



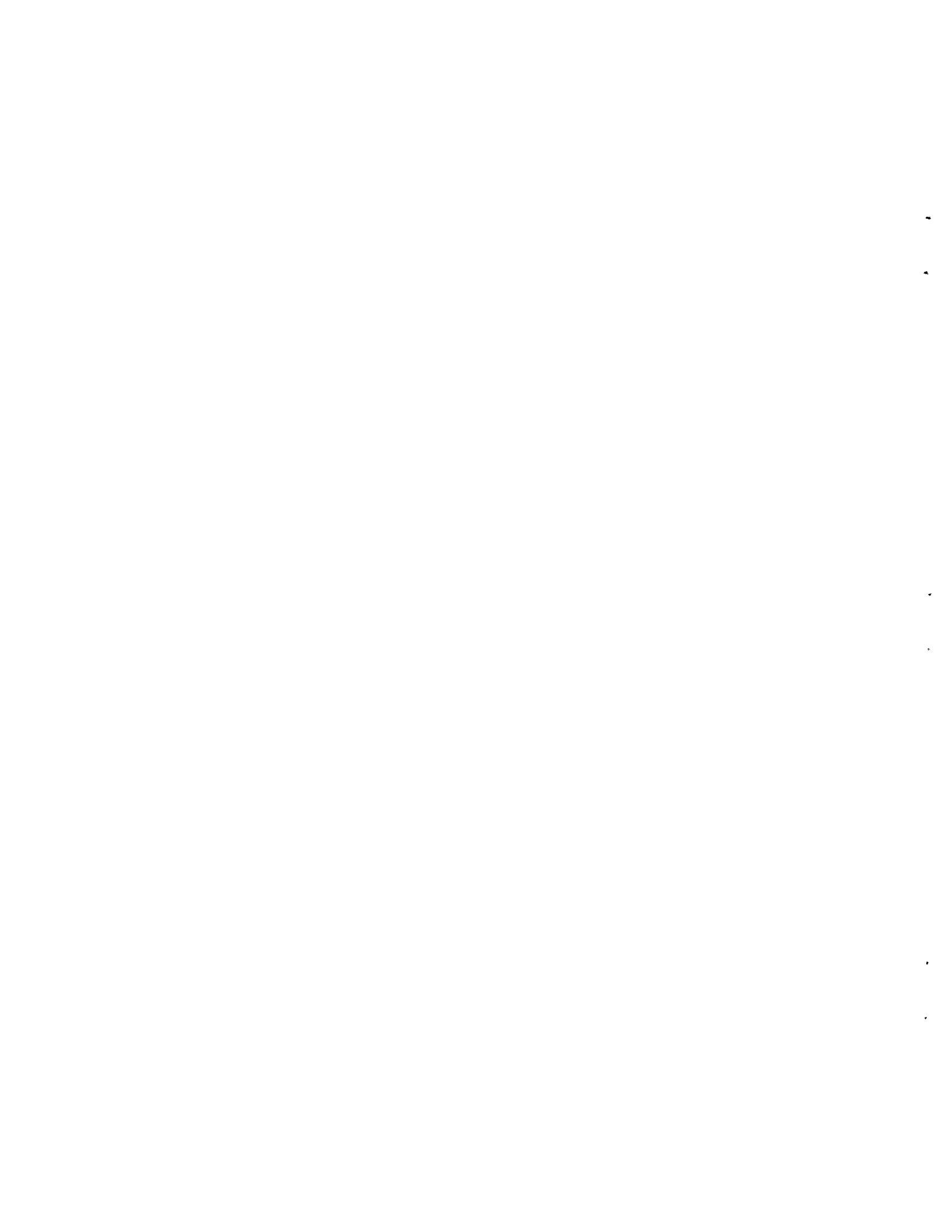
**THE EXTERNAL DEBT PROBLEM FROM  
A LATIN AMERICAN VIEWPOINT**

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## **ABSTRACT**

The starting point for this paper is Latin America's present economic situation of poor growth prospects combined with a severe and continuing external debt crisis. The author evaluates the strategy implemented so far and examines alternative theories about its failure to resolve the crisis. He puts the arguments in the context of economic and political changes affecting individual countries and the region as a whole. He discusses the phenomenon of "adjustment fatigue," the effects of the dual conditionality imposed by the international banks and the IMF, and the probable effects of the conditions attached to recent proposals; and concludes with some practical suggestions for future policy.

## **RESUMEN**

El punto de partida de esta ensayo es la situación económica actual en América Latina de pobres prospectos de crecimiento, combinados con una severa y continua crisis de deuda externa. El autor evalúa la estrategia implementada hasta ahora, y examina teorías alternativas por el cual fracasó en resolver la crisis. Sitúa los argumentos en el contexto de cambios económicos y políticos que afectan países individuales y la región en su totalidad. Discute el fenómeno de "fatiga de ajuste," los efectos de la doble condicionalidad impuesta por los bancos internacionales y el FMI, y los probables efectos de las condiciones adjuntas a recientes proposiciones; y concluye con algunas sugerencias prácticas para la política del futuro venidero.



Latin America has reached an impasse. After more than four years of harsh adjustment programs, the prospects for economic growth in the major debtor countries are far from promising. Current projections, based on an oil price of \$18 per barrel and interest rates around 8%, show a likely rate of GDP growth for the rest of the decade of not higher than 3.7% per year.<sup>1</sup> At this growth rate, Latin America would be barely recuperating its pre-crisis levels of GDP. A full decade of growth would be lost.<sup>2</sup> Moreover, given this growth rate and a labor force that grows at more than 2% a year, the employment perspectives for the rest of the decade do not look favorable. Total external debt would reach \$480 billion by 1990. The debt-export ratio would still be, on average for the region, higher than 300% and, by some estimates, Latin America would still be needing something on the order of \$30 billion a year in net capital inflow per year.<sup>3</sup>

These figures are important because they confirm wide-spread doubts about the viability of the strategy implemented so far. This strategy was formed at a time when Latin America's economic prospects appeared more promising. By the end of the 1982-1983 debt crisis, expectations for a more permanent solution to the problem had been bolstered by the rapid growth in world trade, which would have enabled significant expansion in the economies of the debtor countries and increased their ability to pay back their debts. This optimistic perspective was influenced by the views of the creditor banks on the best method of resolving the crisis, and it prevailed until early 1985.

