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Sergio Amaral

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The Foreign Debt From Liquidity Crisis to Growth Crisis

*by Sergio Amaral**

Once again the foreign debt makes headlines and becomes the focus of the financial community. At the Annual Meeting of the International Monetary Fund and of the World Bank, in Toronto in 1982, the impact of Mexico's announcement that it would be forced to halt payments to its creditor banks dominated the discussion. At the 1986 annual meeting in Washington of these same two institutions, the central issue was again Mexico's debt. During the official meetings, the attention of government, bank officials, and the media was centered on Mexico's negotiations with its Advisory Banking Committee. The developing countries' foreign debt was thus one of the key issues at both the 1982 and the 1986 annual meetings. In both cases, Mexico played the role of a pilot case. But between 1982 and 1986 the nature of the problem underwent a substantial change. What was at stake in 1982 was the capacity of a country or of a group of countries to continue making interest payments to creditor banks. What is at stake now is the prospect for growth and, in some cases, for democracy itself in many developing countries.

When the debt crisis broke in 1982, it posed a significant threat to the financial system. At that time loans made by U.S. banks to developing countries amounted to 11% of their assets and 198% of their capital.[1] For this reason, the debt strategy then conceived and later endorsed by the Williamsburg and London economic summits[2] basically sought to preserve the stability of the banking system in the following ways: bridge loans were made between creditor governments and debtor countries to avoid the suspension of interest payments to the banks; the IMF supervised adjustment programs to increase its capacity to service the debt; and commercial banks gave new loans to refinance interest payments and to make these adjustments possible. From the point of view of the finan-

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* Financial Counselor, Brazilian Embassy, Washington, D.C.; Associate Professor, University of Brazilia.

1 INT'L MONETARY FUND, *International Capital Markets: Recent Developments, 1986 - Statistical Supplement*, at table 29 (Wash., D.C., 1986).

2 The Williamsburg Economic Summit Communique gives a succinct description of the key elements of the debt strategy, while the London Communique points out medium-term policies. On the debt strategy, see Amaral, *The Debt Crisis from the Point of View of a Debtor Country* 17 N.Y.U.J. INT'L AND POL. 139-53 (1985).

cial system, the strategy proved adequate and the results were quite positive: the current account deficit of the two major Latin American debtor countries dropped from U.S. $96 billion in the 1980-82 period to U.S. $5 billion in the 1983-85 period;[3] U.S. banks' exposure in relation to developing countries has been declining since 1983, while the loan/asset and loans/capital ratio in 1985 had already dropped to 8% and 124%, respectively.[4]

Meanwhile, creditor governments and banks adopted a series of measures aimed at strengthening the financial system. The major industrialized nations, meeting under the auspices of the Bank for International Settlements (BIS) in May 1983, approved the "principles for the supervision of banks' foreign establishments," which established new rules for the supervision of international banking. The United States, which since 1979 had adopted a uniform system for the evaluation of debtor countries risk, introduced new guidelines on the disclosure of information about problem loans in 1983. In June 1983, regulatory agencies approved new regulations to oblige the 17 largest banks to increase their capital to at least 5% of their assets. Finally, at the time of the authorization for an increase in U.S. contributions to the IMF, the Congress made additional requirements regarding supervision and information, loss reserves and bank capital.[5]

Commercial banks, partly as a result of the net regulations and partly on their own initiative, have adopted measures to protect their balance sheets against Third World risk. The capital of U.S. banks, as a percent of their assets, has gradually increased over the last few years. The capital/assets ratio of the nine largest U.S. banks rose from 4.5% in 1980 to 6.8% in 1985. As a result of this capital increase as well as of a slight decrease in their exposure, U.S. banks have seen a reduction of the ratio between their exposure to developing countries and their capital, from 198% in 1982 to 106% early in 1986, a figure lower than in 1977. In the case of the nine largest banks, the ratio dropped from 290% to 174% in the same period. If one considers only the exposure to the four largest Latin-American debtors, the ratio dropped to about 100%.[6]

In sum, debtor countries have made a considerable adjustment effort, which has substantially reduced their current account deficit and increased their capacity to make payments on their foreign debt. At the same time, industrialized countries intensified their cooperation in the area of supervision, information, and coordination of international bank-

[3] INT'L MONETARY FUND, *World Economic Outlook*, at 77, (Washington, D.C.) Oct. 1985.

