feasible way of providing the countries with real national security, while maintaining the attributes of true sovereignty;

ii) A political setting could be created that would be favourable to submitting conflicts to peaceful solutions which ward off the threat of the use of force, committing the region's entire political will to this initiative, and

iii) A Latin American treaty could be signed, guaranteeing to each of the countries: territorial integrity or non-aggression; gradual, systematic reduction of military spending in order to devote the resources to economic and social development; respect for democracy as a form of

[7] Stockholm International Peace Research Institute (SIPRI), *Yearbook* 1983.

[8] International Monetary Fund, *Government Finance Statistics Yearbook*, vol. VII, 1983, p. 29 (various years between 1977 and 1982).

government; and respect for ideological pluralism.

Integration and co-operation organs should not be left out of the political tasks of the type mentioned above, since they are responsible for and benefit from the neutralization of geopolitical tensions. The difficulties in confronting this undertaking are enormous, largely because of destabilizing elements from outside the region. Nevertheless, it seems essential to begin the work on this front as soon as possible.

c) *Search for a mechanism of political participation*

In its Protocol Amending the Cartagena Agreement, the Andean Group incorporated the Andean Parliament as the principal organ of the agreement. At the same time, its spheres of competence and concrete links with integration activities were determined. In the medium term, the possibility of choosing the members of Parliament by direct vote was considered.

On 2 October 1987, in Guatemala City, the Treaty Establishing the Central American Parliament and associated organs was adopted and on 16 November 1987, in Lima, the Treaty Establishing the Latin American Parliament was adopted. These initiatives seek to fill the vacuum in participation by political bodies in subregional and regional integration and co-operation schemes. The primary aim is that these bodies should become a channel of expression for country-level political trends, which presently do not have any appropriate way of participating in integration and co-operation activities. As a result, the social forces do not feel committed to the processes of regional unity, and their support is, in general, purely rhetorical.

2. *Convergence of regional efforts*

Regional integration and co-operation will reach their full development only when they succeed in becoming closely linked to the governments' basic priorities, as reflected in their economic policies. This is a fundamental condition, which means closing the traditional gap between the generalized public statements made by social agents, and the actions of these agents. The latter become directly involved in the formulation of the various programmes of regional institutions.

On the other hand, it is vital to overcome the institutional isolation that exists within the region. Each integration or co-operation scheme tends to want to be autonomous. This is a stumbling block in strengthening capacities in pursuit of shared goals and in many cases helps to widen the gap between multilateral and national policies.

The convergence of integration and co-operation schemes is also an essential factor. Normally, integration schemes have concentrated their efforts on trade, and have not actively encouraged the various co-operation initiatives. The bodies in charge of co-operation, for their part, use a limited approach for all practical purposes in their sectoral activity, which does not reach out to other areas.

Institutional convergence is another fundamental requisite, effectively enabling regional endeavours to become support elements and complement national policies. For these reasons, the extreme heterogeneity of the region must be recognized as an important part of the problem. Hence, a single programme for all these nations will rarely be workable. Guidelines which combine the interests of groups of countries with regard to specific projects must be defined. The idea is not to create new subregional groups, much less weaken the existing ones. On the contrary, by respecting the particular features of each scheme, joint actions with other countries can be co-ordinated.

The concept of a Latin American Economic System must be channeled toward these objectives. In essence, the governments, national social and political agents and regional institutions would gradually become part of a whole system with both overall and specific goals. The major elements of the overall goals would be the reduction of vulnerability and dependence in favour of autonomy in defining policies, and the constant quest for regional unity. At the level of specific goals —which may be sectoral or by given topic— the idea is to combine interests so as to create a true, positive interdependence among groups of countries, thereby facilitating the achievement of regional unity.

One of the basic goals of the Latin American Economic System (SELA) is to promote regional co-operation and inter-institutional ties. The Permanent Secretariat, as an organ of SELA, is responsible for promoting the building of the system. In the concept described, however, the System implies shared responsibility and therefore involves all actors, whether at the national, bilateral or multilateral level.

3. *Some concrete measures*

Without intending to present a prioritized agenda of initiatives, the following are some of the steps which could be taken on the short and medium term in order to solve urgent problems, and to which integration and co-operation could make a considerable contribution.

a) *Programme for the reactivation and generation of new intraregional trade flows*

i) Channel new political support to the current efforts by ALADI to implement resolution 15 of the Council of Ministers (March 1987), whose purpose is the reactivation and expansion of trade. The central problem in this case is an operational one. The ministerial political decision cannot be implemented, owing to various technical problems which must be overcome as soon as possible. This would require the direct intervention of foreign trade authorities with clear political mandates, who could collaborate positively with the efforts of the Committee of Representatives and the General Secretariat of ALADI.

ii) Design and promote a new negotiating scheme between the Andean Group and Argentina, Brazil and Mexico. This should go beyond traditional trade negotiations toward sustained increases in the coefficient of supply, with a view to reaching a true regional interdependence.

iii) Build a framework of joint negotiations between Central America and the ALADI countries, with the goal of generating new trade flows which will help to increase the use of installed capacity and to establish operational linkages between the two groups of countries. This trade collaboration must be seen as being complementary to general economic co-operation with Central America.

iv) Study the possibilities of furthering trade negotiations between ALADI and CARICOM countries. Despite the limited results of the "Caribbean Basin Initiative", it could be considered one of the points of departure for business co-operation and joint investments.

v) Promote negotiations to reactivate the trade of foodstuffs. Supply levels could be raised on the basis of the region's actual potentials. A gradual, controlled process of specialization could make better use of resources, increasing business profits and reducing government subsidies.

vi) Elaborate and agree on operational trade strategies in the areas of tariff and non-tariff barriers which, for example, permit the use of the region's purchasing power to improve the access of its exports to the main international markets.

vii) Channel government purchases. This topic has been extensively explored by several bodies, but a reorientation of purchases by government enterprises has not yet materialized. Nonetheless, it is urgent to renew efforts in order to use this considerable potential for trade and development among countries.

b) *Financing and payments*

i) Minimal initiatives include the streamlining of payment mechanisms, the "de-dollarization" of reciprocal trade and the attraction of new foreign exchange in order to provide liquidity to current clearing facilities and financial systems in general. The creation of a Latin American reserve fund could also be considered, or the establishment of a Latin American foreign trade bank, taking into account the existence of the Latin American Export Bank (BLADEX). Such a trade bank could be comprised of certain institutions controlled by regional public or private banks in several industrialized countries. The main idea would be to have the majority of the financial and credit flows generated by transactions pass through this body, which must be capable —because it is solvent and reliable— of attracting Latin American deposits abroad, even those representing capital flight.

ii) In the same vein, various measures to generate short-term effects in the quest for regional interdependence could be formulated. For example, the Andean Development Corporation (ADC), the Central American Bank of Economic Integration (CABEI) and the Caribbean Development Bank (CDB) could establish close ties with LATINEQUIP. The goal would be to channel the acquisition of capital goods from the region in order to increase and renew industrial stock and reactivate the economies. LATINEQUIP could assume the additional obligation of incorporating local replacement parts to correct existing imbalances. It could even promote exports to supplier countries so as to achieve a balance —even though partial— of trade.

iii) In relation to Central America, the co-operation that can be offered by the rest of Latin America and the Caribbean is seen as a complement to the domestic efforts of the countries of the subregion. This should include various aspects. Besides the trade co-operation already mentioned, external financial collaboration is essential. Several countries of the region have joined the Central American Bank of Economic Integration since it opened up to new members, a trend that should be expanded and consolidated. Likewise, there is a vast range of possibilities for developing technical co-operation between the Central American countries and the larger nations of the region.

c) *Foreign debt*[9]

The Cartagena Consensus is proof that it is possible to generate co-operation mechanisms in this matter. However, since the 1982 crisis, neither the region as a whole nor one group of countries has been able to propose a symmetrical negotiating scheme. This should be based, *inter alia*, on the reduction in the size of the debt and an adjustment in the interest rates, bringing them down to their past levels. For these purposes, there are a number of legal precedents worth reconsidering. Latin America and the Caribbean have a strong, unutilized negotiating power in this respect which has a direct impact on their economic and social growth. It is urgent, therefore, to organize and apply this negotiation capacity, putting it to use in the legitimate interests of the countries.

d) *Sectoral measures*

i) A major, joint effort is needed to seek formulas to revitalize industrialization processes on the basis of national and subregional guidelines. These guidelines must be carefully examined, in the light of prevailing international market trends, technological changes and the international division of labour. Likewise, the productive links, spheres of specialization and, in particular, possible complementarities in complex products and dynamic, modern branches of the economy, based on the expanded markets offered by integration, should be kept in mind.

It would be feasible to use these expanded areas to transform industrial activity, especially in those branches which exhibit gaps or very low levels of consumption. The countries which have reached a high degree of development in the region can collaborate effectively with relatively less developed countries in the application of technical progress to manufacturing activities.

ii) A co-operative scheme for agricultural products and commodities should be organized with a view to increasing regional supply, ensuring rational levels of consumption and attaining maximum autonomy, especially with respect to international markets. As is well known, these markets fluctuate sharply because of the subsidy policies of the industrialized countries.

iii) Technological exchange in the agricultural sector should be promoted, to enhance technological knowledge and support the creation of appropriate technologies. This will be geared not only to the export sector, but also, and especially, to the subsistence economy, which has suffered severe productive and food setbacks.

iv) The various efforts being undertaken in relation to food security at the national,

[9]This subject is explored in more detail in the ECLAC document, "Relaciones económicas entre los centros industrializados y la periferia latinoamericana" (LC/R.641), Santiago, Chile, 18 February 1988.

subregional and regional levels should be co-ordinated and organized.

v) A co-operative programme in the service sector, which will help to bolster a joint stand in the Uruguay Round of GATT negotiations, should be implemented.

This sphere could entail such measures as the diversion of trade to the countries of the region, and measures to facilitate the intraregional lending of services; for example, the granting of regional or subregional preferences in respect of access to markets, government purchases and trade financing.

Measures such as those described can be implemented in a relatively short time, since the corresponding initiatives exist and have been discussed, but their results may require longer periods.

For the medium term —even simultaneously with previous measures— the region needs to make the necessary adjustments in the productive apparatus to adapt it to the new circumstances of the international economy. The environment in the coming years will be highly technified and competitive, which will require a continual modernization of the productive structures. Otherwise, the region will be unable to overcome the growing limitations imposed by the changing world scene, or qualitatively modify its participation in the international economy.

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A new integration strategy

*Carlos Massad**

The Great Depression of the 1930s and the Second World War engendered an inward-directed growth process in Latin America, the continuance of which was later spurred by the important interests that grew up in connection with the region's industrial production. The exhaustion of the import substitution process at the national level triggered a new intellectual effort to seek appropriate development strategies; thence arose the interest in economic integration which acquired great impetus from 1960 onwards. Integration enjoyed considerable success in terms of the expansion of trade among the countries participating in the various schemes, and mechanisms were soon added which helped to save foreign exchange in the financing of regional trade payments.

The change in external circumstances, however, led countries to reconsider their production strategy and to embark upon a phase of opening up their trade to the rest of the world. In this setting, integration, conceived as a means of strengthening import substitution, became an obstacle to the new strategy. Integration is going through a crisis.

Curiously enough, this crisis is occurring in Latin America just when current trends are showing that the world of the future will be a world of huge economic and financial conglomerates. The countries of Latin America cannot subsist if they confront this situation as separate units.

It is indispensable to begin giving careful consideration to a new integration strategy: outward-directed integration. This consists in making the whole process of intra-regional liberalization negotiations, of approximations to a common external tariff and of co-ordination of economic policies functional to the objective of facing up to external markets.

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As part of a development strategy based on industrialization and on the strengthening of their home markets, in the 1960s the Latin American countries began to put economic integration devices into practice. Their efforts stemmed from the traumatic experiences of the Great Depression in the 1930s and of the Second World War.

In consequence of the Depression, the Latin American countries found themselves short of resources to pay for their imports, much less repay their debt. The Latin American countries' debt paper came to be negotiable in London at about 16 cents per dollar, on an average, and the countries' repurchases of it around 1936 and 1937 were made at similar prices.

I

Inward-directed development

The world had not fully recovered from the Great Depression when the Second World War paralysed supplies of machinery, spare parts, durable consumer goods and other products coming from the United States, Europe and Japan.

It is not to be wondered at, therefore, that the Latin American countries turned their gaze inward to look for supplies of all the types of goods needful for their development. Moreover, in order to keep the existing stock of capital in operation, in some way or other the indispensable spare parts and replacements had to be produced, a necessity which prompted production efforts in that direction. There are always some who mistakenly regard these efforts as irrational and inefficient behaviour, instead of as a real requisite for survival.

These inward-directed development trends, imposed by circumstances rather than by desire, were strengthened by the fact that as from the second decade of the present century, for long stretches of time the movements of Latin America's terms of trade were unfavourable. Observation of this fact, together with recognition that demand for services grew faster than demand for products, led to the formulation of the theory

that the terms of trade would tend to deteriorate for Latin America unless and until the countries of the region managed to incorporate services in their raw materials, or, in other words, unless and until they reached more advanced stages of industrial processing of their basic products.

Thus, while analytical thinking pointed towards industrial processing of raw materials, external conditions compelled the Latin American countries to look within themselves for supplies of a wide range of producer and consumer goods. These two factors in conjunction meant that development efforts in respect of the structure of production were focussed on satisfying the requirements of the domestic market, often in replacement of imports which in any case could not have been obtained from outside the region, either for want of resources or because of the limitations set to supplies by the war.

Here it seems to me extremely important to distinguish between the thinking of Latin American economists around the middle of the century, and the effect of external circumstances on the region. The theories formulated at the time reached the conclusion that some degree of industrial processing of our basic products was essential. They did not conclude that inward-directed development was desirable. This latter feature of development strategy was enforced, first by circumstances, at least until the end of the 1950s, and secondly by the interests that grew up around the region's industrial production, an important source of employment and of generation of public and private income.

Protectionism and emphasis on import substitution were imposed, not by the Latin American thinking of the day, with Raúl Prebisch at its head, but rather by force of circumstances.

II

Inward-directed integration

The heavy cost of sustaining this process after the rest of the world economy had normalized its production and the transport problems created by the War had been resolved led to rapid exhaustion of the opportunities of growth by way of import substitution. This prompted a new intellectual effort directed towards a search for development strategies which, by taking maximum advantage of the existing structure of production, could create additional employment and growth opportunities. Thus came the dawn of interest in economic integration, which would make it possible to broaden the market for the region's manufactures, facilitating the exploitation of economies of scale. Import substitution would thus be carried out on a regional scale, whereby the national costs of substitution strategy would be drastically reduced.

The year 1960 saw the birth of the Latin American Free Trade Association (ALALC), reestructured in 1980 as the Latin American Integration Association (ALADI), and the Central American Common Market came into being. In 1969 the Andean Integration System was established, within ALALC, and then in 1973 the Caribbean Common Market (CARICOM) was created. Among the countries members of CARICOM the Organization of East Caribbean States was set up in 1981.

These integration efforts were extraordinarily successful in terms of the expansion of trade among the member countries. Between 1960 and 1980 the countries members of ALALC had raised the value of their reciprocal trade 20 times over, whereas their trade with the rest of the world had increased only tenfold. An even greater success was scored by the countries members of the Central American Common Market: trade among them had been multiplied by a factor of 40, but that with the rest of the world only by a factor of nine. In the case of the Caribbean Community, their reciprocal trade had reached a level 17 times higher, as compared with an increase in their total trade by a factor of 10. As for the countries of the Andean Group, representing probably the most impressive case of trade expansion, they had enlarged their reciprocal trade fiftyfold, as compared with an

increase only by a factor of eight in their exports to the rest of the world.

This rapid trade growth was encouraged by machinery which made it possible to save extraregional foreign exchange in regional trade payments. The establishment of the Central American Common Market Clearing House in 1960, of the ALALC Payments and Reciprocal Credit System in 1965 (in the conception and launching of which I had the honour to take part) and of the Caribbean Multilateral Clearing Facility in 1977, made it easier for reciprocal credits to be conceded by the participant countries, for clearance of reciprocal payments as long as these were kept within the credit limits agreed upon.

The most important of these payments agreements, that of ALALC/ALADI, showed an increase in clearing balances from US$31 million in 1986 to US$1 648 million in 1981. Total operations transacted through the Agreements rose from US$106 million in 1966 to US$9 331 million in 1981, a sum which represented 83% of total inter-member-country exports. To finance this export total, which amounted to US$11 200 million in the latter year, it was necessary to transfer foreign exchange only to an amount of US$2 500 million, equivalent to the clearing balance plus advance transfer payments on operations which exceeded the agreed credit limits.

III

The 1970s: a change in national strategies

This resounding triumph of integration, however, was not a lasting success, capable of withstanding adverse external conditions and even providing an adequate development dynamic. While external conditions were favourable, integration forged steadily ahead, although generating increasing imbalances within each system. In the case of ALALC/ALADI, for example, in 1981 the unfavourable balances of countries in deficit totalled a little more than US$2 700 million, while Brazil recorded a surplus of some US$2 500 million, representing 91% of the cumulative deficits.

Progress in the liberalization of intraregional trade operations, in its turn, became increasingly difficult, and the targets set up in the original ALALC agreement could not be met. Countries found that given the circumstances prevailing towards the end of the 1970s the time had come to reconsider their production strategy and to embark, more or less aggressively, upon a phase of opening up their trade to the rest of the world. The integration organizations reached a crisis; their institutions were weakened; some countries began to reconsider their membership of specific systems, and one country withdrew formally from a particular integration scheme in which it had participated.

It looked as though the external financing bottleneck had been relieved, so that it had become possible to run risks in respect of economic openness, relying upon the cheap and easy financing provided by the expansion of the Euromarkets.

By the end of the 1970s the strategic approach had undergone a change: it was now a matter of each individual country's seeking integration with the outside world rather than with its neighbours, and financing the process with external indebtedness.

In response to the new situation, integration commitments were made more flexible or simply allowed to lapse. ALALC became ALADI, with commitments much more in keeping with the real circumstances prevailing at the end of the 1970s. In some Central American countries discussion began to see around their own development strategy: a discussion in which the integration commitments assumed figured as a constraint on development rather than as a basis on which to sustain it. Efforts to create a common currency which should be more than a mere accounting unit of little economic importance failed or were shelved.

IV

The 1980s: the crisis

It is in the context of a review of objectives and strategies such as this that the devastating effect of the debt crisis on integration efforts can best be understood. With the emergence of the debt problem, the causes of which have been analysed at length, intra-regional trade suffered far more than world trade, since many countries immobilized the payment of their trade balances under clearing agreements. By 1987, the operations transacted through the ALADI Payments and Reciprocal Credit System had dropped to practically one third of those recorded in 1981. In the case of the Central American Clearing House, the total value of operations transacted by it sank from US$780 million in 1981 to barely US$30 million in 1987.

Trade among the ALADI countries declined from US$11 300 million in 1981 to US$7 600 million in 1986; while that of the Andean Group decreased from US$1 260 million to US$690 million. That of the Central American Common Market was reduced to half in the same period, and by 1986 that of the Caribbean Community countries had shrunk to little more than 40% of what it had been in 1981. For the Latin American and Caribbean countries as a whole, the percentage of intra-regional trade in total trade dwindled from nearly 17% in 1980 to a little over 10% in 1985, a figure comparable only with the proportion of intra-regional trade in total trade recorded in the first half of the 1960s, more than 20 years before.

The trade financing machinery of the subregional integration organizations had a limited degree of support in secondary subregional financial mechanisms. The Santo Domingo Agreement, the Andean Reserve Fund, the Central American Common Market Fund, while they did play some sort of role, were quite insufficient to allow of normality in trade payments. The Latin American Bank Acceptances (ABLA), perfected in 1976, failed to gain a footing in the external financial markets, in face of the abundance of other forms of financing. The external trade financing programmes of the Inter-American Development Bank and the credits issued by the Latin American Export Bank (BLADEX), by reason both of their characteristics and of the amounts they represented, produced no perceptible effect. Nor have the renewed efforts to establish currencies of subregional or even bilateral or trilateral acceptance prospered hitherto. The general climate is far from benign for integration.

The member countries of the various integration groups are seeking bilateral arrangements and global exclusions from operations under payment agreements, or, in other words, are trying to get out of the latter with a view to keeping up some level of reciprocal trade and ensuring trade payments by other means. Bilateral arrangements under ALADI between 1982 and 1987 amounted to almost US$2 000 million and their global exclusions to some US$700 million. Since 1983 the Santo Domingo Agreement has been usable only for possible renewals of loans extant in 1983. In that same year the Caribbean Multilateral Clearing Facility reached the available credit ceilings, and it has completely ceased to operate up to the present. Only the Andean Reserve Fund has succeeded in significantly enlarging its resources, both through increases in capital and through deposits by the central banks of the member countries, and is planning further steps to extend its range beyond the limits of the Andean Pact.

