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**Working Paper**

## Financial Markets: A View from the Semi-Periphery

Center Discussion Paper, No. 367

**Provided in Cooperation with:**

Yale University, Economic Growth Center (EGC)

*Suggested Citation:* Bacha, Edmar L.; Díaz-Alejandro, Carlos F. (1981) : Financial Markets: A View from the Semi-Periphery, Center Discussion Paper, No. 367, Yale University, Economic Growth Center, New Haven, CT

This Version is available at:

<https://hdl.handle.net/10419/160292>

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YALE UNIVERSITY

Box 1987, Yale Station  
New Haven, Connecticut

CENTER DISCUSSION PAPER NO. 367

FINANCIAL MARKETS: A VIEW FROM THE SEMI-PERIPHERY

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January 1981

Note: Center Discussion Papers are preliminary materials circulated to stimulate discussion and critical comment. References in publications to Discussion Papers should be cleared with the author to protect the tentative character of these papers.

Financial Markets: A View from the Semi-Periphery\*

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Private international financial intermediation has witnessed successive cycles for the last 160 years. In this century, it blossomed before the First World War and through the 1920s. In the 1930s and 1940s, private capital markets went into an eclipse, to reappear timidly in the 1950s, booming in the 1960s and 1970s. Theorizing about financial markets has on the whole followed those cycles. Few are the examples of powerful propositions emerging from general financial theories which are independent of historically-specific institutional arrangements.

This paper discusses the interplay of financial aspects of the history of world capitalism with theorizing about financial markets, carried out mainly in Northern countries. It is organized as follows. Three epochs in financial arrangement and theories are first briefly reviewed, giving special emphasis to their impact on peripheral countries. They are the pre-1929 years, 1944-1973 and 1973-1980. A long section on the 1970s stylized facts follows. Then some systemic issues of international financial arrangements for the 1980s are discussed. Finally, some aspects of the impact of international financial markets on Latin America are noted, and analytical problems suggested by unexpected consequences of recent attempts at financial reform in Latin America are debated.

Frequent references will be made to orthodoxy. This term is not easy to define; it may be helpful to separate "academic" from "practical orthodoxy". The former is the product of leading academic centers of the time; it tends to be flexible and agnostic. Its leading thinkers often are its own major critics, frequently curious about heterodox notions. Practical orthodoxy is more assertive. It is found in the editorials of the business press, among private or public executives with Masters' degrees, and among some of the more politically or financially ambitious academics. The latter sometimes play a double role: in their Northern universities, disciplined by their colleagues, they are cautious scientists; during their summer tours of the periphery, their libido imperante unleashed, they become fountainheads of practical orthodoxy.

It is practical orthodoxy that puts the system to work and typically sets the Northern tone in North-South debates. As such it will be the main focus of our analysis.

### I-The Pax Britannica

The pre-1929 international financial order enjoyed a degree of intellectual hegemony which has never been regained. The gold-exchange standard was regarded as the natural regulator of the balance of payments. Current account deficits and increases in international reserves were financed using bonds with long maturities and fixed interest rates as well as via direct investments. Under the long Pax Britannica some countries (Germany, the USA) graduated from the role of capital importers to that of capital exporters. At least until the 1920s, London ruled the waves and regulated the whole system,<sup>1/</sup> whose occasional crises were regarded as passing aberrations or a necessary purging of "excesses".

National financial systems showed greater heterogeneity. In the United States populist pressures blocked the creation of a central bank until early this century. France and Germany developed financial systems more centralized and state-dominated than that of the United Kingdom, as analyzed by Alexander Gershenkron. Apparently, British hegemony in international relations of all types explains the greater homogeneity of the international financial rules of the game, in contrast with those applicable nationally.

African and Asian colonies had little choice in their financial systems, and tended to follow prevailing orthodoxy. Several independent Latin American countries, however, had difficulties adhering faithfully to the gold-exchange standard.<sup>2/</sup> Mexico followed a silver standard for many years, while silver depreciated vis-a-vis gold. Argentina and Brazil often resorted to an "inconvertible paper standard", frequently accompanied by fiscal deficits and inflation (the U.S. went through a similar period after its Civil War).

These Latin American experiments with flexible exchange rates were viewed with fascinated disgust by orthodox scholars and bankers. The recurrent need for foreign finance as well as domestic political pressures to keep debt service from taking too much of a share of the budget would sporadically dictate a return to the gold-exchange standard and greater controls over domestic credit expansion. Foreign missions played important roles in attempted returns to orthodoxy. Examples include the Montagu Mission to Brazil in 1924 and those of Professor Edwin Kemmerer to several Andean countries.<sup>3/</sup> At least in the case of the Brazilian return to the gold-exchange standard in the 1920s, the economic results are regarded as negative. During the 1920s the

League of Nations also participated in missions associated with Stabilization Plans in countries such as Austria and Hungary.<sup>4/</sup>

The conditionality attached to international lending before 1929 included not only that linked to the natural desire of bankers to be punctually paid at least the interest due on loans. Political considerations also played a role in regulating access to capital markets. French and German lending were heavily influenced by political factors, as illustrated by the former's loans to Czarist Russia and the latter's loans to the Middle East.<sup>5/</sup> Brazilian access to the New York market was blocked by Herbert Hoover, then Secretary of Commerce, in retaliation for the Brazilian coffee valorization scheme; Brazilian access to the London market in the late 1920s was also discreetly vetoed by the Foreign Office in retaliation for the Brazilian withdrawal from the League of Nations.<sup>6/</sup>

The conditionality imposed before 1929 on the weakest peripheral countries included foreign control over their tariff revenues and other aspects of their fiscal and monetary machinery; this was the case of some Caribbean and Central American nations, in a fashion similar to that of Zaire during the 1970s.

