

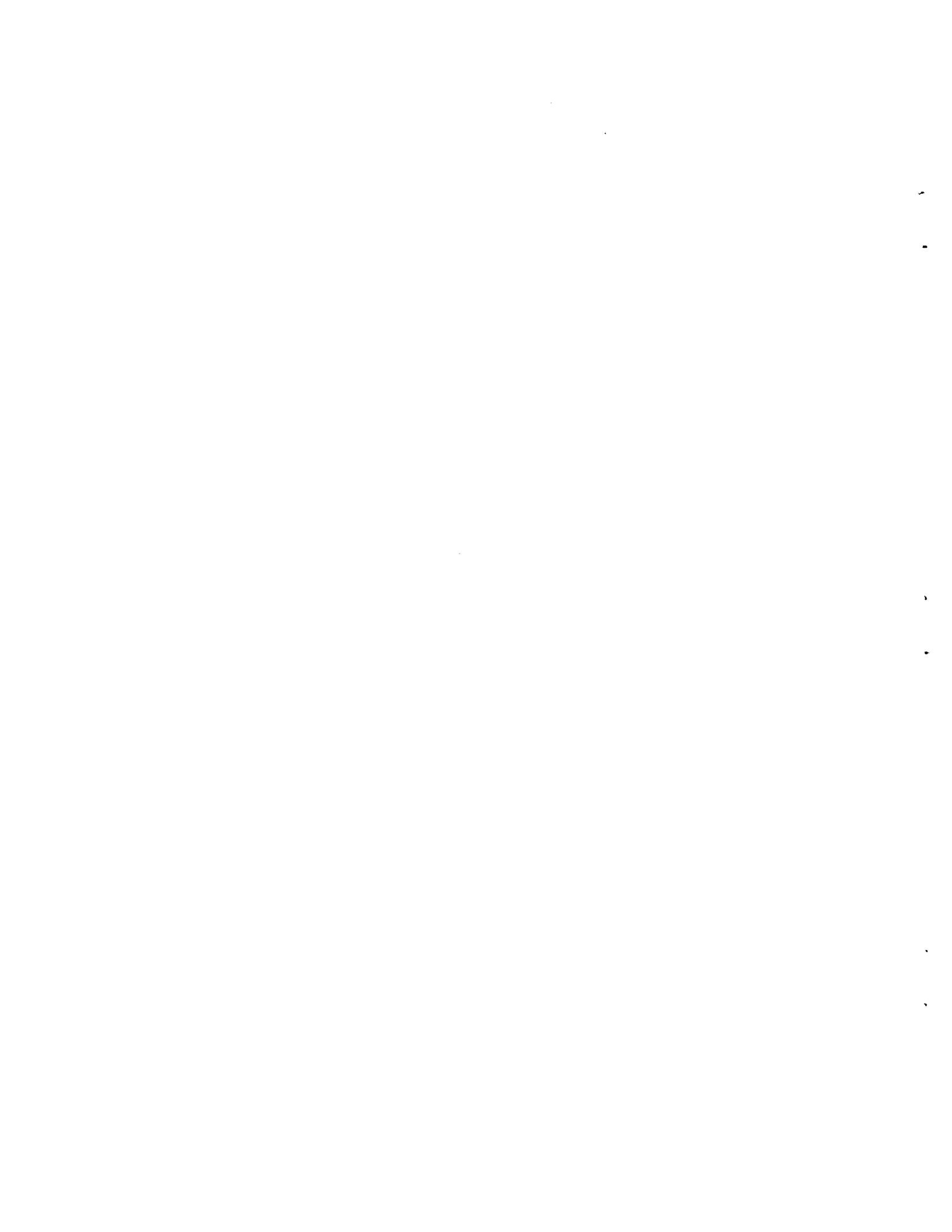


REVISITING THE GREAT DEBT CRISIS OF 1982

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Abstract

This paper situates the problem of Latin American debt within the wider context of the world debt crisis. It demonstrates that this debt problem has immediate consequences. Moreover, it argues that the problem is not of short term duration: it will continue to haunt the debtor countries and the world financial system for some time. Ultimately, the economic and political dimensions of this crisis represent a failure of the market.

The origins of the current debt problem are analyzed in terms of both the disequilibrium of the international economy of the 1970s and the domestic policies of developing countries in the transition from debt-led growth to growth-led debt. The position of expecting economic recovery in the industrialized countries to more or less automatically provide the solution to this debt crisis is called into question. Similarly, the far-reaching economic and political costs of the orthodox stabilization programs of the IMF are evaluated. In particular, the author suggests that these costs may undermine the democratization tendencies in Latin America. He concludes that only medium- and long-term policies of adjustment can successfully confront the simultaneous problems of debt and development.

Resumen

Este trabajo analiza el problema de la deuda latinoamericana dentro del contexto de la crisis mundial. Se argumenta que el problema de la deuda tiene consecuencias inmediatas. Sin embargo, no es a corto plazo: va a continuar como problema para los países deudores y el sistema financiero mundial por algún tiempo. Las dimensiones económicas y políticas de las crisis representan finalmente un fracaso del mercado.

Se analizan los orígenes del problema actual de la deuda en términos del desequilibrio de la economía internacional de los setentas, y de las políticas domésticas de los países en desarrollo en la transición de deuda con crecimiento a crecimiento con deuda. Se cuestiona la posición de esperar que una recuperación económica de los países industrializados de más o menos una solución automática a la crisis de la deuda. De igual modo, se analizan los costos económicos y políticos de los programas ortodoxos de estabilización del FMI. Estos costos pueden socavar las tendencias democráticas en América Latina. Solo las políticas de ajuste a medio y largo plazo pueden confrontar simultáneamente los problemas de deuda y desarrollo.



Introduction

In the aftermath of the Mexican and Venezuelan reschedulings in the Fall of 1984, and in the glow of upward revisions in the expansion of world trade for 1984, the debt crisis seems to have taken another giant step toward oblivion. It is only a matter of time before Brazil also comes to terms with the banks for a multi-year restructuring. Even Argentina and the International Monetary Fund (IMF) have recently reached agreement on a letter of intentions spelling out the policies that will satisfy creditors and change its status from intensive care to convalescence.

These developments seem to confirm the optimism of those who forecasted the stability of the financial system and the ephemeral quality of the debt problem. Before the experience of the past decade is forgotten and its lessons discarded, however, another look is in order. Developing country debt of over 800 billion dollars at the end of 1983, amounting to more than a third of gross domestic product, is not a trivial sum. The corresponding burden on export earnings of interest alone came to 13.2 percent in 1982, and close to 20 percent for major borrowers. The thirty or so countries forced to reschedule their debt payments since 1981 make clear the broad swath of the difficulties. Balance of payments shortfalls have thus not been an isolated phenomenon.¹

Yet, it is also a mistake to ignore their regional concentration. In many ways the debt crisis is almost exclusively a Latin American crisis. It was the dramatic inability of oil-rich Mexico to meet its obligations in August 1982 that first transformed dry statistical accounts of external debt found in the obscurity of financial pages to bold headlines. Mexico was the

second largest developing country debtor at 80 billion dollars and with proven oil reserves of seemingly unlimited value. If it could not service its debt, what of other countries similarly burdened but less favored? Those other countries prominently included Brazil and Argentina, with Chile and Peru not far behind. Latin American countries had been among the largest borrowers, accounting for some 40 percent of the total debt in the early 1980s. Latin America was also the region whose debt burden relative to export earnings was greatest, and where, after 1980, the debt problem most rapidly deteriorated. Hemispheric countries represented about half of all countries forced to reschedule, and were responsible for over 90 percent of the bank debt restructured.²

In understanding the characteristics of the crisis, therefore, as well as the prospects for the future, a regional dimension is useful. It permits greater specificity in defining the effects of world economic recovery. Rising exports from Hong Kong do not alleviate the debt problem of Chile. A regional thrust has the further advantage of introducing new elements of political realism, international as well as internal. Latin American debtors have organized into the Group of Cartagena, and talk of debtors' cartels is largely a regional, rather than a generalized Third World, export. At the same time, the region can be discussed only within the context of the broader problem.

In this paper, I focus on three aspects of the debt crisis of 1982. First, I examine its origins in the disequilibrium of the international economy in the 1970s and in the responsive domestic policies of the developing countries. From that basis, I consider the possibility of industrialized country recovery as a solution. Latin America is given special but not exclusive treatment. Finally, by way of conclusion, I evaluate the adequacy

of the existing institutional framework for coping with the debt problem and satisfying future financial requirements.

1. From Debt-led Growth to Growth-led Debt

The expansion of the Euro-currency market in the 1960s was, on the whole, of little significance to developing countries. European central banks and transnational corporations were the principal transactors. Only as the decade was drawing to a close, largely under the impulse of a recession-induced declining conventional demand for loans, did money center banks begin to search out new prospects. They found a hitherto untapped clientele among the rapidly growing countries of the developing world that later would be christened the "newly industrializing countries" (NICs): Brazil, Mexico, and Korea, among others. Not surprisingly, because of their middle income status, their larger manufacturing sectors, and their greater economic ties to the United States, Latin American countries were especially favored.