[4] INT'L MONETARY FUND, *supra* note 1.

[5] *See* CON. RES. *The stability of the International Banking System; see also* INT'L MONETARY FUND *supra* note 1, at 70.

[6] INT'L MONETARY FUND, *supra* note 1, at 73; Morgan Guaranty Trust Company of New York, WORLD FINANCIAL MARKETS, 7 (Sept. 1986).

ing. Commercial banks increased their capital, raised their reserves and have already begun to diminish their exposure to indebted countries. Over the last four years, the financial system reduced considerably its vulnerability to the foreign debt of developing countries. Although the risk has not been eliminated, under the present circumstances the possibility of a shock to the financial system owing to the Third World foreign debt seems quite remote.[7]

Even though the risks to the financial system may have been alleviated, the foreign debt problem is far from solved. The type of adjustment imposed on debtor countries has engendered a transfer of resources to creditor countries which, in the case of Latin America, has amounted to around U.S. $40 billion per year over the last three years.[8] Owing to a large extent to this unprecedented volume of the transfer of resources from poor to rich countries, Latin America—with the exception of Brazil— still remained stagnant in 1985.[9] The region's per capita income declined 10% to 15% and, in 1985, stood at the same level as 1975. This means as far as development is concerned, the 1980s was a lost decade. Real wages declined substantially, while over 40% of the workers had only occasional jobs or were unemployed.[10] Finally, serious external and domestic difficulties forced some countries, such as Bolivia and Peru, to suspend or to unilaterally limit their payments.

This set of circumstances led to a revision of the strategy that had been followed since 1982. The so-called Baker Plan unveiled by the U.S. Secretary of the Treasury at the IMF/IBRD annual meeting in Seoul, in October 1985, recognized the need for resuming growth and for providing additional resources to finance it. Another of the positive aspects of the Baker Plan, is that it assigns a central role to the World Bank, which is more experienced and more sensitive than the IMF to the problems of developing countries. However, the Baker Plan placed excessive empha-

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[7] This is, certainly, the assessment of most analysts, as the Congressional Research Service points out *supra* note 5. In a recent report, however, the Bank for International Settlements (BIS) still sees the Third World's foreign debt as a serious threat to the banking system. This is especially due not to the increase in investments but rather to loans granted for the purpose of allowing interest payments. *Le Banque des reglements internationaux, dernier bastion de l'orthodoxie financiere?* in LE MONDE DIPLOMATIQUE 15 (1986).

[8] The net transfers of funds totalled U.S.$31.2 billion in 1983, U.S.$25.8 billion in 1984, and U.S.$30.4 billion in 1985. U.N. ECLAC *The Economic Crisis: Policies for Adjustment, Stabilization and Growth*, at table 8 (Apr. 8, 1986).

[9] With the exclusion of Brazil, Latin America's 1985 GDP was less than 1%. In per-capita terms, there was a 1% increase if Brazil is included and a 1% decrease if Brazil is excluded. INTER-AMERICAN DEVELOPMENT BANK, *Latin-American Socioeconomic Development, 1986 Report*, at 16 (Wash., D.C., 1986).

[10] For an assessment of the social impact of the foreign debt on Latin American *see* INTER-AMERICAN DIALOGUE, *Rebuilding Cooperation in the Americas, 1986 Report*, 1-15 (Wash., D.C., 1986); and ECLAC, *supra* note 8 at 96-98.

sis on conditionality and the insufficiency of funds available to finance growth.