The great depression of the 1930s destroyed the gold-exchange standard and international capital markets as they existed before 1929. The prestige of high finance collapsed; in the USA financiers were the target of New Deal attacks, and new legislation limited the flexibility of national and international financial intermediaries. European nazi-fascism popularized exchange and financial controls going beyond those practiced in other industrialized countries. Several industrial countries declared moratoria on domestic debts and witnessed drastic restructuring of their financial systems.

Peripheral countries with certain political autonomy, such as Argentina, Brazil and Colombia, reacted to the Great Depression with a fairly rapid abandonment of gold standard orthodoxy, wisely avoiding classical remedies. Thus, Brazil was advised by a mission headed by Sir Otto Niemeyer, of the Bank of England, to return to a fixed exchange rate and to maintain convertibility, on July 1931!<sup>7/</sup> These large or active Latin American countries allowed substantial depreciations of their exchange rate, imposed exchange controls and maintained a reasonable degree of domestic liquidity. Normal debt servicing was suspended in most cases, just as U.S. farmers suspended payments on their mortgages. Partly due to the closing of international markets, Latin American countries showed greater interest in mobilizing domestic resources via the tax system and the creation of new government controlled credit institutions. The economic performance of these countries during the 1930s was remarkably good, better than that of major industrialized countries.

## II. The Pax Americana

The international financial order which emerged from Bretton Woods in 1944, lasting until 1973, initially reflected the 1930s disenchantment with laissez faire in financial transactions and was influenced by Fabian/New Deal notions then dominant in the United Kingdom and the United States. The then United States Secretary of the Treasury, Mr. Henry Morgenthau, regarded Bretton Woods as the achievement of his lifetime ambition to "drive..the usurious moneylenders from the temple of international finance."<sup>8/</sup>

The International Monetary Fund (IMF) was born accepting changes in exchange rates to correct "fundamental disequilibrium" and allowing controls over capital movements. The International Bank for Reconstruction

and Development (IBRD) reflected pessimism regarding the viability of private financial intermediation in the postwar world. In the USA, the official EXIMBANK, created in the 1930s originally to finance trade with the USSR, was to play an important role in financing US exports of capital goods, and was a critical institution in US-Latin American economic relations. Already in the 1950s and even more so in the 1960s, the original Fabian/New Deal flavor of the Bretton Woods institutions was diluted, but they continued to reflect certain theoretical and practical eclecticism absent in the pre-1929 international financial order.

At least during the late 1940s and 1950s, both national and international financial intermediation received low priority. The ultra-Keynesian notion that "money does not matter" could easily be extended to "financial intermediation does not matter". It was not until the late 1950s that Europe abandoned rigorous exchange controls (the United Kingdom maintained them until 1979).

Early in the postwar, a new practical orthodoxy appeared regarding capital movements. It became common to hear advice aimed at peripheral countries regarding the importance of maintaining a favorable climate for direct foreign investments from the North. Before 1929, especially before the First World War, portfolio investments had dominated those of a direct nature, and a good investment climate involved mainly the punctual servicing of the debt. Direct foreign investment, suppliers' credits plus official development assistance of various sorts made up the bulk of capital inflows into the periphery well into the 1960s. All of these forms of finance implied a complex and fairly intimate relationship between lenders and borrowers.



Academic orthodoxy had surprisingly little to say about the benefits and costs of the postwar structure of capital flows between North and South. There was a tendency to add up all forms of capital flows into one aggregate necessary to finance the "foreign exchange gap". A common attitude was that the greater this aggregate flow, the better all around. This academic complacency was first punctured by peripheral (and Australian, Canadian, and European) criticism of some of the consequences of direct foreign investment and of multinational corporations. Some aspects of official development assistance also came under closer scrutiny, leading to more sophisticated evaluations of the grant element involved in such flows.

As noted earlier, already in the 1950s the IMF and the IBRD began to depart from the vision of at least some of their founding fathers, especially that of John Maynard Keynes. The IBRD stuck to the financing of specific projects, avoiding program lending. The IBRD also refused to lend to oil state enterprises, arguing that there were plenty of private oil corporations willing to invest. The IMF staff increasingly favored rigid exchange rates buttressed by rigorous credit policies, in a pattern similar to the pre-1929 rules of the game. In its dealings with peripheral countries given to heterodoxy, such as several Latin American countries, the IMF missions revived the spirit of Montagu and Niemeyer, advocating stiff stabilization plans. It could be argued that at least during the 1950s the leverage of the IMF missions was not smaller than those of Montagu and Niemeyer, as international credit sources in the 1950s were few, and tended to follow the leadership of the IMF (and the US Treasury). The consequences of the practical orthodoxy of the IMF were not very different from those of the Montagu mission.

As late as the 1960s, those advocating greater resource transfers from North to South would call for more official development assistance under various forms. Regional development banks were created, adding new official financial intermediaries. New aid relationships were sought. Hopes were also expressed for a new spirit in direct foreign investment.

In the meanwhile, the great postwar economic expansion which culminated in the early 1970s was creating new conditions eroding the postwar practical orthodoxy. Almost accidentally, a truly international capital market emerged around the mid-1960s, in the form of Eurocurrency credits.

The Eurodollar market, based on dollar deposits in banks outside the United States, arose from the desire of demanders and suppliers of those deposits to avoid actual or potential U.S. banking regulations. The Soviets were among the first depositors of dollars in banks located in Europe; they feared that accounts opened in the United States might be attached by U.S. citizens who had claims against the USSR. During tight credit conditions in 1968 and 1969 U.S. commercial banks bid for dollars in the Eurodollar market by offering yields above those permitted in the U.S. by Regulation Q, which dates back to 1933. Banks based in London and other European financial centers found that accepting dollar deposits and extending dollar loans was profitable, with reserve requirements dictated only by what each bank deemed prudent. The tacit approval of Central Banks was of course necessary. The practice of accepting deposits in currencies other than that used locally spread to sterling, German marks, Swiss francs and others; banks outside Europe also joined the market which now encompasses agents in Singapore, the Caribbean and elsewhere.