Capital began to flow to finance the increased imports required by accelerating economic expansion. Such loans, and not merely export promotion, were the basis of a more elastic supply of foreign exchange facing these countries, and permitted a more aggressive and accelerating growth strategy. For Brazil, in particular, its economic miracle was characterized by such debt-led growth.

The sudden injection of petro-dollars into world financial markets in 1974 altered both the pace and the purpose of borrowing. OPEC exporters realized a current account surplus in that year of almost 70 billion dollars as a result of the quadrupling of oil prices, and placed much of it in short term deposits with commercial banks. Those dollars were loaned for a longer term to countries that were importers of oil in order to finance their much larger balance of payments deficits. Amid predictions of impending doom and

disaster, private financial markets found a way not only to keep the global economy afloat but, within short order, to fuel renewed expansion. That way was an unprecedented increase of external debt, especially on the part of the developing countries.

Countries did not have to borrow at the time. They could have reduced their purchases of oil or, failing that possibility, have restricted other imports. But such responses would have implied passing along the oil tax not only in the form of lower real incomes, but also of probable diminished output and employment as economies adjusted. That was an unpopular choice for most Latin American governments, especially when many were taking credit for improved economic performance. The other option was to accelerate the growth of exports to offset the increased cost of imports; while no less a reduction of real income, such a strategy at least promised to be less contractionary than policies aimed primarily at import reduction. That choice again seemed dubious when recession in the industrialized countries was slowing aggregate trade growth in 1974 and 1975. If countries in the region had resisted export promotion strategies in favor of the domestic market when world demand was favorable, they were even less inclined to radical responses under uncertain international conditions.

More gradual, debt-financed adjustment was therefore especially attractive to Latin American countries, an option rendered the more alluring by its cheap cost. They had the good fortune of being eligible. Those that had the luxury of borrowing to offset the rise in oil prices were predominately the ones that had already established prior links to the market: they turned from debt-led growth to growth-led debt. In the earlier period, they could count on an elastic supply of foreign capital and could, and did, set ambitious growth targets independent of a foreign exchange constraint. In the later

period, they operated under greater restriction. Although they borrowed more, countries were not facing unlimited supplies of credit: their growth rates had to be set more modestly, with larger debt financing the larger needed import requirements.

Not all eligible countries chose such a path. Taiwan and Singapore, for example, accepted a more immediate adjustment and realignment of real wages to remain competitive in exports. Korea borrowed, but in order to sustain investment in a manufacturing sector more and more oriented to exports. The more dependent economies were upon their exports, the more inclined they were to favor aggressive efforts to expand market shares rather than to accept continuing debt-financed balance of payments deficits. In such open economies, import substitution was not a prominent part of medium-term adaptation, and export competitiveness was best accomplished by short-term flexibility and medium-term efforts to find new competitive niches.

Enough countries opted for deficit finance to permit financial markets to sustain world demand. By making money cheap, the banks induced borrowers to maintain and expand their imports to offset the export surplus of the oil producers. In this fashion, a classic potential over-savings, non-full-employment solution to the surplus problem was averted, and global recovery could build upon the continuing growth of the middle-income developing countries. Increased indebtedness thus had positive externalities.

From a national perspective, debt also produced favorable results. The select group of countries that were able to borrow experienced better economic performance. The poorest countries, on the other hand, had to adjust immediately and painfully, despite larger official lending mobilized on their behalf. As a consequence, a wider gulf opened between the middle-income and the low-income countries in the 1970s, even as it narrowed between semi-

industrialized and industrialized countries. Per capita income grew between 1970 and 1980 at an annual rate of 3.2 percent in the middle-income countries, 2.4 percent in the industrialized, and not at all in the low-income countries other than India and China.³

Table 1 confirms this dominant role of the NICs, and of the Latin American countries, in credit markets in the immediate aftermath of the oil price shock. The NICs accounted for almost two-fifths of the increase in all developing country debt between 1973 and 1976. Mexico and Brazil, together, accounted for about a quarter. All low-income countries could manage little more than 10 percent, almost exclusively from official sources. Five of the non-surplus oil exporters virtually matched that participation.

For some of the borrowers, especially in Latin America, the new credits became habit-forming, even after real prices of oil began to be eroded and industrial country growth recovered after 1975. Balance of payment deficits declined only gradually, as bank willingness to continue to lend opened up new possibilities for public spending. Table 1 reveals a continued high level of participation of the NICs in total borrowing, and an expansion of the role of the oil-exporting countries. Although borrowing had its origins in the oil crisis, it took on a life of its own, a life influenced not merely by the higher price of oil but also that of manufactured imports.

Since banks preferred official guarantees, and these could more readily be given on public loans and indirect borrowing of state enterprises, private international credit markets imparted a significant bias toward public sector expansion. This, too, favored those middle-income countries with a more pervasive network of state enterprises and interventionist tradition. Once again, this asymmetric supply condition reinforced the demand of Latin American countries. They found the speed and less exigent requirements of the

TABLE 1
DEVELOPING-COUNTRY Debta (billions dollars)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
Non-Oil Countries	130.1	160.8	190.8	228.0	280.3	334.3	300.7 ^c	421.4 ^c	492.6 ^c	551.3 ^c	585.6 ^c
NICsb	51.3	66.2	82.3	101.5	122.7	149.5	115.9 ^c	160.9 ^c	184.5 ^c	211.9 ^c	217.7 ^c
Brazil	13.8	18.9	23.3	28.6	35.2	48.4	57.4	66.1	75.7	88.2	97.0
Mexico	8.6	12.8	16.9	21.8	27.1	33.6					
Republic of Korea	4.6	6.0	7.3	8.9	11.2	14.8	20.5	26.4	31.2	35.8	42.0
Southern Cone	10.1	12.4	12.7	13.0	14.9	19.2	27.5	38.3	51.3	55.2	60.0
Argentina	6.4	8.0	7.9	8.3	9.7	12.5	19.0	27.2	35.7	38.0	42.0
Chile	3.7	4.4	4.8	4.7	6.2	6.7	8.5	11.1	15.6	17.2	18.0
Low-Income Countries	26.4	30.9	34.6	40.1	48.6	54.8	62.7	71.4	75.2	81.8	88.0
Selected Oil Exporters	15.4	17.9	21.2	27.3	35.3	47.1	58.2 ^c	65.2 ^c	70.5 ^c	78.3 ^c	90.0 ^c
Algeria	2.9	3.3	4.5	5.8	8.3	12.7	14.9	15.1	15.3	14.8	17.0
Indonesia	5.7	7.1	8.9	11.0	12.8	14.5	14.9	17.0	18.0	21.0	23.0
Mexico							40.8	53.8	67.0	82.0	83.0
Nigeria	2.2	2.2	2.1	1.8	1.9	3.6	4.7	5.6	7.9	11.2	17.0
Venezuela	4.6	5.3	5.7	8.7	12.3	16.3	23.7	27.5	29.3	31.3	33.0
Total ^d	145.5	178.7	212.0	255.3	315.6	381.4	453.5	540.4	630.1	711.6	758.6
Total, All Developing Countries					329.3	398.2	472.0	559.9	646.5	724.8	767.7

^aShort and long-term debt, including private, non-guaranteed debt. Excludes loans from the IMF.

^bNewly industrializing countries, here equivalent to IMF category of "major exporters of manufactures," excluding Argentina but including Mexico.

^cExcludes Mexico.

^dSum of Non-Oil Countries and Selected Oil Exporters.

Sources: 1973-76--Non-Oil Countries, NICs, and Low-Income Countries from IMF, World Economic Outlook (Washington, D.C.: 1983); for NICs and Low-Income Countries, estimated short-term debt--excluded in the source--has been added by the author.

1973-82--Brazil, Mexico, Republic of Korea, Argentina, Indonesia, and Venezuela from William R. Cline, International Debt and the Stability of the World Economy (Washington, D.C.: Institute for International Economics, 1983). Algeria and Nigeria estimated from Morgan Guaranty Trust Company, World Financial Markets, June 1983, and World Bank, World Debt Tables (Washington, D.C.: various years). Chile from Morgan Guaranty, World Financial Markets, June 1983, and R. Zahler, "Recent Southern Cone Liberalization Reforms and Stabilization Policies: The Chilean Case, 1974-1982," Journal of Interamerican Studies and World Affairs, Vol. 25, No. 4 (November 1983), pp. 509-62.

1977-83--Non-Oil Countries, NICs Low-Income Countries and Total, All Developing Countries, from IMF, World Economic Outlook (Washington, D.C.: 1984).

1983--Brazil, Mexico, Republic of Korea, and Argentina from OECD, External Debt of Developing Countries, 1983 Survey (Paris: 1984); Chile and Venezuela from Euromoney, March 1984; Algeria from Quarterly Economic Review (The Economist Intelligence Unit), No. 1, 1984; Nigeria from Wall Street Journal, February 21, 1984; and Indonesia estimated by the author from 1983 borrowing data provided in Quarterly Economic Review (The Economist Intelligence Unit), No. 1, 1984.

private banks a welcome contrast to the rigidities of official loans, and their implicit interventionism.

