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Development Planning and the International Debt Crisis in Latin America

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Economic development within the Third World is necessarily a long-range process and cannot be achieved by the short-term crisis management measures that most developing countries have been obliged to adopt during the current debt adjustment period. Under modern conditions, governments are expected to take the lead in fostering economic growth while stabilizing the macroeconomy. If socially defined goals are to be met, it is essential to operate with some defined long-term strategy for development and to maintain continuity of policy.

During this century, nations in Latin America have adopted a succession of growth strategies, not always deliberately selected and consciously pursued, but always ultimately defined and politically defended by those whose interests have been served. Until the watershed of the Great Depression of the 1930s, the most successful strategy, notably exemplified by Argentina during its post-colonial period, utilized international free trade and private long-term investment as the principal means of growth. Private investment was the institutional vehicle by which technological innovation was transmitted to an underdeveloped region in the form of railways, packing houses, grain elevators, farm machinery, mining and oil-drilling equipment, and countless other installations that increased output and enhanced the complementarity of the Latin Amer-

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ican frontier with industrialized centers in Europe and the United States. Two world wars and the Great Depression dealt massive blows to the post-colonial strategy of growth.

Later strategies in Latin America have entailed much more intervention by national governments. These strategies have included import substitution industrialization, national and regional economic integration, massive external assistance and institutional reform under the Alliance for Progress, export-oriented growth, and experiments in populism and state socialism. Each of these shifts in strategy, while not universally successful, has carried Latin America farther along an uncertain and often erratic growth track—nevertheless a growth track. The accumulated experience, especially in those countries whose economic performance has been characterized by abrupt swings in stop-go policy, has driven home the need for greater continuity of policy and a clearer vision of the long-range objectives of an effective growth process.

Yet in the immediate period, in which Latin America is undergoing its worst economic crisis in a half-century, and in which eight newly elected governments are struggling to resume constitutional control over their destinies, development planning is virtually at a standstill. In part this circumstance is a result of exogenous forces beyond the control of individual governments. The principal exogenous forces have been the world energy crisis beginning in 1973, major recessions in the industrial countries, and the cumulative impact of external borrowing under inappropriate institutional auspices.

The debt problem now dominates all policy decisions. Total Latin American external debt, including both public and private, amounted to about $300 billion at the end of 1982, and has since probably increased by another $50 billion.[1] The overwhelming share of this debt has been incurred by only four countries: Argentina, Brazil, Mexico, and Venezuela, and the current obligations of each are so large that repeated threats of default have sent tremors throughout the entire international banking community. By September 1984, Brazil was estimated to have a foreign debt of $98 billion, Mexico $96 billion, Argentina $45 billion, and Venezuela $37 billion.[2] Yet on a per capita basis the debt burden is even more severe in countries such as Chile and Costa Rica. By 1981, half of the region's export earnings were required to service debt, and in the following two years normal imports were curtailed sharply as countries struggled to meet their current account commitments.[3]

As the magnitude of the debt crisis mounted in 1982 and 1983, most of the Latin American countries (15 of the 25 regional member countries of the Inter-American Development Bank) were obliged to seek special

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assistance from the International Monetary Fund and to accept the austerity conditions dictated by the Fund's "conditionality" requirements. Prolonged negotiations with foreign commercial banks have afforded some short-term relief in deferred debt payments, but few agreements have provided for the new financing urgently needed by the debtor countries. Only larger borrowers such as Argentina, Brazil, Chile, and Mexico received substantial commitments of new funds as part of the renegotiation packages, and even these commitments were not always fulfilled. Foreign commercial banks, under pressure from regulatory authorities to acknowledge nonperforming loans, were increasingly reluctant to make new loans, and as a consequence, external borrowing by Latin America fell dramatically in 1983.[4] It was clear that the period of financing long-term development through short-term commercial credit was coming to an end.

The Roots of the Problem

Gerald M. Meier has pointed out that the current international disorder has its roots in actions taken by the U.S. government during the Nixon administration, beginning on August 15, 1971, when the dollar was cut free of the Bretton Woods system and ultimately devalued. These actions, he says, "altered the foundations of the international monetary system, without any consultation with the I.M.F., and . . . forced the world onto a floating exchange rate system, or non-system."[5] Subsequent protectionist measures taken by the United States, induced recessions, and monetary policies that altered the world's interest-rate structure also contributed to U.S. responsibility for the growing international debt burden. These measures were reflected in similar defensive actions taken by other industrial countries.

