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Article — Digitized Version

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Intereconomics

Suggested Citation: Westphalen, Jürgen (1991) : The development finance challenges facing Latin America in the 1990s, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 26, Iss. 6, pp. 281-286,
<https://doi.org/10.1007/BF02929012>

This Version is available at:

<https://hdl.handle.net/10419/140322>

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Jürgen Westphalen*

The Development Finance Challenges Facing Latin America in the 1990s

Growth in Latin America in the 1980s was much slower than it had been in previous decades and real resource transfer has been negative since 1983. What are the chances that this situation will change in the nineties? Where can the necessary development finance come from? Can bottlenecks be avoided?

The 1980s were more than merely a lost decade for Latin America, and have been referred to as a "década de aprendizaje doloroso", or decade of painful experiences, in a publication put out by the UN's economic commission on Latin America, CEPAL.¹ But experience has indeed been gathered during those ten years, new developments have been set in train and new policy approaches have been found. Examples which immediately come to mind are moves to introduce or expand the market economy, to renounce import substitution which relies on protectionism, to combat inflation and to broaden democracy. There really is therefore a justification for describing the 1990s as a "década de esperanza" (of hope), as Enrique Iglesias, the president of the Interamerican Development Bank, has done. Yet the crucial question, particularly in the light of the past decade, remains one of how Latin America's substantial development needs ought to be financed.

This article begins by assessing the volume of finance needed: to do so, it is first necessary to look back over the 1980s and to point out the "inherited burden" of the last decade, or at least the pent-up demand for financing which has accumulated in recent years. It will then examine the past development of the main funding sources, both domestic and international, before finally asking what the future holds in store. In this regard, particular attention will be paid to private-sector foreign direct investment, which is the subject of such great expectations in Latin America today.

In comparison with previous decades, the 1980s brought a period of much slower growth. Average economic growth in Latin America as a whole was 5.4%

during the 1960s, 5.9% in the 1970s and only 1.1% in the 1980s.² The last-quoted annual rate was considerably less than the population growth during the same decade, which meant a substantial decline in per capita incomes and increased poverty in Latin America.

The 1980s can also be clearly subdivided into three different growth phases,³ the first from 1981 to 1983 being a recessionary phase, with growth rates of 0.2% in 1981, -1.1% in 1982 and -2.8% in 1983; this was followed by the recovery phase in the period 1984-1986, with annual growth rates of 3.3%, 3.6% and 3.7%, then a period of slowdown with growth of 2.7% in 1987, 0.3% in 1988 and 0.7% in 1989.

A pronounced hiatus occurred in 1982 when the debt crisis which had been building up during the previous two decades broke out for all to see. The region's total public-sector foreign indebtedness (disbursed portion) rose from \$5.8 billion in 1960 to \$15.8 billion in 1970, then to \$128.7 billion in 1980 and finally \$172.5 billion in 1982. By 1989, Latin America's public foreign debt burden had reached \$325 billion. Thus the increase in indebtedness was 172% during the 1960s, 715% in the 1970s, but "only" 153% between 1980 and 1989.

The consequence of the increasing levels of foreign debt and the growing debt-service burden has been a large-scale net transfer of resources away from Latin America.⁴ That net transfer consists of the balance

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¹ CEPAL: Balance Preliminar de la Economía de América Latina y el Caribe 1991, published 1990, p. 22.

² Interamerican Development Bank: Economic and Social Progress in Latin America, 1990 Report, Washington D.C. 1990, p. 20.

³ Ibid., p. 19.

⁴ CEPAL, op. cit., p. 33.

between the net capital inflow from abroad and the outflow of repayments, profits and interest to those other countries. Until 1981, that net transfer was still positive, i.e. the capital inflow was still higher than the outflow of profits and interest; since 1982, however, the net resource transfer has been negative, and the cumulative figure for the period 1982-1990 was \$224 billion, or 22% of the region's exports of goods and services.