Growing macroeconomic disharmonies among the industrialized countries in the late 1960s, the US involvement in Vietnam, and increased capital mobility put enormous pressures on fixed parities. These circumstances led to abandonment by the US of gold convertibility in August 1971 and to generalized floating of key currencies in early 1973. This Annus Mirabilis culminated with the sharp rise in oil prices, putting an end of the postwar era of cheap energy.

### III. Pax Arabica?

The period 1973-1980 has been highly unusual in the history of international finance. A new type of capital exporter has emerged, which has no historical precedent. Consider the following contrast between OPEC capital exporters and those of earlier eras:

a) The military power of major OPEC countries is trivial, certainly insufficient to enforce financial contracts against recalcitrant debtors. It has been noted that every lender ultimately needs bailiffs at his back;<sup>9/</sup> OPEC does not have them.

b) OPEC countries lack capital goods industries, or indeed an extensive industrial base, to achieve the real transfer ultimately desired by foreign-exchange-constrained capital importers. OPEC's technological base is weak. It is difficult to imagine the equivalent to British exports of railway equipment or US direct foreign investment for the OPEC case. Oil is a nonrenewable asset for OPEC, but a current input for importers.

c) OPEC capital exporters had during 1973-80 only limited financial institutions of their own; they have relied heavily on financial intermediaries of industrialized countries.

d) OPEC national currencies are used only marginally as reserve or vehicle currencies; the influence of OPEC over international monetary arrangements is growing, but is still modest.

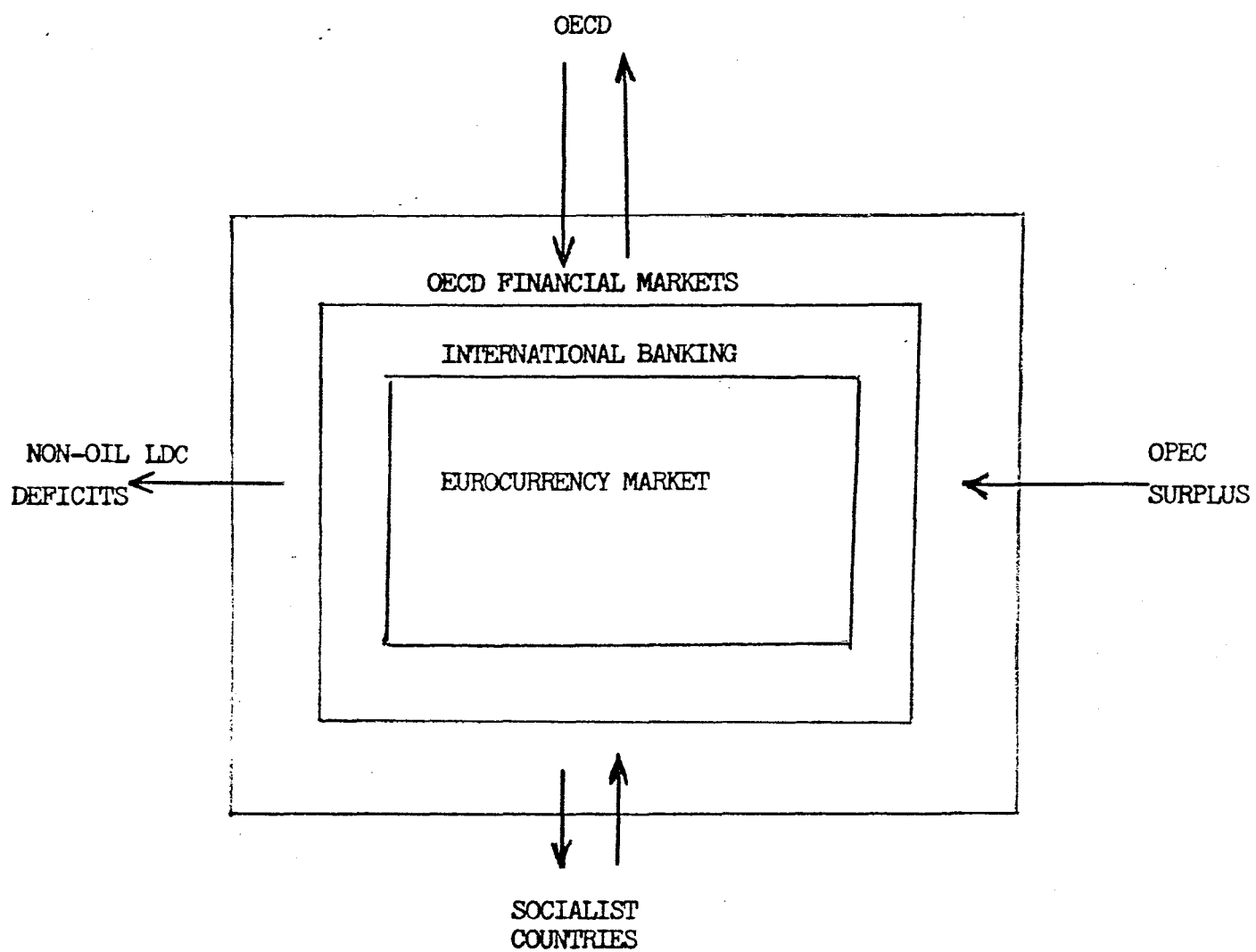
e) The major component of OPEC wealth is a nonrenewable resource. If investment in financial or real assets yield low rates of return, OPEC countries could adjust by decreasing their oil output, i.e., by investing in oil under ground. Thus, part of OPEC's "home investment" could decrease the world's aggregate supply in the short and medium term.