Almost the totality of the financial flows into Latin America in the form of loans are now subject to some kind of conditionality. The idea of conditionality is not new, nor is its intensified use due only to the Baker Plan. However, the Baker Plan reinforced a trend already noticeable in the financial community and led to the extension of conditionality to a multiplicity of situations, such as:

a) conditionality understood as "the policies the Fund expects a member to follow in order to be able to use the Fund's general resources,"[11] was introduced in the operations of the International Monetary Fund in 1952 and has been applied to the majority of cases of financial assistance provided by the Fund. However, in the last few years, the concept of conditionality has been extended considerably so as to encompass—in the different stand-by and extended facility arrangements signed with developing countries—not only measures directly related to adjustments of the balance of payments, but to practically all relevant economic policy variables.[12] Furthermore, the ways of assessing the implementation of a program have been considerably refined through the adoption of quantitative targets, performance criteria, and other indicators, which often impose serious constraints on the management of national economic policies;

b) at the World Bank the emphasis on policy-oriented loans has also broadened the use of conditionality. If, indeed, policy-oriented operations seem more adequate than simple project loans to meet the requirements of a more profound adjustment on the part of developing countries, the way in which the new conditionalities are formulated and applied may constitute a further handicap rather than an incentive to the adjustment process;

c) an intensified conditionality is equally manifest in the adoption, in the loans of an institution, of the conditionalities developed by another institution. It is the so-called "cross conditionality," which is implied in the IMF/IBRD joint programs for low-income countries, under the Sectoral Adjustment Facility.[13] The idea of cross conditionality is im-

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11 Gold, *Conditionality*, in 31 INT'L MONETARY FUND PAMPHLET SERIES (Wash., D.C., 1979).

12 The letter of intent signed by Brazil on January 6, 1983, includes measures in the following areas: productivity of the agricultural sector, strengthening of the private sector, wage and price policy, elimination of export subsidies, raising prices of public services, tax legislation, reduction in public expenditures, restraining the expansion of state companies, monetary policy, exchange policy, imports liberalization. It would be difficult to imagine a single relevant sector of the economy which is not contemplated in this document.

13 When the IMF Board approved the Structural Adjustment Facility (SAF), it endorsed the proposal of "a policy framework paper" to be prepared by the IMF and World Bank staffs, in

plicit in the proposal of a single policy framework paper to be used by different institutions as a basis for the negotiation of specific projects. This proposal has also been introduced in the discussions about the Inter-American Development Bank's reform;

d) the linking of private loans to political reforms in borrowing countries is a more recent development. It may take the form of a link between the new loans and structural or sectoral programs with the World Bank (Chile and Uruguay), or of the so-called "enhanced surveillance," in which the multiyear restructuring of the debt (MYRA) of a country is subject to IMF supervision of the economy of a country during the debt consolidation period, which exceeds the time span of a regular agreement with the Fund (Mexico, Ecuador, Venezuela, and Yugoslavia).[14] The most recent modality of linkage and certainly the most restrictive, is the so-called serial MYRA, which sets specific conditions for each segment (usually one year) of the debt restructuring. Failure to comply with these conditions implies the suspension of the restructuring process. Thus, in the cases of supervision associated with a pluriannual restructuring, the loan or rescheduling of a loan is linked to the implementation of specific policies in future years.

In other words, the increasingly scarce financial flows into the developing countries are being progressively conditioned to the adoption of economic policy reforms. In many cases, the proposed policies are inspired in models or policies prescribed by industrialized nations but refined, adapted, and negotiated by the major multilateral financial institutions.[15] It must be admitted that many of the proposed policies are necessary and would eventually be adopted by the indebted countries, with or without conditionality, and with or without adjustment programs under supervision of the IMF or the IBRD. In many cases, the debtor countries were the first to adopt structural adjustment programs, to seek a reduction in public deficit, to implement rigorous programs to combat inflation, and to introduce export incentives. Nevertheless, what can be said in relationship to the strengthening of conditionality is, first, that it has been extended to almost all relevant variables of economic policy. This makes some adjustment programs an alternative development

collaboration with the authorities of the interested country. This paper is meant to serve as the basis for the financial assistance provided by both institutions. INT'L MONETARY FUND, SELECTED DECISIONS OF THE INTERNATIONAL MONETARY FUND AND SELECTED DOCUMENTS, 41 (12th Ed. 1986).

[14] On the different modalities of association of private loans to policy reforms, see INT'L MONETARY FUND, *supra* note 1. at 58.