There was also a marked deterioration in price trends in past decades,⁵ as borne out by a comparison between the 1960s and 1989. During the 1960s, there were still 117 out of 25 countries in the region with inflation rates of less than 5%, whereas there was only one, Panama, in 1989. Four countries had inflation rates between 5% and 12% in the 1960s, but twelve in 1989, and the number of countries with inflation rates above 20% also went up from 4 to 12. The highest inflation rates during the 1960s were 46.2% in Brazil and 47.8% in Uruguay; in 1989, on the other hand, there were price rises of 1,284% in Brazil, 3,079% in Argentina, 3,399% in Peru and as much as 4,770% in Nicaragua. There are nevertheless one or two examples of inflation having been combated with some success, as in Bolivia (down from 8,293% in 1985 to 11% in 1987) or Mexico (159% in 1987, 20% in 1989).⁶

Diminished Competitiveness

The unsatisfactory developments of the past inevitably leave their scars both on the present and on the future. For example, the competitiveness of broad areas of the goods-producing economy in Latin America has fallen off due to inadequate growth rates and the drastic curtailment of imports. Nine of the 25 Latin American countries had negative economic growth rates for the last decade when taken as a whole; in just the one short recessionary period from 1981 to 1983, real per capita income in Latin America as a whole fell by 10%. At the same time, sharp cuts were made in imports in an effort to achieve equilibrium in the trade balance, if not indeed an export surplus: the total import figure fell from \$101.4 billion in 1981 – the last year before the "Mexico shock" – to just \$60.4 billion in 1983. Although total imports into the Latin American countries had again risen to \$84.6 billion by 1989, that still left them 17% down on the level of 1981.⁷ It is impossible to confine the effects of such a drastic cut in imports to consumer goods alone, and in reality there has been a certain tendency to refrain from importing spare parts, capital equipment and other production inputs, which has

inevitably had an adverse effect on competitiveness, in the industries affected.

Furthermore, the economic problems of the past have exacerbated social inequalities in Latin America. The efforts to reduce government deficits led to expenditure on public projects or subsidies being cut or eliminated altogether, with all the negative consequences that triggered off for the labour market, the health and education sectors and the incomes of the broad mass of poor people. In a bid to combat inflation, rises in the minimum wage were generally kept below the rate of inflation, generating cuts in real incomes for all those who earned no more than that minimum. Consequently, according to CEPAL's executive secretary, Gert Rosenthal, there were 183 million people, or 44% of the total population, living below the official poverty line in Latin America in 1989; in 1980, the corresponding figures were 136 million and 41% of the population.⁸

Challenges for the 1990s

CEPAL's executive secretary Rosenthal, at a joint conference staged by the Interamerican Development Bank and the OECD's Paris-based Development Center, cited a number of different challenges which he felt Latin America would be facing during the 1990s:⁹

□ *Modernizing productive structures:* Latin America has lost ground in the competition to gain international markets in recent years. Its share of world trade fell from 5.1% in 1981 to 4.1% in 1989. The main motivation for industrialization in the past had been import substitution, and it was accompanied by the erection of protectionist import barriers which were bound to have an adverse effect on industry's development standards sooner or later. Even in Brazil, a country with a relatively high level of industrial development, industry has approximately 15 years to catch up on its rivals in the industrial nations. The aim for the future has to be to encourage industrialization by renewing industrial structures based on the export of industrial goods.

□ *Adjustment to a changing international environment:* The technological progress the industrial nations have made, particularly in the fields of microelectronics and computer technology, has strengthened their position relative to that of Latin America, which will therefore need to redouble its efforts to close the gap in those fields. Now that a new international order is emerging after the end of the Cold War, Latin America is presented with new opportunities on the one hand, but also major new risks on

⁵ Interamerican Development Bank, op. cit., p. 24.

⁶ Deutsch-Südamerikanische Bank AG: Kurzbericht über Lateinamerika, No. 1/91, p. 125.

⁷ Ibid., p. 127.

⁸ Gert Rosenthal: Five Challenges for Latin America and the Caribbeans in the Nineties (facsimiled), Paris 1990, p. 6.