These considerations imply a good deal of interdependence between the old and the new capital exporters, involving both economic and political aspects. The latter have become highly visible since 1973 in contrast with previous years, when they were discreetly hidden. The network of trade flows has also become more complex and multilateral, involving greater triangularity among old and new capital exporters and the Third World.

The Eurocurrency market and international banking, already vigorous before 1973, have turned out to be (on the whole) flexible and efficacious instruments to accommodate the new capital exporters and the major semi-industrialized capital importers. A closer look at the Eurocurrency market and its links with the OPEC surplus is warranted.

Many transactions in Eurocurrency markets are between banks, and produce a limited amount of maturity transformation. International corporations also engage in considerable borrowing and lending in those markets. Depending on circumstances, economic agents switch from OECD national financial markets to the Eurocurrency market, and vice-versa. Using an old analogy, illustrated in Figure 1, Eurocurrency markets,

FIGURE 1



international banking and OECD financial markets more generally may be viewed as a giant bathtub within which much churning (gross financial intermediation) takes place, and where ripples in one segment are quickly transmitted to other segments.

Net inflows into and net outflows out of this bathtub can be defined in a number of ways, depending on one's analytical focus, including desired level of aggregation. In this paper we will be interested mainly in the role of financial markets as providers of Balance of Payments net financing to large groups of LDCs, as well as their role as receivers of net inflows from OPEC.

It should be clear that Eurocurrency markets have a life and a financial role which are independent of OPEC surpluses, just as their coming into being was not caused by U.S. balance of payments deficits of the 1960s. The gross stock of assets and liabilities of these markets is only marginally influenced by the net flows generated in a given year by the Balance of Payments of different countries. Even if all countries were to be in Balance of Payments equilibrium from now on, one could expect Eurocurrency markets to continue to grow as financial intermediary among the various agents participating in international trade and finance.

While the performance of international banks as financial intermediaries during 1973-80 was remarkably good, present arrangements remain historically anomalous and vulnerable in several ways.

Besides the contrasts already noted between new and old capital exporters, consider the following points:

a) The level of OPEC capital exports depends heavily on the real price of oil, rather than on stable long-term saving and investment propensities. During 1974 through 1977 OPEC surpluses were large, but tending to decrease until 1978, when they practically disappeared; in 1979 they rose sharply once again. For some importers of both oil and capital it is unclear whether the inflows are adding to productive capacity or simply maintaining consumption above levels sustainable in the long run (assuming the persistence of high real energy prices). Contrary to much historical experience in the periphery, worsening terms of trade accompany the capital inflow.

b) The 1973-80 recycling was aided by "money mirage" in the part of capital exporters. Ex-post real yields on dollar-denominated financial assets were low, certainly lower than the yield of oil in the ground. One wonders how long such a money mirage can last. Yet insistence by capital exporters on "normal" positive real rates of return on their financial assets would add to the problems of capital importers.

c) Political relations between old and new capital exporters are far from harmonious. Tensions between Iran and the USA, leading to the freeze in 1979 of Iranian assets in US-owned banks, had important negative repercussions in the syndicated Eurocurrency market. Catastrophic scenarios are much too easily imagined.

The historical anomalies raised by the emergence of OPEC as the major capital exporter deserve closer empirical scrutiny. The next section presents structural features of international financial flows and stocks since 1973, emphasizing those of special interest to the Periphery.

#### IV. The 1970s: stylized facts and trends

This section is organized as follows. Global balance of payments patterns are reviewed first, emphasizing LDC and Latin American deficits. Recent LDC financing arrangements are discussed and compared with earlier postwar experience. The analysis of financial flows leads to a consideration of debt magnitudes and of the burden of debt servicing, which are placed in historical perspective. A discussion of international private banking follows. The section closes with a comparative look at official and other lenders.

##### A. Global patterns

The global pattern of current account deficits and surpluses since 1973 are summarized in Table 1, and are expressed in dollars of constant value. It may be seen that net capital flows fluctuated considerably from year to year; the OPEC surplus was only \$4 billion in 1978 but is expected to reach \$71 billion (at 1975 prices) in 1980. The average pattern for 1974-80 is likely to continue well into the 1980s. Indeed, with the indexing of oil prices and more prudent and steadier OPEC development plans, the indicated pattern could be more stable during the 1980s than it was in the 1970s, when the real OPEC surplus declined sharply between 1974 and 1978. Both the OPEC surplus and the LDC deficit can be called structural in the sense that neither could be eliminated within a reasonable time span just by changes in exchange rates and macroeconomic policies.



TABLE 1Global Patterns of Current Accounts

(In Billion U.S. dollars at 1975 prices)

	Industrial Countries	OPEC	Non-oil LDCs	(Of which Western Hemisphere)	Socialist countries and errors and omissions
1973	25	9	-16	(-7)	-19
1974	-15	76	-42	(-15)	-20
1975	16	35	-46	(-17)	-5
1976	-2	40	-32	(-12)	-6
1977	-5	29	-26	(-8)	1
1978	25	4	-29	(-10)	-
1979	-8	48	-39	(-13)	-2
1980	-32	71	-42	(-13)	3
Average					
1974-80	-3	43	-36	(-13)	-4

Source: Adapted from Table 11, Appendix C, p.95, in World Economic Outlook; A Survey by the Staff of the International Monetary Fund, Washington, D.C.

May 1980. Data in current dollars were deflated by the dollar unit value indices for industrial countries exports, as published in International Monetary Fund, International Financial Statistics. Data for 1980 are rough estimates.