[15] The discussions at the United States Congress on the increase of the contribution to the IMF provide some interesting indications about the kind of adjustment policies prescribed by the Administration and the Congress. *Hearings before the House Subcomm. on International Trade, Investment and the Monetary Policy, on the Increase of IMF Quota*, 98th Cong., 2d Sess., 16-19.

model rather than an instrument for correcting economic imbalances. Second, reforms are expected to occur quickly.

If the conditionalities proposed or under discussion are not applied with a considerable degree of flexibility, rather than a contribution, they may become a point of political friction and a further obstacle to the adjustment effort. Indeed, it would be a delusion to expect that economies more fragile by nature and still debilitated by recent years of recession can, within the short period of an adjustment program, completely eliminate public deficits, subsidies, and trade restrictions, when not even the more advanced and mature economies have been able to do so. How could it be possible to impose serious constraints on the domestic decision-making process in reference to such important economic policy variables as price and wages policies, measures related to savings and consumption, precisely at a moment when the transition to democracy raises legitimate expectations of an increased participation of society in government decisions? Thus, conditionalities may touch on the real question of the implications of the foreign debt for the consolidation of democracy. On the one hand, the new democratic governments need an influx of financial resources to encourage resumption of development—a condition for the very consolidation of democracy. On the other hand, these resources are loaded down with conditionalities not always compatible with the aspirations of society. How to overcome the tension between external demands for full debt service, austerity measures and specific economic reforms with the internal demands for alleviation of the debt burden and resumption of growth, is possibly one of the greatest challenges facing the new democratic governments. Soon after the 1982 crisis, external demands tended to outweigh internal ones. The advent of democracy in many countries, however, may well reverse this picture and allow internal demands to predominate.

The Baker Plan has certainly reinforced the idea of conditionality, but seems to have failed to ensure the flow of resources needed for the resumption of sustainable development. According to estimates by different agencies, such as the World Bank, ECLAC, and the Institute for International Economics, the major debtor countries will need about U.S.$20 billion a year through 1990 in order to achieve a 4% growth rate per annum until the end of the decade.[16] The Baker Plan calls for U.S.$20 billion from development banks, and U.S.$20 billion from commercial banks over a three year period, that is, about U.S.$13 billion per annum.[17] The problem is not so much the insufficiency of the resources

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[16] WORLD BANK, *Achievement of Sustained Growth in Middle-Income Countries*, 21 (Wash. D.C., 1986) *see also*, ECLAC, *supra* note 8, at 28 *and* B. BALASSA, TOWARD RENEWED ECONOMIC GROWTH IN LATIN AMERICA 40 (1986).

[17] Address by U.S. Secretary of the Treasury at the meeting of IMF Interim Committee (April 1986).

contemplated, but rather the commercial banks' reluctance to meet the quota assigned them by the Baker Plan. The banks continue to reschedule the payment of the principal. In some cases, under financial packages sponsored by the IMF or the World Bank, the banks continue to provide new resources, in limited amounts, to meet emergency situations of balance-of-payment deficits. Such is the case for the recent package for Mexico.[18] But the banks certainly are more reluctant to provide resources for growth and to resume voluntary lending. In fact, the commercial banks have been reducing substantially their loans to the Third World. The developing countries' share of the total financing by the commercial banks has dropped from 27% in 1982 to 4% in 1985. Loans to the 15 largest debtors— those targeted by the Baker Plan—dropped from U.S. $5 billion in 1984 to U.S. $1 billion in 1985.[19]

The reasons for the withdrawal of commercial banks are many and suggest that it will be difficult to reverse this trend in the short run. However, it appears that changes introduced by the banks in their operational strategy will deter loans to the developing world. As regards the United States, two new lines of action deserve attention: one is a greater concentration on activities geared to the domestic market, a development which was facilitated by the relaxation of regulations that previously prohibited banks from operating in more than one state; the other has to do with the new services provided by the banking system, which also opened new possibilities for operation in the internal market. As far as international activities are concerned, the objective of the banks since the onset of the crisis has been above all to reduce their exposure to debtor countries. This has happened not only because of the risk component inherent to loans already made, but also because of the visibility factor, that is, the perception on the part of shareholders and of potential investors that a bank may have accumulated too high a percentage of problem loans. Furthermore, it does not make economic sense for a bank to grant new loans to a debtor whose papers are being sold in the secondary market at a discount price. Thus, in the words of a banker, "in a best case scenario, the resumption of voluntary lending would require additional financial resources to repay banks choosing to reduce their exposure."[20]