I must lay stress on my conviction that the problems generated by the debt crisis did no more than aggravate the difficulties of the integration process, which had already been making themselves felt towards the end of the 1970s. When the countries of the region as a whole have to hand over to the rest of the world, in little more than six years, net financial resources totalling US$150 000 dollars, it is not surprising that payments difficulties among them should arise. What is more remarkable is that apparently the Latin American countries have been more prepared to default in the case of intra-regional trade payments than in that of trade with the rest of the world. This is merely

an additional indication of the difficulties by which the integration process was already beset even before the debt crisis.

To grow costs, foreign exchange, and intra-regional trade, while saving it, does not provide it. Every percentage point of growth of the gross domestic product costs, on an average, US$1 800 million in imports. The open-trade policies pursued in the recent past by many Latin American countries have made the region increasingly vulnerable to fluctuations in world markets. The burden of this vulnerability tends to be borne by trade with the neighbours, as the available figures show.

V

External financing prospects

Yet another factor creates new uncertainties. The economy of the industrialized countries is now in the sixth year of a steady process of recovery, probably the longest spell of uninterrupted economic growth since the end of the Second World War. Flows of capital or credit into Latin America, however, have not recovered. There seems to have been a structural change in the direction of capital flows in the world, brought about by the United States' great fiscal and balance-of-payments current account disequilibria. These imbalances are financed with external borrowing or foreign investment from Europe, Japan and even the Latin American countries themselves.

World economic growth beneath the influence of such large-scale disequilibria is ultimately bound to undergo an adjustment process which will be more or less traumatic according to its pace. In the course of this adjustment, unfortunately, the peripheral countries will once again see their foreign trade affected, since the imbalances on the deficit side will probably tend to be corrected faster than those on the surplus side in the industrial countries, so that part of the adjustment will be forced on to the less developed countries. This is only another way of representing the fact that the process of world economic adjustment is subject to significant asymmetries, materialized either through the influence of the multilateral credit agencies or through the force of circumstances themselves.

The change in the structure of capital and credit movements is most directly reflected in the immobilization of flows of financing into the Latin American countries. The international financial system, both private and multilateral, has followed a procyclical line of conduct, in exactly the same way as it has done in every major economic crisis since the beginning of the last century.

It is perfectly understandable that the private international financial system should take this procyclical line. It is perfectly true that banks, by their very nature, have to protect the interests of their depositors and shareholders, and in their view they protect those interests best by withdrawing their loans when their clientèle as a whole is exposed to an increase in risks.

On the other hand, it is neither understandable nor admissible that the multilateral financing agencies, whose duty it is to watch over the smooth functioning of the world economy and world trade, should behave in the same fashion. Both the World Bank and the International Monetary Fund are withdrawing net resources from our region, with the consequent aggravation of the external financing problems that are afflicting our countries. Both agencies seem to be making efforts to avert this negative effect, but hitherto those efforts do not appear to have been successful. If an increase in the resources available to these institutions is hampered in its use by the very constraints prevailing today, such an increase is of no interest, in my view, for the purposes of promoting growth and resolving current problems.

The object of these remarks is only to stress that in present circumstances it does not seem

that any substantial relief of the region's financial difficulties can be hoped for by way of a larger supply of fresh resources from the outside world. In contrast, increasing emphasis must be placed on the need to seek a more drastic solution to the debt problem, while intensifying the exercise of all our bargaining capacity to broaden our external trade prospects.

VI

Latin America and the rest of the world

Curiously enough, the crisis in our integration schemes is occurring at the very time when the rest of the world is substantially strengthening its own. The European Economic Community is advancing towards a common market to be perfected in 1992. The United States has concluded a comprehensive trade agreement with Canada. The Soviet Union and the countries of Eastern Europe are making rapid headway in a process of decentralizing economic decisions, introducing direct incentives at the enterprise level and reducing central control and State planning. This means that the Soviet Union and the COMECON countries are establishing a reform of their economic system which will enormously facilitate their trade with the West. It would not be surprising if in the fairly near future these countries were to seek formulas for closer co-operation with the European Common Market.

Albeit integration is gaining strength in the more developed areas of the world, the methods and strategies there pursued are not necessarily the most appropriate for our countries. There are profound differences which will compel us to seek our own paths.

As early as 1938 about 30% of Western Europe's total trade was intra-regional. This figure, which had somewhat decreased in the years immediately following the Second World War, had been completely regained by 1955.

The United States are in themselves a vast common market, and trade among the States of the Union greatly exceeds United States trade with the outside world.

In both instances, the currencies of the countries themselves constitute foreign exchange which is more or less readily acceptable on the world market. This facilitates the creation of common currencies, since their backing is sufficient for them to command, should it be so desired, a broad international market for their circulation and use in transactions.

In Latin America's case, intra-regional trade is a small fraction of total trade, and our countries' currencies, often affected by rates of inflation that spiral up *ad absurdum*, have no hope whatever of constituting the basis for a common currency in international use.

The narrowness of our markets means that import substitution, even at the regional level, quickly reaches its limits. Furthermore, the nature of the negotiations which have to be conducted in order to obtain tariff reductions in inter-Latin American trade, as well as to forestall other forms of protection, leads to the laying of emphasis on counterpoised rather than on common interests. Negotiation itself thus becomes an obstacle to integration.

Nor is that all. In the struggle to gain external markets for our exports, with the aim of obtaining foreign exchange, integration commitments become a handicap. Thus, the commitments assumed are often evaded by means of ingenious formulas; or at least, new commitments are avoided that might place at risk a country's capacity to employ all its instruments in the conquest of external markets.

VII

The "super blocs"

Does this mean that we should abandon all interest in Latin American integration? Must the present difficulties really make us throw overboard the political idea that inspired the Liberators 180 years ago?

These are questions of such importance for the future of Latin America that they must be studied with the utmost care and objectivity. I cannot claim to make such a study here, but I should like to establish certain facts which in my view constitute a clear pointer to the nature of the reply.

The first fact I have already mentioned. European economic integration is making giant strides, and relations between the resulting systems and the COMECON countries may well become increasingly close. China and India, in their turn, are growing fast. The total population of these two countries numbers 1 800 million persons, whose per capita income today averages some US$300 at 1984 prices. At the growth rates they are currently attaining, their per capita income will rise six times higher in 25 years, forming a total gross product on the same scale as that of the United States and Canada together at the present time. In 1984 the two last-named countries, with almost 280 million inhabitants, had a total product of US$3.8 thousand billion. The market economy industrial countries of Europe and the countries of Eastern Europe form a conglomerate of 750 million persons, with a total product of US$4.5 thousand billion. Japan, which is also growing at a very rapid pace, has 120 million inhabitants, with a gross product of over US$1.5 thousand billion.

Such are our probable trading counterparts in the world of the future. Latin America, with a population of some 400 million inhabitants, will be unable, disunited, to face up to next century's super-blocs. If it tries to do so, it runs the risk of being, at least commercially and culturally, absorbed.

Nevertheless, our integration strategy seems to have reached a crisis. We do not co-operate with one another, often not even to the extent of giving information. The efforts made by our integration organizations often encounter limited interest on the part of governments, which is absolutely understandable in view of the external circumstances that undoubtedly will continue to prevail for several years more.

At this point, I should like to revert to the brief historical review appearing a few pages back in connection with the emergence of Latin American thinking and action in the field of integration.

Integration was originally conceived as a way of promoting inter-Latin American trade in order to permit the broadening of the market for production and sale of import-substituting goods. In other words, it was "inward-directed integration", just as development strategy had in its day been "inward-directed". The integration style outlived the development style, and this probably explains why the integration crisis began even before the debt crisis. For progress to be made in integration, as Gert Rosenthal, Executive Secretary of ECLAC, has pointed out, integration commitments must be seen by the formulators of national economic policy as functional to development objectives.

VIII

A new integration strategy: outward-directed integration

If we look into the future, I do not doubt that the economic frontier of Latin America will be found outside rather than within the region. Much yet remains to be done within our countries: vast masses of their population are still right outside the market fringe. Perhaps 40% of the Latin American population is poor or extremely poor. In many countries the debt crisis has caused a reduction of per capita income, which has especially affected the more defenceless population groups. Development with justice, an imperative requisite for peace, will be imposed by reason or by the force of circumstances. The continent's democratic governments are seeking it by the light of reason; dictatorships are defeated by hard facts.

Development with justice will not be enough, however, if our countries attempt to face the super-blocs of the future alone, as separate entities.

Hence my belief that it is indispensable to begin giving careful consideration to a new integration strategy: outward-directed integration.

The idea is not a new one. Many have already posited the need to co-operate in some respects: the management of the debt, certain Latin American multinational enterprises. My own proposition is more ambitious. It comprises a systematic search for all possible forms of co-operation with a view to penetrating external markets, resolving financial problems, progressing in the technological field, taking advantage of economies of scale, joining up our external purchase and sales capacities, and thus confronting, united, the huge economic blocs whose formation is already under way. It consists in making the whole process of intra-regional liberalization negotiations, of approximations to a common external tariff, of co-ordination of economic policies, functional to the objective of gaining a foothold in external markets.

As an economist I cannot allow my own ideals to stand in the light of objective thinking. I cannot pretend that this will be easy. But I do believe that it will be much simpler to find common interests in respect of tackling external markets, and to make them the springboard for our integration efforts, than to go on wearing ourselves out in exhausting and unproductive discussion of how to reconcile our desire for openness to the rest of the world with the constraints that seem to be imposed upon us by the strategy that has prevailed in the past.

Neither can I say that such a change of strategy will be painless. The common effort to penetrate into external markets may often mean renouncing the frequently fallacious belief that any one of our countries can obtain better terms from our financial and commercial partners in the exterior by itself than through any form of co-operation. The reorganization of production will necessitate giving up some items and raising the production standards of quality and regularity required.

The recent Meeting of Presidents at Punta del Este is a clear indication that it is possible not only to meet at the highest level, but also to devise mechanisms whereby concrete proposals can be formulated to pave the way for the necessary political decisions. The difficulties which we are facing in the fields of trade and financing, and which show no sign of easing up, are a spur to the adoption of such decisions. Our crisis of today may be turned to account in constructing our strategies for tomorrow.

In the field of integration, "outward-directed integration" strategy implies strengthening our productive efficiency, our technological capacity, our financial machinery and our bargaining power.

Where productive efficiency is concerned, domestic policies play a decisive role. The tax system must be overhauled in order to prevent the generation of incentives or disincentives which careful social valuation does not warrant. The financial system must be modernized so as to tap and efficiently utilize the savings that must be the basis of development financing in

the future. There must be implacable insistence on efficiency in State activities, to prevent transmission to the rest of the community of excessive costs representing simply waste. Workers must feel themselves participants in the social and economic development process, to avert unsustainable social tensions. Care must be devoted to macroeconomic equilibria, to forestall the need for violent adjustments which distort the whole process. In this last respect, outward directed integration strategy implies close co-operation among the developing countries to secure indispensable changes in the international monetary system which may limit the negative effect on our economies of the economic policies pursued by the industrial countries. Otherwise, in so far as this proves impossible, we shall once again suffer new debt and external financing crises in the future. But by then patience will have been exhausted.

Strengthening our technological capacity entails special concern for education at all levels, for research in enterprise and university alike, for information as to what is going on in other centres. It may often happen that the scale of work required for making headway in technology exceeds the potential of some of our countries individually considered. Here, multinational laboratories in the region might make a contribution of great importance to technological progress, while at the same time generating common interests to galvanize the integration process and make it irreversible.

A first requisite for strengthening our financial machinery is to strengthen institutions. It is highly probable that we need to concentrate talent in a few institutions to plan their operations and means of increasing their resources. The Inter-American Bank covers the area of public and private investment projects financing and, to a very limited extent, includes commercial financing for exports. But the field of the Latin American commercial banks is completely open. Perhaps the commercial banks of the region, both public and private, might co-operate in establishing an entity to cover matters relating to the region's commerce, perhaps using as a basis the Latin American Export Bank (BLADEX). A regional banking institution in the field of trade might attract more external resources than we are obtaining today or, at least, internalize some of the commissions which we have to pay at present on operations of this kind.

The idea is not to displace the traditional commercial banking system, but simply to supplement it with a regional co-operation effort designed to seek additional resources that any single one of our countries will have difficulty in attracting by itself.

Lastly, strengthening our bargaining capacity means looking for ways of producing and bargaining jointly, for the purposes of buying and selling whatever we need. Here too multinational corporations in the region may play a very important role, and governments should encourage the formation of enterprises of this kind. An initial field of regional collaboration, however, lies in the current Uruguay Round, where close co-operation among our countries may obtain much better results than could isolated action.

These ideas call for very careful analysis. I should not discharge my responsibility as an academic and an international civil servant if I did not attempt to call attention to the changes that are taking place in the world economy and to the need of not giving up our integration efforts and seeking new strategies which may improve our chances of success in the next century. Failing these, history may well show us once again that frontiers afford much weaker protection than we suppose today. I do not know whether there is a single frontier in the world that has not undergone some change in the last 100 years. Empires have been dismembered; countries have disappeared and others have been created; important territories have changed hands. In the world of the future, face to face with the super-blocs that are already beginning to take shape, Latin American integration may be not only an instrument of economic growth, but also the basis of collective survival. This and nothing less is the challenge which in my opinion lies ahead of us today.

CEPAL REVIEW No. 37

The old logics of the new international economic order

*Vivianne Ventura-Días**

The institutional environment of international economic co-operation is based on harmony between national and international interests. Conflicts between those interests can be expected to arise, however, in a period of major industrial transition marked by changes in international competition and in production technology, such as that of recent years. The factor of power, so often neglected in the discussions of international economic co-operation, comes up distinctively when a country tries to change the international rules to maintain its competitive position as an industrial power. This article analyses in particular the relations between Brazil and the United States in this respect.

Section I deals with the changes in the world economy and trade and raises some queries about the integration of the developing countries in these spheres. Section II analyses the importance of the multilateral negotiations on goods and services. Section III takes up the problems raised by the arbitrary rules and principles defined by the United States and the discriminatory use that country makes of access to its market. Section IV examines the main achievements of the informatics sector in Brazil and contrasts them with the experience of that country's motor industry: in this respect, an analysis is made of the importance of the ownership of capital in the development of endogenous technological capacity. Section V reviews some highlights of the United States' conflict with the Brazilian informatics policy. Finally, some closing observations are made.

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Introduction*

The attitude of the United States toward the Brazilian policies on informatics and intellectual property rights illustrates, dramatically, the conflict between national interests and the international order. The United States Administration has threatened to impose surcharges on Brazilian exports of several manufactured products to force the property rights of United States corporations, in the areas of computer software and pharmaceuticals, to be recognized by Brazilian laws[1] and to reduce the scope of domestic policies in high-value-added areas.

This dispute is of particular interest because the international principles which could provide a legal basis for unilateral measures of commercial retaliation in the case of national practices dealing with services and intellectual property rights are still being negotiated in the new round of Multilateral Trade Negotiations (MTNs) in Geneva. The operation of the principles embodied in section 301 of the revised version of the 1984 United States Trade and Tariff Act shows the impatience of the United States to have them included in a new legal framework to regulate international trade transactions of goods and services.

The use of the protectionist instruments of that United States Trade Act by the United States Administration to obtain concessions at the bilateral level underlines the issues at stake in the current MTNs —the Uruguay Round— underway in Geneva. These are: a) the United States assigns strategic importance to goods and services of high technological content; b) domestic policies —particularly investment-

*The Omnibus Trade and Competitiveness Act of 1988, signed by former President Ronald Reagan on August 23 of that year, incorporated and considerably expanded the principles and instruments of section 301 of the 1984 Trade Act, which are discussed in this paper (see Trade and Tariffs Act, 1984).

[1]On 16 September 1985, the United States Trade Representative started an investigation into the Brazilian policy on informatics, pursuant to section 301 of the Trade and Tariff Act (TTA) of 1984. Later, another investigation followed concerning inadequate patent protection of pharmaceuticals in Brazil. Several countries, such as the Republic of Korea and Argentina, among other developing countries, have already been affected by section 301 of the 1984 TTA.

oriented domestic policies— will be the focus of trade negotiations and, c) developing countries face the unpalatable choice of giving up their domestic markets for goods and services of high technological content in return for access to markets in the developed countries for mature technology goods.

Long negotiations preceded the inclusion of services, trade-related investment measures and trade-related aspects of intellectual property rights in the new MTNs. A careful wording of the Punta del Este Declaration, that launched the negotiations, was necessary before it could be signed by all countries.

Countries such as India and Brazil wanted to be sure that intellectual property rights and foreign investment would not be discussed *per se* (as this is not allowed by the General Agreement on Tariffs and Trade), but only in so far as they relate to trade in goods. It was also accepted that a framework for trade in services would be negotiated in the new round of negotiations but in a group formally separated from GATT, and therefore not limited by its norms and procedures. This was necessary in order to prevent *cross-concessions* or concessions in the realm of the new issues being demanded in return for concessions in the realm of traditional products. Such cross-concessions are precisely those which were demanded by the United States in the case of the Brazilian informatics and patent policies.

There is very little understanding, in most countries, of the full implications of these negotiations for the development process. Many developing countries perceive the future of their economies in the areas in which they presently have static comparative advantage, such as agroindustries and other mature industries. Entrepreneurs in traditional industries, in developing countries, have difficulty in accepting the risks and costs of creating the technological capability to produce technologies locally. They prefer to participate in the new technological wave as consumers of embodied and disembodied technology, in the form of machines, equipment and services which will be used to update and improve their competitiveness in traditional markets, assuming that these technologies and foreign exchange to pay for them will always be readily available.

The characteristics of the new technological wave associated with the intensification of the internationalization of national economies have been used to question growth and development policies. Developing countries are again being urged to liberalize their markets for goods and services and to rely on international markets for the domestic allocation of resources.

Moreover, in this context of dynamic technological transformation, the institutions, categories and methods of analysis used in development studies are depreciated. Economic development concepts, and in particular the centre-periphery model designed by Raúl Prebisch in the late 1940s and early 1950s, are among those challenged by the ongoing structural transformations as outdated concepts. The question is how relevant Prebisch's concepts and policies are in a highly integrated world economy in which world production may or may not be geographically segmented, but will remain dominated by international and transnational corporations.

In my understanding, the basic question of how developing economies should be integrated into the world economy as sovereign nations remains as important now as it was for the post-war economy. The industries, as well as the specific problems involved, have certainly changed. But developing countries cannot accept the role of trading low-valued for high-value-added goods, just as they could not accept trading primary commodities for manufactured goods in the past. The former would mean the passive acceptance of the current levels of world income distribution and consequently of the unequal pattern of income distribution in their countries.

Brazil is ill-prepared to take advantage of the new technological wave. It is a newly-industrializing nation but has lost a great part of its bargaining power as a high-debt developing country. The country has to face simultaneously economic, social and political problems which involve different levels of technological sophistication and human suffering. In spite of some democratic reforms, Brazilian society is not yet allowed to discuss fully and openly the various levels of problems, the alternative courses of actions and the different costs and benefits implied in each case.

The 1980s have been called the lost decade for development. Over the past years, many developing countries —and Brazil in particular— have been merely responding to pressing needs, without having any resources left for designing and implementing strategic goals.

The country has gone through several periods in which it was possible to use the State apparatus to build up political consensus around the establishment of major industries: steel and oil, motor vehicles, telecommunications and informatics. In a few cases, there was a deliberate decision to allocate resources for the creation of technological capability: in intermediate industries such as steel and oil, in telecommunications and in the recent case of informatics.

The negotiations of the Uruguay Round aim at a further liberalization of trade in goods and services, thus increasing the scope and freedom of transnational corporations based in industrial countries. Developing countries are told to benefit from that liberalization as consumers of better products at competitive prices. In this new international order of highly mobile transnational corporations, national concern in developing countries, such as Brazil, over the future of their domestic markets and of their domestic enterprises is deemed old-fashioned. Development experience show, however, that the establishment of a domestic technological capability in developing countries cannot be dissociated from domestic ownership of the production of goods and services.