Negative signs imply deficits in current account.

Non-oil LDCs can be expected to be net capital importers, but it is important to examine how the deficits were financed and whether the inflow was accompanied by the maintenance of domestic savings efforts. Given dollar inflation and economic growth, it is also of interest to establish the magnitude of financing needs relative to other macroeconomic magnitudes.

The current account deficits of non-oil Latin American countries are presented in Table 2 as a percentage of exports and goods and services since 1950. These deficits resulted from short term fluctuations as well as from the interaction of demand and supply for long term capital. One may conjecture that the deficits for 1960-62 (the heyday of the Alliance for Progress) and 1970-73, in the order of 22 percent of exports, represent reasonable approximations to desired long run capital inflows. The low numbers for the 1950s reflect poor supply conditions in world capital markets, while the extraordinary deficits for 1974-76 indicate special circumstances unlikely to be sustainable over the long run. By 1977-78 the deficit was around 1967-73 levels, but rose again in 1979.

Two remarks may be made about the relative magnitudes of pre- and post-1973 Latin American deficits, with conflicting implications regarding the sustainability of 1977-79 deficits. The GNP growth rate accompanying post-1973 deficits was lower than that for 1967-73; the former was roughly 5 percent per annum in contrast with 7 percent for the earlier years.

World inflation, however, is leading to an overestimation of the magnitudes of external savings. Under present institutional arrangements the allocation of debt service between interest and

TABLE 2

Current Account Deficit of Latin America, excluding oil exporters,  
relative to exports of goods and services.

	(Percentages)
1950-54	8
1955-59	13
1960-62	22
1963-66	9
1967-69	16
1970-73	22
1974	44
1975	52
1976	30
1977	18
1978	20
1979	27

Sources: Computed from data presented in Cuadernos Estadísticos de la Cepal, El Balance de Pagos de América Latina 1960-1977, Naciones Unidas, Santiago de Chile 1979, Table 4, and from revised and updated data kindly made available by Andrés Bianchi, of the Cepal staff. The table includes 16 countries; Cuba, the newly-independent Caribbean nations, Bolivia, Ecuador and Venezuela are excluded.

amortization is distorted in favor of the former by dollar inflation, thus increasing the magnitude of current account deficits. A numerical example clarifies this question. Suppose that net debt at the end of the previous year is \$1,000, and that nominal amortization remittances this year are zero and the nominal rate of interest is 15 percent per annum.

Dollar inflation, affecting the debtor country export and import prices, is 10 percent per annum. Consequently, the real value of net debt at end of this year is \$900. Of the \$150 interest paid out, \$50 is real interest and \$100 is real debt amortization. Ordinary balance of payments accounting registers a \$150 outflow in current account and a zero outflow in capital account. Inflation-proof accounting should register \$50 in service payments and \$100 in debt amortization, the latter being a capital account item. Real domestic savings is \$100 higher and real foreign savings \$100 lower than indicated by current accounting procedures. In the case of Brazil, for example, it has been estimated that using inflation-proof accounting methods, the current account deficit for 1978, expressed as a percentage of GDP, is 2.1 percent instead of the 3.1 percent given by uncorrected data. For 1979, the contrast is even stronger: 2.2 percent versus 4.0 percent.<sup>10/</sup> Given an investment rate, estimates for domestic savings would have to be adjusted upwards by corresponding percentage points.

In the Brazilian study just mentioned, inflation in the United States was used to deflate debt figures. Other debt deflators have been proposed: dollar export prices of the country in question, terms of trade, and the consumer expenditure deflator (adjusted for exchange rate changes). <sup>11/</sup> Deflating by terms of trade is plainly wrong; the use of the consumer expenditure deflator is likely to run into practical difficulties. The theory of shadow exchange rates and

practical considerations strongly suggest a deflator which is a weighted sum of dollar export and import prices, with the weights reflecting the marginal shares of exports and imports in the adjustment process.

#### B. LDC Financing arrangements

Net financing needs during the 1970s have gone beyond those indicated by current account deficits; dollar inflation, real trade growth and a more uncertain international environment have led to an increase in the demand for reserves. Few LDCs could rely on perfectly flexible exchange rates to do away with reserves. Thus, Table 3 includes net reserve accumulation together with current account deficits to obtain net financial needs of all non-oil LDCs, expressed at current dollar prices. As measured by traditional indicators, the reserve accumulation shown in Table 3 does not appear excessive. For all non-oil LDCs gross reserves amounted to 28 percent of imports of goods and services during 1967-72; this ratio moved down to 21 percent during 1974-76, recovering to 25 percent during 1977-79 (data source as in Table 3). The corresponding figures for non-oil Western Hemisphere LDCs give a somewhat different picture: 22 percent for 1967-72, 22 percent for 1974-76 and a jump to 33 percent during 1977-79. This bulge, however, is being reduced during 1980. Many LDCs contracted debt when conditions were favorable during the 1970s, letting reserves as well as undisbursed debt fluctuate.

Table 3 shows that two traditional sources of finance, grants and direct foreign investment, reduced their relative contribution after 1973. Net long term borrowing from official sources such as the World and regional banks, and from private financial institutions, mainly banks, make up the bulk of the expansion of external finance. Bond issues and suppliers' credits from non-official sources remain relatively small contributors of net finance.