However, it must be recognized that the principal factors precipitating the liquidity crises and the attendant disruption of the growth process in Latin America were the oil shocks of 1973-74 and 1979-80 administered by the Organization of Petroleum Exporting Countries (OPEC). The escalation of oil prices without any significant addition to the flow of real goods in international trade has permanently affected the circular flow of money income in the world economy and forced a revision of conventional mechanisms for financing trade and development.

At the time of the first energy crisis in October 1973, there were eighteen countries in Latin America that were net importers of petroleum. Even Venezuela, an important supplier of oil to the United States, and Mexico, which subsequently became a major exporter of oil and natural

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gas, were severely affected by the vicissitudes of the energy crises. In general, the impact on Latin America of the repeated escalations of oil prices and the subsequent world economic recessions was to curtail the earlier trend toward economic growth, introduce throughout the region a pattern of inflation that previously had been confined to a few countries, and disrupt export markets that might have alleviated the severity of the domestic exigencies.[6]

Most of the affected countries responded with orthodox stabilization measures, known as austerity programs, to cope with domestic inflation and external payments problems, and a few made vigorous efforts to expand or find substitutes for conventional energy resources, with limited success except for Brazil and Mexico. The social cost of monetarist stabilization policies, thoroughly tested in Brazil and the countries of the Southern Cone, is now amply recorded and consists of widening disparities of income distribution, massive unemployment, widespread business failures, seriously impaired banking systems, and political unrest, without the promised alleviation of inflationary tendencies, payments deficits, or exchange rate depreciation.[7] In all of the affected Latin American countries growth rates have fallen below pre-OPEC levels, and negative growth rates appear with increasing frequency.[8]

The Nature of the Malady

When the first energy crisis occurred in 1973-74, the sudden large-scale diversion of normal international income flows to low-consumption countries, such as the Arab states, aroused fears that the industrial countries, heavily dependent on OPEC oil, would experience a terminal liquidity crisis that would bring down the entire international banking mechanism. Efforts were made to organize a "safety net" to serve as a lender-of-last-resort, principally for the industrial countries, in the event of such a crisis. However, it soon became apparent that commercial banks with international connections were able to restore world circular liquidity through "recycling" deposits by the OPEC countries into loan channels that, for a time, alleviated the needs of countries whose oil import costs had risen four- or five-fold, and were later to rise even more.

As interest rates rose toward the end of the decade, banks found the recycling mechanism increasingly profitable, and began a vigorous competitive search for loan opportunities with increasing disregard for the creditworthiness of loan recipients. Banks fell into the basic error of utilizing demand liabilities to finance short-term assets that, in the course of time, became intermediate-term assets and ultimately nonperforming

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loans.[9] As the relative prices of petroleum and other imports continued to rise, and the compounding effect of high interest rates far exceeded attainable real domestic growth rates, developing countries simply found the load heavier than they could bear.

With growing recognition of the unsustainability of the new condition, the recycling process lost the glow of success, and banks began to look to the International Monetary Fund as the only agency that could and would impose fiscal discipline on borrowers, and that had the potential resources, on a worldwide scale, to serve as an assured lender of last resort. Even the Reagan administration in the United States, which had initially opposed increasing the resources of the Fund, was persuaded by December 1982 that too much was at stake to allow the Fund to run dry.

While the Fund was created with a principal aim of aiding individual countries in temporary balance-of-payments difficulties, its creators did not contemplate that this would become a generalized role in a world economy with a permanently altered international income flow bearing little relation to a long-term shift in the production and consumption of real resources and final goods. Since 1973 the OPEC countries have partially alleviated the recycling problem by increasing their rates of consumption of imported goods, and some members have themselves incurred substantial payments deficits as the "revolution of rising expectations" for consumer goods overtakes their sales of oil, even at recent price multiples. Yet, as a whole the OPEC countries have added little to the world's former flow of real goods, and the larger expenditures of countries such as Saudi Arabia, Iraq, Iran, and Libya in support of military operations have provided negligible stimulus to growth and development, save in a few less-developed countries with arms industries, such as Brazil and Israel.

The recent increase in the loan resources of the IMF, combined with repeated and widespread reschedulings of debt by the commercial banks, may put off the day when some segment of the international financial network attempts to secure terminal liquidity and brings down the entire structure. Yet merely postponing the world liquidity crisis does not meet the goal of financing long-term growth in the developing countries, including managerial skill, from developed to less-developed countries. Especially is this true when one considers that the IMF has found no other formula for imposing fiscal discipline than conventional austerity measures, which, by their nature, retard growth. At the same time, the World Bank, in making long-term development loans, utilizes similar criteria in defining creditworthiness. An exception is the case of "loans" made by its affiliate, the International Development Association (IDA). These

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interest-free fifty-year loans actually represent grants-in-aid, or a permanent income transfer, by the industrial countries to the poorest countries. Many of these countries have little development potential; nevertheless, the soft loans made by the IDA underwrite a significant flow of exports from industrial firms in the developed countries to underdeveloped countries that otherwise could not be financed and thus contribute to the international circuit flow of income. This suggests that pure transfers may become necessary to sustain acceptable levels of world trade.

