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LATIN AMERICA AND ITS EXTERNAL DEBT

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Serious problems experienced by Latin America today will be reflected in the region's economy for at least the next two years. During this period, the region will undergo a recession or, at best, an economic stagnation resulting from the severe restrictive policies which will have to be imposed in many countries, particularly those with greater relative weight within the area's economy.

This situation is a consequence of the recent behavior of its individual economies. We therefore feel it is important to analyze briefly their recent history, so as to understand why they find themselves in the current straits and why their immediate future takes on the appearence to be described below.

Starting in 1973, a substantial change began to be observed in the behavior of these economies. This change was due, on one hand, to the increase in oil prices, which implied for many of these countries — Brazil, Mexico, Argentina, and others of less relative weight in the area,— a substantial increase in their import bills. On the other hand, the recession in the industrialized countries in 1974 and 1975, caused a drop in their demand for raw materials, which forced down the export prices of many Latin America nations, and deteriorated their terms of trade.

This latter factor was reflected in a decline in the exports of the vast majority of Latin American countries, which, combined with the increase in their imports, led to a generalized deterioration of their current accounts.

These circumstances, together with the fact that the Latin American nations aspired to rapid economic growth so as to accelerate their development processes, caused a brusque increase in their needs for financing as of the mid-seventies. Thus, these economies sought out large volumes of resources on the international financial market, to cover their foreign deficits on current account, and their ambitious development projects. The demand for funds was satisfied largely by private banking, which received a vast ammount of resources from the oil-exporting countries, particularly those of the Persian Gulf which, unable to absorb all of the funds generated by their oil exports, placed them in the international financial system, increasing private banking's lending capacity. Thus, private banks served as a link in recycling petrodollars from the oil-exporting countries (OPEC) to oil-importing countries.

This explains why the foreign indebtedness level of developing countries, particularly in Latin America, grew at such a steady and dizzying rate as of 1974. These loans in addition to financing the current account deficits, made it possible for these countries to achieve a steady high growth rate, substantially above the average for industrialzed nations. Thus, average yearly growth of Latin America's G.D.P. was 5% between 1974 and 1978, compared to only 2.6% in the developed countries (1). At the same time, the foreign debt level of the region grew by a yearly average of 27% in the same period (2), although this was not a particularly heavy effective burden, since service on this debt was covered by refinancing from the

(1) International Monetary Fund estimates: Annual Report, 1981

(2) Refer to public external debt only.

same lending institutions, which were also willing to grant new loans, increasing the volume of foreign debt within Latin America.

As it was correctly stated, (3) such a situation could be sustained over time so long as three basic conditions were met. The conditions were:

1- That resources obtained through foreign indebtedness would be used to increase the productive capacity of the borrower countries, so that these investments would generate funds to pay back the debt;

2- World economic activity would not experience major negative fluctuations which could considerably weaken the debt payment capacity of debtor countries; and,

3- The flow of international financial resources would not suffer sudden interrumptions.

Recent history shows that the conditions mentioned were not met, thus making a crisis inevitable sooner of later. It can be said that today's crisis actually began in 1979, when the second oil shock occurred. New price hikes in the international market made non-oil LDC's experience abrupt increments in their current account deficits, and industrialized countries to enter into a prolonged recessive phase, although it was not caused only by the effects of the oil price increase, but also by the implementation of severe restrictive monetary policies meant to control the serious growth of inflation.

The application of these policies caused international interest rates to

(3) Massad, Carlos; América Latina: Aspectos Principales del Financiamiento Externo. Santiago de Chile, December 1982. (Mimieograph).

rise abruptly, making new credit operations more expensive, and also increasing the service of the previously acquired debt, since that had been granted at variable interest rates.

This latter factor, combined with oil price increases and the deterioration in Latin America's terms of trade created even-more vulnerable and adverse situa tions in the area's economies. However, the indebtedness process continued during the 1979-1981 period, due not only to the irresponsibility of the borrower countries, but also to the myopic attitude of the international financial system, which failed to perceive its own vulnerability.

This process led to the 1982 crisis which was set off to a large degree by the sudden decline in the international banking credit capacity, due to the lower injection of petrodollars coming from the oil exporting countries, in response to the abrupt weakening of the international oil market. This fact, combined with the difficulties of Poland and Mexico to cover their financial obligations, made banks tighten their loan conditions, which brought about the generalization of a crisis within Latin American countries, since in addition to experiencing substantially lower export levels due to price deterioration of their products, these countries found it impossible to refinance their heavy debts, large part of which were short-term obligations. This latter element put Latin America in a frankly vulnerable position, since payment of the debt and its high interests placed several of these economies near default.

Thus, at the end of 1982, service on the foreign debt of Latin America's eight largest countries was equivalent to 125% of their total exports of goods and servicies, while the same ratio was only 38% for Asian countries and 56% for the Middle East and Africa (4). This explains why, in the second half of 1982, and in

(4) Morgan Guaranty estimates

1983 to date, the different Latin American countries have made great efforts to refinance their foreign debt with major international banks, since the transformation of the high short-term debt to long- term debt would imply a substantial alleviation of the amortization burdens of these foreign commitments.