TABLE 3

Financial Sources for all Non-oil LDCs

(Annual averages in current billion dollars)

	<u>1973</u>	<u>1974-75-76</u>	<u>1977-78</u>	<u>1979-80</u>
Current account deficit	11.3	38.3	32.1	61.5
Net reserve accumulation	<u>9.7</u>	<u>4.3</u>	<u>15.0</u>	<u>10.0</u>
	<u>21.0</u>	<u>42.6</u>	<u>47.1</u>	<u>71.5</u>
Net transfers received by governments	4.5	6.8	7.7	10.4
Net direct investment	4.3	5.1	5.8	7.7
Net long-term borrowing:				
—from official sources	5.5	10.4	15.3	17.5
—from financial institutions	4.0	9.1	17.5	16.8
—from bond issues, net	0.5	0.5	3.1	9.8
—from suppliers' credits	0.4	0.9	1.9	
—other	1.5	3.3	-3.4	
Net short-term borrowing, other net, and errors and omissions:	0.3	6.5	-0.8	9.3

Sources: Adapted from Table 19, p.101, in World Economic Outlook; A Survey by the Staff of the International Monetary Fund, May 1980, Washington, D.C. Data for 1979-80 involve rough estimates as well as projections. Data on gross reserves relative to imports of goods and services are given in pp.41 and 94

These trends are sharper for Latin America, as may be seen in Table 4. Grants have been a very minor part of external finance since the early 1960s; other forms of public resources have also undergone a decline in importance during the 1970s. Private direct investment, which provided nearly one-third of all long-term external resources during the 1960s, by 1977-78 accounted for little more than one-sixth. Private banks and other private financial institutions have become the major suppliers of external finance.

### C. Debt accumulation and servicing

The summation of net yearly borrowing flows yields the increase in non-OPEC Third World debt. Thus, according to Table 3, long-term debt to all official and private creditors must have increased by about \$141 billion between the end of 1973 and the end of 1978. The summation of net direct investment flows yields the increment in foreign equity in the capital stock located within non-oil LDCs, ignoring capital gains and losses; such equity has no predetermined repayment schedule, as debt has under present institutional arrangements, although it generates outflows of profit remittances, as debt generates interest payments.

Reported debt figures contain great variety; they are often presented in a manner intended more to shock than to enlighten. One source of discrepancy among estimates is whether short-term (less than one year) debt is or is not included. At any one point there is a large float of short-term credits to finance LDC imports; such stock grows with the increase of trade values, but it can be expected to provide little help to financing current account deficits over the long run. Short term policy headaches may arise if normal commercial credits are suddenly curtailed, but this is not what most observers have in mind when discussing the "debt problem". Another way in which debt figures can

TABLE 4Net Long Term Inflow of External Resources for Latin America

(Annual averages in current billion dollars)

	<u>1961-65</u>	<u>1966-70</u>	<u>1971-73</u>	<u>1974-76</u>	<u>1977-78</u>
<u>Net public inflow</u>	<u>1.0</u>	<u>1.1</u>	<u>1.4</u>	<u>2.8</u>	<u>1.7</u>
Multilateral	0.3	0.4	0.8	1.6	0.9
Bilateral	0.6	0.6	0.6	1.2	0.8
 <u>Net private inflow</u>	 <u>0.6</u>	 <u>1.6</u>	 <u>3.9</u>	 <u>9.6</u>	 <u>17.0</u>
Suppliers	0.1	0.4	0.2	0.3	1.6
Financial institutions	-	0.3	2.0	6.7	9.9
Bonds	0.1	0.1	0.1	0.3	2.3
Direct investment	0.4	0.9	1.6	2.4	3.2
 <u>Total</u>	 <u>1.6</u>	 <u>2.6</u>	 <u>5.3</u>	 <u>12.4</u>	 <u>18.8</u>

Sources: Adapted from Table III-13, p.85, in Inter-American Development Bank, Economic and Social Progress in Latin America; 1979 Report, Washington, D.C.

"Latin America" includes the Inter-American Bank's developing member countries in the Western Hemisphere.



be inflated is the inclusion of undisbursed portions of contracted loans.

A second major source of difference in reported debt figures is whether or not items other than those owed by official LDC borrowers, or which are officially guaranteed, are included. Published World Bank data, for example, only cover official and officially guaranteed debt. Most medium and long-term credits to the Third World would fall under this category, but some countries (e.g. Argentina) have large private debts not guaranteed by the government. The summation of balance of payments data should give net increases in debt, whether or not officially guaranteed.

A third difference comes about from definitions of "net". Suppose for example, that all accumulated long term borrowing from financial institutions shown in Table 3 for 1974-78 (\$62.3 billion) came from banks which also held the accumulated increase of LDC reserves (\$42.9 billion). Reported net debt to those banks could then be said to have increased only by \$19.4 billion. Data on private bank positions vis-a-vis LDCs are frequently "netted" in this fashion.

Other differences may arise from geographical or other coverages. There has been a proliferation of ways of grouping Third World countries, even within old geographical units. The IMF has a category of "net oil exporters" within the group of "non-oil developing countries", and non-oil Western Hemisphere developing countries is not quite the same as what used to be meant by Latin America. Behind these confusions lie the growing heterogeneity of the Third World. Aggregation, especially in the area of debt, has only a limited usefulness and can yield misleading or meaningless numbers.

The total outstanding public and publicly guaranteed long term external debt of all non-oil developing countries rose from \$76 billion at the end of 1973 to \$212 billion at the end of 1978, an increase in line with the data of Table 3. The IMF, in the publication cited in that Table, also estimates a debt of \$280 billion for the end of 1980. The corresponding figures for non-oil Western Hemisphere developing countries are \$26 billion for 1973, \$83 billion for 1978, and \$104 billion for 1980. It is estimated that about half of the debt of all non-oil LDCs is owed to private creditors; for the debt of non-oil Western Hemisphere developing countries the corresponding figure is higher, somewhat less than two-thirds.