I

Structural changes in the world economy

Few doubts remain today that the world economy has gone through a major industrial transition determined by two principal forces: i) changes in international competition and ii) changes in production technology. The world economy has been more and more characterized by a multi-polar world. In this course of events, major industries of the United States manufacturing and services sectors have been forced to face massive exposure to international competition, with unpredictable results for the international order.[2]

Advances in production technology are promoting fundamental changes in the structure of the world economy: firstly, the reduction to marginal importance of the primary-products sector because of the natural resource-saving feature of the new technologies. For instance, in 1984, for every unit of industrial production, Japan consumed only 60% of the raw materials consumed for the same level of industrial production in 1973; the raw materials in a semiconductor microchip account for 1% to 3% of its total production cost; 50 to 100 pounds of optical fibre cable transmit as many telephone messages as does one ton of copper wire, and producing 100 pounds of such glass fibre cable requires no more than 5% of the energy needed to produce one ton of copper wire.[3]

The impact of these changes on export earnings has already been felt by most of the developing world.[4] New materials and the adoption of technological innovations by traditional industries in industrial countries will also provide these countries with a competitive edge which may neutralize the influence of low wages in imports from developing countries.

Secondly, the new technologies are labour-saving. Higher volumes of manufacturing output are achieved with fewer and fewer persons directly employed in productive activities. As

[2]See J. Zysman and S. Cohen, "The International Experience", in D. Obey and P. Sarbanes (eds.), *The Changing American Economy*, Basil Blackwell, N.Y., 1986, pp. 41-55.

[3]Drucker, P., "The changed world economy", *Foreign Affairs*, Spring, 1986, p. 773.

[4]In this context, Drucker (*op. cit.*) p. 775, footnote 7) paid tribute to Prebisch's perception that primary products would become of marginal importance to the economies of the developed world when he recognized that in the early 1950s even he could not believe the rightness of Prebisch's propositions.

Drucker (1986, p. 776) points out: "In the 1920s one out of every three Americans in the labour force was a blue-collar worker in manufacturing. In the 1950s the figures was one in four. It now is down to one in every six and dropping".[5]

The same author concludes that, to remain competitive —or even to remain *developed* over the next 20 years— a company, an industry or a country must sharply increase manufacturing production while at the same time sharply reducing its blue-collar work force.[6]

In this transitional period, the American Dream of the Great Society has vanished and has been replaced by a dual society with higher levels of economic inequity. High-wage jobs in manufacturing industries are replaced by low-paid jobs in service industries. These, on the other hand, create a small number of highly skilled and highly paid jobs.

Knowledge and knowledge-intensive industries are the dynamic and growing sectors of the new technological wave. Moreover, it is in these sectors that the intimate relationship between goods and services becomes more visible. Drucker (*op. cit.*, p. 779) holds that: "Two distinct kinds of manufacturing industry are emerging. One is material-based, represented by the industries that provided economic growth in the first three-quarters of this century. The other is information- and knowledge-based: pharmaceuticals, telecommunications, analytical instruments and information processing such as computers. It is largely the information-based manufacturing industries that are growing.

These two groups differ not only in their economic characteristics but especially in their position in the international economy. The products of material-based industries have to be exported or imported as 'products'. They appear in the balance of trade. The products of information-based industries can be exported or imported both as 'products' and as 'services', which may not appear accurately in the overall trade balance."[7]

The dominant role that services play in domestic employment and production will not, however, be equivalent in international trade. Regardless of how precise the estimates of international transactions in services may be, the conclusion is that trade in services will remain less important than trade in goods. Actually, the share of services in total world trade in goods and services has remained almost constant at 17% to 18% over the past 15 years. There is little doubt that international competitiveness in manufactured goods, and especially in high-value-added manufactured goods, depends on *knowledge-based-services* (computer software, engineering, banking and finance and different kinds of business services).[8]

Skilled labour has become the main source of comparative advantage. Economists and some of the most vocal advocates of protectionist policies in the United States believe that decisions on human-capital development define a nation's competitive strategy. It has been said that the coherent Japanese strategy is effective because it is rooted in the adoption of higher-skilled, higher-valued economic activities. In contrast with the United States, Japan has moved both to upgrade old industries' production processes and to move up to higher value-added production.[9]

Japan has been able to harvest the full benefits from the introduction of new microelectronics and laser controls in the production process, while at the same time the country has also been consolidating a reputation in the services sector. The sector comprising fashion, movies, television programming, publishing, consulting, real estate, design, construction, leisure, tourism, advertising, insurance and finance has been targeted, together with high technology, as the most promising growth areas.

[5]Drucker, *op. cit.*, p. 776.

[6]Drucker also referred to capital movements rather than trade (in both goods and services) as the driving forces of the new world economy: together goods and services amount to around US$2.5 trillion to US$3 trillion a year. "But the London Eurodollar market, in which the world's financial institutions borrow from and lend to each other, turns over US$300 billion each working day, or US$75 trillion a year, a volume at least 25 times that of world trade" (p. 782). The perverse results are the impact of exchange rates determining trade in goods and services and not the other way around. Therefore, they also become a "comparative advantage" factor (pp. 786-788).

[7]Drucker, *op. cit.*, p. 779.

[8]United States Congress, Office of Technology Assessment, *International Competition in Services* (OTA-ITE-328), Washington, D.C.: United States Government Printing Office, July 1987.

[9]See R. Reich, "Beyond Free Trade", *Foreign Affairs*, Spring 1983, pp. 773-804; Thurow, L., *The Zero-Sum Solution*, Simon and Schuster, N.Y., 1985.

According to Reich and Mankin, the Japanese strategy in joint-ventures with United States-based companies has been "to keep the higher paying, higher value-added jobs in Japan and to gain the project engineering and production process skills".[10] The resulting gains in market shares in the United States markets have divided the opinions of economists and policy-makers in the United States. Some of them are concerned that short-run profits of "off-shore" management can be offset by long-run losses in terms of the downgrading of domestic skills and the weakening of the domestic technological capability.

Emphasis has been placed on the economies of learning and on the importance of controlling manufacturing operations for a successful combination of manufacturing and service production. In the view of the above-named authors: "Unless United States workers constantly gain experience in improving a plant's efficiency or designing a new product, they inevitably fall behind the competition. This is especially true in high-technology sectors where new and more efficient products, processes, and technologies quickly render even state-of-the-art products obsolete. For example, as the Japanese moved from supplying cheap parts to selling finished products in the consumer electronics industry, vital United States engineering and production skills dried up through disuse. The United States work force lost its ability to manufacture competitive consumer electronics products".[11]

In the midst of these transformations, the industrialization strategy in the developing countries, which was so controversial in the 1950s, has now been trivialized and has become almost a commonplace. Major development agencies and business journals urge developing countries to move away from deteriorating commodity markets and to adopt an outward-looking strategy to industrialize their economies.[12]

[10]See R. Reich and E. Mankin, "Joint ventures with Japan give away our future", *Harvard Business Review*, March-April 1986, No. 2, p. 78.

[11]Reich and Mankin, *op. cit.*, p. 79.

[12]The 1987 *World Development Report* emphasized the linkages between industrialization and trade régimes, but nevertheless underlined the institutional support that the Bank will provide to correct policies leading to the industrialization of developing countries.

The 1987 World Development Report emphasized the importance of global manufacturing and illustrated the argument with the case of the Ford Escort, produced by the Ford Motor Co., which is assembled in the United Kingdom and in the Federal Republic of Germany, with the production of its parts scattered among 15 industrialized countries (12 European countries and Canada, United States and Japan). The result is an intense two-way trade in manufactures among industrialized countries. In the context of intra-industry trade, the World Bank admitted, cost advantages can only be assessed "at the level of finely disaggregated product categories".[13] Therefore, it should be concluded that the theoretical basis for international specialization has become almost irrelevant.

Corporations based in industrial countries need the "global village" to be completed through institutional changes in the international trading system so that they can make their investment and production plans freely and benefit from industry-specific cost advantages across all borders. In the words of the magazine "Fortune" (2 February 1987, p. 23): "More and more companies manufacture in two, three or more countries, treating the whole world as their shop floor and market place. Such companies already account for more than half of the world exports of non-agricultural goods, and a quarter of that trade consists of transfers between subsidiaries of the same company".

A corporation such as the United States-based Singer Corporation, for instance, produces machine shells in Cleveland, United States; motors in Campinas, Brazil; drive shafts in Monza, Italy; to assemble them in Taiwan and export them back to the United States. The IBM PC which is assembled in the United States, has 73% of its components made overseas. Only the manufacture of the case, the assembly of the disk drives and the computer are undertaken in the country.

Changes in the world economy and in the structure of world trade will not occur once-for-all, as in text-books economics, but will be introduced slowly and irreversibly. In the above-mentioned issue of the magazine "For-

[13]World Bank, *World Development Report*, Washington, D.C., 1987, pp. 38-39.

tune" (p. 22) some analysts forecast that in the next decade, sunset industries of "the world production of what are now essentially 'manufactured commodities', basic steel or even cheap cars will shift to countries with low labour costs but increasingly skilled work forces, such as Taiwan, South Korea and Brazil".

It is unlikely, however, that world production and international specialization in the next decades will be divided along the lines of two-digit-level industries. After almost 15 years of international debate on "protectionism and structural adjustment", it has become clear that industrial countries will not give up their domestic senile industries. Behind protectionist barriers, governments in industrial countries have been rejuvenating them and recuperating the capacity to out compete developing countries in these areas of production. The combined processes of structural change and adjustment in the industrial countries have been associated with different forms of protectionism and managed trade, through bilateral agreements designed to insulate particular domestic economic groups from the costs of adjustment.

The industrial countries are not becoming "post-industrial", service-based economies. They are going through a process of intersectoral integration which is accompanied by an increase in the services content of the different productive activities, both within manufacturing enterprises and in service firms.[14] That was the conclusion of a recent study on the United States service industries: "To maintain a society with high living standards and large numbers of well-paying jobs, the United States must remain competitive in both high-value-added goods and knowledge-based services; this, in turn, requires a well-educated and highly skilled labour force...".[15]

It is now evident that the mode of growth that led to the expansion of the world economy in the 1950s and 1960s has run its course. As one author phrased it: "The world must now make the transition from a set of social and institutional arrangements shaped by the characteristics —and fostering the full deployment— of a constellation of mass production technologies based on low-cost oil, to another capable of fruitful and appropriate interaction with a new system of flexible technologies based on low-cost electronics".[16]

The international organizations on trade, finance and money were established in the wake of the industrial structure of the late 1890s early 1900s. The last round of Multilateral Trade Negotiations, the Tokyo Round, did start to attempt to readjust the trade organization, the GATT. It is evident that the current Uruguay Round will either lead the organization to a collapse or else adopt it to the new world economy and trade. However, adaptation to a new world economy does not mean adaptation to the development needs of the developing countries.

II

The Uruguay Round: the issues at stake

The United States played a leading role in the establishment of the post-war trading system. The consensus among industrial countries on the free-trade ideology was a consequence of the unprecedented growth in mass consumption of standardized goods and of huge technological differentials among industrial and semi-industrial countries. The hegemonic role of industries such as steel, chemicals, automobiles, rubber and electrical machinery shaped the United States trade policies that were later codified in the General Agreement on Tariffs and Trade and in the subsequent trade rounds. These indus-

[14]See references in V. Ventura-Días and G. Fernández Saavedra, "América Latin y el Caribe en la economía mundial", series *Estudios e Informes de la CEPAL*, No. 66 (LC/G.1478-P), ECLAC, Santiago, Chile, September 1987.

[15]United States Congress, Office of Technology Assessment, *op. cit.*, p. 6.

[16]See C. Pérez, "Microelectronics, long waves and world structural change: new perspectives for developing countries", *World Development*, vol. 13, No. 3, 1985, p. 441.

tries with high fixed costs required stability and predictability for their investment plans. Moreover, at the time of GATT's foundation, trade in goods was a partial substitute for the movement of factors.[17]

The years after the Second World War saw crucial changes in the pattern of capital flows. The convertibility of the dollar, the gradual liberalization of trade and payments, the privileged position of United States enterprises, and technological changes in transport and communications, data processing and management techniques favoured the growth of foreign direct investment as the major component of private capital flows.

The current international economy is highly integrated by the international production activities of firms. To illustrate this argument, it may be noted that 20% of United States imports (and much more for some individual products) represent shipments from United States affiliates abroad to their parent companies. Indeed, the estimate could go up to three-fourths of United States imports in the case of microelectronics, consisting of intra-firm shipments, primarily from subsidiaries in Asia.[18] As discussed in the previous section, the structure of world trade has considerably changed, with intra-industrial trade replacing the inter-industrial pattern that had prevailed until the inter-war period.

Over the last three decades of increasing internationalization of productive activities, the developing countries have increased their capacity to negotiate with TNCs and have been able to extract more favourable terms from these companies. In Brazil, successful efforts have been made to control the unrestricted "transfer" of technology. Training of officials and the establishment of a data bank on available technologies in the country and overseas were part of an intensive programme of the National Institute of Industrial Property to improve information and to create a real "market" for technology purchase.[19]

The autonomy that governments can display in demanding export performance from multinational enterprises (MNEs) of the inclusion of domestic inputs in the production plans of foreign affiliates introduces stochastic factors into the strategic planning of global enterprises, and in their perception these measures restrict their investment freedom.

Moreover, policies adopted by developing countries in pursuit of economic growth, technology transfer and technological autonomy affect the use of "proprietary technologies". Policy-makers in the United States are concerned at the narrowing of that country's lead in technology. The reasons were found to be not only in the technology base of the United States but also in the steady upgrading of technical abilities in other parts of the world. This was the result of the improved negotiating capacity of the receiving countries, which were able to regulate inward investment and technology transfer.[20]

MNEs would prefer not to share their proprietary technologies with a local partner and the United States government would prefer American companies to use these technologies to produce at home and export instead of licensing technology on the terms dictated by receiving countries. Also, corporations are unwilling to agree to limit trade secret protection to a certain number of years (as in Mexico and Brazil) which is often judged too short for accumulating the expected earnings on the technologies.

These are the reasons behind the request made by the United States to include investment measures, high technology and trade in services in the work programme of GATT at its 38th ministerial-level session in November 1982.[21]

Trade-related investment measures and intellectual property rights were formally included among the 14 negotiating groups on

[17]See Reich, *op. cit.*

[18]United States Congress, Office of Technology Assessment, pp. 45 and 334.

[19]The National Institute of Industrial Property was created by Law No. 5.646 of 11 December 1970.

[20]See United States Congress, Office of Technology Assessment, *op. cit.*

[21]The Trade and Tariff Act of 1974 provided a Presidential mandate to negotiate "more open and equitable market access for the United States exports of goods and services". But it was not until 1982 that the Contracting Parties of GATT agreed to consider the exchange of information about trade in services on the basis of national studies carried out by industrial countries. See M. Gibbs, "La reunión Ministerial del GATT y el futuro del sistema de comercio internacional", *Gaceta Internacional*, vol. 1, No. 1, 1983, pp. 99-110.

goods when the Uruguay Round was formally launched in September 1986. The recognition that governments can create comparative advantage through appropriate policies and policy instruments is implicit in the request to examine a broad array of national policies. In spite of the text approved at Punta del Este, these policies will be at the centre of the negotiations.[22]

Trade in services is being negotiated in a group apart.[23] It is generally admitted by the industrial countries, however, that "international transactions" in services and not merely trade across borders should be part of the negotiations. And by definition, "international transactions" in services involve a foreign presence for the delivery of many services. Consequently, negotiations on investment necessarily to become part of the negotiations on services trade.[24]

The developing member countries of GATT have tried to separate negotiations on goods from negotiations on services: this is the two-track agenda for the Uruguay Round. For the United States government, however, concessions on goods trade must be exchanged for concessions on services, and even those cannot be taken for granted, in view of the protectionist feeling reigning in the country. Labour unions, for instance, have expressed deep reservations over the exchange of concessions in manufacturing for lower barriers to services trade.[25]

It should be added that the logics of free trade do not apply to the protection of intellectual property rights. Whereas higher levels of competition are ensured in the first case, in the second, corporations are allowed to make monopolist gains. In addition, such protection provides unfair competition because these enterprises can acquire rental gains in local markets after having spread the costs of development over international markets. Conversely, the same arguments that justify the maintenance of reserve markets with rental gains to induce investments in R & D apply to reserve markets in industries targetted by governments for development.

Despite this the United States seek the establishment of a new international trading system that takes into consideration the broad interests of their multinational corporations operating both in goods and in services. However, the United States government does not act just on the multilateral level. The negotiations on services are expected to be lengthy and difficult and to continue well into the 1990s. In the meantime, concessions are extracted through domestic policies that impose unilateral restrictive measures against trading partners that do not provide enough intellectual property protection or that restrict the operations of United States-based multinational corporations in goods and services.

[22]See, in particular, United States Congress, Office of Technology Assessment, *op. cit.*, and United States Congress, Congressional Budget Office, *The GATT Negotiations and United States Trade Policy*, 1987 United States Government Printing Office, Washington, D.C..

[23]The 14 negotiating groups on goods were regrouped as *Access to markets* (groups on tariffs and non-tariff measures; tropical products; textiles and clothing; and natural resource-based products); *Group on Agriculture; Normative areas* (groups on safeguards, settlement of disputes, GATT articles, MTN agreements and arrangements, subsidies and countervailing measures; and functioning of GATT); and *New Issues* (groups on trade-related investment measures and on trade-related aspects of intellectual property rights).

[24]See F. Prieto, "Services: a disquieting link between Latin America and the world economy", *CEPAL Review*, No. 30 (LC/G.1441), December 1986, pp. 117-236, for a detailed discussion of services and services negotiations; see also P.S. Randhawa, "Punta del Este and after: negotiations on trade in services and the Uruguay Round", *Journal of World Trade Law*, vol. 21, No. 4, 1987, pp. 163-171.

[25]United States Congress, Office of Technology Assessment, *op. cit.*, p. 321.

III

The United States 1984 Trade and Tariff Act: the extent of the market

The traditionally protectionist character of United States trade legislation was reinforced by the Trade and Tariff Act (TTA) of 1984. The Trade Act of 1974 had already provided unilateral relief measures for domestic industries. It also marked the first time that trade in services was included among the negotiating objectives of the United States. The TTA of 1984 amended the existing "presidential retaliation" authority (section 301 of the Trade Act of 1974) and significantly extended the negotiating objectives to include foreign investment and service industries.[26]

The 1984 TTA increased the presidential retaliation authority already provided by section 301 of the 1974 TTA. It allows the President to impose commercial sanctions against trading partners which incur in unfair commercial practices or establish arbitrarily defined *unjustifiable* or *unreasonable* restrictions against the access of United States products, services or foreign investment to their markets. The *reserve market* for Brazilian manufacturers of microcomputers and software is perceived as an *unreasonable* restriction against United States enterprises.

It was correctly pointed out by M. Rodríguez that "the TTA does not provide greater access to the United States market as an incentive for other countries opening of their own markets. Rather, it creates new obstacles for exports from countries that 'impede' the expansion of United States investments, goods and services". Even the nature of the United States Generalized System of Preferences (GSP) is radically changed by the TTA, converting it into a negotiating tool to obtain concessions from the beneficiary developing country. The TTA makes protection for United States intellectual property rights a factor in decisions on renewal of agreements under the GSP.[27]

The purposes of Title III of TTA 1984, also called the International Trade and Investment Act, are *inter alia* to improve the ability of the President to identify and to analyse barriers to and restriction on United States trade and investment and to achieve the elimination of such barriers and restrictions; also, to encourage the expansion of a) international trade in services through the negotiation of agreements (both bilateral and multilateral) which reduce or eliminate barriers to international trade in services and b) United States service industries in foreign commerce, as well as to enhance the free flow of foreign direct investment through the negotiation of agreements (both bilateral and multilateral) which reduce or eliminate the trade distortive effects of certain investment-related measures.

The chapter on Barriers to Market Access entitles the United States Trade Representative (USTR) to: "a) identify and analyse *acts, policies or practices* which constitute significant barriers to or distortions of: i) United States exports of goods or services (including agricultural commodities) and property protected by trademarks, patents, and copyrights, exported or licensed by United States persons) and ii) foreign direct investment by United States persons, especially if such investment has implications for trade in goods and services".

The Trade Representative can initiate investigations after examining a petition filed with his office by *any interested person.* The USTR can also initiate the investigation on his own.[28] If, upon the advice of the USTR, the President determines that action is appropriate "... b) to respond to any act, policy, or practice of a foreign country or instrumentality that ... ii) is unjustifiable, unreasonable, or discriminatory and burdens or restricts United States commerce", then he may use his authority to impose or unilaterally raise tariffs or otherwise restrict access to the United States markets.

[26]See also M. Rodríguez, "Latin America and the United States Trade and Tariff Act", *The Journal of World Trade Law,* vol. 20, No. 1, January-February, 1986.

[27]See Rodríguez, *op. cit.,* p. 47.

[28]The investigation on the Brazilian informatics policy was initiated by the Office of the United States Trade Representative and that on the Brazilian property rights in pharmaceuticals by the Pharmaceutical Manufacturing Association.

The term *commerce* "includes, but it is not limited to —a) services (including transfers of information) associated with international trade, whether or not such services are related to specific goods, and b) foreign investment by United States persons with implications for trade in goods or services".