The strategy of the banks consisted of trying to achieve two simultaneous objectives. First, they wanted their financial position to improve rapidly. They planned to achieve this by reducing their credit volume in Latin America and capitalizing a high proportion of their profits so as to cover themselves against the risk of nonpayment by some of the debtors. Their success in fulfilling this objective meant that by mid-1985,

their financial position was already equal (in terms of the ratio between the banks' capital and their claims in debtor countries) to the level in the years preceding the debt crisis.<sup>4</sup>

Secondly, the banks wanted to improve the ability of three major debtors in particular--Mexico, Brazil, and Argentina--to make their payments. The banks closely followed the performance of these economies and in-depth studies were undertaken to evaluate their prospects at the end of the decade.

Banks measure a country's credit-worthiness on a variety of aggregate ratios. The one that is probably used most often is the debt-export ratio. A country is considered to be solvent and credit-worthy when this is under 200%. It should not be surprising, then, that the banks felt confident when some financial institutions made projections for Brazil and Mexico and found, under plausible assumptions, that these countries seemed capable of reaching the year 1990 with a debt-export ratio under 200%. There was still concern about Argentina whose situation was particularly difficult to forecast, both because of the government's unclear position on the debt payment and the uncertainty surrounding the application of an internal economic adjustment policy which Argentina did not appear ready to accept. However, in June 1985, when Argentina implemented a shock policy that was even harsher than the IMF's and showed a willingness to catch up on foreign debt interests payments, it seemed that the main obstacles to solving the debt problem in Latin America had dissipated.

Of course, the banks were aware that the situation of the other countries in Latin America was not necessarily the same as that of the major debtors. In fact, projections for the small and medium-sized countries, such as Chile, Peru, Bolivia, Nicaragua, Jamaica, and others, showed that their debt-export ratios did not reach the minimum necessary to be regarded as credit-worthy. The position the banks took on these other countries was that governments and multinational agencies should aid their economies with easy credit terms.

The current situation of the principal debtors has modified the banks' optimistic outlook. The September 1985 issue of World Financial Markets reviews its previous projections for the economies of Argentina, Brazil, and Mexico so that none of the three countries even approaches, by the end of the decade, the threshold of a 200% debt-export ratio. The levels projected for 1990 are about 300% for Brazil and Mexico; 350% for Argentina.<sup>5</sup> These estimates do not take into account the impact of oil price reduction on the Mexican economy, which is already having a devastating effect on that country's capacity to meet its debt obligations.

The deterioration of the economies in these countries is not an isolated occurrence. It is clearly a problem affecting the entire region. According to bank sources, around October 1985, ten Latin American nations were behind in their interest payments; six others had not been successful in meeting the goals of the adjustment programs established by the IMF; and two others refused even to negotiate with the IMF. In 1985, Bolivia and Nicaragua fell behind in their payments, and Peru unilaterally announced a ceiling on the interest that it would pay and refused to negotiate with the IMF. The Dominican Republic and Jamaica struggled to maintain a precarious level of domestic stability in the face of extremely severe austerity policies. Chile entered into a new period of economic stagnation. Mexico held back payment of nearly one billion dollars and requested more than six million dollars to keep up with its payments in 1986. The IMF declared Mexico to be out of compliance with the established goals. Brazil kept up its interest payments, but was not able to settle differences with the IMF regarding an adjustment program.

Against this economic backdrop, Latin America's main debtor countries were applying political pressure for a new approach to solving the debt problem; one that would be compatible both with the banks' goal of avoiding a solvency crisis and with the resumption of the economic growth in Latin American economies which was seen as

indispensable to payment of the foreign debt. Some analysts interpreted these political reactions of the governments as a symptom of "adjustment fatigue."

### 1. Beyond "Adjustment Fatigue"

As has been indicated in the previous section, growth expectations for Latin America do not offer much hope for improvement in living conditions in the reasonable future. In light of this, some countries tend to regard efforts to comply with the current adjustment policy as simply pointless. It is important to note that, in spite of this perception, most countries have not considered the option of a moratorium, such as the one that occurred in the 1930s. This is because they have believed until now that the costs would be too high. On the one hand, considerable emphasis has been placed on the possibility of a liquidity crisis, which could arise if the flow of credit to a country were suddenly interrupted. On the other hand, there has been hope that "good behavior" in the form of timely payment of the debt would create conditions to quickly re-establish voluntary credit channels through the international banking system.

Another important consideration in the past was the internal political situation. Authoritarian governments who saw their internal base of support weakening attempted to strengthen links with their principal sources of outside political and economic support--the U.S. government, multinational institutions, and creditor banks. This was the case in Chile, which became the most faithful observer of conditions favored by the IMF, the banks, and the U. S. government, and maintained this observance despite the catastrophic social consequences of the imposed adjustment.

Paradoxically, Latin America's new democracies arrived at similar political conclusions, but for different reasons: the fragile nature of these new democratic systems and the absolute importance of avoiding any economic disaster set off by a



sudden break in the flow of credits from banks led governments, such as those in Argentina, Uruguay, and Brazil, to be overly cautious in their approach to the debt questions and, despite their reluctance, to follow the policies suggested by the IMF and the banks. The perception of the costs of not having credit available, however, has been changing because the flow of credit towards these countries has actually been decreasing dramatically since the end of 1984. Despite their "good performance," several of these economies are currently going through various liquidity problems. Recent events in Mexico are a salient example. One has only to look at the figures to see where the problem lies: The net credit from private international banks to the seven major debtor countries in Latin America grew by only 2.5% in 1983 and by 1.6% in 1984; during first-quarter of 1985, the net flow was negative.<sup>6</sup>

The threat of loss of access to voluntary bank loans in the future is also diminishing in effectiveness in view of the general impression in financial and political circles that the banks will not in any case voluntarily renew a normal flow of credit before the end of this decade, except perhaps to larger countries, such as Brazil, which have been able to sustain solid recovery with significant levels of economic growth.