Debt has grown, but so have price levels, exports, and production. Table 5 expresses the stock of debt as a percentage of LDC output and exports. Viewed in this light, the growth of LDC debt appears significant but less terrifying. For all non-oil LDCs debt has risen relative to Gross Domestic Product between 1973-74 and 1979-80; relative to exports of goods and services it rose between 1973-74 and 1977-78, and declined after that. Latin American indebtedness is above the average for the Third World, and on the whole rose faster during the 1970s. The last column of Table 5 shows debt relative to merchandise exports for non-oil Western Hemisphere developing countries; it indicates a sharp rise between 1974 and 1978, but a steep decline after that year. In short, Table 5 serves to emphasize the obvious (but often forgotten) point that so long as output and exports continue to expand pari passu with debt, the servicing of the latter should not generate major anxieties. It may be noted that around 1910 the Argentine public external debt amounted to 184 percent of its merchandise exports, a figure higher than any

TABLE 5

Public and Publicly Guaranteed External Debt

	As a Percentage of Gross Product			As a Percentage of Exports of Goods and Services	
	<u>All non-oil LDCs</u>	<u>Major LDC exporters of manufactures</u>	<u>All Latin America</u>	<u>All non-oil LDCs</u>	<u>Major LDC exporters of manufactures</u>
1960	n.a.	n.a.	11	n.a.	n.a.
1970	n.a.	n.a.	14	n.a.	n.a.
1973	14	11	17	70	61
1974	13	10	18	64	55
1975	15	12	19	76	62
1976	16	12	23	78	61
1977	18	13	25	82	61
1978	19	14	28	86	63
1979	19	13	n.a.	80	57
1980	19	14	n.a.	74	53

n.a. = Means data are not available.

Sources: Data for 1973 through 1980 comes from Table 23, Appendix C, p.103 in World Economic Outlook; A Survey by the Staff of the International Monetary Fund, Washington, D.C., May 1980. "Gross Product" refers to Gross Domestic Product. Data for 1960 through 1978 comes from Table III-23, p.97, in Inter-American Development Bank, Economic and Social Progress in Latin America; 1979 Report, Washington, D.C. "Gross Product" refers to Gross National Product. "Latin America" includes the Inter-American Bank's developing member countries in the Western Hemisphere. The last column is computed from data in the World Economic Outlook, op cit, pp. 99 and 102

registered in the last column of Table 5.<sup>12/</sup>

Interest plus amortization payments are presented in Table 6 as percentages of exports. This measure of the debt burden will increase as debt maturity shortens; if all debt were made up of consols, only interest would be included in the servicing, but if all loans had to be renewed yearly, annual service would cover the whole debt plus interest. The statistic for the debt service ratio will be interpreted differently depending on what is assumed regarding the automaticity of the roll-over process. Table 6 shows a sharp increase in this statistic for Latin American countries between 1974 and 1978; for other LDCs the increase is smaller.

A longer and broader perspective on the burden to Latin America of servicing all accumulated capital inflows is presented in Table 7. Latin America came out of the 1930s and 1940s with little debt and some direct foreign investment. Pre-1929 debts and foreign investment were sharply reduced relative to GNP and exports by defaults, renegotiations, nationalizations, inflation and war-induced European liquidations. During 1950-54 profit remittances by direct foreign investors exceeded debt service charges. Since then the latter have expanded steadily, even as a fraction of exports of goods and services. Profit remittances also tended to grow relative to exports until 1965-69; since then it has undergone a little-noticed but important decline. In 1974-76 profit remittances represented a lower percentage of exports of goods and services than during 1950-54; during 1977-79 that percentage rose again, but remained below 1970-73 levels.

As noted earlier, dollar inflation, under present institutional arrangements, increases interest payments relative to amortization in the servicing of a given loan. Inflation may also shorten the average

TABLE 6

Service Payments on Public and Publicly Guaranteed External  
Debt as Percentages of Exports of Goods and Services

	All non- oil LDCs	Major LDC exporters of manufactures	Principal Debtor Countries in Latin America	Rest of Latin America
1961-65	n.a.	n.a.	15	5
1966-70	n.a.	n.a.	16	6
1971-75	n.a.	n.a.	15	7
1973	9	8	15	8
1974	7	7	12	7
1975	9	8	16	6
1976	9	7	18	7
1977	10	8	22	7
1978	11	9	30	15
1979	11	9	n.a.	n.a.
1980	11	8	n.a.	n.a.

n.a.=Means data are not available

Sources: Data for 1973 through 1980 comes from Table 25, Appendix C, p.104, in World Economic Outlook, op cit. Data in the last two columns comes from Economic and Social Progress in Latin America, op cit., Table III-26, p.101. "Principal Debtor Countries" are Argentina, Brazil, Colombia, Chile, Mexico, Peru and Venezuela. Service payments include interest and amortization.

TABLE 7

Net Financial Service Charges of Latin America, Excluding Oil  
Exporters, relative to Exports of Goods and Services

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(Percentages)

Period	Interests	Profits	Interests plus Profits	Amortizations
1950-54	1.3	5.9	7.2	2.8
1955-59	2.3	5.2	7.5	7.2
1960-64	4.0	6.5	10.5	10.9
1965-69	5.5	8.8	14.3	13.7
1970-73	7.4	7.1	14.5	17.2
1974-76	11.1	5.5	16.6	19.1
1977-79	12.0	6.8	18.9	28.1 <sup>a/</sup>

a/ refers to 1977-78 only.

Sources: As in Table 2. "Profits" include earnings of foreign direct investments net of taxes, whether remitted abroad or reinvested domestically (see p.5 of the source listed in Table 2). Interests and profits received by Latin American residents are netted from the payments made under these rubrics. For example, interest earned by Latin American Central Banks on their holdings of international reserves are deducted from interest payments on the external debt. Amortizations cover those for both private and public debt of more than one year; however, data on amortizations of private debt not officially guaranteed are shaky for most countries.

maturity of all debt; that average maturity will also increase as a result of a greater share of borrowing from private sources. Both of these factors can increase amortizations relative to both exports and interest payments. Table 7 indicates a decline in amortizations relative to interest payments from 1955-59 until 1974-76; in the most recent years this trend was reversed.