⁹ Ibid., esp. pp. 10 f.

the other, and these too call for substantially increased efforts, especially as far as greater economic integration is concerned. Thus considerable significance should be attached to President Bush's initiative to create a free trade zone stretching from Alaska to Tierra del Fuego, and also to the South American "Cono Sur" countries' endeavours to establish a common market, known as MERCOSUR, which at the current stage of negotiations would include Argentina, Brazil, Paraguay and Uruguay.¹⁰

□ *Narrowing the social divide:* In this regard, Rosenthal stressed the urgent need for improvements in the social infrastructure, notably education and health care, more support for the rural population and small businesses, and not least also for a more sensible and effective population policy.

□ *Consolidating the pluralist and democratic systems:* Democratic governments are bound to find themselves in difficulties if they prove incapable of delivering the improvements in economic and social conditions expected of them by the public. Even for this political reason, then, it is essential that economic growth should be accelerated and the gap between rich and poor narrowed. If these objectives are to be achieved, CEPAL estimates that an annual growth rate of 7.2% is needed during the 1990s, coupled with an investment ratio equivalent to 22% of gross domestic product. The annual growth rate in the 1980s averaged just 1.1%, and even in 1990 the investment ratio was still only 17% of GDP.

Domestic Savings

The most important and the most difficult challenge in the current decade, however, is one of improving the capacity to provide development finance.¹¹ Because of the need to catch up the ground which has been lost, the demand for capital is both very high and growing very rapidly. Yet, on the other hand, domestic savings have stagnated or are actually declining due to the generally weak levels of economic activity. During the recessionary phase in the early 1980s, the gross domestic savings ratio fell from 22.3% of GDP in 1980 to 20.4% in 1983, a drop of almost two percentage points. Above-average falls in the ratio occurred in Chile (3.4 points), Bolivia (3.8 points), Brazil (5.9 points) and Peru, where the fall was as high as 6.2 percentage points.

Simultaneously, the reduction in the ability to mobilize external savings was still greater: the appropriate measure of this is the real resource transfer, i.e. the sum of

the net resource transfer and the balance of trade. This fell by almost eight percentage points from + 5.9% in 1980 to -1.8% in 1983.

Consequently gross investment, which consists of gross savings plus the real resource transfer, was thoroughly unsatisfactory, dropping by almost ten percentage points from 28.2% of GDP in 1980 to only 18.6% in 1983. By 1989, there had been a very slight recovery to 19%, made up of a domestic gross savings ratio of 22.2% and a real resource transfer of -3.2%. An investment ratio of that magnitude is much too low to cope with the development needs faced by Latin America in the 1990s. It should be said, though, that there were substantial differences from country to country in Latin American investment rates during the 1980s. This will be illustrated by just a few examples: the decline in the investment ratio, in percentage points, between 1980 and 1989 was 13.6 in Venezuela, 15.7 in Argentina and 16.4 in Ecuador, yet in Colombia it was 4.2 and in Chile only 1.9. Evidently, some countries have coped better than others with the problems of the past decade.

An important immediate aim for future years is to raise domestic savings levels, but it must be appreciated that private households and industry cannot be expected to achieve much until economic growth has picked up, and that all the measures now needed to reduce the gap between rich and poor may also impede rather than assist such improved savings levels. Moreover, there is substantial pressure to catch up on the consumption side in Latin America, and fulfilling those needs will also have an adverse effect on saving. That all means that the task will first need to be taken on by the public sector, primarily by cuts in government expenditure which neither impair the international competitiveness of business nor exacerbate the social problems which already exist. There will be no need to elaborate any further on why this is an extraordinarily difficult undertaking.

The Development of Foreign Trade

A vital question is how the negative real resource transfer which has been taking place since 1983 can be reversed. To achieve that it is necessary to improve the balance of trade, but to do so by increasing exports rather than curbing imports. Industrialized trading partners will also have to do their bit towards realizing this objective, and they could start by improving on the disappointing progress so far made in the Uruguay Round of GATT negotiations. Furthermore, the demand for import liberalization currently being made of the debtor nations ought also to be matched by a swift reduction in protectionism among creditor countries. Finally, further

¹⁰ On this, see Karin Curilla: Neue Integrationsansätze in Lateinamerika, in: Deutsch-Südamerikanische Bank, op. cit., pp. 13 ff.