However, we should now ask whether refinancing of the foreign debt is sufficient to solve the serious problems experienced by these economies. Obviously the answer is that it is not, since these countries must implement an extensive and complex package of meassures meant to respond to the serious overall problems.

In addition, International Banking and the developed economies must also play major roles in the process of overcoming the current crisis.

In a recent study economist Rimmer de Vries concluded that the solution to the problem demands the cooperative action of four major parties: developing countries, international institutions, commercial banks, and industrial countries (5).

To prove this point, de Vries simulated three scenarios for the possible future development of international finance within 21 major developing debtor countries. These scenarios are summarized as follows:

Scenario 1 - Implementation of severe adjustments in developing countries, together with a very moderate recovery in the OECD countries.

Scenario 2 - partial adjustments in the developing countries, togehter with a moderate recovery of the OECD countries; and

Scenario 3 - severe adjustment in the developing countries, together with a marginal recovery of the OECD countries.

(5) de Vries, Rimmer, "Global Debt, Assesment and Prescriptions." World Financial Markets Morgan Guaranty Trust Co. of New York. February, 1983, pp. 1-14.

One of the most interesting results of the study is the fact that in the case of the third scenario, the inbalance in current foreign transactions in the developing countries would be substantially higher than under the first scenario, to the point that in 1986 the deficit in the current accounts of the developing countries studied would exceed $ 100 billion, while, in the first scenario, it would reach only $ 30 billion. This is particularly interesting in view of the fact that in both scenarios (first and third), the developing countries are assumed to make substantial adjustments in their economies by implementing severely restrictive policies; but the assumption of recovery or non-recovery within the OECD countries is what establishes the great difference. Obviously, in scenario 3, the persistence of the recession in the developed countries would prolong economic stagnation and the demand for raw materials, thus limiting exports from the developing countries. The current account deficit gererated by this situation would in turn force these developing countries to obtain large loans from abroad so as to finance their serious current transaction imbalances; thus their total foreign debt would exceed $850 billion by 1986, equivalent to 186% of their exports of goods and servicies. In scenario 1, however, the lower deficit in current transactions would exercise less pressure for new indebtedness and thus total foreign debt for the countries studied would reach approximately $ 660 billion by 1986, equivalent to 127% of the countries' exports of goods and services. (See chart next page).

International commercial banking must also play a crucial role in the immediate future, by maintaining credit lines for these countries, and by converting the short-term debt into long-term, since this would substantially reduce the weight of their amortization payments. If this reconversion of the debt does not materialize , the most heavily indebted developing countries would be forced to default, which would in turn place the international financial system in a very difficult situation and possibly threaten its collapse, at the same time that it would virtually

INTERNATIONAL FINANCIAL OUTLOOK FOR 21 MAJOR L.D.C. BORROWERS

(Percentages except as noted)

	Scenario 1				Scenerio 2				Scenario 3			
	1983	1984	1985	1986	1983	1984	1985	1986	1983	1984	1985	1986
OECD Real GNP Growth	1.5	3.0	3.0	2.5	1.5	3.0	3.0	2.5	0.5	1.5	2.0	2.0
LDC's Terms of Trade	1.0	3.0	4.0	0.0	1.0	3.0	4.0	0.0	-2.0	2.0	4.0	0.0
Results:												
Current Account ($ billion)	-51	-38	-27	-30	-57	-54	-55	-65	-73	-83	-91	-102
Total Debt ($ billion)	553	595	627	662	558	616	675	744	567	655	751	857
Total Debt as % of Exports of Goods and Services	170	153	136	127	171	158	147	143	182	183	180	186

Scenario 1: Major LDC adjustments and moderate OECD recovery.

Scenario 2: Partial LDC adjustments and moderate OECD recovery.

Scenario 3: Major LDC adjustments and minimal OECD recovery.

Source: Morgan Guaranty Trust Company of New York.

do away with any possibility of emerging from the current crisis in Latin America.

This is particularly true in the case of the large international banks, which should not only refinance the conversion of short-term debt which they supplied to the developing countries to long-term, but should also finance part of the debt contracted by the developing countries from smaller banks, since the latter have expressed a desire to terminate their loan arrangements with Latin American countries, having no interest in continuing lending money in such a risky market.

International financial organizations, such as the International Monetary Fund and World Bank, as well as major central banks, should also play a key role in the immediate future, contributing to a solution to the problem, since loans granted to countries such as Mexico, Brazil, Argentina, and others, would alleviate the burden on these indebted countries, and at the same time would reduce needs for refinancing their debt through commercial banks, which would help to relieve some of the pressure on these latter international financial institutions.

The Reduction of Oil Prices

Many experts concur that the lowering of oil prices will bring about more positive than negative effects, as it will help strengthen the recovery of the industrialized countries, at the same time alleviating external imbalances in the non-oil developing countries. Although this is obviously true, it is not so clear that the reduction in oil prices will have a positive impact on the international financial system, since that would imply a limitation of petrodollars availability. On the other hand, it is argued that lower oil prices would improve the external position of the oil importing countries, increasing their ability to meet their international financial commitments. However, we think that unless export prices of these countries are simultaneously increased, the improvement in their external position would not be strong enough to compensate the negative effect of a petrodollar shortage.