The cost of reducing concerted actions with banks in favor of more concerted actions among countries is considered lower now, not only for the reasons mentioned above, but also because in several cases these governments have been able to considerably strengthen their internal basis of political support. The examples set by Alfonsín, Sanguinetti, García and Sarney illustrate this point very well. It could in fact be argued that precisely this perception of the economic crisis, combined with the impossibility of improving the economic situation by depending, as in the past, on high levels of external credit, might make it possible for Latin America's new leaders to launch an appeal for large-scale nationwide mobilization in order to solve the debt crisis through domestic savings and internal efforts.

The recent experience of Argentina could serve as a lesson. So long as the country's economic situation did not deteriorate drastically, it was impossible to attain the political support necessary for economic adjustment. Alfonsín's political talent enabled him to recognize the critical point of crisis, and convert it into an opportunity. When the gravity of the crisis became well-known and there was no other alternative open to Alfonsín's government, it took harsh economic measures--the so-called "Plan Austral"--which the population as a whole supported despite the immediate costs to each particular group. Alfonsín came out of the crisis stronger and was able to gain time before tackling the structural problems underlying the current economic crisis in Argentina. The same happened in Brazil in early 1986, when the "Plan Cruzado" was put into practice with widespread popular support.

The point is that it is possible for a country subject to severe external constraints to achieve dynamic levels of growth. But it needs leadership capable of mobilizing the population through a national development plan which spurs the country's imagination and encourages it to make a special effort to save and work in order to free itself from crisis. What countries need are their own national strategies for overcoming constraints. Much historical experience points in this direction. What blocks this path for Latin American countries in the 1980s is their governments' limited autonomy in defining national development plans in response to their own institutional structures, experience, and knowledge, on the basis of past successes and failures.

## **2. A New Conditionality?**

Current efforts by the U. S. government point to a shift in the focus of its approach to the debt problem, by acknowledging the need for economic growth in order to pay off debt. Greater emphasis is now being placed on the importance of structural

change for renewed growth. Structural readjustment could be a necessary condition for the proper use of capital that agencies such as the World Bank might make available to debtor countries at higher levels. This increase in resources would be subject to compliance with long-term development policies consistent with the "correct policies" view held by these agencies and/or the governments that have the greatest influence on them. This would represent a new form of conditionality which would be superimposed over that defined so far by the IMF.

However, the extension of the principle of conditionality to the sectoral or structural change programs undertaken by developing countries may imply limiting the ability of each country to find the development scheme most effective in mobilizing its creative energies. Public statements by Secretary Baker seem to be saying to the multinational development organizations that their new mandate is to loan preferably to those indebted countries that are willing to try in a serious way to move towards "reaganomics": privatization of public enterprises, free-market policies, free trade practice, liberalization of financial markets, supply side incentives through lower taxes. It would seem that this new form of conditionality takes little account of the past experiences of some countries who have used such policies, particularly in the Southern Cone in Latin America.

Jamaica is another instance. This country has been subjected to simultaneous and superimposed conditionality by the IMF and the World Bank over its economic policy and development program. Its structural adjustment program included more than twenty simultaneous conditions that cover domestic concerns (such as privatization of state-run bus companies and publically-held land, reorganization of the stock exchange, a program for reforming public administration, altering government-run hotel rates and public radio commercials rates, and introducing staff-reduction quotas in specific state-run companies) in addition to the more standard conditions on foreign trade, taxation, and finance.

If this form of conditionality becomes more widespread, countries will be severely constrained in defining their own development programs and will have no leeway in their application; in some cases, they will be led into the same errors committed by those Latin American countries who hurriedly liberalized their economies in the 1970s. The alternative for these countries would be to seek a deliberate de-linking from the international economy. This may become an appealing alternative for some countries in the area. But the historical lesson is well known: isolated, autarchic countries with "war-time economies" inevitably end up restricting civil liberties and developing very authoritarian-looking "war-time policies."

We will return to these topics shortly. First, however, it is useful to critically examine the basic assumptions of the current strategy for solving the debt problem.

### **3. External and Internal Adjustments**

There are two aspects that contribute to the fragility of the current strategy for solving the debt problem: the first is related to the notion that industrial countries' growth will be the basic mechanism by which debtor countries will be able to solve the debt problem in the long run. The second has to do with the difficulty of sustaining the massive transfers of funds from debtor countries to developed countries, that have been occurring since the inception of the debt crisis.

#### **3.1 The Locomotive Theory**

According to this theory, the debt problem could be solved, without the need for government intervention, if stable, strong growth rates were achieved in the industrial economies.

Strong growth rates--above 3% for the OECD economies--would make it possible to expand the exports of developing countries to annual rates of at least 6%.<sup>7</sup> With real interest rates in the international markets projected between 4% and 5%, the higher growth of exports would make it possible for these countries to allocate even fewer exports to debt service maintenance than before. Thus, the solution for the problem would not be short-term, but a favorable result would be guaranteed in the medium term, with no other intervention than that necessary for maintaining sound macroeconomic policies.

The developed economies in 1984 grew at a respectable 5%, a high rate which stemmed from the 6.8% economic growth in the U.S. economy that year. This rapid growth, aided by unusually high U.S. demand for imports as a consequence of the high dollar, made it possible for Latin American exports to the United States to grow at an astounding rate in 1984. This high growth of exports actually began in 1983, providing for that two-year period an annual expansion rate of 32% in exports from Latin America to the United States, although the impact was partially offset by a drop in Latin American exports to the rest of the world. These results seemed to fully validate the strategy currently being used.