Nor does the performance of the world economy provide incentives to the adjustment efforts made by indebted countries. On the one hand, it is true that the lower nominal interest rates experienced since 1985, will provide relief to the servicing of the debt amounting to U.S. $15

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18 The Mexican financial package is relevant not only because of the amount of the resources—about U.S.$12 billion by the end of 1987—but also because it includes contingency measures in the event of significant fluctuations in the price of oil and of low growth rate of the economy.

19 INT'L MONETARY FUND, *supra* note 1, at 41.

20 Brainard, *More lending to the Third World? A Banker's View*, in UNCERTAIN FUTURE: COMMERCIAL BANKS AND THE THIRD WORLD, 32 (1984).

billion a year. On the other hand, this reduction is much smaller than the drop in export revenues. Furthermore, real interest rates still hold at higher levels than the rates of export growth in debtor countries, which discourages the inflow of loans.[21] The growth rate of major industrialized nations, after climbing to 4.8% in 1984, dropped to 3% in 1985 and is expected to be at best 2.7% in 1986. In the developing countries, the growth rate fell from 3.3% in 1985 to 2.7% in 1986.[22] The deterioration in terms of exchange has reached unprecedented levels. The price of primary products dropped 20% from mid-1984 to the end of 1985; and they fell another 15% in just the first semester of 1986.[23] The developing countries' current account deficit is expected to rise from 3% of exports in 1985 to 9% in 1986 when it will be much more difficult to finance this deficit.

> For the group of capital importing developing countries, the financing situation is characterized by virtual cessation of reserve accumulation, with larger reserve losses among fuel exporting countries being combined with lower reserve gains among fuel importers; a renewed buildup of arrears, a steep rise in the amounts of debt rescheduled, a subdued pace of official lending (which at about U.S.$20 billion per annum in 1985-87, is running at only about two thirds the rate of 1981-84); and continuing weakness in private lending, which is expected to average only about U.S.$10 billion per annum.[24]

Despite modest loans, the debt is expected to grow to U.S.$52 billion, reaching U.S.$967 billion by the end of 1986. The debt/exports ratio should rise from 169% in 1985 to 179% in 1986. Thus, in 1991, the developing countries' foreign debt indicators are expected to be as unfavorable as in 1982. These discouraging figures and estimates justify the now prevailing pessimism for the prospects for the debt problem in coming years. In other words, under the present circumstances, there seems no way out of the dilemma.

In this context, the Brazilian case is unique. The structural adjustment initiated in the mid-70s, if not nearing completion, is at least in a quite advanced stage.[25] Brazil is also one of the rare countries to have

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21 Presentation by Alexandre Kafka, IMF Executive Director, at the XXIII Meeting of Latin American Governors of the International Monetary Fund, Panama, (Sept. 1986).

22 INT'L MONETARY FUND, WORLD ECONOMIC OUTLOOK, 5, table 2 (1986).

23 *Id.* at 13.

24 *Id.* at 9.

25 The debt incurred by Brazil in the 1970s served to finance "the boldest investment program undertaken by any non-OPEC developing country," which encompassed projects in different areas such as expansion of industrial and agricultural production; development of the capital goods sector; alternate sources of energy; creation of an efficient transportation sector. *See Moreira, The Brazilian Quandary*, in TWENTIETH CENTURY FUND PAPER 15, (1986). On the more recent process of economic adjustment see Amaral, *Dealing with the Debt Problem of Latin America: A View From a Large Debtor.*, 1984 CONG. RES. SERVICE 24.