The terms *unreasonable* and *unjustifiable* were defined as to incorporate the United States' demands on the right of establishment and national treatment of corporations based in that country. These concepts are part of the proposal tabled by the United States in the Negotiating Group on Services in Geneva last year:

Unreasonable. The term "unreasonable" means any act, policy or practice which *while not necessarily in violation of or inconsistent with the international legal rights of the United States, is otherwise deemed to be unfair and inequitable.* The term includes, but it is not limited to, any act, policy or practice which denies fair and equitable: a) market opportunities; b) opportunities of adequate and effective protection of intellectual property rights.

Unjustifiable. a) In General: the term "unjustifiable" means any act, policy, or practice which is in violation of, or inconsistent with, the international legal rights of the United States; b) Certain Actions Included: The term "unjustifiable" includes, but it is not limited to, any act, policy, or practice described in subparagraph a) which denies national or most-favoured-nation treatment, the right of establishment, or protection of intellectual property rights.[29]

IV

Industrialization and technological capability

1. *The Brazilian informatics policy: technological autonomy*

In 1986, the Brazilian informatics policy celebrated its first 10 years of existence. In 1976, the Co-ordination of Electronic Processing Activities Agency (CAPRE) imposed import quotas on data-processing equipment and began the preparation of an overall policy to develop a broadly defined Brazilian computer industry, and in June of that year, the agency issued recommendations that "when feasible, mini- and microcomputers and peripheral devices be reserved for the domestic industry" —marking the beginning of the market reserve policy which was to be embodied in the National Informatics Law.[30]

The next step was taken in June 1977, when the Brazilian government refused permission to IBM, Burroughs, NCR, and several other leading transnational corporations in the computer industry to manufacture mini-computers in Brazil.[31] Finally, on 24 October 1984, Law 7.232 on the National Informatics Policy was passed overwhelmingly by Congress and was signed on 29 October by the President. The Law gave eight years' total protection to nationally-owned companies in the micro and mini-computer sectors.[32]

In May 1977, the Data General Corporation sent a report to the Trade Representative of the Presidency, describing the possible negative impacts of the establishment of a locally-owned Brazilian computer industry and requiring an investigation for unfair trade practices (ABICOMP, May 1984:3-4).[33]

[29]Section 302. Initiation of Investigations by United States Trade Representative, *Congressional Record*, October 5, 1984, p. H 11548 (my italics).

[30]A. Botelho, "Brazil's independent computer strategy", *Technology Review*, May-June, 1987, p. 39.

[31]P. Evans, "State, capital and the transformation of dependence: the Brazilian computer case", *World Development*, vol. 14, No. 7, 1986, p. 791.

[32]For the purpose of the law, any activity related to the rational and automatic treatment of information is considered informatics activity (Article 3 of Law 7.232).

[33]The multinationals already established in Brazil, such as IBM, Burroughs and Hewlett-Packard, put in a year-long campaign behind the scenes against the new legislation. But, as noted in *Financial Times* (31 October 1984), "they received little support from any significant sector of Brazilian society".

Up to 1976, all the computers in Brazil were produced by foreign firms. In 1986, almost 50% of the industry's production originated in locally owned firms, but even so, IBM Brazil's total sales in that year were over US$800 million, i.e., almost six times those of the largest Brazilian enterprise (Itautec Informática, US$126 million), and they accounted for approximately 37% of the industry's sales, while together with Unisys and Olivetti, they accounted for 54% of such sales (EXAME, September, 1987).

It is not our intention here to give the precise chronology of the industry, which has been described better elsewhere.[34] Suffice it to quote some of the various factors that made possible a domestic microcomputer industry.[35]

The major factor was the particular direction of technological change, which created a "moment of transition". This provided developing countries with certain possibilities to enter into those industries. According to Evans (p. 803), such moments are those in which: "technological change is accompanied by a disjunction in established corporate control over technology. In the case of the computer industry, two overlapping disjunctions were crucial. First, the move to smaller machines was made by new companies without established international operations. Second, a fundamental technological breakthrough (the microprocessor) became available in the open market; it was controlled by firms with no proprietary interest in final demand sales".[36]

Obviously, it is not enough to have such moments of transition and nothing else. Considerable infrastructure is required to take advantage of them. Brazil had people with the technical skills necessary to take that initiative. Also, the country had acquired a lot of experience with the administrative process of import-substituting industrialization. Finally, there were nationalist engineers totally committed to creating technological capability in the country. Nevertheless, as Evans points out, they "were able to act because the régime's general commitment to a new round of import substitution in basic industries, on the one hand, and the connection between informatics and national security, on the other, created a political space for their campaign.[37]

The benefits of the informatics policy cannot be measured just in terms of market shares or the number of computers produced in that period, but rather in terms of the establishment of the technological capability that otherwise would not exist. The engineers of the informatics policy can easily show that while production was dominated by transnational corporations, most administrative and sales positions were open to Brazilian engineers.

The computer industry, at the beginning, faced problems in recruiting engineers experienced in system software and hardware design and development. The foreign computer firms which supplied the Brazilian market before the reserve market for domestic firms was established trained local engineers and technicians only to perform customer support activities and to develop some application software. According to SEI, even in 1983 the foreign corporations in Brazil employed 40% fewer university-level workers than Brazilian firms, and 43% of those were in sale-related activities. Only 4% of university-level workers were employed in R & D, as compared with 30% in domestic enterprises.[38]

After more than 10 years of existence, the number of high-level engineers able to design modern hardware, video terminals, microcomputers, different kinds of digital equipment and the corresponding sophisticated software is estimated at over 30 000.[39] In the whole area of informatics, including high-level technicians, the number is estimated at 250 000 professionals just in the State of São Paulo, with an estimated deficit of 150 000.

[34]See Evans, *op. cit.*; Botelho, *op. cit.*; S. Helena, "A indústria de computadores: Evolução das decisões governamentais", *Revista de Administração Pública*, vol. 14, October/December, 1980, pp. 73-109.

[35]Those were Evans' *op. cit.*, conclusions.

[36]Evans, *op. cit.*, p. 803.

[37]Evans, *op. cit.*, p. 804.

[38]P. Tigre, "Protectionism in the Brazilian computer industry", *Science and Public Policy*, June, 1983, p. 147.

[39]I. Costa Marques, *Dez Anos de Politica Nacional de Informática. O que conseguimos? O que poderemos conseguir?*, paper prepared for the CNPq, 1987.

2. *The Brazilian motor vehicle industry: foreign capital and foreign technology*

The informatics industry may be contrasted with the Brazilian motor vehicle industry in order to highlight the positive and negative impacts of foreign and local ownership on domestic technological capability. Although this task falls beyond the scope of this paper, it is worthwhile outlining some facts.

The motor vehicle industry in Brazil represented a successful example of industrial sectoral planning. Through import controls, tariffs, fiscal and financial incentives the government induced foreign automobile producers to start manufacturing operations in the country. The strategy was simple and effective. First, the motor vehicles were required to be assembled in the country. Second, the local car components industry was protected and it was forbidden to import parts *similar* to those produced locally. After that, the content of domestically produced parts was prescribed by the public sector. The domestic content of the motor vehicle was defined as a percentage of the total weight and total value of the vehicle. Preferential exchange rates and subsidies were given for the importation of parts to complement those locally produced.

Tariffs and discriminatory exchange rates introduced distortions in the system of relative prices. The local production of previously imported goods was accomplished in a market organized through oligopolies. The former importer was induced to start manufacturing operations by the assurance of reserved markets. The industrialization which took place in this way imposed a high social cost on society as a whole: it has been highly inflationary, and it was achieved with great disparities in income distribution, socially, sectorally and regionally.

The creation of a domestic industry did not mean domestic ownership. The incentives were clearly biased toward foreign enterprises which were supposed to bring foreign currency and modern technology to the country. Although the process can be perceived as essentially continuous throughout the civilian populist and autocratic military governments in Brazil from the early 1950s to the 1970s, the final results may hide different conceptions of the role of foreign capital in the Brazilian process of industrialization. The discussions are partially documented in the records of the Automotive Industry Executive Group (GEIA), which was responsible until the late 1960s for handling the problems of the sector.[40]

Actually it was only in the second half of the 1960s that industrial mergers in the automobile sector gave equity and managerial control to the major multinational car corporations.[41] Likewise, it was only then that these corporations started to produce passenger cars. With the exception of the German Volkswagen, during the first 10 years of the industry in Brazil passenger cars were produced by joint ventures with a majority of capital held by Brazilians. Concurrently, the motor parts industry also came to be dominated by foreign enterprises. The sector is atomized in hundreds of small and medium-sized enterprises that depend on final goods producers to change their technology. Hence, their investment plans are also dependent on car manufacturers' strategies. Foreign companies prevail in the sophisticated segments of motor parts production.

Similarly to what happened in informatics, it was the alliance between nationalistic government officials, some of them civilians but mostly military, and small to medium entrepreneurs that made possible the whole infrastructure for the industry to arise. General Macedo Soares, who had served as technical director of the State-sponsored steel plant and was the president of the National Steel Commission created in 1940, said that the Commission had in mind the local production of motor vehicles when setting up that company. Admiral Lucio Meira was the head of the Subcommittee on Jeeps, Tractors, Truck and Passenger Cars, created in 1952. He was to be Minister of Transportation in the late

[40]For further references see V. Ventura-Días, *The Brazilian Motor Vehicle Industry. A Case of Sectoral Planning*, unpublished Master's Thesis, University of Berkeley, 1975.

[41]In the second half of the 1960s, after the 1964 *coup d'état*, a set of mergers was stimulated by the government: Vemag and Willys Overland were purchased respectively by Volkswagen and Ford Motor Co., Simca do Brasil and International Harvester were bought by Chrysler Corporation do Brasil, and Fábrica Nacional de Motores was sold to the Italian Alfa Romeo company.

1950s and responsible for the implementation of the project outlined by the Subcommittee.[42]

The presence of domestic capital in the automobile industry was supplementary to the foreign enterprises. The government incentives were directed to the foreign investor. There was no commitment of the public sector to domestic entrepreneurs.[43] Local industrialists had to import equipment without preferential exchange rates, unless they were associated with foreign investors.

Undoubtedly, the domestic companies which invested in the production of passenger cars helped to build the local motor parts industry. This was done either by developing locally owned companies, by bringing original suppliers to the country or by producing the parts themselves.

At the time the National Passenger Car Plan was issued (1957), the Brazilian suppliers had not yet achieved the sophisticated technological capability required for the production of the parts for an average American car. When the American companies bought the joint ventures stimulated by the Brazilian government, they bought altogether 10 years of technological development and market growth. They were able to expand their sales of medium-sized and luxury cars within efficient production patterns. In the beginning, they lost the market for small popular cars to Volkswagen, but in a few years that would not make a great difference.

Similarly, the National Plan for the production of motor vehicles was based on the requirements of increasing the content of domestically produced parts in the weight and value of the vehicle. There was never a requirement that those parts should be bought from local suppliers or from local enterprises with domestic capital and management. As a result, part of the production of parts was internalized in the assembler plants or was carried out locally by the original suppliers of the assembler.

The reasons underlying the foreign control of the motor parts industry were the low level of technological development of local manufacturers and the complex technical requirements of automobile production. Proprietary technologies of products and processes have remained internal to the corporations. Rather than develop a future competitor, the foreign enterprises mainly preferred to combine the earnings from license fees with the returns on equity capital, jointly with managerial control over the decisions of the firms.

The large corporations benefited from the high turnover in the labour market introduced by the autocratic military régime in the mid-1960s. They did not create conditions for the expansion of highly skilled occupations, and the local universities were not invited to participate in the creation of car design and construction technology.

[42]Lucio Meira drew the following conclusion, after holding general meetings with the industry: "I got the impression that the foreign motor vehicle concerns have no interest in producing 100% domestically produced automobiles in our country and they will not do that unless they are forced to. This is evident in the contacts with Ford and General Motors. We can see that they will use national products only when required by government policies" (in W. Moreira Franco, *A Nacionalizaçao dos Veiculos no Brasil*, unpublished master thesis, n.d.).

[43]In contrast, many authors have already emphasized the importance of local entrepreneurship to explain the success of Korean exports in highly sophisticated markets. The history of the Korean automotive industry is similar to that of Brazil, considering the administrative procedures and import prohibitions, although it started a little later (in the early 1960s). Nevertheless, the number of car producers was limited and there was never a totally foreign-owned corporation. On the contrary, in the case of subcompacts, for instance, there are only two firms' Daewoo Motor Company (a 59:50 joint venture between a large Korean conglomerate and General Motors) and Hyundai Motor Company (owned by Korea's largest conglomerate, with 10% equity of Mitsubishi) (A. Amsdem, and L. Kim, *The Korean Production and Exports of Subcompact Automobiles: A Case Study in Industrial Strategy*, paper presented at the UNCTAD Symposium on South-South Trade, Geneva, June, 1985).

V

Development policies at bay

From the beginning, the Brazilian government was under increasing pressure to modify its nationalist computer policy. The military officers at the Secretaría Especial de Informática (SEI), the government body in charge of computer policy, however, pushed ahead with their plan to extend the market reserve policy, originally applied to mini-computers, to other sectors of the market.

The pressures for change were made explicit during the visit of President Reagan to Brazil at the end of 1982. Concessions on the informatics policy were part of the conditions for financial aid. Representatives of multinationals were claiming that difficulties in importing some product lines had made the companies lose export orders, with heavy costs to the country. Brazilian businessmen willing to form joint ventures in some areas of information technology, warned that, as a result of the restrictive policies applied, the country could finish up with an obsolete industrial complex, as local companies did not have the resources to keep up with the latest developments, particularly in the key area of factory automation.[44]

The *Federal Register*, vol. 50, number 179 of 16 September 1985 published a notice announcing that the United States Trade Representative was initiating an investigation into Brazil's informatics policy and invited interested parties to submit written comments. Pursuant to the norms of the Trade and Tariff Act (TTA), the United States government had previously requested formal consultations with the Brazilian government, which took place in Geneva in February 1985. There, the Brazilian delegation tried to prove that the reserve market did not infringe any of the rules or principles of the GATT. The investigation to ascertain whether Brazil's market reserve policy constituted unfair trade was carried on parallel to the diplomatic talks.

The announcement of the investigation was well-timed, because it coincided with the preparations, in Geneva, for the GATT Ministerial Meeting to discuss the new round of MTNs. The Brazilian delegation had from the beginning actively opposed the inclusion of services, investment and intellectual property rights in these negotiations.

In February 1986, the Brazilian government approved a joint venture between Gerdau and IBM to form Gerdau Serviços de Informática S.A., in which IBM would have a 30% stockholding but would supply most of the equipment and technology. This would mean a more flexible application of the law, which prescribes a maximum of 30% of foreign capital, without voting rights. The law also requires domestic managerial and technological control, if corporation is to be accepted, for the purposes of the law, as a Brazilian or national business. The final approval depended on the Secretaría Especial de Informática (SEI).

The strategy of the United States government was to leak information that sanctions might be imposed on Brazil, while at the same time denying the existence of any official report on the results of the investigations on the Brazilian informatics policy. In April 1986 there were hints of a status report drawn up by the International Trade Commission and the Technical Commission of the Department of Commerce, containing recommendations of two types of sanctions to be imposed on Brazil: a 40% reduction of all imports from Brazil and the opening of new investigations in specific areas such as the fine chemicals industry.[45]

Late in April 1986, Secretary of State George Schultz sent to the Brazilian Foreign Minister a letter requesting explanations concerning the computer industry law. The Brazilian reply stressed the development goals of the Brazilian computer policy and noted that no international rights or principles were being infringed by the

[44] *Latin America Weekly Report* WR-83-24, 24.6.83, p. 2.

[45] *Gazeta Mercantil*, International Edition, 28 April, 1986.

Brazilian government: "Brazil maintains that any effects of its computer industry law on the interests of trade partners must be examined in the light of both countries' international rights and obligations..."[46]

In May, the White House spokesman announced, that President Reagan was considering imposing trade sanctions on Brazilian products if there were no changes in the implementation of the informatics policy. By the end of May, the United States Undersecretary of State, John Whitehead, visited Brazil and was received by the President of that country. That visit marked the beginning of formal negotiations on the Informatics Law (officially non-negotiable), which took place in meetings between Brazilian and United States diplomats, out of which very little transpired.

In June 1987, the threat by the Reagan Administration to impose trade sanctions against Brazil was more than 18 months old. The sanctions had been forestalled when the Brazilian lower house of parliament, the Chamber of Deputies, approved a software law. The new software protection bill led the Cabinet-Level Economic Policy Council to recommend against imposing sanctions. But the Council advised the President to keep his trade complaint alive to make sure that both houses of parliament approved the legislation and that Brazil complied with United States demands in other high-technology trade and investment problems.[47]

In July, the SEI determined that SISNE, an operating system developed by a Brazilian company (Scopus), was functionally similar to the MS-DOS system manufactured by the United States company Microsoft. Consequently, in September, the agency denied a license to four Brazilian firms to market the United States product. The Brazilian authorities claimed that the Scopus system was perfectly adequate and that they did not want to discourage other Brazilian firms from developing that type of computer programmes.

On 13 November 1987, President Reagan announced his intention "to raise tariffs on Brazilian exports to the United States and to prohibit imports from Brazil of certain computer products in response to the maintenance by Brazil of unfair trade practices in the area of computer products", going on to say that: "Brazil's national informatics policies, in place since the 1970s, severely restrict foreign participation in Brazil's computer and computer-related market. The United States has unsuccessfully raised its concerns with Brazil in bilateral and multilateral consultations since 1983. In September 1985 I initiated an investigation of these practices under Section 301 of the Trade Act of 1974, and in October 1986 determined that Brazil's informatics policies were unreasonable and a burden amd restriction on United States commerce. I suspended parts of this investigation after Brazil made commitments to implement its 'informatics' law in a more flexible reasonable, and just manner".[48]

The Reagan Administration estimated at US$105 million the lost sales opportunities for United States companies. As perceived by the Washington Post, the options were complicated by two factors: many Brazilian exports to the United States were either manufactured by United States multinationals based in Brazil or contained United States-made components, so sanctions would inevitably hurt United States interests. In any case, one week later, the office of the United States Trade Representative issued a request for public comments on possible United States actions in response to certain Brazilian unfair trade practices. At the same time, a list of Brazilian products which were being "considered" for increased duties or other import restrictions was produced.

The mere announcement of possible sanctions caused Brazil to suffer trade losses of nearly US$500 million.[49] The list involved the most heterogeneous set of products, from coal tar to optical fibres, from household ware to industrial machinery, from motor vehicles to aircraft and space craft and parts, from footwear and luggage to furniture, pistols and rifles.[50]

The hearings in December showed the differences in the approaches of the aircraft indus-

[46]*Gazeta Mercantil*, International Edition, 5 May, 1986.

[47]A draft of the Brazilian software bill was shown privately to the USTR (Clayton Yeutter) (*Washington Post*, June 26, 1987).

[48]Statement by the President, 13 November 1987. The White House, Office of the Press Secretary.

[49]*Folha da Tarde*, 25 November 1987, p. 11.

[50]USTR office, docket No. 301-49, 19 November 1987.

try (a Brazilian State-owned enterprise) and the motor vehicle companies in their defences against possible commercial sanctions. The testimony by the Aerospace Industries Association of America indicated the risks of the confrontation between United States and Brazil in the aerospace sector. This would jeopardize billions of dollars worth of pending and future United States aerospace exports to Brazil, since the Brazilian company could prompt counter-retaliation by Brazil against those exports. The Vice-President of that Association noted that: "A trade war with Brazil could prove very demaging to the United States aerospace industry through: lost sales of complete United States commercial transports, helicopters and light aircraft; lost sales of components, systems and engines to Embraer; and increased cost of components supplied by Embraer to United States-built aircraft".[51]

In the statement by the Vice-President of Volkswagen of America, Inc.; the exports from Brazil were identified as necessary imports by the United States-based Volkswagen operation, to substitute for the closing down of its Pennsylvania plant: "Restrictions should not be imposed on a product that will harm a United States company that has demonstrated a desire to invest in the United States market and has made a good-faith effort to do so".[52]

Meanwhile, the two houses of the Brazilian parliament hastily approved a new software law which was sanctioned (with a few vetoes) by the President on 18 December. He vetoed some of the articles that United States diplomats had found unacceptable, in particular reducing the scope of action of the SEI. The year ended with emotional discussions and active criticisms by the conservative media against the Brazilian informatics policy. Application of trade sanctions was postponed until January 1988, pending, it was believed, promises of reconsideration of the decision on the Microsoft MS-DOS.