Commercial banks, on their side, found their new customers an important source of profits. They made their money on the higher up-front commission fees and spreads for loans to developing countries; and low real interest rates, or even negative rates, were no worry. Indeed, they were welcome in minimizing the debt servicing problems of the developing country borrowers. As long as bank depositors were willing to accept negligible returns, and surplus oil producers had such a preference for liquidity that they were accepting such returns, the arrangement was quite satisfactory. In addition, the banks benefited from access to domestic banking facilities in the largest borrowers. These added significantly to the profits earned from international loans, which helps to explain the willingness to lend at modest, and declining, spreads. Citicorp's Brazil operations, for example, generated 20 percent of all corporate earnings in 1982.⁴

As a result of these influences, all developing country debt grew at a rate of about 20 percent a year from 1973 to 1978, increasingly weighted by the floating rate loans of banks. For Latin America, the rate was an even greater 22 percent. Lenders bore the risk of a mismatch between overnight deposits and six or eight-year loans; borrowers bore the risk of changing interest rates and had their costs pegged to the London Interbank Offer Rate (LIBOR). In addition, countries were exposed to the high rates of loan turnover implicit in the short maturity structure of commercial loans. This translated into debt-service ratios that far exceeded previous conventional standards, without providing comparable access to increased real resources.

A relatively small number of countries, almost exclusively Latin American, thus embarked on a strategy of growth-led debt in the 1970s subject to

special vulnerabilities. They were financing medium and long-term capital formation on the basis of short-term credits with an uncertain and variable price. Inherent in any debt strategy was an inability to know its real return because the uncertain future prices of exports were an important determinant of the potential benefits. Compounding the problem in this case was an unpredictable cost of debt, and a vulnerability to future capital market supply conditions.

Yet, up to the second oil price shock, the gamble was worth taking. Export growth was sustained in world markets at favorable prices, despite worries about protectionism. As a consequence, the ratio of debt outstanding to export proceeds was more favorable for all non-oil developing countries in 1979 than in 1970-1972 (although assisted by rising oil revenues for some new exporters in the group). Debt service, even if claiming a larger share of exports than earlier as grace periods expired and interest rates crept upward, was still a modest 19 percent for the group as a whole. Short-term loans were not yet much in evidence and posed no cash-flow problem. The ratio of reserves to debt outstanding at the end of 1979 was a third more satisfactory than the level in 1970-1972. Latin American borrowers, although subject to debt-service ratios twice as large as for the aggregate, had also accumulated reserves and seemed equally immune from adverse effects.

Rather, as noted earlier, those developing countries with access to the financial market succeeded in sustaining their rates of growth far more effectively than those forced to do without. They did so because they utilized increased foreign savings to finance higher levels of investment. Evidence on the consumption behavior of a number of the major debtor countries is reported in Table 2.⁵ It confirms the productive application of the much larger foreign capital inflows in the period after 1973.

TABLE 2a

	Marginal Propensity to Consume from <u>National Product</u>	Marginal Propensity to Consume from Foreign Capital	
		<u>1965-1978</u>	<u>1979-1981</u>
Argentina	.76 (21.39)	.82 (2.49)	1.02 (1.20)
Brazil	.79 (48.24)	-.02 (.04)	.90 (1.91)
Chile	.86 (33.92)	.95 (2.84)	.51 (1.62)
Colombia	.73 (35.68)	.69 (2.67)	.20 (.50)
Indonesia	.67 (37.80)	1.00 (6.84)	.76 (4.63)
Korea	.68 (34.87)	.20 (1.82)	.48 (1.97)
Mexico	.76 (36.26)	.43 (1.30)	-.51 (1.54)
Venezuela	.46 (1.16)	.54 (7.40)	.38 (1.72)

Sources: Data on national accounts from International Financial Statistics.

^a t-values in parentheses

In the first place, despite the acceleration in borrowing, the propensity to consume out of net foreign proceeds in 1973-1978 was not statistically significantly greater than in the prior period. If foreign resources were not all applied to investment, neither were they diverted to consumption in proportions different than they had been. Second, the share allocated to savings from foreign borrowing in 1973-1978 was significantly greater than the allocation from gross national product for Korea; for both Brazil and Mexico, the deviations are in the right direction although falling short of statistical significance. Indeed, for these three largest debtors, the savings coefficients from net capital inflow are high enough that the hypothesis that all borrowing was saved cannot be rejected. At the margin, for these countries, debt translated more than proportionally into investment. Third, even after the second oil shock in 1979-1980 provoked further uncertainties and reduced growth and investment, there was no systematic tendency toward greater consumption out of borrowing. Some countries did show a rise, Brazil most prominently, but the only statistically significant change was Mexico's in the direction of greater saving. Finally, the pattern of expenditures in a non-debtor country like Colombia is not much different from that in the largest debtors.

This conclusion of no gross displacement of domestic saving is corroborated by IMF studies comparing changes in average ratios of saving to GNP with relative changes in the current account between the late 1960s and the 1970s. Taking into account as well simultaneous investment increases, the "increases in external deficits can in most cases be accounted for by expansion of investment (relative to total output) rather than by growth of consumption."⁶ The cross-section methodology leads to the stronger result that debt had its principal application in investment, not true in our sample for

such borrowers as Argentina, Chile and Indonesia. What seems clear is that countries did not borrow in order to increase their consumption ratios, although their absolute consumption may have risen.

Although some countries encountered difficulties and were forced to reschedule, and while some analysts remained skeptical of the magic of the market, the consensus judgment about developing country debt until the second oil shock was a positive one. Rapidly growing debt was a solution rather than a problem. Capital outflows that would later cause the growth of debt to exceed substantially the growth of resources domestically applied were not yet a major concern. Even in 1980, an IMF Occasional Paper could read:

In sum, the overall debt situation during the 1970s adapted itself to the sizable strains introduced in the payments system and, in broad terms, maintained its relative position vis-a-vis other relevant economic variables. Though some countries experienced difficulties, a generalized debt management problem was avoided, and in the aggregate the outlook for the immediate future does not give cause for alarm.⁷

A Changed International Environment

Even as those lines were being written, the bases for its optimism were being eroded by a deteriorating global economy. In the first instance, oil prices soared again under the impulse of uncertain supplies as war broke out in the fall of 1979 between Iran and Iraq. After considerable volatility in the spot market, the new average 1980 oil price settled at a level almost two and a half times greater than its 1978 value of 12.83 dollars a barrel. The immediate impact, reminiscent of the first oil price shock, was a large OPEC surplus offset by a large non-oil developing country deficit.

Once again there was a recession in the industrialized countries, as contractionary policies sought to contain inflation, but this time more seriously. The impact on developing country exports and terms of trade was to

prove longer lived. Finally, there was a new element in the formula: real interest rates began an upward ascent. Where before the capital market facilitated deficit finance, it now penalized not only the flow but also the stock of past debt contracted on a floating basis.

Table 3 quantifies the approximate contribution of each of these three adverse factors to the current account deficit realized by the group of non-oil developing countries as a whole. The role of the oil price shock, even allowing for the favorable impact on such countries as Mexico, Peru, Egypt, and a few others, is paramount in timing and magnitude. In second place is the recession-induced reduction in export earnings, the result of both slower growth in volume and deterioration in price. This negative influence is most pronounced in 1982. By that time, the severity and length of the slowdown in the industrialized countries produced a volume, as well as an increasing cumulative price, effect. It is not surprising that by 1982 countries found themselves in more and more balance of payments difficulty.

The counterpart Latin American calculations using the same method are found in Table 4. There are important differences in the findings. There is no net oil effect for the region, excluding Venezuela, because imports and exports approximately cancel out. Indeed, by 1981 the region is a beneficiary of the oil shock. Table 4 also shows a modest recession effect, owing exclusively to swings in the terms of trade. Latin America bore a larger part of the brunt of declining commodity prices than did other middle-income countries less reliant on exports of primary products, but in compensation expanded the volume of its exports at a higher than predicted rate. Hence, the actual volume of exports over the period 1979-1982 was greater than the hypothetical level without the recession.

TABLE 3

SOURCES OF DETERIORATION IN THE CURRENT ACCOUNT OF NON-OIL DEVELOPING
COUNTRIES, 1979-1982
(billions of dollars)

	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>Cumulative 1979-82</u>
Actual Trade Balance	-36.6	-51.3	-74.3	-79.6	-52.2	--
Adjusted Trade Balance ^a		-46.3	-57.3	-47.8	8.8	--
Oil Effect ^b		5.0	17.0	18.6	14.8	55.4
Recession Effect ^c		--	--	13.2	46.2	59.4
Export Volume ^d		--	--	--	23.2	23.2
Terms of Trade ^e		--	--	13.2	21.3	34.5
Interest Payments on Debt Service (gross)	-19.4	-28.0	-40.4	-55.1	-59.2	--
Interest Rate Effect (gross) ^f		-1.1	.5	11.4	23.0	33.8
Interest Rate Effect (net) ^f		-.5	.2	6.5	14.0	20.2
Actual Current Account	-41.3	-61.0	-89.0	-107.7	-86.8	--
Adjusted Current Account ^g	-41.3	-56.5	-71.8	-69.4	-11.8	--

Source: Actual trade balance and actual current account from IMF, World Economic Outlook (Washington, D.C., 1983)

^aAdjusted Trade Balance: Actual trade balance minus sum of oil and recession effects.