In 1985, however, the situation took a sudden turn for the worse. Industrialized nations as a whole grew only at a rate of 2.8%. This modest growth was accompanied by continued deterioration in the purchasing power of Latin American exports. In 1985 alone, it decreased by 4.6%,<sup>8</sup> and most analysts agree that the deteriorated terms of trade for Latin America are not likely to recuperate in the short to medium term.<sup>9</sup>

These figures show the fragility of the mechanism on which the debt-payment capacity of debtor countries is based.

The "locomotive" mechanism, which presumes that rapid, stable growth in the industrialized economies would create a sweeping demand for Latin American exports as

well as an automatic improvement in the region's terms of trade, does not seem to be reliable enough to bring about an "automatic" market solution to the debt problem in Latin America. There is a need for intervention from governments and international lending institutions in order to "guide" the process, neutralizing the negative impact of external "shocks," until the economies are able to recover their ability to grow in a sustained manner, and pay off the debt.

### 3.2 Can Internal Efforts for Paying the Debt in Latin America Be Sustained?

We mentioned that since 1983 Latin America annually transferred about US\$30 billion to the industrialized countries. This represents approximately 5% of the region's GNP. To effect this transfer, Latin American economies had to free resources that would otherwise have been added to internal savings for investment. Transfers were paid with the foreign exchange produced from surplus trade balances. If the economy is at full employment, these surpluses are achieved by reducing internal spending in order to generate the savings that need to be transferred abroad.

In order to ensure their ability to transfer resources for paying the debt, countries apply adjustment programs negotiated with the IMF. Although the nature of these programs is well known, two aspects should be emphasized: the dual conditionality to which the countries are subject and the fact that the IMF programs tend to ignore particular circumstances and new economic constraints arising from the debt crisis itself.

Dual conditionality occurs because different entities--the banks on the one hand and the IMF on the other--each impose their own conditions. After the debt crisis, the international banks decided to limit the total amount of loans a given country may receive. They use three criteria to determine these totals: their need to reduce banks' exposure in a given country, their aim to increase reserves in order to cover the risk of nonperforming loans, and their decision to give out new loans only to the extent required by a given

country in order to allow it to continue interest payments without affecting its credit-worthiness. As a consequence, the internal effort that the country has to make is determined by the size of its debt and the level of the interest rate, as well as by the banks' upper limit in their desired lending to the country in question as derived from the above stated criteria.<sup>10</sup>

The resource constraint for the country is thus determined by the amount of new external credit the banks and official agencies are willing to provide. The magnitude of the internal adjustment effort that the country must make is in turn conditioned by the ceiling imposed by the banks on the new lending that is available. This is the first conditionality constraint.

A second type of conditionality is present when the country asks the IMF to help finance a balance of payments deficit. The IMF usually sets two types of conditions. First, the country should reduce imports by tightening spending, and second, the country has to take measures that would allow it to divert resources to the production of either exportable goods or goods that can be used to replace imports.

The adjustment that began in 1982 in Latin America showed just these features, and the results were as expected. Imports dropped very rapidly. Significant reductions in production followed. The drops in production resulted from Latin America's traditional dependence on imported raw materials and imported capital goods for full capacity use and internal production expansion. When imports fall 40% in two years, as was the case in 1982-1983, the resulting shortages in raw materials and intermediate goods inevitably brings down output levels in the economy.

Internal adjustment policies have also created huge complications in the fiscal sector. The IMF has always placed emphasis on reducing the fiscal deficit. The recommendation is often very simple. The rule of thumb seems to be: cut the deficit in half each year, regardless of its relative level.

Following the period of financial liberalization in Latin America, two events occurred. The governments, state-run companies, and the private sector borrowed excessively abroad. When external funds dried up, the renegotiation of loans became inevitable. At this point the international banks pressured governments to take over external liabilities contracted by the private sector. This was achieved by either government guarantees on the private debt or by having the public sector assume the obligation to make payments in dollars.

In order to make the interest payments on the foreign debt, governments had to purchase dollars with surplus internal resources obtained either by reducing spending, or by printing more money, or by issuing bonds that were placed on local financial markets. If the choice was to reduce spending, this only accentuated the contractionary trend set in motion by the IMF adjustment policies regarding the non-financial deficit. Contractions in government expenditures usually had the largest impact in the area of investment and in spending for social services.

The other options for the government consisted of either borrowing in the domestic capital market or, alternatively, printing more money. When the first alternative was chosen, the consequence was a rise in the interest rate which accentuated recession; on the other hand, when the second alternative was chosen, inflationary pressures immediately increased, as could be observed in the cases of Argentina and Brazil where inflation shot up to the three-digit level.

Furthermore, the requirement to convert government savings into foreign exchange in order to pay the debt in dollars meant that the government had to purchase this foreign exchange, thereby creating upward pressure on the exchange market. The fear of devaluation caused by this pressure could only be assuaged by providing a strong inducement to hold domestic currency which, in turn, implied increasing domestic interest rates. This was the mechanism chosen by Alfonsín's economic team; variants of this



mechanism have also been used in Mexico and Brazil, which explains the extremely high real interest rates that prevailed in these countries during the adjustment period.

All of these aspects have obvious repercussions on the economic climate of the countries during the post-crisis adjustment phase. The undesirable consequences of austerity policies against a background of excessive borrowing can be summarized as follows: slow growth or outright stagnation in production levels, aggravation of the financial position of firms, high rates of real interest, pressure on the dollar, and a permanent climate of economic uncertainty.

Uncertainty is perhaps the most significant unintended consequence of the drastic adjustment effort. IMF targets for the main macroeconomic variables have to be continually revised, due to the inability of most countries to meet them. While this occurs, the IMF interrupts the flow of external funds until negotiations with each country's policy makers are reinitiated. These negotiations take months, during which time the economic agents can do nothing but wait.