Moreover, it is becoming increasingly apparent that the IMF conditionality policies designed to impose fiscal discipline on an occasional errant national government, when generalized to a large group of countries in similar circumstances, exert a powerfully depressive effect on the level of world trade. When one country tightens its belt and limits imports, it is of no great moment; when forty-five of the 146 member countries are under the same injunction, where will the industrial countries, with their manufacturing and agricultural surpluses, find their markets, and how will world recovery take place?[10]

The U.S. Department of Commerce has estimated that 25,200 jobs are generated each year in the United States by each $1 billion of exports.[11] U.S. exports to Latin America fell by 23 percent, from $39 billion in 1981 to $30 billion in 1982, and continue to decline in 1983. According to Sanjay Dhar, an economist with the Federal Reserve Bank of New York, declining exports from the United States to Latin America accounted for the loss of 250,000 jobs in 1982. He estimated that 150,000 more jobs would be lost in 1983, a total of 400,000 for the two years. Such losses are, of course, also being felt in other industrial countries.

The Institutional Evolution at Lending Functions

We should recall that in the nineteenth century, when international lending was largely in private hands, the respective sources and functions of short- and long-term credit became well defined, and commonly accepted mechanisms existed for expunging errors of judgment in the extension of commercial credit and in undertaking long-term ventures. These functional definitions and corrective mechanisms have become blurred over the past four decades of the postwar period.

Under the system that prevailed, influenced largely by the British until World War I, merchant bankers typically financed the costs of carrying on current trade, using commercial bills of exchange, bank drafts, and corresponding documents certifying transfer of possession of goods. Such transactions emphasized the self-liquidating nature of short-term types

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of loans appropriate to the specific conditions of trade in various parts of the world. No one would have thought of them as means of financing long-term development ventures affording slow rates of return, and rarely were they used to bail out governments in balance of payments difficulties unless arising from the outbreak of war. If bankers made mistakes in judging the creditworthiness of borrowers, they sustained defaults and took their losses, and were thus encouraged to exercise closer oversight in the next period. Defaults on commercial loans did not in general affect the process of investment lending, which was carried on with other instruments through other channels.

Similarly, when long-term investment ventures failed, as they sometimes did, it was the bondholders and owners of shares in limited liability companies who took the loss. For most such investment, direct sovereign obligations or government guarantees were not involved, so that the losses were expunged, rather than left for subsequent political administrations and their creditors.

These rules, functionally separating the flows of trade and investment credit from their consequences in wiping out the results of errors in judgment, were not laid out in advance. They were learned from painful experience, as when during the rampant land speculation associated with the rapid growth of Argentina during the 1870s and 1880s, British banks and individual investors over-extended credit. Much of it went to buy bonds with a fixed gold parity issued freely by the Argentine national and provincial governments. When the debt structure collapsed in 1890, it brought down the investment house of Baring Brothers and endangered the stability of the Bank of England itself, which was acting as lender of last resort to the merchant banks.[12]

The lesson had to be learned again in the 1930s, by which time the principal source of international credit had become the United States rather than Europe. U.S. banks and brokers had made many foreign portfolio loans with little supervisory attention to the uses of these funds in the recipient countries. A series of major defaults taught U.S. investors that sovereign guarantees by Latin American governments meant nothing when real investment did not occur or was poorly carried out. In the subsequent depression period private foreign investment in most Latin American countries virtually ceased.

Despite these investment crises, a longer view reveals that by and large trade credit and investment loans were effectively applied prior to the Great Depression, so that world trade reached record levels and complementary resources were effectively brought together. The result was a highly symmetrical system, or network, in which goods flows and pay-

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ments flows were closely matched so that they could be sustained over long periods of time.

The Network of World Trade, a study carried out under the auspices of the League of Nations, statistically described this system of multilateral trade, and showed that the breakdown that occurred in the 1930s was not attributable solely, as was generally believed, to the general rise in trade barriers beginning with the impact of the Hawley-Smoot Tariff in 1931. "This increase in barriers," the study concluded, "was itself clearly caused by the general nervous urge to achieve liquidity in international accounts, resulting from heavy capital withdrawals and known as the financial crisis of 1931. These capital withdrawals, in turn, marked the climax of disturbances in the international capital and money markets that can be traced back to the middle of 1928."[13] That is, a high volume of world trade and the domestic growth processes associated with it in the participating countries could not be carried on in the absence of adequate circular liquidity and long-term investment flows.