been able to reconcile control of inflation, growth, and servicing the debt. Inflation, which had reached 224% in 1984, and 235% in 1985, in the first months of 1986 gave signs of accelerating even further. It climbed an additional 17% in January and 22% in February. At the end of February the government adopted the so-called "Cruzado Plan," an unconventional therapy for an equally unconventional illness— an almost completely indexed economy. The short-run results exceeded expectations. The inflation rate remained at about 1% the first four months after the reform, to rise slightly afterwards. More importantly, instead of entering a recession, the economy continued to grow and is expected to achieve a growth rate close to the 8.3% growth rate achieved in 1985. This happened without strongly affecting the performance of the foreign sector. It is true that the 1986 trade surplus is expected to be somewhat lower than that of 1985, which reached U.S.$12.5 billion. But even so it has allowed Brazil to make large interest payments for two consecutive years (U.S.$9.6 billion in 1985 and approximately U.S.$9 billion in 1986) without the need for new loans.

But, even in the case of Brazil, the continuation of heavy transfers of resources cannot be sustained. Last year, the new transfer of resources amounted to 5% of the GDP and to 24% of domestic savings.[26] Nogueira Batista points out that transfers of such magnitude impose a severe constraint on the country's development, for several reasons. First, they restrict the import capacity of an economy that must achieve high growth rates through the modernization of its industries. Second, it affects the capacity to adequately supply the domestic market and thus keep inflation in check. Third, it aggravates the financial situation of the foreign debt, forcing the nation to increase its domestic debt in order to purchase the currency generated by the trade surpluses produced by the private sector. Fourth, it reduces the resources available for investments, thus curtailing the economy's growth potential in the medium and long runs.[27]

Thus, the perception is taking shape that, should the current situation with its massive transfer of resources from poor to rich nations persist, not only will the debtor countries be unable to resume sustained growth, but the creditor countries will also continue to be penalized equally and unnecessarily. Several recent studies point out that in order to preserve the financial system, the strategy adopted to solve the debt problem has harmed the productive sector, both in debtor and in creditor countries. The 1986 Report of the Inter-American Dialogue stresses that, in order to generate foreign exchange, the Latin American countries

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[26] Address by Minister Dilson Funaro before the Int'l Monetary Fund) 1986.

[27] Batista, *Formacao de Capital e Transferencia de Recursos ao Exterior*, 1986 INSTITUTO BRASILEIRO DE ECONOMIA, 2.

had to keep imports under strict control, bringing them down from U.S.$100 billion 1980 to U.S.$60 billion a year, each year from 1983 to 1986.[28] A study prepared by the staff of the U.S. Congress Joint Economic Committee states emphatically that:

> the policies implemented (relative to the foreign debt) allowed the banks to maintain and even increase their lucrativity. At the same time, however, these practices have seriously—and unnecessarily—harmed the performance of other sectors of the U.S. economy, particularly farming and manufacturing. And they have done little to solve the debt crisis permanently.[29]

More recently, the Democratic staff of the Joint Economic Committee called attention to the fact that while U.S. exports dropped from U.S.$237 billion in 1981 to U.S.$214 billion in 1985, half of the loss (U.S. $12.5 billion) corresponds to exports to Latin America. Moreover, the potential contribution of the Latin-America market to the reactivation of U.S. exports is twice the sum of the Western German and the Japanese markets. And the document prepared for the use of the Joint Economic Committee continues:

> falling U.S. exports to Latin America are not an inevitable or unavoidable consequences [sic] of the debt crisis. Rather, . . . they are the direct outgrowth of administration policies for managing the debt crisis—policies which are tantamount to telling debtor countries that they must promise to continue paying interest and stop purchasing U.S. products.[30]

There is a consensus that it is necessary to ensure the conditions for growth resumption in the indebted countries. Divergences, however, center on how to achieve this objective. The spectrum of proposals is broad, ranging from small adjustments to rather drastic changes. The commercial banks seem satisfied for the most part with the approach adopted toward the debt problem and favor a:

> flexible pursuit of the existing strategy, preserving the good and necessary features of what already is being done . . . constructive initiatives are always worth exploring on their merits. What must be rejected, as both unnecessary and unworkable, is a politically imposed plan, that purports to solve the needs of debtor countries regardless of circumstances, and to solve U.S. trade problems.[31]

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28 Inter-American Dialogue, *supra* note 10, at 5.