In this environment it is impossible to maintain a stable economic policy, and frequent changes make the public lose confidence in the policy makers. What suffers most are investment levels. Economic agents do not feel they can make rational decisions in such an uncertain environment, and they often choose to hedge against uncertainty by buying dollars. Capital flight turns out to be the last escape valve in the face of a climate of economic deterioration and uncertainty. In fact, the figures for capital flight from Latin America are impressive: During the 1983-1985 period alone, it reached \$31 billion for the ten largest Latin American debtors.<sup>11</sup>

### 3.3 Lessons To Be Learned From Dual Conditionality

The picture drawn in the previous section would not be balanced if one did not also recognize the valuable role that the IMF played during the crisis in preventing a collapse in the international monetary system. The IMF's key function was to put pressure on countries and banks to maintain payments flows and minimum levels of new credit that were essential to prevent the "debt bomb" from exploding.

On the other hand, it cannot be denied that the debt-burdened countries had to adjust their economies to the new conditions of scarce credit. To achieve this, greater fiscal discipline was necessary, along with internal savings efforts and a redirection of national production toward external markets. It is also clear that the achievement of greater international competitiveness continues to be the best basis for a solid solution to the debt problem.<sup>12</sup>

But what is often not recognized by international lending agencies is that economic policy approaches in Latin America in the 1980s are more sophisticated and pragmatic than old stereotypes would admit. Most governments and policy makers in Latin America today would stress the importance of the market and its proper functioning as a necessary, although insufficient, condition for the efficient allocation of resources in these economies. This approach recognizes the reality of mixed economies in Latin America as a valid historical formation that has existed and will continue to exist in the future, whatever the ideological intents of the extreme left or right.

Latin America today has a greater understanding than ever of the need to promote more incentives for the development of entrepreneurial capacity. What is needed is a dynamic private enterprise sector that is productive and competitive at the international level.

Furthermore, critical evaluations of past free market experiments are currently under way in Latin America. It is generally accepted now that a naive and radical hands-off attitude on the part of the governments leads to serious distortion in resource allocation: low investment, high capital flight, etc. This was often due to poor performance in specific markets, such as domestic capital markets that in some countries produced real interest rates in the range of 20-50% for several years; to persistent goods and labor market disequilibrium, to unchecked speculative behavior by economic agents that led to capital flight, to imperfect world markets for key export products, etc. Thus it seems that an active regulatory role for the government is needed, as well as government intervention for the protection of the poorer sectors through vigorous development of social programs.

The difference between this sort of active government presence and old-fashioned statism lies in the fact that what is stressed now is a decentralized, smaller government that opens channels for the private sector and organized labor to participate in the decision making process. Discussions in Latin America today focus more on decentralized development, social pacts, and concerted action; and less on an omnipresent state role or the advocacy of unrestricted free markets.

With this in mind, we can now discuss some of the lessons that can be drawn in Latin America from the experience with "dual conditionality."

The IMF's mandate is to promote international financial order by conditioning its financial support of countries in difficult situations on their compliance with measures to normalize the balance of payments. In addition to the necessary emergency measures, the success of external adjustment depends most importantly on strengthening the ability of the economy to export and to substitute imports efficiently. An aspect that is usually ignored in the redirection of production toward export goods is that success hinges on the impact that the macroeconomic adjustment policies will have at the microeconomic level, i.e., on the firms themselves.

Adjustment policies during and after the debt crisis were characterized by reductions in investments of up to 30% and by the persistence of a recessive trend in the economy. For firms this meant low sales levels and chronically idle capacity. Stagnation in sales weakens the ability of the companies to pay off debt. Recessive adjustment with restricted credit pushes interest rates up and sales down. This in turn sets off an internal debt crisis: firms cannot pay back their credit and the proportion of banks' nonperforming loans goes up sharply, resulting in bankruptcy among some banks and financial institutions, and government intervention to stave off bankruptcy in others. Efforts to save productive firms from bankruptcy lead either to liquifying the debt through inflation, as in the case of Brazil and Argentina, or to repeated renegotiation of the debt with the banks, as in Chile. In the latter case, the governments, through their central banks, end up subsidizing the renegotiated interest rates and assuming the exchange risk if, for any reason, the private debt is "dedollarized."

Private enterprise, saddled with debt, is unable to contribute to the economy's recovery because of prevailing recessive conditions affecting sales. Investment in projects to modernize production and expand capacity cannot be undertaken because the cumulative effect of the prevailing recession and its accompanying uncertainty forces business to turn to purely defensive, survival-oriented strategies. The government is pressed to accept a write-off of private firms' debts and reduce the size of the work force, as well as reducing wages and benefits for employees. When the situation becomes critical, the private sector lays off even its most highly-skilled workers. It then enters a period of stagnation and sluggishness; the morale of both managers and employees drops. Uncertainty over work and wage conditions decreases interest in work, and this affects productivity levels. Under such conditions, no incentives remain for the internal creativity which is essential for achieving international competitiveness.

Can the successful export experience of East Asia be repeated in a microeconomic climate that stifles innovation, creativity, and modernization of the production process? The real cause of the recent decline of private enterprise in Latin America is not so much crowding-out by the government or an excess of government control: On the contrary, the economic climate was on the whole quite permissive for private enterprise during the seventies. Latin America's current problems can better be explained by errors committed during the period of liberalization, such as excessive borrowing and the prevalence of interest rates far above the rate of return on assets. Without a doubt, the greatest source of problems was the adjustment policy, conceived as a purely macroeconomic process without sufficient consideration of its potential effect on industry at a micro level.

The lesson is that if the IMF's conditionality is to strengthen export capabilities, attention must be focused on the microeconomic conditions necessary for production firms to recover from their current debilitated state.

The first requisite is internal financial house-cleaning of the firms. The IMF, however, normally limits itself to imposing conditions at the macroeconomic level for the central bank to tighten credit, a large part of which is used precisely for salvaging companies, private or state-run, which would otherwise go bankrupt. Reducing this credit has a negative effect on the position of these firms. Naturally, their ability to pay back their debts depends on their profits, which, in the short run, depend on anticipated sales levels. An adjustment policy without prospects for a reactivation of demand makes it impossible for the firms to move from a purely survival-oriented strategy to another, more active, strategy that would normalize their financial position, while preparing the ground--through relatively high exchange rates and low tariffs--for directing firms toward the external market.