¹¹ The statistical data on development funding capacities are taken from: Interamerican Development Bank, op. cit.

progress in reducing the debt-service burden along the lines of the Bolivia Model,¹² or in debt restructuring as proposed by the Brady Plan is also desirable. Some improvements in the balance-of-trade position of Latin American countries since the recovery from the 1980s recession are indeed now discernible: total exports of goods and services increased from \$97 billion in 1983 to \$133 billion in 1989, a rise of 37%, and the trade surplus rose during the same period from \$21 billion to \$27 billion, though imports had to be curtailed to achieve that improvement. The export of industrial goods¹³ from the region's three large countries of Argentina, Brazil and Mexico accounted for 50% of the Latin American total in 1980, and that share had risen still further to 70% by 1989. The small Central American country of Costa Rica increased the proportion of non-traditional goods in its exports from 16% of the total in 1980 to no less than 41.6% in 1989. Most Latin American countries, however, will continue in future to face the urgent need to accelerate the increase in their trade surpluses even while allowing imports to rise, or in other words to bring about disproportionate increases in their exports.

Foreign Loans

It is also absolutely essential for establishing a positive real resource transfer that the inflow of foreign loans should be increased. There were major changes in the relative significance of different foreign financing sources for public-sector debt between 1970 and 1988. Amongst the private-sector sources of credit, there was a marked decline in the relative importance of trade credit, which had its highest share in 1970 with 16.9% of total public-sector foreign borrowing, and its lowest in 1987 with just 3.3%. Borrowing from banks first rose distinctly, before falling off towards the end of the period, being at its lowest level in 1970 with 16.9%, its highest in 1984 with 58.5% and attaining 52.4% in 1988. The share of all private-sector foreign lending sources combined rose from 45.2% in 1970 to 73.3% in 1984, before falling back to 65.7% in 1988.

Shifts also occurred over time in the relative significance of public-sector foreign finance sources. Lending from multilateral institutions such as the Interamerican Development Bank, the World Bank and others saw a long period of relative decline, and did not rise again until the latter part of the 1980s, the percentage shares being 24.3% in 1971, 14.7% in 1984 and 18.8% in 1988. Bilateral credit arrangements with individual foreign

governments followed a similar pattern, with their highest relative value in 1970 at 30.8%, their lowest in 1983 at 11.9%, and a return to 15.4% of total foreign borrowing by 1988. The percentage shares for borrowing from all public-sector sources combined thus amounted to 54.8% in 1970, falling off to 26.7% by 1984 and rising again to 34.3% in 1988.

Despite their decline towards the end of the 1980s, in 1988 borrowing from commercial banks (52.4%) and from all private-sector sources combined (65.7%) were still much more important than they had been in 1970 (16.9% and 45.2% respectively). Conversely, even though they have again been playing a more significant role in recent years, loans from public-sector sources are nevertheless some way off achieving the same share of total lending as they did in 1970. That difference is particularly high as far as loans from bilateral government sources are concerned.

One factor which needs to be considered when comparing private and public sector sources of funds, however, is that a large portion of the private foreign borrowing done in Latin American countries, which in turn is normally drawn from private-sector sources, has also been converted into government debt from the private sector, as the central banks frequently had too few foreign currency reserves available to transfer the repayments.

The statistics show that public-sector lending has quite some catching up to do. However, there are a number of factors which adversely affect the likelihood of that need being fulfilled. As far as bilateral agreements are concerned, it must be remembered that the USA is now itself an importer of capital, and that European industrial countries, too, face growing capital requirements within their own borders. At least for the duration of the 1990s, Germany will need to deploy an increasing amount of capital to finance the unification of its two former parts, while economic and political change in the former socialist countries elsewhere in eastern Europe will also require large sums of money to be injected. In the address cited above, Gert Rosenthal¹⁴ said of the prospects of increased lending from multilateral sources that, "The multilateral agencies clearly do not have enough finance at their disposal to fill the enormous funding gap."