Finally, on 20 January 1988, the National Council of Informatics, in a Pyrrhic decision, maintained the prohibition of the marketing in Brazil of versions 3.0, 3.1 and 3.2 of MS-DOS, but approved the sale of version 3.3. The decision was judged ironic because it is common knowledge that a new version of a computer programme adds very little to the previous one. In other words, whoever is capable of designing versions 3.0 to 3.2 can also develop version 3.3.

The sanctions were postponed again, and the last official note from the United States Administration on the subject did not change the overall situation. Officially, the United States is not satisfied with the Brazilian informatics policy and will watch carefully future attitudes of SEI which may hurt the interests of United States corporations. The sword of Damocles will be kept hanging over Brazilian exporters, as the best way to gain domestic allies against the implementation of Brazilian policies which could jeopardize United States interests in the near future.[53]

More recently, after the investigations under section 301 on Brazilian practices on pharmaceuticals were closed, new trade sanctions were threatened against Brazil if it does not properly safeguard the interests of the United States corporations in pharmaceuticals. The Brazilian official complaint was that: "They (the United States measures) not only try to coerce a party to change an internal policy which is perfectly consistent with internationally agreed instruments that regulate intellectual property rights. They also try to make that party mold its position on the Uruguay Round in accordance with the wishes of a more powerful trading nation".[54]

[51]Statement by Celia M. Sherbeck, Vice-President, Civil Aviation Aerospace Industries Association of America, Inc. to Section 301 Committee on Proposed Trade Retaliation Against Brazil, 18 December 1987.

[52]Statement by Volkswagen of America, Inc. to the Office of the United States Trade Representative concerning the United States response to Brazil's informatics policy, 17 December 1987.

[53]*Folha de Sao Paulo*, 18.6.88 ("EUA adiam retaliacoes às exportaçoes brasileiras").

[54]International Foundation for Development Alternatives, (IFDA), *Special United Nations Service*, 28.7.88.

VI

Final remarks

Brazil is fighting hard just to stay in the same place. Clearly, however, staying in the same place within a dynamic and fast changing international economy means going backwards. Textiles, shoes, and small aircraft were taken as hostages indefinitely, to be exchanged for endless concessions in terms of intellectual property rights, investment in R & D, market reserve for local capital and indigenous technological capability.

The informatics industry is now aware that the use of mainframes has stopped growing, and they will eventually give way to networks of microcomputers of extraordinary capacity. Moreover, the future of the industry is not even in the hardware, which will become an inexpensive commodity, but in the engineering of software. Services and goods in informatics are part and parcel of the same industry, mutually conditioning their production.

In the new international economic order, the logics may by blurred by the intricacies of new jargons and the sophistication of the technologies involved. In reality, however, what used to be the colonial exchange of primary commodities for manufactured goods will be posed in terms of the unstable exchange of segments of the production organized by transnational corporations in return for the permanent presence of these corporations in all the higher-value-added segments of the production of goods and services.

The 1984 Trade and Tariff Act is a summary of what the United States wants to see recognized in the GATT negotiations as the legal framework for regulating domestic policies dealing with, *inter alia*, services, investment and technology. If that legal framework existed, the National Policy on Informatics would be a still-born administrative measure, because it would have to be discussed by interested parties before it could be enacted.

Section 301 of the 1984 TTA, under which the United States Administration has acted in defence of the interests of its corporations, is a clear violation of GATT rules and principles. Yet the issue has never been officially brought before GATT. The United States are proud of the extent of their market. They know that their trading partners cannot go through costly litigations. Developing countries, and especially the NICs, will rather comply with the United States demands and settle the matter rapidly, because newly-industrializing and hight-debt countries depend on their access to that market to produce the trade surplus required to service their debts with United States banks.

CEPAL REVIEW No. 37

Participation and concertation in social policies

*Carlos Franco**

The author of this article contends that, as a consequence of the debt crisis, macroeconomic goals and social goals have become relatively dissociated from one another and that the latter have tended to be reduced to the provision of special attention to the needs of the poorest groups in the population.

On the other hand, in the various instances of concertation within the region, emphasis has been placed on reaching agreement with different types of organizations that are, to some degree, integrated into the economic structure. However, the economic situation and, more specifically, the form of adjustment that has been chosen hinder the materialization and continuation of such concertation initiatives.

The author goes on to discuss the incompatibility between a substantive form of social development and a fall in the product and suggests that there is a need for a re-examination of the relationship between economic and social policies and the corresponding division of labour among State bodies. In pursuing this line of thought, one promising concept is that of the association between the growth of the product and the satisfaction of the basic needs of the population.

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Within the framework of the more general concept of development in Latin America, it is interesting to observe the way in which the approaches taken to the issues of basic needs and social policies have changed. Indeed, each new view of regional development brings with it a change in the relationships between the economy and basic needs, as well as a shift in the way economic policies and social policies are ranked.

I

Views of development and social policies

Up until the late 1950s, a basically economic concept of the industrialization or "modernization" process in the countries of the region prevailed which, explicitly or implicitly, characterized the satisfaction of the basic needs of the population as some sort of natural by-product of economic growth and, for that reason, social policies were regarded as being subordinated to production policies.

In the 1960s and early 1970s, however, the normative views of development which arose modified, at least at the level of theory, the relationships between economic growth and basic needs in such a way as to make them equal in importance and complementary in terms of policies for their management. The ramifications of this change were not confined to the equalization (in word rather than in deed) of economic development and social development in terms of their priority, but also gave rise to a process whereby social problems and policies began to be seen as separate elements of development. In other words, whether due to the experience of those years or to the re-thinking of development approaches, it began to be understood that social problems are not natural by-products of economic problems, but rather that they have an identity of their own which is affected by a multitude of economic and extra-economic (i.e., political, cultural, psycho-social and historical) processes. Precisely for this reason, even though social policies continued to be

linked to economic policies, their independent identity and specificity began to be recognized.

In the 1980s, the approach taken to development and to the relationships between economic and social problems and policies has changed markedly. A pessimistic view of the present and immediate future of the region, which purports to be realistic and to be based on an "objective" perception of the effects of the crisis and of the failure of some of the national States' expansionary and redistributive policies, has turned the word "adjustment" into an ambiguous term that may refer to either the economic recession or "healthy" growth. Both meanings of the word, although they differ in their application of certain kinds of short-term policies, reflect a belief in the "inevitability" of a drop in the product or the "necessity" of more or less mediocre economic growth rates. In this context, the renunciation of certain types (or all types, in some cases) of economic growth is coupled with a reassessment of the importance attributed to social problems and policies and a reconsideration of their relationship to economic problems and policies.

In fact, for several years now the belief has been expressed that certain significant social goals can be reached in spite of the economic recession or the distressingly slow growth of the regional product. This point of view is diametrically opposed to that of the preceding decades. While the approach taken in the 1960s characterized social goals as secondary offshots of economic goals and while the two were viewed as being complementary in the 1970s, now, in the 1980s, social goals (at least some of the most significant ones) have become relatively dissociated from overall economic goals and, as is also true of the social policies that make them possible, have become almost entirely independent issues ... in the realm of theory.

It is not our purpose here to discuss the value assumptions of this concept, the nature of the diagnostic analysis that underlies it, or the coherence of the view it entails of the relationships between social and economic policies, much less to make value judgments about its political meaning. Instead, we are more concerned with considering how this approach is thought to make the achievement of certain social goals possible within a situation of flagging production.

1. *The political will of the region's governments*

According to this perspective, the achievement of certain social goals in a context of flagging production requires what is referred to as "the political will of the governments of the region", an expression that apparently alludes to the relations between governments and social groups living in conditions of critical poverty. At one level, it refers to the contents of speeches, plans, policies, programmes, instruments, and amounts and uses of resources, which are or could be defined by the governments, as they relate to the disadvantaged social groups within society and to how they are judged, on the basis of their technical relevance or political appropriateness, by the national and international groups or institutions advocating social development. At another level, this concept seems to refer to the quality of the politico-institutional relationship between the State and these social groups, based on what has been called a special concern for the poorest sectors. Certainly, these two levels, that of the content of public plans and that of the politico-institutional relationship, are regarded as being complementary and, hence, as forceful expressions of the "political will of the governments". In this sense, then, "political will of the governments" and "special concern for the poorest groups" are equivalent or, at least, related concepts, in that the latter specifies the meaning of the former by identifying its social referent.

The term "special", however, has an undeniably comparative connotation; it implies that when the State is faced with competing demands for public resources and the use of power by different social groups or classes, it will choose to allocate a greater share of such resources to the satisfaction of the needs of the poorest social groups. As is obvious, this can only happen if the two have a special socio-political relationship which takes precedence over the State's relationship with other social groups or classes or with the institutions representing them. Naturally, the extent of the difference in the amount of attention the State devotes to the various social interests will depend, all other things being equal, on the amount of resources at its command. If they are abundant, then the State can

combine a special concern for the poorest groups or a special relationship to them with a lesser, but still significant, amount of attention to the more affluent social groups. Conversely, if resources are scarce, then it is more probable that in order to devote special attention to the poorest groups, the State will have to significantly reduce the resources it allocates to the more prosperous social groups and its relationships with them.

2. *Participatory policies*

In Peru, as in other countries of the region, the expression of the political will of the State to give the interests of the poor or marginal social groups a special status was embodied, in past decades, in what are referred to as participatory policies or strategies. National differences or specific conditions aside, these policies were understood as involving the following: political action aimed at promoting the organization of mobilization of underprivileged social groups; allocating economic and political resources to the satisfaction of their basic needs; opening up mechanisms for participation by such groups in local government at the community level; organizing community programmes for joint management in the fields of health, education, housing and employment; or, as in the Peruvian case, reforming the system of ownership in agriculture and industry in order to make it more equitable.

We are not concerned here with evaluating the successes, problems and failures of past experiences with participation at the grassroots level. It is of interest, however, that such participatory policies were preceded or initially accompanied by expansionary economic cycles in the domestic markets in question and by a growing inflow of external resources from the international economy. It should also be noted that the gradual or abrupt elimination of such policies was preceded or accompanied by the beginning of recessionary cycles in these national economies and by the crisis in the international economy.

It should be stressed that these expansionary economic cycles and the inflow of external resources had, *inter alia*, two specific effects on such participatory policies: firstly, they increased the amount of resources available to reformist States for use in attending to the needs of poor groups; secondly, they minimized or rendered manageable the opposition or reservations expressed in relation to these policies by industrial, financial, commercial and professional groups and, in certain cases, by trade unions. Thus, the expansionary economic cycle permitted the coexistence, at least in Peru, of priority State participatory policies with less, although still significant, State attention to the so-called intermediate organizations belonging to the national power structure.

Especially in the Peruvian case, the most forceful formulations of the participatory approach in the late 1960s and early 1970s were basically concerned with, or made explicit reference to, the relationship between two socio-political entities: the State and organizations of marginal groups (especially of peasant and informal urban sectors, as well as the union movement). In this sense, the expression "grassroots participation" signified a special relationship between these two socio-political entities which dominated or subordinated, at least at the theoretical level, the State's relations with entrepreneurial and professional associations and political parties. Moreover, the prevailing theories held that participation-oriented States should establish a direct link, or one involving as little intermediation as possible, with grassroots social organizations and that, in order for this to be done, it was necessary to bypass or circumvent the "intermediate" institutions whose interests were judged to be external, competitive or opposed to the interests of lower-income social groups.

In practice, the interests of the institutional organizations belonging to the modern economy and the power structure were considered and satisfied relatively fully, but the advocates of the participatory orientation attempted to bypass or devalue them in favour of the State's special relationship with grassroots social organizations. The political consequences of this approach were the reluctance or refusal of the established groups and institutions within the economic and political system to regard the interests of the poorest groups as legitimate or

to agree to share the attention, resources and power of the State. Hence, the hypotheses formulated by the advocates of participatory policies concerning the behaviour of the intermediate organizations within the system acted much like a self-fulfilling prophesy and were thus ultimately borne out. In other words, the political reactions of the strongest industrial, commercial, financial, professional and even trade-union organizations ranged from distrust to rejection of participatory policies, and they ended up by vigorously defending their own interests when the close of the expansionary economic cycle left the governments' without the economic resources they needed in order to manage social conflicts.

II
On concerted action

The examination of the experiences left many people with the impression that there was a need for a critical review of and theoretical improvement upon these participatory approaches. They began by questioning the desirability of confining the participatory approach to the relationship between the State and grassroots social organizations and by asserting that its coverage should be broadened to include the presence, interests and relations with the State of all social groups and representative organizations within the society. They then went on to argue that the allocation of public resources for the achievement of social goals, as well as social policies themselves, should be justified or rationalized in keeping with short-term economic policies. Finally, they contended that the relationship between the State and low-income groups would not be viable in the medium term unless it was protected by a network of political relations between the State and the organizations forming part of the modern economy and the power structure and by a progressively stronger commitment on the part of these organizations to meeting the basic needs of the population. Thus, the subject of grassroots participation gradually became a secondary issue in the ongoing intellectual and political debate as it gave way to a new topic —the concept of concertation— which, since the late 1970s, has become a question of increasing interest to social scientists, politicians and public officials in the region.

A review of the few national experiences with concertation, starting with that of Venezuela and continuing on to the most recent one, in Uruguay, as well as of the Spanish experience, soon leads to the conclusion that these experiences have involved the creation of the political conditions for a transition from authoritarian to democratic systems. The consensuses formed in these cases have basically referred to the relations between civilian governments and armed forces, constitutional and institutional guarantees for parliamentary and party systems and a basic minimum of reforms in the structure of the State and in its relationship to the civilian society. The Spanish social pact, among others, also defined the framework for relations between the State and business and labour organizations, as well as basic agreements on price and wage management.

If we then go on to examine the concertation strategies of the countries of the region, we will quickly see that their main components refer to short-term economic policies, the regulation of prices and wages and the creation of institutional frameworks and mechanisms for relations among the State, entrepreneurs and the trade-union movement. In some cases, these strategies include medium-term economic plans, constitutional reforms or the introduction of new institutional instruments. The point I wish to make here is that in none of the cases of which I am aware have these experiences and strategies centred on the definition of social policies or national goals concerning nutrition, a decline in infant mortality, primary health care, or programmes on literacy, housing or basic services in general. In other words, the interests of the

poorest social groups have not been taken into account, at least in any overriding sense, in these concertation experiences and strategies.

If we now look at the works of the region's economists, we will soon note the paucity of studies or proposals relating to either an economy geared towards the satisfaction of basic needs or an economy based on concertation. Furthermore, the growing literature on concertation produced by the region's social scientists in the past decade includes extremely few analyses or specific studies on the links between political concertation and basic needs or between the real agents of concertation and social policies.

In my judgment, this is no accident, and I have two reasons for holding this belief: firstly, because the social or political subjects which propose or take part in concertation initiatives are generally the State, political parties, business societies and the trade-union movement, i.e., the organizations whose power, interests and resources allow them to act directly and independently in the political scenarios of the region; and secondly, because in a context of economic recession, insufficient production and a shortage of resources, the victors in the political struggle to obtain the small economic surplus that exists or to avoid paying the costs of the crisis will be those agents or interests that are the most powerful or the most solidly embedded in the institutional fabric.

The way in which concertation has actually evolved therefore indicates that its focus and practical expression deserve the criticism made of the participatory approach and policies in the past decade although certainly in a different sense. Whereas the participatory approaches devalued the State's relationship with intermediate organizations or those integrated into the modern political and economic structures as a means of fostering its special relationship with the community-level organizations of the lowest-income sectors, the approaches taken to concertation have marginated or devalued the State's relationship with the latter with a view to promoting an exclusive or exclusionary relationship between the State and the former.

An analysis of the above situation also reveals, however, that adjustment policies or those adopted in response to economic recessions tend to:

a) Erode popular support for the governments of the region or cause the breakdown of the implicit social pacts on which their democratic authority and their relatively autonomous exercise of power are based;

b) Reduce the governments' freedom of action as regards their functioning, their management of conflicts of interest or their imposition of limits on mounting processes of anomie or on social and political violence;

c) Heighten the inequality of the political and representational power of the various social groups that are competing for public resources and favourable State decisions;

d) Promote institutional and political disorganization within the less powerful social groups in the society and reduce their representational capacity for gaining access and independently expressing their views to the State or for pressing for or influencing public decisions in their favour;

e) Eliminate the economic surplus or, in other words, the material resource base which permitted these States to direct their actions in the 1960s and early 1970s towards attending to the basic needs of the poorest social groups through participatory policies;

f) Strengthen the privatist, corporativist and sectoral tendencies of intermediate organizations and impede them from integrating or accepting the demands or needs of the poorest social groups;

g) Severely lessen the possibility that consensual agreements on social policies will be reached among the State, organizations representing interests directly connected with the political régime, and the poorest social groups. In other words, they hinder the State from using a combination of participatory policies and concerted policies in order to promote social development.

III
Returning to the approach of the 1980s

Having identified what seems to be a general trend in many of the countries of the region, we may now return to one of the initial subjects of this discussion, i.e., the possibilities of relaunching *significant* social policies and goals in economies undergoing recession and adjustment.

Current trends provide grounds for our scepticism about this approach. Even in the midst of a crisis and the implementation of adjustment policies, we do not deny that it is ethically plausible to propose the achievement of social goals and that it may be possible to reduce, in some respects, the speed and intensity of the deterioration in the living conditions of the poor majorities in the countries of the region. There is certainly no question about that, at least for us. It is evident, however, that a discussion of this approach is meaningful only if it indicates that social policies can be reintroduced in a substantive way and that significant social goals, i.e., goals having a recognizable impact and coverage, can be reached. Close examination of current trends, however, indicates quite the opposite. They suggest that a substantive form of social development is incompatible with a stagnation or decrease in the product and thus call for a more careful reconsideration, at the theoretical level, of the relationships between social and economic policies. An analysis of the way that events in the region and concepts about its development have evolved shows that the approach taken in the 1950s, which characterized social development as a natural by-product of economic growth, is just as questionable as that of the 1980s, in so far as it seems to portray social development as being independent of productive growth or as a form of moral compensation or political rationalization for a resigned acceptance of the role assigned to the region's national economies in the current world economic order or of the content of recessionary or adjustment policies.

Nothing said up to this point detracts from the importance of the efforts being made to cushion the impacts of the crisis on the poorest social groups or from that of creative initiatives for achieving some minimum goal relating to the population's basic needs. The criticism of this approach, in its strict sense, does not ignore the need to introduce socially selective guidelines for the formulation and execution of economic "adjustments" for the benefit of the poorest sectors of the population. In this respect, when the approach in question is dissociated from its most ambitious purposes or arguments, it can become a source of initiatives for making use of the potential resources of society to benefit the poor, for incorporating the experiences of grassroots organizations into the design and execution of social programmes or for making innovations in the institutional organization of the State or in participatory methodologies for furthering human development.

IV
Reformulating social policies

In those countries in which the crisis has been less severe or in which the government has maintained its political will in spite of economic constraints, it is vital that the content of social policies be reformulated. The use of the word "reformulation" refers here, firstly to the need to ensure that the content of these policies is not defined exclusively in terms of a combination of unmet basic needs (statistically selected by social level, geographic scope or age group), quantitative objectives or targets (defined solely on the basis of the available budgetary allocations), and

action programmes or instruments (defined exclusively by the technical-professional staff or the personnel available within the government service).

Any diagnosis of the situation that does not consider the specific degree of organization of the population to be served, its social practices and degree of mobilization, as well as its potential or real resources, does not provide an adequate basis for determining either what strategy should be used for carrying out social policies or what kinds of goals can be reached.

A similar effect is produced by a failure to take into account the orientations, resources, organization or power of all the social actors, including institutions which are external to the poorest social groups but which are directly or indirectly involved due to the nature of the goals established in accordance with social policies and the public or private resources that have been or could be mobilized. Any diagnosis that does not chart the dynamics of social and political interactions does not permit a precise definition of the goals, resources, strategy or programmes in which public policies are expressed.

The experience gained in the region over the last three decades also indicates that it is necessary to broaden the coverage of what we usually call social policies. This experience seems to show that no social policy can achieve its objectives if it does not incorporate, with the greatest possible degree of precision, the following elements: strategies and mechanisms for participation at the grassroots level by the target social groups; the concertation of the social and political agents or actors that are a part of the public power structure; the decentralization of the State and technical-administrative innovation; and the prioritization, in spatial as well as in social terms, of the actions to be taken. Policies of participation, concertation, decentralization and spatial prioritization are not distinct from social policies and are not, therefore, the responsibility of other public sectors or ministries. They are essential components of social policies as redefined above and their focuses, instruments and practical application are indispensable to the achievement of the goals that have been outlined.