How can private enterprise be strengthened when it simultaneously faces debt problems and a decline in markets? Who will take on investment projects to put the paralyzed economy back on its feet? Government and public sector enterprises have important roles in this situation, as was shown by the successful strategy used by industrial and Latin American economies to recover from the Great Depression in the 1930s. At that time, private enterprise suffered from problems which, like those faced in Latin America today, kept it from becoming an active factor in ending the recession and reinitiating growth.

Even with private enterprise on the way to recovery, there would still be the problem of strengthening export capabilities. This depends on more than just financial rehabilitation and favorable exchange rates. It requires research into new products, improvements in product quality, and access to new markets. Future conditions in external markets, according to most estimates, will be difficult: world trade is expanding at a slower rate than in the 1970s; there is more protectionism; and more countries are attempting to increase exports simultaneously to the same markets. It is unlikely that this type of export strategy will be successful unless it is based on a close relationship between current or potential exporters and the government. This was the method used in post-war Europe and, more recently, in East Asia.

Finally, world economic conditions in the 1980s are characterized by instability, volatile interest rates, and potential external shocks from adjustments in industrialized economies. The presence of these factors indicates the advisability of clear rules of the game set by the government to reduce uncertainty and stabilize expectations of domestic economic agents so as to allow them to consider new investment decisions and modernization plans aimed at increasing productivity and international competitiveness. Mechanisms for coordination and exchange of information with private enterprise, and

involvement of labor organizations could aid in reducing uncertainty and stabilizing expectations about the future.

Other lessons related to the IMF's conditionality have to do with the acknowledgment of various structural complications that may interfere with the economy's recovery. One is the high prominence of the financial component--payment of the foreign debt--in current government budgets in Latin America. If this is not adequately recognized and the condition is imposed mechanically that, regardless of the level of spending, the deficit of the public sector must be cut in half, the government will find itself facing a dead-end. For it would be forced then to suspend the very same investment projects necessary for reactivation, and to reduce spending for social services, which are aimed precisely at compensating the worst effects of the recession on lower-income groups. Moreover, the policy will ultimately produce a rise in the interest rates that the government has to pay in order to attract resources to finance the payment of interest on the public debt. Overkill in the reduction of public spending has gone so far in some cases as to prevent countries from using World Bank credits because the required counterpart of domestic public resources are just not available.

Another valid lesson to be learned from recent adjustment policies is that the combination of tight domestic credit policies and the liberalization of the foreign exchange market are likely to induce capital flight which is very difficult to reverse once it has started. The point of the lesson is that the government should control the foreign exchange market and actively regulate the flow of external funds in order to avoid the worst consequences of procyclical behavior on the part of external creditors and domestic borrowers alike. This, in turn, is what will allow the country to recover some degree of autonomy in monetary and financial policy.

A final lesson can be drawn from the dual conditionality imposed by the IMF and the banks: the banks' strategy of rapidly reducing exposure forces governments to adjust

too drastically. Since adjustment occurs through import reduction in the short run, this has a negative impact on the exports of industrial countries, leading to loss of jobs.<sup>13</sup> The magnitude and speed of the productive employment loss generated by this process in industrialized economies is ultimately determined by the velocity at which the major private international banks decide to withdraw from the credit market in debtor countries, because this is what regulates the intensity of the adjustment effort needed by their domestic economies and, thus, their required import reduction. In this way, the policies of private international banks towards developing countries have an indirect, but significant, effect on unemployment rates in industrialized countries.

Of particular concern is the drop in net capital flows to debtor countries. These fell from a peak of \$37 billion in 1981 to \$4.7 billion in 1985.<sup>14</sup> This tight lending policy on the part of the banks will probably accent, rather than moderate, the contractionary characteristics of the adjustment programs that, as argued before, tend to weaken production units the most and, therefore, to end up by jeopardizing the ability of Latin American economies to pay off debt, recover, and grow in the medium and long term.

#### **4. What To Do?**

The concern of the banks and the U.S. government over the apparently unsuccessful debt strategy has resulted in a policy shift. A proposal has been made to increase the role of the multinational organizations by expanding the credits granted by the World Bank and the IDB. This would entail a \$9 billion increase in net new loans over a period of three years, plus the creation of mechanisms which would allow cofinancing by the World Bank and private banks, as well as World Bank guarantees on some of the loans made by private banks, as has already occurred in the Chilean case. It is hoped that this will help the debtor countries attract \$6 to 7 billion per year in private credit.<sup>15</sup>



Some of the proponents of these measures want the World Bank, possibly in cooperation with the IMF, to condition new loans on obligatory structural reforms and economic policy reforms on the part of debtor countries. The proposed changes include the privatization of state-run companies, the liberalization of trade and financial flows and, in general, the active promotion of a free market and pro-private enterprise policy. This new form of conditionality would be a third dimension added to the conditions already imposed by the banks (ceiling for the total of new external credits available) and IMF conditions pertaining to the specific type of economic policy the country should adopt in order to adjust the economy in the short run. This new conditionality would be based on the process now being applied by the World Bank in its structural adjustment loan (SAL) programs which, in turn, reflects current U. S. government policies of promoting liberalization and privatization.

No doubt that the proposed increase in the availability of government and private funds constitutes a move in the right direction. However, the new forms of conditionality are not necessarily helpful. The basic challenge, which is now all but unanimously recognized, is to create conditions that will enable Latin American economies to resume their normal economic growth. Otherwise, their ability to pay the debt will become increasingly weaker with time.