^bOil Effect: Actual cost of net imports of oil (using import price of industrialized countries) minus estimated cost using oil price that varies after 1978 with export prices of oil-importing countries.

^cRecession Effect: Composite of terms of trade and volume effects (does not add because of interaction).

^dExport Volume: Non-oil export value times cumulative negative percentage deviation between actual export volume of oil-importing countries and volume predicted by 3.2 percent industrialized-country growth in 1980-82.

^eTerms of Trade: Cumulative negative percentage deviation between actual non-oil terms of trade (export prices of non-oil, oil-importing countries; import prices of oil-exporting countries in 1973-1974, 1979-1980, non-oil countries in other years) and terms of trade predicted by 3.2 percent OECD growth and deceleration of industrialized-country inflation at 1 percentage point per year beginning in 1979.

^fInterest Rate Effect: Based on difference between the 1975-1978 average real interest rate and actual real rates. For short-term interest payments, the U.S. prime rate was used. Interest on long-term and medium-term loans was calculated by using the real U.S. prime rate with a weight of 1/3 and the OECD long-term fixed interest rate with a weight of 2/3, corresponding to portfolio weights reported in

OECD, External Debt of Developing Countries, 1982. Rates were applied to average annual debt, obtained by using average of year-end debts. Net interest effect includes the offsetting earnings from short-term assets. This method approximates well the actual gross and net interest payments in IMF, World Economic Outlook (Washington, D.C.: 1983).

⁹Adjusted Current Account: Actual current account minus sum of oil effect, recession effect, and net interest effect.

TABLE 4
SOURCES OF DETERIORATION IN THE
CURRENT ACCOUNT OF LATIN AMERICA,^a 1979-1982
(billions of dollars)

	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>Cumulative</u> <u>1979-82</u>
Actual Trade Balance	-1.2	-4.1	-8.9	-10.0	5.5	
Adjusted Trade Balance		-3.2	-8.3	-1.3	13.3	
Oil Effect		.9	.6	-1.1	-3.6	
Recession Effect		--	--	9.8	11.4	21.2
Export Volume		--	--	--	--	--
Terms of Trade		--	--	9.8	11.4	21.2
Interest Payments on Debt Service (gross)	7.9	12.4	19.5	28.7	35.3	
Interest Rate Effect (gross) ^e		-1.1	1.5	12.8	21.0	34.2
Interest Rate Effect (net) ^d		-.6	.5	8.6	15.9	24.4
Actual Current Account	-13.3	-21.4	-33.4	-45.4	-34.9	
Adjusted Current Account		-21.4	-32.2	-28.1	-11.2	

Source: IMF, World Economic Outlook, 1983; IMF, Balance of Payments Yearbook, 1983; Economic Commission for Latin America, Annual Economic Survey, 1982.

^a Excluding Venezuela

^b Export prices of Latin American non-oil exporters, import prices of Latin American oil exporters, both from Economic Commission of Latin America, Annual Survey, 1982.

^c Weights of .7 for prime rate and .3 for OECD multilateral non-concessional loan rates were used for long and medium term debt.

^d Actual earnings of interest income reduced by ratio of hypothetical real prime to actual and subtracted from gross payments.

Higher interest rates are, however, the distinctive hallmark of the region's vulnerability. Debt was not only relatively larger compared to the volume of trade, but a much larger proportion of the Latin American debt was contracted on a floating rate basis. Even official loans were not on concessional terms. A comparison of Tables 3 and 4 shows that the adverse rate effects of 1981 and 1982 were almost exclusively a Latin American phenomenon.⁸ Other countries still enjoyed a preponderance of fixed rate obligations as well as larger offsetting earnings from foreign exchange reserves; the Latin American countries were forced to deplete their reserves after 1979.

But even this calculation of significant foreign exchange costs does not capture the full significance of the rise in the interest rate. It not only contributed to the current account deficit, but also had immediate adverse effects on the willingness of creditors to lend more. Between 1978 and 1981 interest payments on the debt rose from 19 billion dollars to 55 billion dollars for all non-oil developing countries, and the ratio to exports from 7.3 to 11.9 percent. The change for Latin American borrowers was much greater, as the interest service ratio climbed from 14.9 to 25.4 percent. Only an amortization profile skewed toward the future kept the overall debt-service ratio within bounds. It did not always register that the higher nominal rates at first were partially equivalent to shorter maturities, because they were compensating for inflation rather than signalling a deterioration in the capacity to pay. Spreads rose, loans were rationed, and maturities were shortened.

Such higher rates thus exacerbated the crisis through their implications for continuing the supply of capital, and were a crucial factor in making developing country adjustment more difficult just when export receipts were

falling off. Recession in the industrialized countries in the past had at least been partially offset by more abundant and cheaper loanable funds.

The new positive real interest rate regime was largely the consequence of conscious policy in the industrialized countries. Tighter money became the principal instrument to reduce inflation. Reaganomics carried the process a further step by marrying lax fiscal policy to an insistence on lower inflation; the predictable consequence was higher deficits, interest rates and unemployment. Restrictive policy also yielded indirect effects that reinforced the tendency for interest rates to rise. Reduced surpluses were progressively realized by oil producers facing a softer and more competitive market and those surpluses, formerly a source of savings to finance the deficits of the oil importers, were no longer available.

International capital markets thus magnified, rather than dampened, the oil shock of 1979-1980. Banks, concerned about their exposure, raised premiums to oil importer borrowers and, more importantly, became reluctant to lend at all. They began to prefer shorter loans, ostensibly trade credits, but in reality, like all lending, balance of payments finance. The differential effect on Latin American borrowers is clear. Estimated debt of less than a year rose 111 percent between 1979 and 1982 while medium and long-term finance increased by 51 percent for all non-oil debtors. The corresponding regional statistics are 192 percent and 61 percent. Short-term loans to Latin American countries amounted to almost a quarter of their outstanding obligations at the end of 1982.

As Table 3 suggests, the cumulative effects of the external shocks experienced after 1979 were sufficient, for non-oil developing countries as a whole, to convert the large 1982 deficit of 87 billion to one of 12 billion dollars. That is, the sometimes drastic efforts on the part of these countries

to curtail their imports could have led to significant improvement in their payments situation rather than the continuing difficulty actually experienced.

For the Latin American countries, per Table 4, the shock had a different, non-oil composition, originating primarily from rising interest rates. That enforced a radical reduction of imports beginning in 1982 that has continued to be the principal factor in the region's improved balance of payments. Clearly for those countries in the region like Brazil and Chile, that were both oil importers and large debtors to commercial banks, circumstances were even more trying.

But Tables 3 and 4 also make abundantly clear that the sharp initial rise in the deficit from its 1978 level must be explained on other grounds. By 1980, even abstracting from the oil price shock and the price of exports, the current account deficit of non-oil developing countries had risen by 75 percent over its 1978 level. The increase for Latin America is even greater. It is a mistake to blame the oil price and recession shocks alone for what was also an inadequacy of domestic policy and an excessive readiness on the part of the banks to lend.

For one thing, as Table 1 shows, there was much increased borrowing by Chile and Argentina as they pursued more open capital markets as an integral part of their new international monetarist stabilization experiments. Between 1978 and 1981 their previously moderate debt almost trebled, as they alone accounted for some 12 percent of increased developing country indebtedness. High domestic interest rates in conjunction with pre-announced, and in the case of Chile, fixed exchange rates encouraged rapid capital inflows that were translated into larger imports, but without the same proportion saved as was true of the earlier NIC borrowing in the aftermath of the 1973 oil shock.

For another, oil exporters, and in particular Mexico, relied heavily on external finance to sustain high rates of growth of product and, disproportionately, of imports. The very initial shock of higher oil prices worked to their advantage. They borrowed not to accommodate to adverse external circumstances, but rather to exploit their new riches. Needless to say, they were attractive clients for banks again flush with Euro-deposits in search of application.

In both groups of countries, moreover, increased indebtedness did not fully translate into net increases in resource transfers. Indirect calculations from the recipients' balances of payments show that between 1978 and 1981 Argentina experienced a capital outflow equivalent to 60 percent of incremental indebtedness; Mexico, 40 percent; and Venezuela, more than 100 percent.⁹ Contractual obligations, primarily publicly guaranteed, brought foreign exchange into the countries only to make it available for residents to send right back out. Chile, despite claims of critics to the contrary, does not seem to have fallen victim to this exchange of national liabilities for private assets held abroad; nor does Brazil.