29 STAFF STUDY PREPARED FOR THE USE OF THE JOINT ECON. COMM., *The Impact of the Latin American Debt Crisis on the U.S. Economy*, 99th Cong. 2d Sess. (May 10, 1986).

30 DEMOCRATIC STAFF OF THE JOINT ECON. COMM., *Trade Deficits, Foreign Debt & Sagging Growth: An Analysis of the Cause and Effects of America's Trade Problem*, 36 (Sept. 1986).

31 Morgan Guaranty Trust Company of New York, *supra* note 6, at 2. (Noting that while Brazil "should be able to restore access to voluntary credit markets in the not-too-distant future . . .

A study sponsored by, among others, the Institute of International Economics entitled "Towards Renewed Growth in Latin America," proposed a strategy somewhat similar to the perspective of the commercial banks, in that it suggests the continuity and a greater coherence of the policies that have already been adopted, rather than significant changes: "our recommendations will draw on previous worthwhile effects, in this sense, our proposals will not always be 'new.' But none of them were applied within a coherent, comprehensive framework."[32] The strategy proposed emphasizes outward orientation through a set of incentives to exports and to efficient import substitution; increased domestic savings and a more efficient use of them; a reformulation of the State's role in the economy; and policies in the industrialized countries that are compatible with this adjustment effort. This proposal has another element in common with that of the commercial banks, in that it starts out from the assumption that "all private capital flows to the region are likely to remain modest for some time . . . ," for the resumption of voluntary lending to Latin America is going to take some time. Consequently, alternative sources of growth financing should be sought in domestic savings and in the expansion of loans from multilateral development banks.[33]

Proposals submitted by U.S. Congressmen stress the need to adopt a form of debt relief that will allow debtor countries to resume growth and increase their imports. Senator Kerry (D-Mass.) has suggested the establishment of a correlation between trade balance and a reduction in debt servicing. Senator Bradley (D-N.J.) has proposed that a summit meeting of lenders and borrowers be called to examine ways to reduce the servicing of the debt, in a way conducive to the liberalization and expansion of imports on the part of debtor countries. The links between debt and trade, incidentally, were the theme of a New York Conference sponsored by a bipartisan group of Congressmen for the purpose of finding new formulas capable of providing a solution to the debt problem and the expansion of trade, and possibly to shrink the distance between the Baker Plan and the Bradley proposal. Finally, the U.S. Executive Branch appears to share the perception that the Baker Plan needs to be complemented and readjusted, and that it is necessary to ensure additional sources for financing growth in the debtor countries. Deputy Secretary of State John Whitehead has proposed that the emphasis of the Baker Plan be shifted to focus more on investments than on new loans.[34]

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others of debtor countries face a longer and still-difficult road." In Morgan's view, the way out would lie in exploring new forms of financing, mainly the conversion of debt into equity).

32 B. BALASSA *supra* note 16, at 23.

33 *Id.* at 40.

34 "Any plan which just involves more lending, more borrowing, more interest payments, more repayment requirements, is not a total plan for success. And therefore, it seems to me that the Baker

It is still early to forecast the course the debt may take. It is evident however, that the fact that the debt is evolving from the financial sector alone, impacts on the productive sector as well. Paradoxically, although the declared purpose of the adjustment process has always been a return to the market, the decisions as to when, how much, and under which conditions to lend to indebted countries stem decreasingly from market considerations and increasingly from concerted actions. This shows that, the solution to the debt issue will not come from the market, but will be the object of a long negotiation process, for what is at stake is the sharing of the costs of the global adjustment among the major partners, namely, the commercial banks and the creditor and debtor countries. The experience of recent years has demonstrated that unless the debtor countries can resume growth, the cost will be greater for all.