Growth in Latin America has come to a standstill as a result of the insufficiency of the level of imports that the region is currently able to finance. Around 1981, imports to Latin America were on the order of \$100 billion. In 1985 they totalled \$57 billion. A "normal" level, based on that which existed in the second half of the 1970s, would be around \$80 billion in 1985. In order to recover this level, an additional \$20-25 billion will be required each year. This would make it possible to increase imports by one third. Using the import elasticities estimated by Lessard and Williamson, this could lead to an 8-

15% increase in the region's GNP, with a probable 5% reduction in the unemployment rate.<sup>16</sup>

Latin America's new inflow of capital in 1984 and 1985 was on the order of \$8 billion annual average. Adding between \$20-25 billion in new resources would produce a net capital inflow similar to the one that existed immediately prior to the boom period of 1978-1981. So long as reserves remain constant, this would represent a deficit in the current account of the balance of payments similar to 1976 and 1977 levels, a period when growth rates could be characterized as "normal" with annual GNP growth at about 5%. The availability of US \$30 billion in net new external funds would be equivalent to 8% of Latin America's combined debt. Assuming annual rates of growth in the 5% range and 3% inflation, net credit expansion would be consistent with maintaining the ratio between the region's debt and its GNP constant in the future.

How can this capital expansion be financed? Fishlow and others have suggested a formula based on two principal components.<sup>17</sup> The first puts a ceiling on the interest rate paid on credits. Any excess over this limit would be capitalized; as a result, the real value of the debt would remain constant. The second aspect of the formula would require an expansion in official credits--from governments and from multinational lending agencies.

If a reduction of 4 points in nominal interest rates could constitute an acceptable target for the maximum rate to be paid in any one year by indebted Latin American economies and if the difference with respect to market rates were capitalized, Latin America would reduce by this means its current net transfer of capital outside the region from \$30 billion to \$18 billion. How can the difference be financed in order to come up with \$20 billion per year?

In a climate of resumption of economic growth and rational, more stable economic policies, one could expect current low levels of direct foreign investment of around \$2

billion per year to return to their previous levels. Foreign investment in Latin America as a whole exceeded \$4 billion annually in the 1981-1982 period. Hence, it would be possible to obtain an additional \$2 billion per year.

The remaining \$6 billion would still have to be financed with new official credits to the region. Two points of significance should be noted. First, this amount is equivalent, in 1985 dollars, to the annual average level of external government financing available to Latin America in the 1961-1970 period (the Alliance for Progress years). Second, under the Marshall Plan, U. S. government transfers were equal to 14 billion in 1985 dollars per year between 1948 and 1951. Over 85% of these funds were grants. That financing effort represented 1.2% of the U.S.' GNP each year. A similar percentage of the U.S.' GNP today would represent an average annual level of aid of U.S. \$46 billion.<sup>18</sup>

Our proposal is that a Latin American Development Fund could be established to grant long-term credit at interest rates not in excess of 2% in real terms. These credits would be used to aid countries' development programs and investment plans by cofinancing with the countries themselves. The decisions of the Fund would be made jointly by representatives of the government agencies providing resources to the Fund and by representatives from Latin America chosen on the basis of their technical capabilities and their political significance in the region.

The conditionality criteria to be applied to these credits should avoid the exaggerated forms of "policy conditionality" often required by multinational agencies. The criteria should be tailored to specific circumstances. It would be advisable for the IMF to continue to supervise the adjustment of imbalances in the external sector of the economies. The forms for internal adjustment should vary, however, depending on the nature of the imbalance and the structural characteristics of the particular economy. As Bacha points out, the IMF should not, as it frequently does, apply a rigid conditionality for the internal adjustment of the economy. Rather it should leave the country free to design

its own domestic adjustment program as long as the goals set for the balance of trade and the balance of payments are met.<sup>19</sup>

It has been noted that Brazil improved its balance of payments at the end of the 1970s through highly unorthodox domestic economic policies.<sup>20</sup> It increased, rather than decreased government investment, directing it toward sectors of tradable goods and thereby creating conditions for the subsequent expansion of exports and substitution of imports. Thus, Brazil in recent years has been able to generate strong trade surpluses (about \$12 billion a year) which have enabled it to continue paying the interest on its gigantic foreign debt.

Countries should be able to proceed more selectively in their internal adjustment. IMF-mandated adjustment policies have the strongest impact on wage earners (because they increase unemployment), and on the poorer strata of society (because these groups are most affected by the general drop in income and by cuts in public spending that reduce social services). A strong argument, based on equity considerations, can be made that a selective fiscal and spending policy should be applied.

Conditionality in a development fund should concentrate on increasing investments, particularly in the areas of exports and substitution of imports, and on the absorption of unemployment. The instruments for achieving these goals should be tailored to the specific characteristics of each country. These criteria contrast with the current concept of policy conditionality, which assumes that a particular instrument of economic policy, if used in a certain way, will necessarily produce the same results in any context. Albert Hirschman has called this view "mono-economics," arguing that it tends to ignore the entire achievement of development economics.

The discipline of development economics arose in the post-war era with the growing awareness of the specific nature of economic problems in developing countries, and the need to identify those factors that distinguish between developing and

industrialized countries as well as those that distinguish among developing countries themselves. Within the discipline, attempts were made to design specific strategies and select appropriate policy instruments to remove obstacles to development in a particular historical and structural situation.

The same policy instrument used in the same manner in structurally different developing economies can produce very different results. Dornbusch shows this by comparing the effects of devaluations of the exchange rate in Korea and in Brazil.<sup>21</sup> In Korea, exports account for 37% of the GNP, whereas in Brazil, they only reach 10%. While income distribution in Korea is rather evenly distributed, in Brazil it is not. Under these conditions, devaluation in Korea will have a much greater impact on the balance of payments than in Brazil. Indeed this is the factor that explains why Korea was able to adjust quickly to the debt crisis by devaluating its exchange rate and producing an immediate response in terms of greater production of internationally tradeable goods.

In Brazil's case, however, the impact of devaluation is smaller for two reasons: first, tradeable goods play a smaller role in the country's overall production. Secondly, the uneven distribution of income imposes a ceiling on the tolerable level of real devaluation for the local currency. Real devaluation normally implies a loss of purchasing power for the population--that is, a drop in real wages. Drops in income will be poorly distributed if the differences in income between groups are very large. Wage-earners at the lower end of the scale often push for cost-of-living adjustment clauses in their contracts. This wage indexing, while protecting them from loss in purchasing power, greatly hampers the effectiveness of devaluation as an instrument for adjusting the balance of payments in the case of Brazil. The limits of "mono-economics" and the dangers of a uniform conditionality that ignores countries' structural characteristics and development levels should be evident in this example.