A third category of continuing borrowers can also be identified. Some oil importing countries, prominently Brazil, habituated to debt-financed adjustment, understated the different and more persistent international recession and took few precautionary measures. Brazil chose, for internal political reasons, to expand in 1980 at the expense of a deteriorating payments position. This expansion was checked early on by an increasingly inelastic supply of credit. As a consequence, Brazil's debt expanded relatively less than that of its Latin American neighbors. It also averted the hemorrhage of capital flight that afflicted some of the others.

Between 1978 and 1981, the principal debtors in Latin America were responsible for more than 40 percent of the increased debt tabulated in Table 1, compared to an initial participation of 30 percent. Almost all of the new debt was accumulated on a floating rate basis, and progressively, no longer at the rates previously available. For many, prudent import policies might have averted some of the later grief. A prominent exception was Brazil, whose large outstanding debt absorbed virtually all of the foreign exchange borrowed, and whose real imports remained compressed.

This country variability is lost in the aggregation of Tables 3 and 4. The countries with relatively large reserves that gained from higher interest rates are not those most affected by payments problems because of lagging exports. Nor did prices for all products move uniformly. The terms of trade of Asian oil-importing countries fell by 5.5 percent between 1980 and 1982; those of the Latin American countries by 13.6 percent. But however much external events impinged, as they impressively did, domestic policies and international negligence were also components of the seriously deteriorating situation that finally became patent in 1982.

Global equilibrium in response to the second oil shock was achieved at lower levels of real income. Instead of buffering the impact as before, developing country debt now transmitted it. Only so long as growth-led debt was compatible with developed country aversion to recession and OPEC willingness to hold Euro-currency deposits yielding low or negative real rates, could the strategy be effective. It made little difference that current account deficits in the early 1980s would have been in line with the trend of modest improvement had the external environment remained stable. What counted was that the strategy chosen was no longer viable, and also not easily reversible.

Once in debt, it was more difficult to maneuver. Growth-led debt, especially for Latin America, had been converted to debt-led debt.

2. A Liquidity Crisis?

By the Fall of 1982 there was widespread agreement that there was a debt problem. Time Magazine, perhaps overeager to sell copies, made the situation a cover story and christened it a "debt bomb." Others more sober and analytically inclined differentiated between a liquidity crisis and a solvency problem: a short-term interruption of cash flow versus a long-term inability to repay debt. The majority view, including bankers, government officials and independent observers, inclined to the former. The World Bank, in its 1983 report on external debt stated it as follows:

There is no generalized debt crisis: rather, the mutual difficulties of developing countries in servicing foreign borrowing and of commercial banks in obtaining service payments on foreign lending are an outgrowth of the broader economic problems that grip all of the world's economies. The resolution of these difficulties lies in a restoration of economic health to the global economy and a resumption of strong growth in international trade.¹⁰

There is basis for such a characterization in the magnitude of the effects set in motion by the oil price shock in late 1979 and the policy response to it, as Tables 3 and 4 have already brought out. There is also persuasive evidence from casting the perspective forward rather than backward. As the IMF's medium-term scenarios show, Morgan Guaranty's balance of payments model confirms, and William Cline's more recent projections for 19 of the largest debtors reemphasize, "If this growth rate [3 percent annually for industrialized countries] can be achieved, the debt problems of the developing countries should be manageable and should show considerable improvement....The central result of this analysis is that the debt problem can be managed, and that it is essentially a problem of illiquidity, not insolvency."¹¹

I am partial to this assessment. Yet at the same time, it requires qualification in two important respects. For one, the analogy of countries to firms is not entirely adequate. Solvency for a firm is defined by an excess of assets over liabilities; otherwise it is bankrupt, and its creditors may benefit from its dissolution. Countries, on the other hand, do not cease to exist, nor can their assets, at least any more, be seized for distribution. Their technical requirement for solvency is a zero cumulative balance of payments over a very long time horizon, in order to guarantee repayment of accumulated intervening debt. It is of limited practical significance. Since policies are variable, such a condition in principle could always be met over a suitably long period. So can the additional requirement that the real return on borrowing repay its cost, since capital in the developing countries remains relatively scarce.

A more relevant solvency criterion is therefore not the eventual capacity to pay, but the medium-term prospect for decelerating the increase in debt relative to exports. Such a criterion incorporates availability of foreign exchange rather than saving as the determining constraint in meeting obligations.¹² It also substitutes the existence of a limiting debt/export ratio, with continually growing debt, for the condition of its full repayment.

For the debt/export ratio to converge to a maximum, with developing countries still recipients of a net resource transfer from the industrialized countries, requires that export growth exceed the interest rate.¹³ If it does not, the further borrowing necessary to cover both interest payments and import purchases will exceed the increase in exports, and force the debt/export ratio to continuously higher levels. An example, assuming balanced trade, illustrates the process. With imports and exports exactly equal, the rate of growth of the debt is simply equal to the uncovered interest costs

that must be borrowed. If exports do not grow at the interest rate, the debt/export ratio rises.

Only by running a merchandise surplus, i.e., transferring real resources to creditor countries, can debtors prevent the debt/export ratio rising when interest rates exceed export growth. That, of course, is what many such countries have been forced to do since 1982, but that does not make them solvent. Rather, it accepts the present disequilibrium as a permanent state and refuses to see beyond the temporary favorable balance of payments to the longer term implications. Estimates suggest that such a transfer from the Latin American countries amounted to 20 billion dollars in 1982 and 30 billion dollars in 1983, representing 19 and 27 percent respectively of the value of exports of goods and services. "Thus was prolonged a situation that, taking into account the relative degree of development of the region, can only be qualified as perverse."¹⁴ More generally, for all the countries in the World Bank reporting system, the positive net transfer of 16 billion dollars in 1981 was converted to a negative 7 billion dollars in 1982 and a larger negative 21 billion dollars in 1983.¹⁵

Favorable medium-term projections of the balance of payments, without regard to the transfer of resources to the developing countries required to sustain adequate rates of growth, are thus no ipso facto guarantee of solvency. Nor are even demonstrations of declining debt/export ratios, if they are achieved through premature graduation to export of real resources. Such exercises ignore the magnitude of the sacrifice entailed for the developing countries. They assume that ability to pay is equivalent to willingness to pay regardless of the costs. The caution of bankers in the face of such positive results and forecasts show that they, at least, understand the distinction.

But the forecasts themselves may be too rosy. That is my second objection to the prevalent characterization of the debt problem as a simple liquidity crisis. My concern is that the balance of payments calculations underlying such a diagnosis are overly optimistic. They place an undue emphasis upon economic recovery in the industrialized countries as a solution to the debt problem of the developing countries.

There are two reasons for a more cautious stance. One is the possible overstatement of the responsiveness of developing country exports, and especially those of the Latin American countries, to income growth in the OECD countries. The other is the distinct possibility that future global development may show a less trade-intensive pattern than that of the past on which the estimates are based.

Estimates of the elasticity of export volume of non-oil developing countries, and of the Latin American countries more particularly, vary. Most, however, fall short of the value of 3 used by William Cline in his influential study already cited. Calculations reproduced in Appendix Table A suggest a value of 1.7 for the aggregate, and a lesser 1.5 for the region. Cline reaches higher values because he looks at the relationship of total OECD imports with respect to OECD growth, and subsequently makes allowance for increasing participation of developing countries in this trade.

In the second instance, favorable trends in the prices of developing country exports may be overstated in the optimistic scenarios. In particular, the relationship with projected depreciation of the dollar may be flawed. If export prices responded exactly proportionally to currency changes, then dollar depreciation could improve the ratio of debt to export earnings; it would simulate the effects of inflation in reducing the burden of the debt, without inducing a compensating rise in interest rates. But again, evidence is mixed.

Although the IMF reports a unitary relationship between dollar prices and the value of the dollar for quarterly commodity exports, a recent Federal Reserve study finds an elasticity of .5 for all exports.¹⁶ Appendix Table B reports insignificant, and on the whole, wrong sign association between annual export prices of non-oil countries and the value of the dollar. For quarterly Latin American commodity export prices since 1973, no satisfactory statistical relationship was found, and a fortiori, no inverse correlation with the dollar. It should come as no surprise. In 1978, when the dollar depreciated, dollar export prices actually fell, despite a growth rate of 4.1 percent in the income of the industrialized countries. These findings confirm the absence of any a priori reason why demand and supply relationships should produce a proportional outcome. The results depend upon the role played by dollar and non-dollar buyers and sellers in world markets.

Dollar depreciation is anticipated to be the major source of higher export prices in a period of moderate international inflation. Terms of trade improvement in response to recovery is another, but secondary, contributor. Such an effect we have already encountered in gauging the extent of its opposite impact during the 1979-1982 recession. Once again there are differences in statistical estimates of the strength of the terms of trade effect, differences that are compounded because of the differential export composition of individual countries. One can choose more or less optimistically.