It is equally clear that so-called social policies cannot be defined on a parallel or sectoral basis by ministries which lack institutional channels of communication or which are only loosely connected by the notoriously unsuccessful mechanisms of inter-ministerial co-ordination. In a situation where resources are in short supply and must therefore be used as efficiently as possible, it becomes more necessary than ever to harmonize the States' social policies and to define common goals as regards the expenditures to be made by public sectors. In reality, a government has, or should have, one single social policy, even though its administrative execution may be carried out by various agencies. Thus, in my opinion, it is necessary not only to consider the institutional option of integrating all "social" ministries by placing them under a single authority, but also to agree upon a single social budget so that social programmes can be articulated or integrated, thereby co-ordinating the time frames for their execution, aligning the pattern of expenditure and maximizing the effectiveness of resource use.

Perhaps the greatest challenge in respect of the design of social policies in the region is the redefinition of their relationship to economic policy. If in the past these two types of policies were regarded as being unrelated to one another, it was because the growth of the product and the satisfaction of basic needs were assumed to be separate spheres of action. This gave rise to the State's division of labour, whereby the former was the responsibility of the ministries of economic affairs and production and the latter that of the social ministries. In its turn, this division of labour led to a division of roles whereby social policies were assigned the functions of offsetting, making up for or rectifying the deviations, omissions or errors of economic policy.

Hence, it is clear that if the style of the product's growth is associated with the satisfaction of basic needs, then economic policy becomes the best tool of social policy or its best operational vehicle. In other words, a progressive transformation of the profile of the social needs to be met, of the composition of productive supply, of patterns of financing, investment, employment, distribution and consumption is actually the best social policy instrument. Should that occur, the present division between economic policies and social policies would disappear.

Thus, I believe that there is an alternative —one which is forcefully suggested by the nature of the current crisis in the countries of the region— to an insistence on the compensatory role of social policies, whether this is based on the continuity of the structural pattern of the productive apparatus and the style of growth or on the inevitable continuation of financial and technological dependence. I am not unaware of the problems involved in bringing about a progressive change in the production structure and the style of growth or in a reconfiguration of the social and political alliances within each national State. However, past failures and those likely to occur in coming years, as well as the enormous human costs associated with the approach which we are calling into question here, indicate that it is plausible to consider, at least as a hypothesis, the pursuit of other options.

We are convinced that a broader definition of social policies and a redefinition of their linkage with economic policies could place the countries in a position to increase the economic, political and social resources at their command; to organize, on a larger scale, the network of socio-political interests and alliances upon which social policies must be based if they are to have continuity over time and be effective in terms of action; to ensure a more active form of participation on the part of the groups concerned; and to achieve a political coverage that reflects current experiences. In short, they would then be in a position to stimulate the development of an awareness of the plight of the poorest sectors of the region's population and to encourage concerted public action in their behalf.

Unless substantive, albeit gradual changes are brought about in the international economic order, in the socio-political alliances among States, in the content of short- and long-term policies and in the resources made available by an economic, restructural, sustained and selective form of growth in the productive apparatuses of the countries in the region, it will be extremely difficult for these States to meet the dramatic social challenges facing them.

CEPAL REVIEW No. 37

The heterogeneity of poverty. The case of Montevideo

*Rubén Kaztman**

The economic crisis suffered during the present decade by the Latin American countries reduced the wages and incomes of many families, with a consequent deterioration in the living conditions of the affected population. Homes which had previously met the minimum conditions for ensuring the social integration of their members sank into poverty, thus increasing the heterogeneity of this phenomenon.

In this article we propose a method for identifying this heterogeneity on the basis of the information customarily gathered by national household surveys concerning income and ability to meet basic needs.

The applicability of the method is illustrated by means of data on Montevideo for the years 1984 and 1986. An analysis of the changes recorded during this period in the percentages of homes that were short of income or failed to meet basic needs enables us to draw some conclusions concerning the effects of various policies on the situation of the various categories of poor people.

The macroeconomic policies applied by the democratic government which was established in Uruguay in early 1985 —policies which have been reflected in an increase in real wages, a drop in unemployment and the containment of the inflationary process— improved the situation of the "recent poor" but not that of the "chronic poor", nor that of the households suffering from "inertial shortages". These last two categories did not seem to react in the short term to macroeconomic reactivating policies. The author suggests some specific policies to benefit these groups.

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Introduction

Poverty is usually defined as the more or less permanent situation of households whose shortage of income causes critical shortages in meeting basic needs. Many of the limitations affecting both the studies on this subject and the design of policies based on the results of such studies arise from the variety of interpretations that can be placed on some elements of the definition. This is why the word "poverty" denotes phenomena with different meanings.

One such element, an analysis of which is essential for a determination of what poverty means, is the duration of the situation of critical shortages brought about by the shortage of income. Until this variable is defined, "poverty" will cover widely divergent situations. For example, it will include the results of the impact of recessions or economic crises on the labour market, with the consequent deterioration of the living conditions of households and the failure to satisfy certain basic needs of their members. It will also include those other situations of chronic poverty whose maintenance and reproduction are promoted by factors which are endogenous and exogenous to the population segment affected. In these latter cases, which are usually the most severe ones, the permanent nature of the poverty situation may be the result of the productive system, of ethnic or cultural discrimination and of the internalization, in various spheres of life, of values and attitudes that reinforce what has been called the "vicious circle of poverty". The existence of these mechanisms poses one of the most serious and complex challenges from the standpoint of the design of policies aimed at the eradication of poverty.

A discussion of the subject of insufficiency of income to meet basic needs is also fundamental for clarifying the meaning of the word "poverty". In the quantitative investigation of poverty the greatest effort has undoubtedly been concentrated on determining the poverty line, that is to say, the minimum income required in order to enable households to ensure the psycho-physiological development and social integration of their members. The widespread use of this measurement is a result, first, of the

fact that the conceptual underpinning that serves to support it has a relatively solid logical articulation and, secondly, of the fact that the basic information for estimating the poverty line is available in an increasing number of countries which have adopted regular household surveys as instruments for the systematic collection of data on household incomes. Nevertheless, for reasons which we shall discuss below, the measurements obtained by this method are not enough to distinguish poverty caused by temporary business conditions from the other kind of poverty which results from the economic or the socio-cultural structure or a combination of both. Thus the total number of households which are below the poverty line includes both the chronic poor and the recent poor.

These notes are intended to explore a new method for approximating the number and nature of the households affected, which would enable us to determine the meaning of poverty as a concept through the differentiation of its more or less permanent manifestations. In this method information on income that is normally collected in household surveys is combined with indicators of the failure to meet basic needs, formulated on the basis of data which are investigated by means of the same instruments.[1]

Our proposal thus has at least two advantages. First, it enables us to differentiate the categories of households suffering from shortages —those in which we find shortages in the satisfaction of basic needs or find insufficient income, or both— a subset of which consists of poor households; in this way it indicates objective groups for whose benefit specific policies helping them to solve their problems should be formulated. Secondly, it enables us to follow the evolution of such categories through an examination of the information contained in regular household surveys.

Among the most significant consequences of the most recent economic crises in the Latin American countries, and particularly in Uruguay, are the processes of downward mobility. This is why we shall first analyse with special attention those situations in which poverty is generated by a decrease in household income. Without prejudice to the foregoing, we also examine the characteristics of the three years from 1984 to 1986, during which those income levels improved.

The basic assumption of this exercise, a discussion of which takes up the next chapter, is that the index of unmet basic needs responds only to very severe deterioration in household income, and the response lags far behind that deterioration. Thus, when an economic crisis impoverishes many households, a large percentage of them will have incomes below the poverty line, but without exhibiting critical shortages in the dimensions of basic needs incorporated into the index. This assumption concerning the time lag of the impact of economic vicissitudes on various characteristics of households enables us to regard some of them as hangovers from the past, and therefore to formulate hypotheses concerning the direction of the social mobility experienced by the household.

I

The index of unmet basic needs

The annexed diagram shows the indicators selected for constructing the index. These are strongly skewed towards shortcomings in housing and in the support infrastructure for its functioning. The bias was not intentional but resulted from the type of information furnished by the conventional instruments used for the massive and systematic collection of data in Uruguay (censuses and household surveys), whose permanent purpose is not that of investigating how well households meet such fundamental needs as food and health. The index incorporates in the category of "unmet basic

[1] Detailed descriptions of the processes used for selecting these indicators are given in separate documents prepared by the ECLAC Office at Montevideo, one of them in collaboration with the General Directorate of Statistics and Censuses of Uruguay. (See ECLAC and ECLAC-DGEC.)

Diagram

BASIC NEEDS, DIMENSIONS FOR MEASURING THEM AND INDICATORS OF CRITICAL DEPRIVATION

Basic need	Dimensions	Indicators of critical deprivation
1. Housing and minimum domestic equipment needed for the household.	• Type of dwelling.	• Households living in rented dwellings, huts, houses built from discarded materials and types of dwellings whose walls are not made of masonry.
	• Overcrowding.	• More than two persons per room.
2. Infrastructure that will guarantee minimum sanitary standards.	• Availability of drinking water.	• Households which use water from cisterns, wells, streams and brooks for drinking and cooking.
	• Type of system for the elimination of human wastes.	• Households with no bathrooms or with a waste elimination system classified in the category of "others" with respect to this variable. Shared by three or more persons in the household.
3. Access to educational services.	• School attendance.	• With the presence of children from 6 to 12 years of age who have stopped attending school or have never attended.
4. Subsistence capacity of the household.	• Heads of household who have dependants and insufficient educational levels.	• Heads of household 44 years old or younger who did not complete primary school and those 45 years old or older with 0 to 2 years of formal education, in households with more than three persons per wage earner.

needs" those households which are unable to take care of all the needs under consideration. The undemanding nature of this criterion was compensated by using such procedures for the selection of indicators as would guarantee the criticality of each of these shortages.

One of the consequences of the aforementioned bias is that the index tends to reflect aspects of the household's living conditions which are more permanent than those reflected by income in household surveys.

The poverty line is calculated on the basis of the income levels necessary to cover the cost of a basic consumer basket. We then deduce that when a household's income decreases below this line, all or some of its members will necessarily suffer from one or more critical shortages. In the face of this situation, the household must define priorities, ordering its needs and the means for satisfying them in accordance with the decision-makers' perception of the relative costs of the changes in each of these satisfying means, which ultimately reflects the relative importance assigned to them by the household.

The index of unmet basic needs relates to a very limited fringe of the spectrum of needs that are taken care of by the contents of our basic consumer basket; consequently, rising above or falling below the poverty line need not be reflected in changes in the satisfying means covered by the index. The income elasticity of the satisfying means selected in comparison with that of the other satisfying means for basic needs will be greater or smaller, depending on the priority given them as a factor of adjustment to the new situation and, on the other hand, the greater or lesser immediacy of the changes in each satisfying means, once the decision to change them has been taken.

In the consideration of the income elasticity of the indicators related to the dwelling, we must emphasize the central role played by the dwelling and its territorial location as symbols of belonging to a specific social stratum. It should also be taken into account that length of residence in the household's present home is associated with the degree of integration into the local community, with the existence of personal

links with neighbours, with a knowledge of the forms of access to various types of services and with the intensity of feelings of identity and belonging. This explains the resistance normally provoked by changes in domicile, especially when these represent a downward movement in the scale of local prestige.

One of the possible responses to a deterioration in income is a move to a dwelling which is less desirable with respect to location, quality of structural materials, overcrowding, drinking water and forms of access to and suitability of sanitary services. Nevertheless, in the light of the foregoing, we may conjecture that it would take a very sharp drop in household income and a very prolonged situation of economic shortage to overcome the social inertia that results from being rooted in a dwelling of a specific level.

Among the alternative responses that may affect the dimensions of satisfaction mentioned above is the freezing of any investment for the maintenance of the dwelling, which probably causes a significant deterioration in its quality, even though this will become perceptible only in the long term. Similarly, it may be decided that no investments will be made to adapt the dwelling to changes in household size that result from different cycles in family life, and this could eventually result in overcrowding. But since the increase in household size need not coincide with the period of deterioration of income —something which is more likely to decrease the birth rate— the association between the two variables will be visible only in the medium or long term. Lastly, there is the alternative of subletting part of the dwelling, with loss of privacy and comfort, greater density of occupancy, etc.; this is the only response that can be reflected in short-term deterioration in the dimensions of satisfaction considered in the index.

To sum up, it is probable that in the short term the indicators of unmet basic needs related to housing will exhibit a trajectory apparently independent of the variations in per capita income when the household falls below the poverty line. This implies that the manifestation of the effects of the new economic situation lags behind housing conditions, which respond to the combined influence of social and cultural factors.

The other two indicators which make up the index —school attendance and subsistence capacity— are also relatively independent of a deterioration in the economic situation that brings the household below the poverty line. In the first case, parents who have become accustomed to sending their children to school and have built up expectations concerning the children's future on the basis of education will renounce these expectations only in extreme economic circumstances. This is particularly true in a country such as Uruguay, where education is a priority value within the predominant cultural pattern and where there is an extensive system of free public education.

With regard to subsistence capacity, let us recall that the indicator defines as cases of critical shortage those cases in which the head of the household is less than 45 years old and has not completed his primary education, or is 45 years or older and has less than two years of primary education, and in which the ratio of wage earners or unpaid family workers to the total number of household members is less than 1/3. Since the educational status of the head of a household is not affected by a drop in household income, this indicator is, to some extent, independent of the change in a household from a non-poor to a poor condition.

It can be asserted, therefore, that the critical shortages incorporated into the index of unmet basic needs do not function, at least in the short term, as an adjustment variable in the face of the forced reduction of expenditures that must be experienced by households that fall below the poverty line. Undoubtedly they will suffer a lack in the coverage of some basic needs of the household members. But the first needs affected in the unavoidable process of expenditure reduction will be other needs, not those met by the selected indicators.

II

Estimation of the number of households below the poverty line

1. *Methodology used in constructing the poverty line*

The poverty lines utilized here result from the application of the method based on food. This consists in estimating the cost of a food basket that will "adequately" cover the minimum nutritional needs of the population and then multiplying that cost by the reciprocal of the fraction of total expenditures represented by food expenditures, calculated on the basis of those households whose food expenditures are somewhat higher than the estimated minimum budget needed to meet the aforementioned nutritional needs.

The food basket corresponds, with a minor adjustment, to the one defined by Altimir (1979), which, according to that author, was estimated "...on predominantly normative bases, even though account was taken of the relative availability of foods and the consumption habits in each country".

On the basis of this basket, expressed in grams per person per day for each type of food, we calculated the individual needs per month, and we then evaluated them at the average market price for each month. Such market prices are representative of those charged in Montevideo in the market of final consumption (prices to the consumer), and the great majority of them correspond to the average prices used by the General Directorate of Statistics and Censuses for calculating the Consumer Price Index and published together with it.

With respect to the significance of food expenditures as a fraction of total expenditures —which include housing and all consumer expenditures— we considered the value used by Altimir (50%). Consequently the food expenditure was multiplied by 2 to obtain its equivalent in total expenditures.

With the above-described method, we estimated the per capita values of the poverty line for October 1984 and for October 1986; the values were found to be N$2 754 and N$9 607, respectively.

2. *The stability of household income*

In order to determine whether or not a household is in a poverty situation, we compare the monthly income per member of the household with the value, at market prices, of monthly needs per person, as established by the poverty lines.

The amounts of income considered in defining the position of the household with respect to the poverty line are those for the month preceding the time of the interview. Accordingly, the poverty or non-poverty of the household in question is defined only with respect to this period. Any attempt to investigate more permanent economic situations of households runs into the limitations of the information collected by the continuing survey, which was not designed to cover long periods of reference. One month is the period for which most of the sources of income considered in the survey were investigated (the earnings in cash and in kind of labourers and office workers, members of production co-operatives, self-employed persons, employers, retired persons and pensioners, in addition to subsidies, fellowships, grants and rents). An exception is constituted by special gratuities, prizes and profit shares, which are declared on a quarterly basis, and interests, cash dividends, and royalties on patents and copyrights, for which the income received during the year prior to the interview is investigated. These latter sources, however, are of little significance for households which are on the verge of the poverty line.

To sum up, the household incomes used here are sensitive to variations caused by temporary conditions of the economy and the labour market, and consequently they do not enable us to distinguish whether the inadequacy of resources experienced by a household is permanent or transient in nature.

III

Tentative classification of households according to income and critical shortages

In this chapter we shall analyse the categories arising from the cross-linking of low income and critical deprivation, as well as the results of their application to the data of the permanent household survey for Montevideo, recorded for the second halves of 1984 and 1986.

The following double-entry diagram defines the types of households involved.

The relative weight of each of these types in the total number of households is shown in table 1.

	Incomes below the poverty line	Incomes equal to or above the poverty line
Al least one critical shortage	Households in a situation of chronic poverty	Households with inertial shortages
No critical shortages	Households in a situation of recent poverty	Househols in a condition of social integration

1. *Households in a condition of social integration*

In this category we included those households whose per capita income exceeds the amount required to cover the cost of a basic consumer basket and which have no critical shortages in the dimensions of the needs considered. Obviously this situation defines conditions which are necessary but not sufficient for effective integration of the household and its members into society. By reason of the relative numerical weight of this group and its influence in the functioning of society, its living conditions define the standards of what is understood as a dignified level for the entire population.

Between 1984 and 1986 the share represented by this category increased by 4.2% (table 1), unquestionably as a consequence of the economic recovery and the improvement in real salary experienced by Uruguay during these three years. Contributions to this increment were made by all of the other categories, but particularly by the category of households in a situation of recent poverty. The share represented by this category decreased by 3.3%, leaving only 0.9% as the contribution of the other two categories. This is consistent with the fact that while the percentage of households below the poverty line decreased by 4.1% (representing one fifth of the original value), the percentage of those with critical shortages decreased by only 0.9% (8.1% of the value observed in 1984).

Table 2 shows the aggregate profiles of each type of household for a series of indicators linked to the demographic, employment and social-marginalization characteristics of the heads of household. Households which are socially integrated are clearly distinguished from the rest by the fact that the heads of these households are

Table 1

MONTEVIDEO: DISTRIBUTION OF HOUSEHOLDS ACCORDING TO TYPOLOGY, SECOND HALVES OF 1984 AND 1986

(Percentages of total number of households)

	1984	1986
(a) Households in a condition of social integration	76.0	80.2
(b) Households in a situation of chronic poverty	7.5	6.7
(c) Households in a situation of recent poverty	13.0	9.7
(d) Households with inertial shortages	3.6	3.5
	100	100
Percentage of households below the poverty line	20.5	16.4
Percentage of households with at least one critical shortage	11.1	10.2

Source: ECLAC, prepared on the basis of data of the *Continuing Survey of Households*, General Directorate of Statistics and Censuses.

Table 2

MONTEVIDEO: SOCIO-DEMOGRAPHIC PROFILES OF HOUSEHOLDS ACCORDING TO CATEGORY: 1984 AND 1986[a]

(Percentages of the total for each category)

Characteristics of the heads of household	Chronic poor		Recent poor		Inertial shortages		Integrated		Total	
	1984	1986	1984	1986	1984	1986	1984	1986	1984	1986
Demographic										
— Average age (years)	43.0	43.8	49.6	49.3	48.4	48.7	54.7	53.9	52.9	52.6
— 60 years or older	12.1	14.3	30.8	30.2	28.4	25.2	40.5	38.5	36.7	35.6
— Retired persons and pensioners among those who are 60 years of age or older	95.9	69.8	83.8	80.1	56.2	71.8	76.5	76.9	78.7	77.0
— Women	17.5	16.7	21.2	21.0	13.0	21.3	24.9	24.3	23.4	23.3
Employment										
— Unemployed	6.8	6.3	7.2	5.1	1.8	1.9	3.0	1.6	3.8	2.3
— Employers	0.7	1.7	0.7	2.3	2.3	8.5	8.9	9.9	6.8	10.8
— Self-employed but without business premises	13.8	16.7	13.8	20.0	7.0	5.9	6.5	5.6	7.5	7.9
Social marginalization										
— Did not complete elementary school	43.5	43.7	30.5	27.9	39.1	39.4	21.4	17.7	24.9	21.2
— Unmarried cohabitation couples	25.4	23.7	9.9	11.2	10.1	21.0	3.5	4.2	6.5	6.9
— Squatters and *de facto* occupants	35.3	31.2	10.1	12.5	19.6	15.4	6.1	8.8	10.7	10.7
— Owners	19.2	27.2	33.8	31.1	40.2	46.3	67.3	65.4	58.4	58.7
— Income per person	1 626	5 804	2 051	7 333	4 787	17 022	7 621	26 368	6 348	22 828

Source: ECLAC, on the basis of data from the *Continuous Household Survey* of the General Directorate of Statistics and Censuses.
[a] Second half of each year.

older and —possibly as a result of this— there is a larger percentage of female heads of household. In addition, they include a larger proportion of employers and entrepreneurs and a correspondingly smaller percentage of marginal positions in the labour market, as is often the case with self-employed persons who have no workplace of their own. But the most marked differences are found in the specifically social sphere. The percentage represented by marginal forms of cohabitation and of occupancy of dwellings is much lower than in the other categories, and there is also a clear difference in the proportion of heads of household who have not completed their elementary education.