The experience of the last few years shows also that sustained growth will be possible only if some conditions are met. The adjustment effort on the part of debtor countries must continue. However, rather than concentrating on strict public deficit and monetary expansion performance criteria, developing countries will be forced to adapt to a new international economic reality. As Peter Drucker stresses, "the world economy is not changing, it has already changed—in its foundations and in its structure—and in all probability the change is irreversible."[35] One of the changes is precisely the marked devaluation of the products exported by developing economies. "By early 1986 raw material prices were at their lowest levels in recorded history in relation to the prices of manufactured goods and services—in general as low as at the depths of the Great Depression, and in some cases (e.g. lead and copper) lower than their 1932 levels."[36] The collapse of the prices of primary products, as Drucker points out, is not a transient phenomenon; rather, it is structural and stems from, among other factors, the simultaneous effort on the part of debtor countries to expand exports. This fact, adds Drucker, calls into question the traditional development theories and inserts in the agenda for the coming years the policy of import substitution, already adopted by Latin America, particularly in the 1960s and in the 1970s. To increase the efficiency of import substitution, while preventing the fostering of protectionism, requires the promotion of reciprocal opening of remarks among developing countries through free trade agreements.[37]

Plan is now moving into a new phase where equity investment is emerging as a very important factor permitting these economies to begin to grow again." Whitehead, *Swap Debts - or Write Them Down?*, Wash. Post, Oct. 16, 1986.

[35] Drucker, *The Changed Economy*, 64 FOREIGN AFF. 768 (1986).

[36] *Id.* at 769.

[37] In this sense the recent integration agreements signed by Brazil and Argentina and joined by Uruguay are not only a timely initiative of regional cooperation but also quite possibly the germ of a broader process of adjustment to this new reality.

The creation of more favorable conditions in the world economy is another important requirement. The increase of growth rates in ODCE countries, expansion of demand for LDCs products, elimination of protectionism trends, a decline in real interest rates and the stabilization of exchange rates are all necessary developments to ensure growth resumption in debtor countries. The Third World can do little to effect these changes. The attempts at international economic coordination and supervision have not yet generated sufficient incentive or pressure to correct existing imbalances. Thus, the likelihood of rapid change is illusory. For the developing countries, it would be a risky proposition to await an improvement of the international outlook for the solution of their problems.

The developing countries' adjustment to the new economic reality and more favorable world economic conditions, offer a solution for the medium-range future. Two tasks have top priority for the immediate future: the flexibility of the debt strategy must be increased, and the transfer of resources must be reduced.

When it was conceived, the debt strategy stressed the case-by-case approach. In its application, however, this approach revealed a double standard. Proposals of a political dialogue between debtors and creditors are evaluated on a case-by-case basis. However, a blanket approach is used to evaluate proposals for economic recipes and procedures to be applied to different countries at different adjustment stages. For this reason conditionalities should be made flexible and programs should be adapted to the sociopolitical limits of each country.[38] Still further, it would be necessary to remove certain elements of structural rigidity, such as the requirement of a previous arrangement with the IMF for the negotiation of rescheduling agreements at the Paris Club.

Finally, if the objective is growth, the key question lies in the transfer of resources. It is the volume of the transfer that imposes the rhythm of adjustment and the intensity of conditionality. It is the excessive rate of the transfer of resources that reduces the capacity to invest and to grow. And, it is the transfer of resources that diminishes the capacity to import. For this reason President Jose Sarney, addressing a Joint Session of the U.S. Congress in September 1986, proposed that:

> It is necessary to promote an understanding among the leaders of creditor and debtor nations to reduce the magnitude of payments now being made. This would allow the debtor countries to again import more

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[38] Moreira, *supra* note 25, at 43, suggests in this connection that Article IV Consultations, provided for in the IMF Articles of Agreement, should cease to be a unilateral mechanism to become an instrument of cooperation and information between debtors and lenders, so that the IMF, instead of imposing conditionalities unilaterally, may assume the role of an independent observer.

> from the creditor countries, and their own growth could, in turn, contribute to the recovery and normalization of the world economy.

This is the first step for a long lasting solution to the problem of the developing countries' foreign debt. This approach has the merit, as the Brazilian President emphasized, of bringing mutual benefits to debtors and creditors alike, for if the indebted countries are allowed to transfer less resources abroad, they will be able to import more.