The critical element in the most favorable balance of payments projections is this rise in developing country export prices. Morgan Guaranty's 1983 forecast assumed a 25 percent increase in the prices of non-oil commodities between 1982 and 1985; Cline, an annual rate of more than 20 percent for the exports of large, oil-importing debtors between 1983 and 1985. Substituting different responses to similar assumptions can yield significant revisions

in the calculations, as I have demonstrated elsewhere.¹⁷ Moreover, assumptions of dollar depreciation and continuing interest rate reduction have not been realized, and there is even doubt about the continuity of the economic recovery through 1985. Thus, very reasonable arguments can be constructed for uncertainty about the medium term, uncertainty that comes down predominantly on the side of more cautious expectations. The IMF medium-term base scenario prepared for the 1984 World Economic Report was appropriately more measured: it predicted a decline in the debt-export ratio of major borrowers from 1.94 in 1983 to 1.65 in 1987, compared to Cline's reduction (for net debt-export for large oil-importing debtors) from 1.88 in 1983 to 1.28 in 1986.

There is equally good reason even to question whether the experience of the last two decades is an accurate guide to the near future. The world has emerged from an exceptional post-1945 period in which trade growth has been unusually responsive to increases in productive capacity. Trade intensity has exceeded that found in the 19th century Pax Britannica. Some characteristics of the present situation argue against automatic resumption of past trends:

1. Protectionist sentiments are stronger. Advocates of freer trade barely prevailed in passing a new Trade Act in the United States that was stripped at the last moment of a number of potential new restrictions. Even that act makes it easier to file new dumping and countervailing-duty actions. Developing countries competing with basic industries in the United States have become a special target and they are largely the NIC debtors. The real complaint is about competition, not subsidies.

A further factor has been the unevenness of the recovery coupled with easier entry into the American market. The fact that European countries have lagged behind, and the persistence of higher unemployment rates, have strengthened the tendencies toward protectionist policies. Japan continues to

be difficult to penetrate, arousing increasing resentments among its Asian neighbors.

While cyclical factors contribute to this upsurge in protectionism, and especially to the overvalued dollar, it would be wrong to ignore the more permanent changes in the world economy that have occurred. Industrialization is no longer limited to the rich countries, and comparative advantage in many standardized products has shifted. There has been limited recognition of this reality, or the parallel reality of progressively more restricted market access. Pious words in favor of free trade and a new round of trade talks are becoming more dubious guarantors of opportunity for the debtor countries.

2. The present commitment to restrain inflation reduces the likelihood of replicating the commodity booms of the last decade, and with them, periods of much improved developing country terms of trade. Demands for stocks will be moderated since inventories are no longer a valuable hedge against inflation. High real interest rates reinforce this conclusion. We already see some evidence. Commodity prices, in SDR's and not appreciating dollars, have already reversed their earlier ascent. The Economist Index, after a rise in 1983 and the beginning of 1984, has now fallen below year-earlier levels in October by 7 percent. Prices of industrial inputs have declined by 13 percent. This dampens the likelihood of realizing further expected improvements for developing country terms of trade in 1984.

3. Emphasis upon the magical effects of recovery in the industrialized countries ignores the consequences of debt-imposed depression upon Third World trade growth. Trade among developing countries as a whole rose to about a quarter of developing country exports by the end of the 1970s. The decline in demand from other developing countries has been pronounced. For Latin American countries, excluding Venezuela, intra-Latin American trade that

amounted to 19.0 percent of exports in 1980 fell to 14.9 percent by 1982.¹⁸ While the principal market will continue to be the industrial countries, it is wrong to presume that the slowdown in growth that has been experienced, most overt in Latin America, will not have adverse implications for export earnings.

These three alterations in the economic environment add to a concern over optimistic projections that seem to permit significant reductions in debt exposure along with a return to adequate growth rates by developing countries. The apparently favorable results thus far achieved by Mexico and Brazil in 1984 do not nullify a legitimate preoccupation.

For one, their accomplishment has come via a higher volume of real exports than had been anticipated, not through the more favorable vehicle of higher prices. Favorable terms of trade reduce the real burden of the debt by reducing its real resource cost, and hence make the needed export targets more easily attainable over an extended period. Less has to be given up in domestic expenditure.

Second, an eased foreign exchange constraint has benefited in both cases from continuing restraints on growth and imports that have swollen trade surpluses and has made possible the continuation of very large interest payments. The compatibility of real decline in indebtedness and resumed growth, the basic scenario, has yet to be proved. Morgan Guaranty calculates that Mexico can achieve a 3 percent per capita income increase by the end of the 1980s although nominal debt is rising by only 3-4 percent.¹⁹ For Mexico to save enough and import-substitute enough to grow at such rates implies domestic savings out of gross national product of about 30 percent and an import ratio of about 8 percent. While the latter does not differ greatly from the pre-oil boom years, the former is about 50 percent higher.

Third, the experience is not a generalized one. Small Latin American countries will show little improvement in 1984. Chile, Peru, Bolivia, etc. remain serious problems, not to speak of the poorer African countries. In its revaluation of likely trade volumes for 1984 in September, the IMF raised the target for the industrialized countries significantly more than for the developing countries.

The conclusion, therefore, is that it is too early to characterize the problems of the last several years as a mere liquidity crisis that has already largely been resolved. This is especially the case if high real interest rates persist, and it is well to remember that they have actually increased in 1984. Such rates increase the burden of debt service and obligate import restraint, with adverse growth consequences, to equilibrate the balance of payments. Among the Latin American debtors, only Brazil, and not even Mexico, will probably satisfy in 1984 the criterion that export growth exceed the effective interest rate on debt.

This exclusively balance-of-payments-centered approach ignores another important consequence of high real interest rates. The higher the rate, the more resources must be transferred abroad, and the lower is national income. Interest payments must be made at the expense of potential domestic applications of national saving. Smaller countries, with their higher ratios of debt to national product, are especially vulnerable.

Recovery, along with high interest rates, may not therefore be as positive as Cline, for example, has continued to emphasize. His claim that a one percentage point increase in growth is worth seven times as much as a one percentage decline in interest rates is dubious.²⁰ Alternative, and equally reasonable, elasticities halve that margin of superiority, as I have shown. Because growth effects are cumulative, moreover, recovery requires time, while

the effects of interest rate reductions are immediate. Favorable rates can be negotiated directly with banks, as the Mexican restructuring has shown; recovery, and export growth, cannot. The adverse economic consequences of elevated interest rates are therefore legitimately high on the agenda, especially when their real resource costs are also reckoned.

To these considerations must be added political sensitivity. Interest rate variations are viewed as a direct consequence of United States policy decisions and priorities, rather than as a market phenomenon. As such, they take on a significance beyond the direct foreign exchange or resource costs entailed. The extremely adverse reactions of debtor countries to the two point rise in the prime rate experienced between January and June of 1984 is illustrative. Even though exports were expanding at rapid rates for some debtors so that the balance of payments effects were limited, their hostility was manifest at United States' preoccupation with domestic objectives at their expense.

Instead of satisfaction with the present and prospective effects from industrialized country recovery, my message is that a disproportionate share of the adjustment burden has already fallen, and may continue to fall, upon the debtor countries. The liquidity crisis, if that is what it turns out to be, has not been eased by the provision of adequate liquidity, but rather by a sharp reduction in developing country growth. From 1981 through 1984, non-oil countries grew at an average rate of 2.3 percent a year, compared to 5.6 percent between 1967 and 1980. For Latin America the decline has been even more dramatic: from 6.3 percent to a decline of 2.4 percent. Many countries in the region will not attain their 1980 standard of living again until the end of the decade, if then.

The IMF said as much in their 1983 report: "the results of Scenario A are less favorable as far as growth is concerned, and imply stronger adjustment efforts, than those presented last year. In part because of a lower flow of bank lending, the new Scenario A envisages...a lower deficit...despite conditions that would be less favorable for exports. The result is that the aggregate real GDP of non-oil developing countries in 1986 is now expected to be about 5.5 percent less than previously estimated. The volume of their imports is projected to be nearly 13 percent less."²¹

Under these circumstances, it is incorrect to focus exclusively on favorable trade projections. Solvency depends on assessments made by debtors as well as creditors. For the developing countries the greatest real cost of the debt has been the growth foregone, and the vulnerability to its repetition. If they have resisted more drastic actions, it has been both because of the belief that the sacrifice is temporary and that capital flows will resume, as well as the uncertain consequences of unilateral default. The idea of a debtors' cartel has not caught on for two reasons. One is that it has come after the principal costs have seemingly been paid, and rewards are imminent; the other is that, even within Latin America, the situation of individual countries is distinct. Both factors would diminish in intensity were there another generalized downturn.

In the concluding section, we therefore ask whether the institutional response to the debt crisis of 1982 adequately ensures against a repetition and provides a basis for sound recovery of the developing countries.