2. *Households with inertial shortages*

This category includes those households which exhibit one or more critical shortages in the dimensions considered, even though they have declared a per capita income that places them above the poverty line. Their percentage representation among all households is low (approximately 3.5%) and does not show any substantial variation between 1984 and 1986 (table 1).

It has already been stated that the income per household member provides a picture of the situation at the time when the data are collected, while the index of unmet basic needs, in the light of the inherent inertia of the cultural factors associated with each of the indicators that make it up, includes some important keys to the social history of the households, their successes and failures in previous efforts to accumulate material wealth or human resources. It should be added that the existence of critical shortages in these households is a hangover from an earlier poverty situation, which lasted long enough to accustom the household members to a life style marked by such deficiencies.

The low relative significance of this group of households is consistent with the basic character

of the needs selected, whose source of legitimacy lies in the social standards that predominate in Uruguayan society. Thus, the shortages suffered by this group may be interpreted in terms of the time required to adapt the allocation of the principal resources of the household to the general patterns of consumption. In support of this hypothesis, it can be argued that the change in some of the critical shortages usually presupposes some degree of security with regard to the expectation that the household will continue to earn an income beyond the minimum required to cover a basic consumer basket for a period sufficiently long to justify the commitment of expenditures designed, for example, to improve the livability and infrastructure of the dwelling. However, it is also valid to assume a more pessimistic view of the possibilities of a conceivable adjustment between income and shortages, proceeding from the assumption that there will persist certain residues of a "poverty culture" which does not adopt the priorities of the dominant pattern and therefore does not regard as critical the needs incorporated into the index.

The average per capita income of the households in this category is almost three times the value for the "chronic poor" and more than double the value for the "recent poor", both in 1984 and in 1986 (table 2). This means that there is no problem about the measurement of incomes; if this group had been only slightly above the poverty line, there would have been reason to suspect biases that would place it below that line as a result of errors not due to the sample.

An interesting way to gain a better understanding of the peculiarities of these households may be found in a comparison with the profiles of critical shortages of the other group —the chronic poor— that exhibits unmet basic needs. The difference between the two with regard to the level of failure to meet basic needs is very sharply marked (table 3). Most of the households with inertial shortages exhibit a deficiency in only one of the dimensions considered; this in sharp contrast to the situation of the "chronic poor", where the failure to meet basic needs forms part of a syndrome that covers several dimensions of living conditions at the same time. The households which suffer from

Table 3

MONTEVIDEO: HOUSEHOLDS WHICH EXHIBIT ONLY ONE SHORTAGE, 1984 AND 1986[a]

(Percentages of the total number in each category represented by the number suffering from this shortage)

Type of shortage	Chronic poor		Inertial shortages	
	1984	1986	1984	1986
Overcrowding	41.0	38.8	76.4	74.1
Water	32.6	35.6	74.4	69.2
Dwelling	42.2	32.1	77.5	79.7
Sanitary services	16.2	23.7	75.5	61.2
Subsistence capacity	23.5	27.3	91.7	80.0
School attendance	33.3	35.7	90.0	72.7

Source: ECLAC prepared on the basis of data from the *Continuous Household Survey* of the General Directorate of Statistics and Censuses.

[a] For the total number of households with a specific shortage, whether it occurs alone or in combination with others, we calculate the percentage of the latter for each of the two types of households with critical shortages.

Table 4

MONTEVIDEO: HOUSEHOLDS WITH UNMET BASIC NEEDS ACCORDING TO INDICATORS OF CRITICAL SHORTAGES, 1984 AND 1986[a]

(Percentages of the total number of households with unmet basic needs)[b]

Type of unmet basic need (UBN)	Inertial shortages		Chronic poor	
	1984	1986	1984	1986
Overcrowding	18.9	24.1	81.1	75.9
Water	37.1	33.0	62.9	67.0
Dwelling	38.5	48.5	61.5	51.5
Subsistence capacity	19.0	18.5	81.0	81.5
School attendance	21.7	20.8	78.3	79.2
Sanitary services	33.1	33.6	66.9	66.4
Total number of households with UBN	37.7	40.4	62.3	59.6

Source: ECLAC prepared on the basis of data from the *Continuous Household Survey* of the General Directorate of Statistics and Censuses.

[a] Second half of each year.

[b] For the total number of households with a specific shortage, whether it is found alone or in combination with others, we calculate the percentage of such households for each of the two categories which suffer from the critical deprivations considered.

inertial shortages could no doubt be helped by the implementation of *ad hoc* policies relating to specific aspects of the situation; obviously, however, this is not true of the "chronic poor".

The analysis of the information contained in table 4 enables us to infer what are the shortages in which each of these two types of household has been over-represented in the universe of households with unmet basic needs. Those which suffer from inertial shortages are clearly under-represented in the indicators which relate to the size of the household (overcrowding) and to the presence of children (school attendance and subsistence capacity), while they are close to their proper representation in those indicators which relate directly to the quality of the dwelling's infrastructure. It is useful to compare these data with those found from a comparison of the profiles shown in table 2. These indicate that the heads of households which have inertial shortages are, on average, older and better integrated into the labour market. In fact, among these we find a much lower rate of unemployment and a lower frequency of marginal positions in the labour market (self-employed workers without their own business premises) and a significantly greater percentage of employers. However, this is the type of household which is closest to the type represented by the chronic poor with regard to the indicators linked to social marginality (percentage of heads of household who have not completed their elementary education, percentage of cohabitation without marriage and of squatters and *de facto* occupants in the total number of households).

In the light of all of the foregoing, we conclude that one of the typical features of households with inertial shortages would be a history of poverty, during which the members of the household have formed values and habits which control the allocation of the household's resources in a way which is different from the patterns of consumption predominant in Montevideo society. Part of this history has been a consequence of the cost of social reproduction. In the stage of the life cycle which we are considering, children would already have entered economically active life or would have formed their own households, a fact which explains the under-representation of this group in the indicators of overcrowding, subsistence capacity and school attendance. Lastly, for reasons which cannot be identified from the available data, the profile of the position of the heads of these households in the labour market is closer to that of the heads of households which have sunk into poverty.

3. *Households in a situation of chronic poverty*

This category includes those households which are below the poverty line and which exhibit one or more critical shortages. In 1984 they constituted 7.5% of the total number of households in Montevideo, but three years later this percentage had decreased to 6.7% (table 1), thanks to the resurgence experienced by the Uruguayan economy about the middle of the decade.

In the specialized literature emphasis has been placed on the fact that these households constitute the core of poverty. From the point of view of the proposed typology, a basic characteristic of this category is the existence of conditions favourable to the activation of mechanisms which perpetuate poverty. No doubt there are subjective elements participating in this process. We are speaking of those mental attitudes of the household members which have to do with values, expectations and activities associated with fatalism, discouragement, apathy and lack of confidence that effort will bring any reward in the form of significant achievement. These elements are transmitted from generation to generation through the socializing practices of the families (and in some cases through those of the neighbourhood context) and are continually reinforced by experience throughout the life cycle of the household members, in a perverse process which gradually reduces the possibility of the household's working its way up from poverty.

The elements of information available to support the presumed existence of the conditions favourable to the activation of mechanisms which reproduce poverty are derived, in the first place, from the very definition of this group, which refers to insufficient income to cover basic needs and

simultaneously to critical shortages in the dimensions considered. At the same time, the fact that households with only one shortage constitute only a minority of these households reveals the existence of a situational syndrome of complementary deprivations. We see that when a household's unmet basic needs are classified according to type of shortage, the chronic poor appear to be over-represented in those shortages —overcrowding, failure to attend school and subsistence capacity— which are found in the stages of the life cycle of the families that should, at least from the normative point of view, be dominated by the function of social reproduction (table 4). The above-mentioned shortages justifiably emphasize the lack of socializing capacity of these households, which is reflected in the inadequate preparation of a new generation for effective participation and positive integration into society.

A comparative examination of the profiles of these four categories confirms the conclusion that households which have sunk into chronic poverty are noteworthy for their indicators of employment insecurity, and particularly of social marginality (a high percentage of heads of households who have not completed elementary school, cohabitation without marriage and insecure occupancy of the dwelling).

4. *Households in a situation of recent poverty*

This category includes those households which have a per capita income below the poverty line but which do not exhibit any shortages in the dimensions of basic needs under consideration. Their significance in Montevideo has decreased from 13% in 1984 to 9.7% in 1986 (table 1).

The basic assumption in the design of the typology is that those indicators of the capacity to meet basic needs which are incorporated into the index show a certain inflexibility with respect to the changes in the economic situation of the households, and to that extent, they provide important information concerning the previous living conditions of these households. The discrepancy between inadequate income and lack of critical shortages (the ones measured by the index), which is characteristic of this category, seems to reveal a process of downward mobility.

When the reduction in income has been recent, it does not appear to be reflected in any visible deterioration of the dimensions of the household's living conditions that are considered in the index, which would have a relatively low priority and/or greater mediacy in the processes of restructuring of the consumption patterns forced upon the household by the new economic deprivations.

A comparative examination of the profile of this group with that of the other categories that suffer from deprivation (the "chronic poor" and those with "inertial shortages") offers some support for the assumption of downward mobility. Indeed, while this group resembles the "chronic poor" in having indicators which reveal an insecure position in the labour market, it clearly exhibits its own profile with regard to the indicators of social marginality. Thus, with regard to the educational level of the head of the household, it lies closer to the national average than the other two categories. With regard to the legitimacy of the conjugal union, a variable which is often associated with instability of the couple and hence with the situation of the children, the 1984 data show that the "recent poor" are clearly different from the "chronic poor", but not so clearly from those who suffer "inertial shortages", being sharply distinguished from the latter only in 1986. At the same time, within this category the percentage of households with unstable forms of occupancy of the dwelling is clearly lower in both years than the level prevailing in the other groups that suffer from such deprivations (table 2).

To sum up, an analysis of the profile of the "recent poor" is consistent with the hypothesis of downward mobility. Unlike the "chronic poor", these households seem far removed from the syndrome that perpetuates poverty, and therefore they are better prepared to improve their situation when general economic conditions become more favourable.

IV

Conclusions

First of all, we must bear in mind that the results of this exercise are intended only to serve as a guide for the formulation of a hypothesis with respect both to the specific nature of the households included in each category and to the validity and the analytical and practical usefulness of the typology outlined. Any attempt to test the assertions relating to each of these types must be based on the evidence provided by instruments deliberately conceived for that purpose, which will make possible a thorough investigation of the households defined by the combination of poverty and specific shortages. This warning at the outset is intended to alert the reader to the tentative nature of the following conclusions on the recent evolution of poverty in Montevideo and the usefulness of the proposed typology.

Between the second half of 1984 and the second half of 1986, the relative share of Montevideo households represented by those below the poverty line was reduced by 20%. This evident improvement in the people's socioeconomic conditions is consistent with the data on the general evolution of the economy, in particular the data on the increase in real wages and the decrease in the rate of unemployment during this period.

—The poor in 1984 were mostly "recent" poor. A high percentage of these households had experienced a severe decrease in income during the crisis, which, although it was part of a long-term process of stagnation, became much worse beginning in mid-1982. The subsequent process of downward mobility increased the number of those households that were below the poverty line, but it also modified the profiles of poverty. Thus, 10% of the poor detected by Altimir (1979) in Montevideo, with data from about 1970, unquestionably included households whose social and cultural conditions were different from those exhibited by the households which, in larger numbers, made up these same categories 14 years later.[2] In 1984, households in a situation of chronic poverty represented little more than one third of the total number of poor households.

—The clearly differentiated profiles of the two categories suggested that the socioeconomic reactivation would have a greater impact on the situation of the "recent poor" than on that of the "chronic poor". This was in fact the case, as can be seen in table 1. Thus, approximately 80% of the reduction in poverty during this period was the result of a transfer from the category of "households in a situation of recent poverty" to the category of "households in a condition of social integration". In contrast, the macroeconomic changes did not bring any significant alteration in chronic poverty, which was reduced from 7.5% to 6.7%.

—Thus we see clearly the different kinds of impact produced on poverty by different types of public policy. On the one hand, certain categories of households —predominantly among the poor of Montevideo— seem to respond in the expected manner to a general policy of reactivation, with increases in real wages and the generation of employment. This does not happen with the households whose situation is determined by material and non-material conditions that continuously feed the mechanisms that perpetuate poverty. It is thus necessary to design and apply a set of policies that will proceed from the understanding that chronic poverty reflects a situational syndrome and not a mere circumstantial insufficiency of monetary resources, so that it must be attacked

[2]The estimates of the percentages of households below the poverty line about the year 1970 and in 1984 are not strictly comparable, owing to the fact that in the first case the income of households had to be corrected for under-declaration. The results observed on the basis of various hypotheses relating to income correction for 1984, not presented here, also indicate in all cases an increase in the number of poor households, although not an increase of such magnitude as is shown here. In any case, there is no reason to suppose that the level of under-estimation in 1984 was different from that in 1986, so that it is still valid to assert that during this period poverty diminished by 20%. Lastly, let us recall that the main point of this exercise is the usefulness of classification into poor and non-poor households when we combine this with the classification that relates to critical shortages.

with a global and not a specific approach. Such policies will inevitably be aimed most particularly at preventing the destiny of children and young people from being caught in the coils of the generational reproduction of poverty.

—Lastly, the households with "inertial shortages", which exhibit deprivations much more specific than those of the "chronic poor", linked in particular with housing, would derive much more benefit than the other groups from the localized policies that provide support (such as credit support, for example) for adapting living conditions to the household's income, which, while situated above the poverty line, may often be insufficient to generate any capacity for savings. Policies tending to ensure the stability of the household's new income situation tend to operate in the same direction.

—To sum up, this typology attempts to reveal the heterogeneity of poverty, distinguishing categories of households which require different kinds of policies to remedy the deprivations they are suffering from. Parallel with this, since the typology is constructed on the basis of the information collected periodically by the Continuing Household Survey, it constitutes an easily accessible instrument for following the evolution of households that suffer deprivations, for evaluating the seriousness of the shortages suffered by those households and for formulating more exact diagnoses concerning poverty.

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Conceptual aspects of privatization

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The process of privatization has an impact on various macroeconomic variables. This article presents an analytical framework for studying that impact: it is a conceptual study which can be applied to different actual situations.

Among the possible effects of a privatization process, the first to be analysed are those concerning the national product, a distinction being drawn between the effect on transfers of funds and the static and dynamic effects on efficiency. The impact of privatization on income distribution is then considered. Finally, an analysis is made of the question of the proper price of the goods to be privatized, the issue of whether the leading agent should be public or private, national or foreign, and the problem of the operations of monopolic or monopsonic enterprises.

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This memo explores a series of concepts that, in the author's opinion, are likely to be central in any appraisal of a proposed programme of privatization. The principal issues, as we shall see, sometimes involve questions of theory; but more often they are empirical in nature, turning on questions of fact and forecast.

I

Possible effects of privatization

1. *Output effects*

Perhaps the most comprehensive question that can be asked with respect to a proposed programme of privatization is its likely effect on national output.[1]

Privatization can be thought of as having two principal consequences that directly affect national output:

a) It transfers financial assets from the private sector to the public sector;

b) It transfers the ownership (and presumably control) of enterprises from the public sector to the private sector.

Factor a): the transfer-of-funds effect. What has driven most governments to consider programmes of privatization has been the hoped-for transfer of funds from the private sector to the public sector. The fact that so many governments have responded urgently to that stimulus, however, tells us very little about the consequences of the shift upon output. It we attempt to estimate the output effects of factor a), the transfer-of-funds effect, it becomes evident that effects upon output depend on a number of critical assumptions about the *size*, the *origins*, and the *disposition* of the transferred funds.

[1] L.P. Jones, Pankaj Tanden and Ingo Vogelsang, *The Economics of Divestiture*, published in 1988, presents an approach to that question. The approach is deeply flawed in some critical respects, partly because it cannot be implemented in practical terms. But it is useful in exposing and articulating some of the underlying judgements that are implicit in privatization exercises.

The *size* of the shift in funds is determined, of course, by the amounts paid by the private sector for the equity it receives. Economists have sometimes argued that if the private sector is charged appropriately for the equity it receives, the shift of funds to the government should be no more than the government could acquire in an efficient market through government borrowing. That position begs some questions, such as whether an efficient market exists, capable of fixing an appropriate price for the government's assets. And it bypasses others, such as whether the firms' assets in private hands would subsequently be more profitable than if they had remained in the government's hands. As we shall presently see, these are not trivial questions. In any event, we shall be returning to the question of the size of the payments by the private sector in a number of different contexts below.

The *origin* of the transferred funds also determines their output effects. If the funds paid to the government are diverted from domestic private capital investment or from domestic private consumption, the depressing effects on private output associated with the transfer of the funds needs to be taken into account. On the other hand, if the funds are brought in from abroad or if they are diverted from capital flight that might otherwise occur, their effects could be expansionary in the short run through an increase in the supply of money and a decline in interest rates. (Secondary effects are more complex, because the tendency of such funds to stiffen the exchange rate would have to be taken into account.) This element of the analysis, therefore, depends critically on questions of fact which are difficult to ascertain.

As to the *disposition* of the funds received by the government, the output effects would be very different if the funds were used, say, for the reduction of government debt than if used for the improvement of roads and very different again if used to expand the consumption of the poor. A reduction in debt could offset the deflationary impact induced by "crowding out" private investment, while investment in roads could conceivably break bottlenecks that had previously reduced output. Once again, questions of fact dominate the analyses.

Factor b): the efficiency effect. Turning to factor b), the problem is to estimate the static and dynamic effects on efficiency of a transfer from public to private ownership.

It is common practice in developing countries to ask a rather different question regarding State-owned enterprises, almost as if it were a surrogate for the efficiency factor: namely, the question of the size of the cash drain on the public sector generated by such enterprises. It may seem unnecessary to point out that in the circumstances of developing countries, the two questions are imperfectly related. Efficiency is measured not only in money terms but in "real" terms —the "real" output achieved by given "real" inputs, with the inputs being combined at their "real" opportunity costs. Moreover, efficiency is a concept that is independent of the identity of the party receiving its benefits: an increase in efficiency depends on aggregate output, whether in the end that output benefits government, labour, rentiers, consumers, or thieves. The cash drain, on the other hand, depends on the prices paid to capital, labour, and material inputs and the prices charged for final output, all of which are highly manipulated figures in the circumstances of most developing countries. Labour income in State-owned monopoly enterprises, for instance, commonly captures some of the rent generated by the monopolies, not only through high wages but also through a swollen labour force. And consumers are commonly subsidized through price structure that are not expected to recover the real costs.

The problem of measuring the efficiency effects associated with a transfer of ownership is complicated by the fact that such a transfer could have dynamic consequences not readily captured in data on current outputs. The shift from public to private ownership is presumably a long-term decision, affecting the firm for the rest of its existence. That shift could affect all relevant parties in ways that could have a considerable long-term impact on efficiency. Managerial decisions could change with respect to choices of process and product, rates of reinvestment, and physical conditions in the work place. Labour could be affected through changes in the work ethic or in contractual relations to management.

The government itself could be affected in terms of its preferred forms of regulation and supervision. Indeed, political arguments in favour of privatization commonly rest on the assumption —untested as a rule, and difficult to test in any case— that the dynamic efficiency effects will be positive and substantial, offsetting any short-run adverse effects. In so far as any single issue dominates the decision whether to privatize, this issue is probably it.

The argument for privatization, however, is not always based on such sweeping generalizations. In some cases, the expectation of an efficiency increase is based on assumptions that privatization will overcome the adverse effects of some specific inefficiencies in factor markets. In some developing countries, for instance, it is believed that there is managerial and technical talent in the private sector that cannot easily be recruited for State-owned enterprises. The barrier to such recruitment may be based on regulation, such as the level of salaries available in the public sector; it may be racial, as in the case of many African countries that refuse to hire expatriate labour for State-owned enterprises; or it may even be cultural, as in the case of some Latin American countries, where managers in some classes of society are reluctant to work for the State. Distortions in the wage levels and in the costs of capital are also thought to hamper efficiency. Managers of State-owned enterprises, for instance, usually find capital relatively cheap (or even costless) and labour relatively dear, pushing them toward technologies that are less efficient than those the private sector would select.

However, to make any serious exploration of the efficiency effects, static or dynamic, it will be necessary to draw careful distinctions between various kinds of industry. At a minimum, it will be necessary to distinguish between industries with different types of market structure: natural monopolies; oligopolies; and competitive structures.