In the period after World War II, a tendency of some Latin American governments to expropriate foreign investments, or at least to limit their earnings remittances, led some suppliers of direct investments to withdraw from the field, especially in public utilities and mineral development. This function was then taken over by the World Bank and other international lending agencies, which required government guarantees to carry out such projects. Loans of this type, as well as foreign stabilization loans made from time to time by the U.S. Treasury, the Federal Reserve System, and the Bank for International Settlements, have necessarily increased the proportion of government obligations contained in the typical portfolio of external debt.

The significance of these developments is that a large share of the existing debt in Latin America has become nonextinguishable through bankruptcy and default, since those legal processes imperil the very continuity of sovereign governments. Also, as Latin American central banks seek to alleviate current shortages in treasury reserves, they tend to commingle all sources of foreign exchange, whether derived from short-term or long-term commitments, private or public sources. Attempts to prevent the commingling of foreign exchange reserves derived from functionally inappropriate sources by imposing tied loans or by temporarily withholding credit have proved largely ineffective. Stabilization ("bail-out") loans from whatever source eventually become intermediate and long-term obligations through renegotiation, and cumulatively create a burden on current export earnings that cannot ultimately be sustained.

Much of the international investment problem, in light of these de-

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velopments, is attributable to the absence of a clearly defined structure of short- and long-term fund flow and their respective functional uses. Even the World Bank, which typically makes long-term development loans, has recently turned to issuing discount obligations and floating-rate bonds designed to tap funds from the short-term money markets by insuring constant marketability.[14] In financial markets once more characterized by "a general nervous urge to achieve liquidity in international accounts," long-term risk lending apparently is disappearing as a source of development capital, unless provided internally by multinational corporations.

Future Alternatives

It is evident that the world austerity model of coping with the debt problem, which increasingly resembles the "beggar thy neighbor" model of the 1930s, is not working. A number of alternatives have been suggested to avert the danger of a massive liquidity crisis.

Once more there is discussion of a mutual "safety net" for the industrial countries that form the Group of Ten, since the greatest danger to the entire international monetary mechanism would be the collapse of a major group of banks within the industrial countries. Such a safety net would essentially be an enlargement of the General Arrangements to Borrow, which links the credit-creating power of the leading central banks of the world in a lender-of-last-resort and payments-stabilizing function. As such, the safety net provides a potent instrument in the short run, but its capacity should not be over-estimated.

Paul A. Volcker, chairman of the Board of Governors of the Federal Reserve System, warned the American Bankers Association at a conference in Honolulu in October 1983 that while "we have a strong safety net under our own banking system, as do other leading countries," it would be an illusion to think that managers of large banks could "escape scot-free in the kind of environment implied by a breakdown of international credit flows."[15]

Plans for an international safety net are sometimes coupled with proposals to convert multibillions of dollars in short-term, high-interest debt held by private banks into long-term loans or bonds of twenty-five to thirty years' maturity, at interest rates as low as 6 percent, to ease the repayment burden of the developing countries. Whether banks with predominantly demand obligations could assume such a drastic change in portfolio is doubtful, and in any case they would probably require variable interest rate safeguards and government guarantees. Few govern-

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ments would be likely to accept responsibility for underwriting such a volume of obligations, which they generally consider to represent cumulative erroneous judgments by private profit-seeking bankers. As Chairman Volcker has said, "Grand plans set forth by some calling for massive injections of new governmental assistance and across-the-board forgiveness of some debt and interest are simply not negotiable."[16]

A number of other proposals would, in lesser or greater degree, utilize the credit-creating capacity of the International Monetary Fund, represented by its sporadic authority to create Special Drawing Rights, to sell part of its gold reserves in the commercial market, and to offer various forms of extended, supplementary, or compensatory financing facilities. Controversy over enlargements of these powers is likely to go on because of the continuing difficulty in deciding how to allocate loans made possible by reserve credit creation to particular countries. Also, it is uncertain whether the Fund will be able to maintain "conditionality" discipline over the loan recipients when administrators can no longer argue that the Fund serves merely as an international intermediary and must recover the proceeds of loans in order to re-lend them to other needy borrowers.