3. The Present Policy Matrix

At the end of 1984, the structure in place to deal with the debt problem is formally little altered from what it was in August 1982. Yet significant change has been registered. What has been added are additional resources from

the quota increase of the IMF; the considerable experience of the repeated tasks of renegotiating debt and of hammering out country adjustment packages on a case-by-case basis; the new authority of the IMF (and national central banks) in imposing conditionality on the banks by requiring them to make new lending commitments as part of the overall program; and the organization of the private banks into smaller and more effective decision units. The latest outcome is a multi-year restructuring of Mexican and Venezuelan debt on more favorable terms, a process in which official pressures played a tangible role.

Have the modifications been sufficiently far-reaching? Financial circles, despite an official optimism, still have reason to agree with the June 1983 assessment of World Financial Markets. It found wanting the "relatively optimistic, laissez-faire school that assumes the current debt situation is a fairly short-term liquidity issue" to be solved primarily through LDC adjustment along with some OECD recovery. "By ignoring long-term structural elements of the international debt problem or overstating the prospects for global recovery, this approach risks forcing excessive deflationary costs on borrowers. It is also overly optimistic about market forces providing ample new borrowing."²²

Debtor countries are not enthusiastic advocates of the status quo. Internal dissatisfaction with austerity strategies persists. Despite recent more favorable borrowing terms, the new flows of resources have been minimal. Increased international reserves have derived from imposition of the single policy priority of large merchandise trade surpluses. That singlemindedness has had its own costs in the design of more effective domestic medium-term strategy. In the last analysis, as such documents as the moderate Declaration of Quito and the communiqués of the Cartagena Groupe emphasize, the debt

crisis has been the occasion of a Latin American depression that rivals that of 1929.

The present situation derives its stability less from the assurance that it is adequate to the problem than from the fact that it has worked up to now. There is always a preference for marginal policy changes. In this case it has been reinforced by the demonstrated capacity of the present negotiating framework to evolve to meet new demands. The latest confirmations are the Argentine agreement with the IMF in anticipation of a new round of rescheduling discussions with the banks, and the multi-year restructurings noted above.

The Fund has performed three essential functions in structuring the present arrangements. On the one side, it has offset individual bank prudence that would call for a reduced commitment and shorter maturity by imposing proportional lending targets. This new conditionality imposed on the banks defeats the free rider problem inherent in a pure market relationship. Each bank would hope the others would participate, making it better off; such behavior, because none would, would make them all worse off. On the other side, the Fund has devised adjustment programs that assure the lenders that the developing countries will continue to make efforts to meet their obligations, and thereby avoid the moral hazard of countries simply borrowing more without an intention to repay. Finally, the IMF, in conjunction with the BIS, central banks and industrial country governments, has made available public resources to satisfy immediate liquidity requirements and supplement the private market. Central authority has thus been indispensable to a continuing bank-country relationship.

Yet for all its apparent success, this case-by-case framework suffers from serious deficiencies. In the first place, bank participation is largely

on an involuntary basis. They make loans to cover interest payments and thereby avert default, buying an option for return of principal in better days ahead. While a rational decision, since lending to cover interest payments that otherwise would not be made involves no additional cost, the banks have on the whole obtained the best of the bargain. New lending has in fact fallen short of return interest payments, and even of the original expectations of the Fund. From bank financing of about 50 billion dollars a year in 1980 and 1981, borrowing of non-oil developing countries declined to 25 billion dollars in 1982 and 17 billion dollars in 1983. The growth rate of bank claims plummeted from an annual average of about 25 percent in 1979-1982 to 9 percent in 1982 and 4 percent in 1983.²³

Faced with more perilous assets, and a reduced market price for equity reflecting sceptical investor evaluations, banks pressed through the summer of 1984 for better terms and consequent higher earnings flows to mollify shareholders. These decisions meant increased margins, both in the form of one-time fees and on-going premiums over the cost of funds. For the reschedulings completed for Latin America, amounting to some 44 billion dollars for seven countries, banks have obtained commissions of between 1 and 1.25 percentage points, as well as revised spreads that have usually added about a full percentage point to previous ones. By pegging interest rates to the U.S. prime, moreover, they have selected a base that has recently run about one percentage point higher than LIBOR. These efforts might have added between 70 and 130 million dollars to the profits of the largest nine U.S. banks, depending on the relevant marginal tax rates. They translate into an increased return on loans to those countries of about 25 percent in comparison with previous terms, quite independently of higher spreads being charged on new loans.²⁴

Ironically, the absolute effect on total bank profits is relatively small, as is the effect on the borrowers. The cost of the higher premium over LIBOR to Mexico is less than 1 percent of foreign exchange earnings, for example, since what is relevant to the country is the total interest rate, and not the margin. But the ill will of imposing, arbitrarily, increased costs of servicing an already burdensome debt is considerable. Such charges are not market-determined because the lending is involuntary.

At the same time, of course, the large money market banks find themselves under assault. They are being forced to set aside larger loan reserves to satisfy bank examiners and a Congress concerned with excessive bank exposure. They must also cope with second-tier banks who have much less to gain from a continued lending relationship with developing countries and do not want to renew outstanding loans, even at higher spreads. Michigan National Bank has even taken Citicorp to court over the involuntary extension of a 5 million dollars participation in a Pemex loan. For new money, the money market banks can no longer count on tapping their regional colleagues, and must rely on the suasion of the Federal Reserve to pressure the smaller banks into staying in the game.

This short-term mentality provoked an increased country resistance, and an increased emphasis upon injecting larger political considerations, and elements of systematic stability, into the discussion. Banks logically preferred a minimum amount of additional lending or renegotiation. They, and even the Fund, want the country on a short leash, and constantly accountable. While this surveillance may reduce the moral hazard problem, it does so at the risk of miscalculating the provocation to country default and to more concerted organization among debtors. The widening perception, particularly as interest rates rose in the first half of 1984, that the negotiating structure was

inadequate precipitated its latest modification, the Mexican multi-year restructuring.

The agreement included a significant concession on terms. Interest rates were to be based exclusively on LIBOR, spreads were lowered, and no commission charges were imposed. For the first time the banks implicitly recognized that there could be no appeal to market forces in determining the costs of involuntary lending. They accepted reduced profits, before tax, of about 500 million dollars, and a corresponding Mexican benefit, fully reversing their previous strategy. In addition, the public debt was restructured over a 14-year term, explicitly accepting the necessity of a longer time horizon for meaningful resolution of the debt crisis. Indeed, the only notable absence in the package, already a model for application to other countries, is the presence of an interest rate cap that would reduce susceptibility to market volatility. The agreement was thus a victory for those, like Paul Volcker, who from the beginning insisted upon a systemic, rather than a private perspective.

Yet it also raises fundamental institutional issues. The Mexican arrangement signalled another major step down the road of quasi-socialization of international lending inaugurated by the Fund's imposition of conditionality upon the banks. The international banks themselves, now centrally organized into negotiating committees, have conceded the inapplicability of simple market signals. The terms of the Mexican agreement call for the continued presence of the Fund even when the term of the present extended facility expires. It is therefore difficult to argue that one will soon see a return to normal, decentralized market borrowing as some bankers contend. Rather, the new institutional characteristics mirror the likely continued reluctance of bankers to play a major role in meeting current account deficit financing of developing countries as they did up to 1982.

Thus, for all the advance, current policies fail to address the adequacy of the long-term supply of capital. The inability to restore the past should not be unduly regretted. There is no reason to believe that the private profit calculus will produce the right amount of capital for the right developing countries. One of the causes of the present crisis is such market failure, failure that has had to be compensated by ever greater public intervention. But its continuing role is as yet still inadequately defined.

There is not even a clear policy direction should the present signs of improvement recede. This is far from an extreme hypothetical view. Recovery may not continue at its present pace. Rising social costs in one or more of the major developing countries may still lead to failure to live up to stabilization targets. The continuing pattern of adjustment via trade surpluses may provoke even more pronounced tendencies toward protectionism, with significant consequences for the structure of the trading system. Reaction against rapidly rising imports from the NICs can spill over to imports from industrial country competitors. Interest rates may resume an upward course, fed not merely by a continuing large budget deficit, but by threats of a sliding dollar. These possibilities, and with them slowed industrial country growth, are real. That reality contributes to pervasive uncertainty, itself a constraint on recuperation of the global economy in the 1980s.

The debt issue is thus far from definitive resolution. What we have is an evolving process that has averted financial disaster, but at a significant cost for the developing country debtors. Once the dangers of crisis recede, will even the present concern for these debtors survive? Will proper attention be focused upon the longer-term financial requirements of these countries? It is easier to respond to immediate pressure than to take the longer view. Financial collapse has its obvious costs. The costs of inaction are

less tangible, but no less real: taxpayers pay through slower growth and increasing alienation of the developing world rather than by appropriations needed to underwrite public participation in financing development.

A few years ago, prior to the crisis of 1982, I wrote: "The principal danger is not the wholesale default by developing countries and the possibility that it may bring the world financial system crashing down. The principal danger is that available international finance will be inadequate to maintain a reasonable level of world economic growth in the 1980s. If the supply of funds proves inadequate, it will be the largest debtors--many of them Latin American countries--who will be most in danger. They will have to bear the brunt of the adjustment burden themselves....The developed countries may not react to strengthen the system in time to avoid slowing of growth of their exports to the developing countries. The burden will fall primarily on the developing countries. Interdependence is still asymmetric."²⁵ That prognosis unfortunately proved accurate. I regret to say that there is little reason to amend it now.