In the case of *natural monopolies*, if a shift to private ownership takes place, some form of public regulation will presumably be maintained. Estimates of the efficiency effects must therefore make assumptions as to the character of that regulation. If a pattern of regulation existed prior to the ownership, it conceivably might remain unchanged. Nevertheless, even if no change occurs, the managers of the monopoly might respond differently, reflecting the interests of their new owners. They might push more assiduously for rate increases, bargain harder with labour, or resist more energetically proposals for cross-subsidization. If any of these changed managerial responses do occur, what will be their implications for efficiency?

The possibility that patterns of regulation might be altered with a shift to private ownership would also need exploring. In what respects will such patterns change, and with what implications for efficiency?

The *oligopoly* case, common in developing countries, is even more complex than that of the natural monopoly. One possibility, already encountered in some privatization projects, is that the proposed buyers of the State-owned enterprise are private-sector competitors eager to reduce the competition in national markets. In an industry whose firms could reduce their unit costs through higher volumes, a merger could increase the industry's efficiency in the short run by allowing for the greater exploitation of scale economies, while at the same time reducing efficiency in the long term through a loss of positive dynamic effects. Another case, also drawn from actual experience in developing countries, is one in which the private-sector oligopolist tries to capture an upstream facility hitherto in State hands, in order to acquire a competitive advantage over private competitors downstream who have been drawing their supplies from the upstream facility. In such cases, tracing the efficiency effects can prove extraordinarily complex; while the new vertical links can improve the efficiency of the dominant enterprise, the increased capacity of that enterprise for controlling its competitors could have the opposite effect. Once again, the critical questions are empirical.

In most developing countries, oligopolistically structured industries are the object of some regulation by governments, often through price and wage controls. Estimates of dynamic efficiency effects, therefore, often require some guesses about the future shape of government regulation, similar in character to the questions asked with regard to the regulation of natural monopolies. It is commonly assumed that government regulation would be less pervasive

in those industries if private ownership were more dominant; but that is only a guess. It is also often assumed that oligopolies unhampered by government regulation would be more efficient in both the static and dynamic dimensions than those exposed to such regulation. All such issues deserve much closer analysis, applying measures of efficiency that are technically defensible.

The *prima facie* case for expecting an increase in efficiency as a result of privatization is strongest where *workable competition* exists in a market and is likely to continue to exist after the sale of the State-owned enterprise. In such circumstances, it is a reasonable starting assumption that the private firms in the market are under stronger compulsions for efficient operation than the State-owned enterprises. Indeed, there is already some empirical support for that conclusion.[2] But even this category of cases has not been adequately explored and would require much more investigation before one could be reasonably sure that the *prima facie* assumption was well supported by the evidence.

2. *Effects on income distribution*

As usual, there is a conflict between questions of economic growth and issues of income distribution in any effort to define optimal policy; this is as true of privatization policy as of any other issue relating to economic development. Whether it is possible or desirable to combine both sets of considerations in a single social criterion poses some interesting theoretical problems. But they are not problems unique to the issue of privatization.

In any event, any substantial programme of privatization is likely to have significant effects on income distribution. In such cases, various price changes can be expected, usually reflecting a shrinkage in subsidies on some staple consumer items, including transportation, power and foodstuffs. Payrolls are likely to be pared and wages held down. For reasons we shall presently develop, private buyers of the enterprises can be expected to acquire their new investments at windfall prices. At the same time, however, funds will be transferred to the government with unspecified effects on government spending patterns, possibly including effects on the volume of health services, education, and housing delivered to the public.

Generalizing about the income distribution effects of privatization programmes is rendered particularly difficult by the fact that a considerable portion of the subsidies in developing countries is said to go to an urban middle-income group rather than to the poor, and that the labour force of the affected State-owned enterprises is also said to fall primarily in the middle-income group. One cannot assume, therefore, that the changes in subsidies and in payrolls that are expected to accompany privatization primarily affect the income of poor. More empirical work is needed before defensible generalizations can be made. Such generalizations are rendered even more difficult if one tries to go beyond the immediate impact of privatization and tries to trace out long-term distributional effects. Yet such considerations are always implicit or explicit in the decisions of developing countries to support privatization programmes.

II

The right price for privatized property

There is one issue, however, to which governments have given far more attention than it may deserve. This is the question of determining the "right price" for specific offerings.

In the most research on the price issue, the "right price" has usually been implicitly defined as the lowest possible price that the government could charge without exposing itself to the accusation of giving away public assets. Behind that implicit definition lies an ineluctable fact. Whatever the initial motivations of governments may be in launching a privatization programme, once a specific sale is announced the overwhelming

[2]Gabriel Roth, *The Private Provision of Public Services in Developing Countries* (New York: Oxford University Press, 1987); George Yarrow, "Privatization in Theory and Practice", *Economic Policy*, No. 2, April 1986, pp. 323-378.

objective of the government is to ensure that the sale is "successfully" completed. At that late stage, governments are invariably prepared to give up some income from the sale in order to reduce the risk of a "failure" of the offering.

If the objective of governments in privatization projects were simply to maximize social output, they might well be justified in giving away many State-owned enterprises and even subsidizing their transfer. Indeed, if that objective alone were the controlling factor and if one assumed that the efficiency of enterprises usually increased as a result of transfer to the private sector, only one reason would exist for not giving the enterprise away, namely, the possibility that funds shifted from the private to the public sector would add even more to social output. But as we saw earlier, that is no more than a possibility, dependant for its realization on various surrounding conditions. Indeed, one cannot exclude the possibility that the transfer of funds to the public sector would actually reduce social output rather than increase it.

But the objective function of governments includes more than a simple desire to increase output. Governments characteristically place some value on avoiding the appearance of blatant discrimination and on protecting themselves from charges of giving away the national patrimony. With those objectives in mind, governments almost universally reject such possibilities as giving the assets away, or distributing them by lottery, or even selling them to the highest bidder. Instead, they call on advisors to determine a "right price", based upon criteria that will be acceptable to the public, to be used as a basis for sale to the private sector.

In such offerings, one obvious criterion is the value of the State-owned assets to the prospective private buyer. Unless the assets for the sale are priced at levels that are attractive when compared with alternative opportunities, prospective buyers presumably will not buy, but on the other hand, selling far below the prospective buyer's value will open the government to charges of giving away the national patrimony.

Yet, developing criteria for determining the private value of any State-owned enterprise is not easy, for reasons already adumbrated. An enterprise will have different values to different buyers depending on the other interests of the buyer in the national economy. A buyer who hopes to gain control of a competitor through the purchase, for instance, will probably pay more than a buyer who is making a portfolio investment. And when the desired estimates of value are calculated on the basis of different assumptions about the future policies of government, the estimates can also vary enormously, especially in the conditions typically encountered in developing countries. Yet the compelling need to determine a defensible sale price suggests that governments will devote considerable analytical effort to this issue.

III

Old problems in new settings

The principal-agent issue. If there is any issue associated with privatization that invites some hard abstract thinking, it is the question of the relationship of the State-owned enterprise to the government, and particularly whether the State-owned enterprise can fruitfully be thought of as an agent of the State in a sense that distinguishes it from private enterprises.

There are two distinctly different facets of this question.

One of these facets, transcending the privatization issue in importance, is whether it is useful to think of the State as having the attributes of a unitary rational actor, including a definable objective function, or whether instead the State must be thought of as a coalition of interests, each with a distinctly different objective function that cannot be aggregated with the others, so that the idea of maximizing welfare on a national level is meaningless. Economists and

political scientists have occasionally made passes at this difficult issue.[3] But so far, despite its central importance to the State-owned enterprises issue, it remains largely unexplored.

If it is not useful to think of the State as a unitary rational actor, then to what values are State-owned enterprises in theory expected to respond, and how do these differ from the values to which private enterprises are expected to respond?

The issue takes on even greater complexity in the privatization context because so many privatization exercises lead to partial divestiture, producing joint ventures between the public and the private sector. Trying to define the objective function of the principals to which managers should respond in such cases is an overwhelming challenge. Yet it is a challenge that is not easily avoided if one is trying to appraise the consequences of partial privatization.

The same set of issues can also be approached empirically: In what respects do managers of State-owned enterprises actually differ from those of private enterprises in their responses? The question is implicit, of course, in some of the issues already raised in this article including the effects of privatization on efficiency and on income distribution. But raised in this way, the question is likely to lead to a different type of research, much more micro in focus, aimed at generalizing from what will probably in the end be fairly small samples.

One reason why the issue is important is that research on this topic to date suggests the existence of some considerable variations from one national culture to another. In Israel and Italy, for instance, managers of State-owned enterprises appear to respond quite differently from managers in the private sector of their respective economies, yet at the same time, State-owned enterprise managers in those two countries do not appear to have much in common with managers of State-owned enterprises in, say, India or Nigeria.[4] (Indeed, the research so far suggests that the simple dichotomy between managers of State-owned enterprises and managers of private enterprises may prove inadequate for serious research and that breakdowns may be required along various other dimensions, including type of industry and type of manager.)

The foreign investor issue. The process of privatization makes germane once more the question of the effects of foreign investment on developing countries. The issue arises in a number of different variants: in the context of debt-equity swaps; in the context of proposals for joint ventures between State-owned enterprises and foreign enterprises; and in the context of proposals for portfolio investment by foreigners.

There is no lack of literature on the economic and political implications of the consequences of foreign direct and indirect investment in developing countries. Much of the literature on the economic consequences is technically flawed, being more in the nature of polemic than of scholarly research, but in the main, the principal causal chains to be considered in an economic evaluation are reasonably well understood.

The economic advantages of accepting foreign direct or indirect investment are too obvious to require comment. The economic drawbacks that are associated with foreign direct investment in developing countries usually turn around some familiar problems. One of these problems, especially applicable to import-substituting industries, is the fact that domestic markets are often so highly protected as to offer the foreigner the opportunity for monopoly profits. Another is that profits may be siphoned off through transfer prices. And a third is that when profits are repatriated, they may constitute a drain on the economy that exceeds the value of the technology and capital provided by the foreigner. The transfer pricing problems is also applicable to export industries; inputs to the subsidiary and exports by the subsidiary may be priced at levels that generate a net drain on the economy. Apart from these two specific ques-

[3] See for instance Howard Raiffa, "Decision-Making in the State-Owned Enterprise", in Raymond Vernon and Yair Aharoni, (eds.), *State-Owned Enterprise in the Western Economies* (London: Croom-Helm, 1983, pp. 54-62).

[4] The most systematic study of this issue of which I am aware appears in Yair Aharoni, *Managers in the State, Histadrut and Private Sectors in Israel: A Comparative Study*, Research report 53/84 (Tel Aviv: Israel Institute of Business Research, September 1984).

tions, larger researchable issues may be raised, such as the effects of foreign direct investment on choices of product and process, on investment in human resources, and on the propensity to innovate, but the answers are usually inconclusive. Developing countries may be expected to raise these questions in the future, as they have in the past, and despite the voluminousness of past studies on these issues, research that helps to redefine the concepts and methodology by which the required judgements could be made would be well worth undertaking.

Some issues relating to foreign direct investment in the privatization context, however, are quite novel. One of these arises from the fact that some foreign investment is generated through debt-equity swaps. In effect, the government is paid for its equity interest in a State-owned company through the buyer's surrender of some of the external debt of the country in question, such debt being converted at a concessionary rate for the buyer. Organizing the elements in the swap so as to facilitate the government's rational consideration of any proposed deal would be a challenging task well worth addressing.

Another novel issue associated with foreign direct investment in the privatization context arises from the propensity of some State-owned exporters of raw materials to integrate downstream into their principal foreign markets, setting up such downstream facilities in joint ventures with foreigners CODELCO, PDVSA and CVRD are among the growing number of State-owned enterprises that have taken such steps.

The economic consequences of such investments are not simple. The State exporter typically makes a financial investment in the foreign market, entailing some opportunity cost to the government. With that investment, the exporter typically reduces the risk of variability in the foreign demand for its raw material, while reducing at the same time its freedom to charge foreigners what the traffic will bear for that material. Once again, what is needed is a careful mapping of the economic terrain which might serve to guide State-owned enterprises in the making of such investments.

Exploiting monopoly and monopsony. Most privatization programmes in developing countries include proposals to liquidate some State-owned enterprises that were created in the first instance as monopolists in selling or monopsonists in buying some specified commodity for the national economy. The ostensible original reasons for such régimes are of various types. Sometimes their purpose has been to capture some scale economy in export or import, as in transportation of financing; sometimes, to exercise added market power in negotiations with foreigners; and sometimes to perform an excise function, such as collecting an export tax or levying an excise tax on imported sumptuaries such as liquor and tobacco.

The reasons for reconsidering such monopolies are as varied as the reasons for creating them in the first instance. In some cases, governments may have discovered that their original hopes were not realized and that the results being achieved appeared no better than those likely to be achieved without the monopoly. In other cases, the circumstances that originally justified the creation of the monopoly may have changed: increases in volumes of trade may have reduced the need to maintain a monopoly in order to achieve economies of scale; changes in the international market structure (as in the case of oil and copper) may have reduced the gains to be made from exercising monopoly or monopsony power; and improvements in the administrative capabilities of the government may have created alternatives to the monopoly enterprise as a way of levying export or excise taxes. Accordingly, the merits of continuing the monopolies could well have changed.

On the other hand, there is not much indication that governments are rationally attempting to weigh the pros and cons of continuing or terminating their existing monopolies. Systematic explorations of some of these cases could therefore prove useful in guiding government policies.

Recent ECLAC publications

Estudio Económico de América Latina y el Caribe, 1987 (LC/G.1541-P), Santiago, Chile: November 1988 (692 pp.).

This publication is the definitive complete version of the *Economic Survey* for 1987, which appeared in individual fascicles in the course of 1988. It is divided in two parts: the first deals with the economic trends of the region as a whole and the second with the trends of the individual countries.

The first part is primarily an overview of the main trends in the regional economy. A more detailed analysis is then given of trends in the product, employment and unemployment, prices and wages, and the external sector. This part ends with an examination of trends in the external debt and its renegotiation.

The second part contains a detailed analysis of the economic evolution of 20 countries of the region in 1987.

Gestión para el desarrollo de cuencas de alta montaña en la zona andina (LC/G.1533-P), Santiago, Chile: September 1988.

This document is made up of nine studies which analyse the policies and management methods applied for the development of high-mountain riven basins in the following Andean countries: Bolivia, Colombia, Ecuador, Peru and Venezuela.

Together they make up the first serious and exact effort to classify and define the various strategies used by the governments of these five countries to improve the standards of living of high-mountain inhabitants and to conserve the natural resources which support them. The main reference unit for the analysis of the application of these strategies was the corresponding river basin, although other spaces have also been considered such as microregions and politico-administrative divisions.

This document seeks to provide the bases for the creation of a set of theories on management processes for the development of high-mountain river basins and outlines the scope of some particular concepts, including development, regulation, management and protection of river basins, as well as the way these tie in with forms of integrated rural development and regional and microregional development.

The summary of case studies in the last chapter provides concrete information on types of management and on the present situation and development potential of high areas. It also includes references to programmes and projects which are being carried out in the river basins and high areas of the five countries studied.

It is hoped that this document will be useful to those involved in the design of strategies for improving the standard of living of the more than 50 million high-mountain dwellers of Latin America and the Caribbean, as well as in the conservation of their supporting natural resources.

La evolución económica del Japón y su impacto en América Latina ("Estudios e Informes de la CEPAL" series, No. 70, October 1988).

The dynamism of the Japanese economy compels attention both because of the originality of its internal logic and because of its external repercussions.

The purpose of this study is to analyse the most recent processes in the evolution of the Japanese economy and to examine their reciprocal relationships; to determine the degree to which these processes are specifically Japanese and the extent to which they are in harmony with general trends; and to examine their future possible impact on the Latin American economies.

The first chapter examines the adjustments made in the Japanese production and consumption structure after the 1974-1975 crisis; it traces the resulting modifications made in the external sector; it briefly reviews changes to the social structure caused by the economic restructuring; it evaluates the prospects of the structural adjustment to the economy; and, finally, it defines the stimuli generated by this adjustment and transmitted abroad.

The third chapter examines the implications of the Japanese structural changes for the Latin American economies both in the medium and the long term.

Finally, in the conclusions of the study, a summing-up is given and an evaluation is made of the possible place of Japan in the multilateral negotiations on trade in goods and services.

The evolution of the external debt problem in Latin America and the Caribbean ("Estudios e Informes de la CEPAL" series, No. 72, September 1988).

This study analyses and evaluates the international management of the region's external debt problem since 1982 and proposes some solutions.

The first chapter analyses two subperiods: the first, from 1982 to 1984, in which there was organized international management, and the second, from 1985 to 1987, when international co-operation on the matter broke down and gave way to a market menu approach.

In essence, private markets, when left to their own resources, overcome crises very slowly. Consequently, the market menu approach only serves to meet tangential aspects of the problem. It clearly does not attack the macroeconomic core of the problem: how to sustainably and predictably finance the economic reforms and new investments needed by Latin America and the Caribbean in order to start growing now and recover their capacity to service their external debts. Only when this capacity has been recovered will the traditional private investors again begin to place appreciable amounts of capital in countries with

debt problems. The presentation of the menu is undoubtedly a poor substitute for a coherent multilateral initiative capable of liquidating the outstanding debt, which is contributing to the vicious circle of stagnation in the region.

The third chapter suggests options for reducing the burden of the transfer of resources abroad. The optimum solution would be a global multilateral initiative. As this seems to be difficult to bring about, however, a sub-optimum solution is considered: a list of debtor options. These options include a total moratorium on medium-term debt, official limitations on payments, the conversion of the debt to bonds, the issue of bonds in payment of interest, general capitalization, payment in kind, and co-ordination with other debtors.

Certainly, many of the options in the debtors' list run the risk of limiting even more the usual channels for integration with the world economy. Nevertheless, the current serious shortage of financing and the deterioration of world economic prospects are progressively reducing the opportunity cost of resorting to this list. If it is used wisely, and as part of a political and economic programme which takes into account the harshness and restrictions of the external environment as an important policy variable, this list could be compatible with price stabilization and higher sustained growth rates. The great question is to know whether this growth necessarily implies some considerable sacrifices in efficiency, as happened in Latin America in the period between the world wars. Unfortunately, this could indeed be the cost which must be paid in order to circumvent the depressive effects of the international debt management strategy. It is a sub-optimal strategy for all parties.

La distribución del ingreso en Colombia: antecedentes estadísticos y características socioeconómicas de los receptores (LC/G.1430-P), "Cuadernos Estadísticos de la CEPAL" series, Santiago, Chile: June 1988.

This study collects together the results of a study on income distribution in Colombia, and is made up of two parts. In the first, a set of background statistics on income distribution is examined, and in the second part the socioeconomic characteristics of the recipients of the income are described.

In recent years techniques for sample surveys have progressed considerably, and thanks to this household surveys have become one of the most important sources of information on the origin, composition and distribution of income. Moreover, given that these surveys cover various characteristics of the households and their members, they also offer the possibility of creating data bases which can be used for carrying out many different types of studies.

Colombia is one of the Latin American and Caribbean countries which has made most progress in the field of household surveys, particularly through the work carried out by the National Statistics Administration Department (DANE). Therefore, it is not surprising that most of the statistical background in the study comes precisely from this information source.

It is necessary to point out, however, that household surveys are still somewhat restricted as instruments for measuring income. For example, it is difficult to precisely identify the income of entrepreneurs or self-employed workers, or some types of income such as capital returns or income in kind; moreover, from a statistical point of view, large sectors of the population who receive their income from agriculture or rural activities are relatively excluded. On the other hand, thanks to the large quantity of personal and household information regularly collected by these surveys, rich analytical studies can be carried out.

The first part of this study contains an exhaustive compilation of available estimates on income distribution in Colombia for selected years between 1951 and 1982. It collects together both estimates made by official organizations, whether or not they are based on sample surveys, and those based on the main studies carried out by independent investigators. It also gives some information about the methodologies employed in the surveys, in order to inform the reader of the characteristics and possible limitations of the various data bases considered. In spite of the breadth of this compilation, however, it is nevertheless of an eminently descriptive nature and scope.

In the second part, in contrast, the distribution of income is related to other socioeconomic variables to provide researchers with more specialized studies on the interrelationships which exist between the distributive process and specific characteristics of households and individual income recipients. For this purpose information has been used from three stages of the permanent household survey programme carried out by DANE for the years 1971, 1979 and 1982. These include the seven main cities of the country: Barranquilla, Bogotá, Bucaramanga, Cali, Manizales, Medellín and Pasto. The data has been tabulated in a different and more detailed manner than that usually used by DANE in publishing the results of its surveys.

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