Private-sector Foreign Direct Investment

In the light of the above prospects, Latin American countries are today placing great hopes in direct private-sector investment from abroad; the question which therefore remains to be examined is how much this source

¹² This involves providing public-sector capital to allow the repurchase of obligations to foreign banks at their current market value.

¹³ Gert Rosenthal, *op. cit.*, pp. 3 f.

¹⁴ *Ibid.*, p. 7.

of capital can realistically be expected to yield for Latin America during the 1990s. The region has long been a favoured location for private-sector direct foreign investment. The attractions lie in such factors as a wealth of raw materials, the large, expanding markets in some countries, but not least also in the protectionist policies used to guard domestic investors against foreign competition, no serious attempt having been made to dismantle these until very recently. At the same time, a number of negative factors are apparent such as restrictive legislation rooted in a fundamentally nationalistic attitude and acting as a burden on the foreign investor, or else the political instability prevailing in many countries or the limited internal markets in the smaller countries, the latter being a disadvantage which even the various efforts at economic integration have not so far managed to eliminate. Nevertheless, on balance these negative factors were more than compensated for by the locational attractions of Latin America, especially its market opportunities, during the 1960s and 1970s.

The problems encountered in the 1980s, especially the debt crisis and its consequences, were a crucial hiatus for overall investment in Latin America. The gross investment ratio shrank from 27.3% in 1981 to 19% in 1989. Expressed in absolute figures, gross investment was down from \$207 billion in 1981 to \$159 billion in 1989, a 23% decline during a period in which the population grew by 19% or, in other words, in which there was a pronounced increase in the need for investment.

Comparatively speaking, private-sector direct investment from abroad proved relatively stable during the same period. In 1981, the figure for Latin America as a whole was \$8 billion; in 1984, it fell to \$3 billion, but recovered to \$7 billion in 1988 before falling back to \$5 billion in 1989. Despite the marked fluctuations, this was still a more stable field relative to the total flow of foreign capital, which turned from a net inflow of \$24 billion in 1981 to a net outflow of \$8 billion in 1987.

Private direct investment from Germany has followed a similar pattern, and Latin America has long been regarded as an attractive investment region for German industry. Of the total private direct investment made from Germany in the top 17 countries, 59% was taken up by Brazil, Mexico and Argentina alone.¹⁵ The total asset value of existing German direct investment in Latin America¹⁶ rose from DM 12.5 billion in 1981 to DM 16 billion in 1988. Although, here again, marked fluctuations have occurred and there was an actual decline in this capital stock in 1985 and 1986, such falls have invariably been balanced out by above-average increases in other years, such as the investment growth of DM 3.4 billion in 1984 and of DM 2.4 billion in

1988. In a recently published study, P. Nunnenkamp¹⁷ posed the question of whether German foreign investors might not have fallen into a "developing country trap" by misjudging the opportunities and risks they faced when putting their capital into Latin American countries. However, it should be said in response to those fears that German investors tend to take a very long-term view when making their investment decisions, and whatever current difficulties and problems they may face, they continue to have a positive assessment of the long-term opportunities in the region.

By reacting in a more measured way to Latin America's economic problems in the 1980s, foreign private companies or individuals investing directly in business operations helped to counteract the negative trend occurring for private foreign capital as a whole. Even so, one must bear in mind that, according to the 1981 data, only about one-third of the total private capital inflow was taken up by direct investment. Thus its scale is nowhere near sufficient to make up for the decline in new lending by commercial banks.

The prospects for the 1990s in this area vary considerably from one country to another. In Chile and Mexico there is certainly some cause for optimism that direct investment from abroad will increase and, albeit to a lesser extent, the outlook is also relatively promising for countries such as Colombia and Venezuela. For the next five years alone, the USA has held out the prospect of approximately \$16 billion of investment in Chile, and in Mexico, new foreign investment totalled \$4.4 billion in 1990. On an overall view, though, Gert Rosenthal's remark on the lending capacity of multilateral agencies applies in a similar sense to private foreign investment, so the inevitable conclusion is that such investment in the "direct" category will not be at all sufficient to make up the tremendous funding gap facing Latin America in the 1990s.