In the last analysis, the debt problem is a development problem, not an isolated preoccupation with solvency or liquidity. It speaks not merely to the financial system, but equally to the future pattern of production and trade. Above all, it profoundly affects the lives of many hundreds of millions, the majority in this hemisphere. We do not escape its effects: interdependence is no less real for being asymmetric. The issue is not merely a technocratic problem, devoid of political content. Until these realizations become more pervasive, we shall continue merely to cope with the great debt crisis of 1982 rather than confronting and resolving it.

APPENDIX

A. ESTIMATING EQUATIONS^a FOR EXPORT VOLUME ELASTICITY

	<u>Constant</u>	<u>Percentage Growth of Industrialized Country Product</u>	<u>D-W</u>	<u>Adjusted R²</u>
Percentage Change in Export Volume of:				
Non-Oil Developing Countries, 1963-1982	2.5 (2.4)	1.08 (.52)	1.61 ^b	.10 ^b
Non-Oil, Oil Importing Countries, 1973-1982	1.5 (1.4)	1.73 (.42)	1.50	.64
Exporters of Manufacturers	2.1 (1.7)	2.46 (.51)	1.71	.71
Low Income		c		-.10
Asia	3.9	2.29 (2.5)	1.95 (.74)	.49
Western Hemisphere	1.1 (3.8)	1.51 (.73)	1.78 ^b	.31

Sources: Non-Oil Developing Countries, 1963-1982: IMF, International Financial Statistics, Yearbook, 1983.

Non-Oil, Oil Importing Countries, 1973-1982: IMF, World Economic Outlook, 1983.

^a Standard errors in parentheses

^b One observation omitted to adjust for autocorrelation of the residuals.

^c t-valued less than one

B. ESTIMATING EQUATIONS^a FOR EXPORT UNIT VALUE

	<u>Constant</u>	<u>Change in Industrialized Country Growth Rate</u>	<u>Change Logged</u>	<u>Change in Industrialized Country Inflation Rate</u>	<u>Dollar Appreciation</u>	<u>D-W</u>	<u>Adj. R²</u>
Percentage change in export unit value of							
Non-Oil developing countries, 1964-1982	6.10 (4.19)	1.06 (.53)	.03 (.03)	5.04 (.61)	-.18 (.28)	1.86 ^b	.81
Non-Oil developing countries, 1971-1982	10.13 (4.0)	1.43 (.55)	.78 (.50)	5.00 (.70)	-.18 (.26)	1.36 ^b	.90
Non-Oil importing countries, 1974-1982	6.17 (10.0)	1.07 (.45)	.59 (.42)	4.71 (.66)	.27 (.23)	2.33 ^b	.93
Exporters of Manufactures	8.04 (4.35)	1.15 (.46)	.51 (.43)	3.72 (.66)	-.0004 (.23)	2.47 ^b	.90
Low Income	-3.92 (16.7)	.50 (.29)	2.17 (.27)	2.50 (.43)	.41 (.15)	2.36 ^b	.96
Asia	10.22 (2.27)	1.17 (1.11)	.62 (.80)	4.40 (1.27)	-.10 (.46)	2.40	.73
Western Hemisphere	-5.79 (65.3)	1.64 (.50)	1.18 (.46)	6.06 (.73)	.76 (.26)	1.69 ^b	.94

Source: As for Table A.

^a Standard errors in parentheses

^b Corrected for autocorrelation

NOTES

¹The basic sources for developing country debt and associated economic data are IMF, World Economic Outlook; World Bank, World Debt Tables; and OECD, External Debt of Developing Countries. All three are published annually. Coverages differ. This estimate comes from the World Bank.

²For a recent review of bank debt restructurings, through June 1984, see IMF, Occasional Paper No. 31, International Capital Markets, Developments and Prospects, 1984, Appendix III.

³World Bank, World Development Report, 1982, p. 21.

⁴See the article on Citibank in Business Week, May 16, 1983, pp. 124 ff.

⁵These data cover the period 1965-81. During the interval the combination of export opportunities and access to credit gives reason to suppose that simple least squares captures a savings function unconstrained by foreign exchange shortage. To avoid problems of appropriate deflators, the functions are estimated in ratio form: $S/Y = a + b/Y_r + c_1CA + c_2CA$ where S is gross national savings, Y is gross national product, Y_r is real gross domestic product, and CA is the current account deficit. The coefficient $1-a$ is the estimated marginal propensity to consume out of gross national product, and c_1 and c_2 are the period specific propensities to consume out of the deficit for 1965-1978 and 1979-1981.

⁶World Economic Outlook, 1983, p. 143.

⁷IMF, Occasional Paper #3, External Indebtedness of Developing Countries, May 1981, p. 11.

⁸Although Tables 3 and 4 use a similar methodology, they will not necessarily yield a set of Latin American estimates that are an exact proportion of the non-oil developing country total. Thus, the Latin American interest rate effect seems to exceed the total, when it cannot. Yet the conclusion that

Latin America is responsible for the lion's share of the interest rate effect is surely valid.

⁹For these estimates see Michael Dooley, et. al., "An Analysis of External Debt Positions of Eight Developing Countries through 1990," Federal Reserve Board International Finance Discussion Paper No. 227, August 1983.

¹⁰World Bank, World Debt Tables, 1982-83, p. vii.

¹¹William R. Cline, International Debt and the Stability of the World Economy, Institute for International Economics, Sept. 1983, p. 71. World Financial Markets, June 1983.

¹²That is, it takes as the appropriate constraint for developing country repayment the capacity to generate foreign exchange earnings rather than domestic saving. For an example of the latter, see External Indebtedness of Developing Countries, Appendix III.

¹³Specifying the following equations:

$$X_t = X_0 e^{gt}$$

$$M_t = (1+a)X_t$$

$$dD = M_t - X_t + iD_t$$

we can solve for debt, $D_t = a/(g-i)X_0(e^{gt} - e^{it})$. Then the limiting debt/export ratio, $D(t)/X(t) = a/(g-i)$.

¹⁴Economic Commission for Latin America, Balance preliminar de la economia latinoamericana durante 1983, Dec. 1983, p. 29.

¹⁵World Bank estimates reported in the New York Times, January 26, 1984, p. 45 from World Debt Tables, 1983.

¹⁶For the results reported by the IMF, see World Economic Outlook, 1983, Appendix A.9, pp. 154 ff. A different estimate, also for quarterly data, is found in Dooley, et. al., Appendix Table 17. The Latin American commodity

price index in question can be found in Inter-American Development Bank, Economic and Social Progress in Latin America. Petroleum was excluded.

¹⁷See Table 3 in my "The Debt Crisis: Round Two Ahead?" in R. Feinberg and V. Kallab, eds. Adjustment Crisis in the Third World, Overseas Development Council, 1984, illustrating the sensitivity of export earnings to key price assumptions.

¹⁸INTAL, IDB, The Latin American Integration Process in 1982, Table 7, p. 35.

¹⁹World Financial Markets, May 1984, p. 11.

²⁰Cline finds an elasticity as great as 7 based on the aggregation of country estimates, and a value of 5 derived from the elasticity estimates of his projection model. See p. 65. The actual simulations show a larger effect because the sharp decline in the debt-export ratio reduces further the relative importance of interest payments.

²¹World Economic Outlook, 1983, p. 20.

²²World Financial Markets, June 1983, pp. 11, 12.

²³See IMF, International Capital Markets, 1984, Chapter III and Appendix Table 42.

²⁴These estimates start from the terms and sums rescheduled reported in Latin American Weekly Report, 20 May 1983, plus subsequent news accounts. On average, spreads were one percent higher than during the period when the loans were initially contracted in the late 1970s, allowing for intervening grace periods. Commissions for rescheduling ranged between 1.25 and 1.50 percent, of which one percent was regarded as profit (taking into account the World Bank typical commission payment of 0.25 percent).

Commissions are presumed to be paid initially, even if not accounted in bank earnings in that fashion, and to yield a return of 10 percent a year.

The average annual value, spread over the life of the loan, is therefore greater than the simple average (approximately twice as large).

To the before-tax annual earnings obtained by summing the incremental spreads and the average annual value of commissions, alternative marginal tax rates are applied to arrive at after-tax profits. These are then compared to the approximate share of loans to these countries in total bank assets to assess the increased returns on their holdings.

Equivalently, one can approximate the result, excluding commissions, by noting that the spread on rescheduled loans has doubled. Since such rescheduled loans are about one quarter of the total extended by banks to these countries, the effect is about a 25 percent rise in after tax earnings.

The calculations are reported in the Wall Street Journal, December 5, 1983.

²⁵The Political Economy of the Western Hemisphere: Selected Issues for U.S. Policy, Joint Economic Committee, 97th Congress, 1st Session, September 18, 1981, p. 163.