At the same time, the lowering of oil prices could severely affect the large investments made to replace oil with alternative energy sources, and the lower price of gasoline and other oil products could generate a reversal of the energy conservation process of the industrialized countries.

Economic Outlook

The implementation of restrictive monetary and fiscal policies meant to overcome serious imbalances in the foreign sector, as well as high inflationary pressures suffered by most Latin American countries, will caused a generalized recession in the region, or, in the best of cases, a very moderate growth, in contrast to the high dynamism observed in these economies during 1974-1978.

This is particularly true in countries with greater relative weight in the area such as Mexico, Brazil, Argentina, Venezuela and Chile, which are encountering serious economic difficulties that lead to implement the policies mentioned.

High inflation will continue in 1983, less so in 1984. For the present year an average inflation of nearly 100% is foreseen, resulting from high inflationary pressures suffered in economies such as Argentina, Mexico and Brazil. The recently established exchange controls in Venezuela will contribute to the acceleration of its inflation because of the higher import prices it implies. The same will happen in Chile, where recent exchange adjustments of the peso could cause consumer prices to increase by more than 50% this year. Other countries such as Peru, Ecuador, Bolivia, and to a lesser degree, Colombia, are also facing serious inflation ranging between 30% and 60%.

The foreign sector will be in an unfavorable position due, as mentioned above, to the serious deterioration in the prices of major export products and the consequent erosion in the terms of trade. This will be true in spite of severe devaluation and exchange adjustment measures imposed in the majority of countries of the area. This year large deficits could appear in the current account of major Latin American economies, with no mid-term solution to this imbalance foreseen, due to the limited improvement in export prices for those countries, reflecting the predicted relative moderate recovery in the developed countries, mainly in 1983.

LATIN AMERICAN EXTERNAL DEBT

	Total						Due within 1 year					
		As % of		% change in year-end level				As % of		% change in year-end level		
	$ billion end-1981	GNP/GDP	Exports, goods and services	1979	1980	1981	$ billion end-1981	GNP/GDP	Exports, goods and services	1979	1980	1981
Argentina	35.7	53.7	349.7	52.3	42.7	31.3	13.8	38.6	134.9	81.6	46.7	25.6
Bolivia	3.0	64.5	340.9	31.8	-12.1	17.6	0.5	18.3	62.5	38.9	-24.0	-3.5
Brazil	73.5	25.6	295.8	13.7	14.6	14.7	20.3	27.6	81.6	4.1	41.0	13.0
Chile	15.6	63.0	269.2	23.6	29.4	39.3	4.3	27.3	73.5	12.4	40.1	20.9
Colombia	9.0	23.1	197.5	33.6	18.7	20.8	3.2	35.5	70.0	43.8	7.3	4.6
Costa Rica	3.4	98.1	281.5	27.8	30.4	11.7	0.7	21.6	60.9	24.4	56.9	-9.4
Dominican Republic	1.9	22.9	130.9	18.8	17.3	2.0	0.7	36.2	47.4	-6.1	10.9	35.4
Ecuador	5.8	43.1	210.4	18.6	24.1	23.0	2.3	40.3	84.7	3.7	34.8	22.6
El Salvador	1.2	31.3	132.2	1.0	6.7	34.7	0.3	23.9	31.6	-11.1	-15.4	1.9
Guatemala	1.3	12.8	95.8	13.8	13.2	18.3	0.4	28.0	26.8	29.2	20.0	-12.9
Honduras	1.8	63.2	218.5	13.6	20.0	18.0	0.4	20.9	45.7	36.8	7.2	2.7
Jamaica	2.1	63.8	142.6	24.1	10.5	15.7	0.6	27.7	39.5	-12.2	135.0	-0.7
Mexico	74.9	44.1	253.0	18.8	30.2	42.6	29.3	39.1	99.0	-7.0	73.9	52.0
Nicaragua	2.1	12.3	..	5.1	22.4	14.3	0.5	21.4	..	-10.4	6.8	-21.6
Paraguay	1.3	18.8	172.4	28.3	31.3	35.9	0.3	27.4	47.2	52.1	32.8	18.7
Peru	9.7	47.9	237.7	0.1	2.8	3.4	2.9	30.3	72.0	20.8	9.3	9.3
Trinidad and Tobago	0.8	11.5	24.0	8.6	9.4	39.6	0.3	41.8	10.1	-6.5	19.9	30.2
Venezuela	27.8	37.4	136.3	50.7	14.0	6.9	16.1	57.9	78.9	60.8	10.9	3.3
TOTAL	270.9											

Source: Morgan Guaranty Trust Company of New York

	1982
Argentina	38.0
Brazil	85.5
Mexico	80.1
Sub-Total	203.6
Chile	17.2
Colombia	10.3
Ecuador	6.6
Peru	11.5
Venezuela	29.5
Others	23.5
Total	301.6

Source: Morgan Guaranty Trust Co. and E.C.L.A. (United Nations)