At any event, though, private-sector direct foreign investment is of major importance to Latin America even if it did only account for something over 3% of total gross investment in 1990. Foreign private capital generally also brings with it technical know-how, management experience, knowledge of the rules of the game in a market economy and, last but not least, foreign markets which have already been opened up and are then made available to the goods to be manufactured in Latin America. These

¹⁵ Peter Nunnenkamp: *Deutsche Auslandsinvestoren in der Entwicklungsländer-Falle?*, Kieler Diskussionsbeiträge 1644, Kiel 1991, p. 6.

¹⁶ Deutsch-Südamerikanische Bank, op. cit., p. 136.

¹⁷ Peter Nunnenkamp, op. cit., esp. pp. 4 ff.

are all factors which are probably just as significant with regard to overcoming Latin America's problems in the 1990s as access to foreign borrowing.

Conclusions

To conclude, it should be noted that there are now a number of positive developments in the making in Latin America which certainly justify the description of the 1990s as the region's "década de esperanza". However, the optimism expressed by the slogan is tempered by the unresolved question of where the development finance will come from, which could give rise to a serious bottleneck in the years to come. What can be done to avert this danger? The greatest priority must be attached to improving countries' net flow of funds relative to the rest of the world, as expressed in the real resource transfer. To

do that, Latin American exports need to be promoted, not least via greater opening of markets on the part of industrial countries, and a further need is for an increase in private-sector direct foreign investment, but above all for an increase in new lending from foreign public-sector sources.

Not until a marked increase has occurred in this external contribution, assuming domestic stabilization measures are also continued, can renewed growth be expected to occur in domestic savings, and hence also in the gradual establishment of a firm basis for strong, steady economic growth. Unfortunately, though, there are signs that the danger of a number of Latin American countries suffering another "década perdida" in the 1990s has not yet been banished.

Diana Brand*

Free Trade in Latin America: A Successful Way Out of Crisis?

Since the beginning of the 1990s almost all Latin American countries have begun to change their strategies from protectionism to free trade. Historically, plans for regional economic integration have a long tradition on this continent, but attempts to bring them to fruition have failed time and time again. This report surveys past developments and attempts to show the prospects of success for the current free trade strategies in Latin America.

Latin American countries have tried repeatedly in the last thirty years to form trading blocs and to cooperate on a regional level. Table 1 gives an overview of the composition and objectives of the various economic integration groups which were founded between 1960 and 1980 with the primary motive of liberalizing trade. Even though some of these groups showed considerable initial success, integration has always failed in the long term.

The ambitious aims of the Latin American Free Trade Association (ALALC or LAFTA), founded in 1960, did not come anywhere near being achieved in the twenty years of its existence. The main reason for the failure was the differing degrees of industrialization in the member countries, which led to an unequal distribution of the advantages of liberalization.¹

Conflicts over distribution were also partly responsible for the failure of the Central American market, MCCA,

formed by a small number of basically relatively homogeneous countries in 1960. Repeated political disagreements and external shocks also prevented the long-term success of trade integration.

When Bolivia, Chile, Ecuador, Colombia and Peru formed the Andes Group in 1969, the aim was to strengthen the economic power of the above countries within ALALC relative to the predominating economies of Argentina, Brazil and Mexico. The realization of free trade plans failed, first and foremost, due to the national egoism of the participating countries. Economically, the heterogeneous industrial structure of the member countries hindered the implementation of a common external tariff.

¹ Cf. for example R. J. Langhammer and U. Hiemenz: Regional Integration among Developing Countries, Kieler Studien No. 232, Tübingen 1990; and Ricardo French-Davies: Economic Integration in Latin America, in: M. Urrutia et al. (eds.): Lessons in Development, A Comparative Study of Asia and Latin America, San Francisco 1989, pp. 157-180.

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