The key issue in the theory and practice of development economics is the mobilization of existing resources to revitalize the national economy. It is equally important to find a combination of local production factors which encourages innovations in technology and production methods in order to achieve sustained growth in production and productivity levels. When a country finds its own formula for development--a scheme capable of mobilizing and promoting creativity and innovation--it reaches a level of development that has the potential to sustain itself in the future because the conditions for achieving permanent increases in productivity are met.

If this view of the development process is accepted, then it follows that conditionality should not stifle the search for the development formula best suited to a particular country's needs, and it should not impose economic conditions that will leave the government with nothing to offer in the future to motivate economic agents. The combination which should most be avoided, as the result of excessively restrictive conditionality, is that of tough, uniform policies applied by weak governments. From greater rigidity in conditionality will come greater weakness in government.

Conditionality should be consistent with the idea of energizing a society, i.e., putting it in creative tension for development. It should increase, not restrict, the society's degrees of freedom and enhance, not reduce, its indigenous problem-solving capacity. What follows from this is that conditionality should be flexible enough to allow for nonuniformity in the policies applied in different institutional, structural, and even historical contexts. Why recommend further financial and trade liberalization in the countries of Latin America's Southern Cone when their current economic crisis was at least in part due to an unrestricted application of the very same policies being recommended now by some lending agencies? What would be the purpose of pushing for the privatization of banks and state-run firms in those countries where the performance of public firms has often stood up better to external shock than that of private firms?

Take the case of Chile. During the boom, the State Bank was careful to lend only to firms whose projects--after careful evaluation--proved profitable. In addition, it did not engage in the extended practice of private banks of lending (in fact, over-lending) without guarantees. It might also be useful to point out that many public enterprises were able to perform better than their private sector equivalents during the recession (as a consequence of their quasi-monopoly situation that allowed them to stay in the black by upward adjustments in utility rates).

The recognition of different situations and of flexibility in conditionality criteria are part of the necessary ingredients in a suitable economic policy which should be more pragmatic and draw from the evidence of past successes and failures, rather than from ideological preferences. In economic policy, simplistic, ideological criteria are no substitutes for good sense. The conditionality that is applied to adjustment in the short term must be consistent with long term development. If the outcome of adjustment policies is a drop in investment of 25% to 30% for four or five years in a row, as has recently been observed in Latin America, then something is inconsistent between the short and long run elements of the desired policy package.

The problem is no mere technical matter. If what is required is a government with broad support and with the ability to lead the country in mobilizing human and physical resources in order to overcome the external constraint, then an excessively rigid and premature conditionality may nullify the process through which the government is gaining the credibility and legitimacy necessary to actually implement the required economic program. As the case of President Alfonsín illustrates, it is the expansion in political legitimacy--which can only occur under a full democracy--that will enable a government to achieve the levels of freedom that are needed to later apply economic measures that may involve harsh sacrifices for the population.

This sequence of actions is essential for any adjustment-with-growth program to be successful.



## NOTES

- <sup>1</sup>Projections by Project LINK at the University of Pennsylvania, March 1986; and by BID, March 1986.
- <sup>2</sup>CEPAL "The Economic Crisis: Policies for Adjustment, Stabilization and Growth", April 1986.
- <sup>3</sup>Estimates by BID, March 1986.
- <sup>4</sup>Morgan Guarantee, World Financial Markets, February 1986.
- <sup>5</sup>Morgan Guarantee, World Financial Markets, September 1985.
- <sup>6</sup>Morgan Guarantee, op. cit.
- <sup>7</sup>There has been much discussion on the relation between the economic growth of OECD countries and the expansion in exports of developing countries. The most complete discussion of the topic is found in R. Dornbusch and S. Fisher, "The World Debt Problem", a report to the Group of Twenty-Four, September 1984. See also A. Fishlow, "Coping with the Creeping Crisis of Debt", Working Paper No. 181, Dept. of Economics, University of California, Berkeley, February 1984.
- <sup>8</sup>CEPAL, op. cit.
- <sup>9</sup>See Project LINK projections, op. cit.
- <sup>10</sup>The ratio is:  $v^* = (i-y) D/E$
- where:
- $v^*$  = net transfer of resources outside the region
  - $i$  = international interest rate
  - $y$  = rate of increase (reduction) of exposure
  - $D$  = amount of the debt
  - $E$  = volume of exports
- See R. Dornbusch, "World Economic Issues of Interest to Latin America", mimeograph, Inter-American Dialogue, September 1985.
- <sup>11</sup>Morgan Guarantee, World Financial Markets, February 1986.
- <sup>12</sup>Krueger develops this point. She argues that most countries have already adjusted their economies. The main problem now is how to reduce the debt-overhang that constrains the export capacity of many countries. See A. Krueger "Developing Countries, Debt Problems and Growth Prospects," World Bank, August 1985.
- <sup>13</sup>The Chemical Bank has estimated at eight hundred thousand the number of jobs lost in the U. S. economy due to this effect alone. See The Washington Post, September 29, 1985.

<sup>14</sup>CEPAL, op. cit.

<sup>15</sup>The official figure is US \$20 billion in three years.

<sup>16</sup>D. Lessard and J. Williamson, "Financial Intermediation Beyond the Debt Crisis," Institute for International Economics, Policy Analysis, No. 12, September 1985.

<sup>17</sup>A. Fishlow, op. cit.

<sup>18</sup>This information was supplied by Konrad Stenzel.

<sup>19</sup>E. Bacha, "The Future Role of the International Monetary Fund in Latin America", mimeograph, Dept. Economics, P.U.C., June 1985.

<sup>20</sup>R. Cortázar, "Employment, Real Wage and External Constraint: The Cases of Brazil and Chile," PREALC, September 1985.

<sup>21</sup>R. Dornbusch, op. cit.