The closer the IMF approaches the full characteristics of an international central bank, with discretionary power over reserve creation and derivative loan extension, the greater the number of questions that must be answered about preventing the establishment of an international "engine of inflation." While in many respects the Fund has become a supranational agency, it is doubtful that sovereign governments are ready to transfer complete discretionary control over the international money creation mechanism in order to restore circular liquidity.

Liquidity, however, as has been pointed out, is not the entire problem. It is difficult to see how the short-term monetary role of the Fund, even if expanded, would restore vitality to the long-term investment financing mechanism still so crucial to the growth process in developing countries.

The principal obstacle to resumption of long-term lending is the abnormal level of real interest rates, which exceeds the capacity for growth and export expansion of less-developed countries. These rates reflect the risk premium demanded by lenders in a world still beset with fears of recurring inflation, the high level of demand in relation to a paucity of willing investors under current conditions, and, in the domestic credit markets, the effects of deregulation on the cost of savings deposits. However, at the root of much of the current uncertainty is the projection of large fiscal deficits in the United States for years to come.

As Leonard Silk has said, "Although big federal budget deficits are not the sole cause of the problem [of high real interest rates], it is hard to

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imagine a solution that will not involve a significant reduction in the deficits, both to reduce the overall demand for funds and to quiet expectations of new rounds of inflation and fears of intensified competition between public and private borrowers."[17]

While these deficits persist, other industrial countries will feel obliged to maintain defensive measures against inflation and the deterioration of their own currencies. The "general nervous urge to achieve liquidity in international accounts" will continue to delay the functional restructuring of the world lending mechanism necessary to resume growth in the developing countries. The unhappy outlook is that the liquidity crisis, even if surmounted, may remain a prolonged growth crisis. In the meantime, long-range development planning for most of the countries of Latin America appears at a standstill.

Notes

1. *Economic and Social Progress in Latin America: 1983 Report* (Washington, D.C.: Inter-American Development Bank [IDB], 1983), p. 138.
2. Alan Riding, "Latin Debt: Postponing the Burden," *New York Times*, 23 September 1984, pp. F1, 8-9.
3. IDB, *1983 Report*, p. 138; *Economic and Social Progress in Latin America: 1984 Report* (Washington, D.C.: Inter-American Development Bank, 1984), p. 186.
4. IDB, *1984 Report*, 186.
5. G. M. Meier, "America's Burden in Foreign Debt Crises," letter to the editor, *New York Times*, 17 November 1983, p. A26.
6. James H. Street, "Latin American Adjustments to the OPEC Crisis," *Social Science Quarterly* 59 (June 1978): 60-76.
7. The literature assessing the results of monetarist stabilization policies is extensive, but see especially Alejandro Foxley, *Latin American Experiments in Neo-conservative Economics* (Berkeley: University of California Press, 1983); Rudiger Dornbusch, "Stabilization Policies in Developing Countries: What Have We Learned?" *World Development* 10 (September 1982): 701-708; David Felix, "On Financial Blowups and Authoritarian Regimes in Latin America," Working Paper No. 60, Department of Economics, Washington University, 1 October 1983.
8. IDB, *1984 Report*, p. 184.
9. As an example, Citicorp in New York City reported that its "nonperforming" overseas loans, defined as those on which interest is at least ninety days overdue, had jumped 142 percent, to $1.7 billion as of June 30, 1983, from $704 million a year earlier. Foreign loans accounted for 75 percent of total nonperforming loans. *Wall Street Journal*, 8 September 1983, p. 15.
10. "Drawings by Fund Members During January-September Amount to SDR 9.3 Billion," *IMF Survey* 12 (24 October 1983): 336.

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11. Clyde H. Farnsworth, "Third World Debts Mean Fewer Jobs in Peoria," *New York Times*, 11 December 1983, p. 4D.
12. Arthur P. Whitaker, *Argentina* (Englewood Cliffs, N.J.: Prentice-Hall, 1964), pp. 49-53; Aldo Ferrer, *The Argentine Economy* (Berkeley, Calif.: University of California Press, 1967), pp. 81-83, 103-10.
13. Economic Intelligence Service, *The Network of World Trade* (Geneva, Switzerland: League of Nations, 1942), p. 93.
14. Clyde H. Farnsworth, "Floating-Rate World Bank Bonds," *New York Times*, 28 November 1983, pp. D1, 11.
15. Quoted by Leonard Silk, "Good Reasons to Lend More," *New York Times*, 4 November 1983, p. D2.
16. Ibid.
17. Leonard Silk, "How to Solve Interest Puzzle," *New York Times*, 9 December 1983, p. D2.

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