The sum of interests and profits as a percentage of exports shown in Table 7 may be compared to those of "countries of recent settlement" before the Great Depression. During 1900-14 the corresponding figures were 39 percent for Argentina, 22 percent for Australia and 24 percent for Canada. During 1921-29 these three countries had similar ratios: 19 percent for Argentina, 21 percent for Australia and 19 percent for Canada. All of these historical percentages refer to interest and profits relative to merchandise exports (whose statistics are more comparable). For the countries shown in Table 7 merchandise exports were about 82 percent of exports of goods and services. Even after adjusting for this fact, the interest and profit share in exports shown in Table 7 for 1977-79 is roughly comparable to those of pre-1929 "countries of recent settlement."<sup>13/</sup>

#### D. Private Banking

Private banks owned mainly by residents of industrialized countries proved to be the most dynamic agents in international capital markets during 1973-80. Those banks may be located in the country owning them, lending in their own currency, or they may be located offshore, lending in other currencies. The close interconnection among major national and international financial centers makes the distinction of only limited economic interest, although important for the implementation of possible controls and for jurisdictional disputes. Most of the banks engaged in international lending now report to the Bank for International Settlements

(BIS); by the end of 1978 their accumulated lending and borrowing operations were as summarized in Table 8. Claims include loans of all maturities and to public and private agents. The importance of major oil exporting countries (mainly OPEC) and other developing countries for international banking is readily apparent.

BIS reports also show the concentration of bank lending to a few countries. Just Brazil and Mexico accounted for more than one third of the banks' claims on non-oil LDCs at the end of 1978. Other important LDC borrowers include Liberia, South Korea, Peru, Argentina, Ecuador and the Phillipines. On the other hand, a large number of LDCs, including among them those with very low per capita incomes, are net creditors of the international banks, i.e., their reserves deposited with those banks exceed the loans received. Note the low net positions of other Asia and other Africa in Table 8. International banking has no more regard for interregional or interpersonal equity than national banking does.

The credit provided by banks is medium-term, that is, 7 years or so. Technically, credits are renewed every six months but the bank is committed for the full seven years; no cases are known where the six month "roll-over" has been denied (unless there has been a default). Typically, interest is adjusted every six months; the borrower is committed to pay the fluctuating London inter-bank offered rate (LIBOR) plus a margin, the "spread", usually fixed for the full life of the loan. Some credits provide for an increase in spreads during the latter years of the loan to compensate for longer maturities and to allow for inflation. Eurocredits to LDCs have been provided almost totally in dollars. Besides LIBOR and spreads, the borrower pays management and commitment fees; some loan agreements also require borrowers to maintain compensating balances with the lending banks, but this is said to be unusual.<sup>14/</sup>



TABLE 8

International Banks Outstanding Stock of Claims and Liabilities

(Billion current U.S. dollars)

	December 1979			Net Position	
	Claims	Liabilities	Net Position	December 1978	December 1977
"Group of Fourteen"	588	686	-98	-67	-59
Other Industrialized Countries	73	47	26	26	27
Offshore Banking Centers	156	139	16	27	27
Eastern Europe	56	15	41	37	30
Oil-exporting Countries	64	120	-56	-26	-39
Non-oil LDCs	159	90	69	45	37
--Latin America	(104)	(38)	(65)	(47)	(41)
--Middle East	(8)	(16)	(-8)	(-7)	(-5)
--Other Asia	(33)	(27)	(7)	(2)	-
--Other Africa	(14)	(9)	(5)	(4)	-
Unallocated	16	23	-7	-5	-6
<u>Total</u>	<u>1,111</u>	<u>1,120</u>	<u>-10</u>	<u>36</u>	<u>18</u>

Source: Adapted from Fiftieth Annual Report, Bank for International Settlements, Basle, June 1980, p. 119. "Group of Fourteen" includes the better known Group of Ten plus Switzerland, Austria, Denmark and Ireland. Other industrialized countries includes Australia, New Zealand, South Africa and other countries in Western Europe.

Some indicators of lending conditions at the Eurocurrency market are presented in Table 9. It may be seen that LIBOR, the spreads, and the maturities fluctuate considerably from year to year. At any one time the spreads can be quite different as between countries and among borrowers of the same country. At mid-1977 the following spreads were reported for sovereign borrowers:<sup>15/</sup>

Britain, France, Iran, Sweden	0.875
Spain	1.250
Italy	1.375
Mexico	1.625
Philippines and South Korea	1.750
Brazil	2.250
Peru	2.250
Burma	2.500

The criteria used to establish these differences are not transparent. With the wisdom of hindsight one can spot anomalies: note the contrast between the figures given for Iran and Peru, and that between the mid-1977 spreads for Mexico and late 1980 reports that PEMEX is borrowing at 0.25 above LIBOR, the lowest margin known to have been granted on a syndicated loan.<sup>16/</sup> Unpublished attempts to statistically explain differences in spreads across countries suggest that they increase with the ratio of debt to gross national product, and decline the higher the per capita income of the borrower.<sup>17/</sup> Besides country-specific characteristics, spreads seem influenced by general conditions, including such intangibles as "market confidence", as during 1974-75. These issues require further detailed work.

Data on fees are more difficult to obtain than for spreads. Management fees are usually a flat percentage of the loan, ranging from 0.375 to 0.75 percent, paid only at the time the credit arrangement is signed.

TABLE 9

Indicators of Lending Conditions at the Eurocurrency Market  
(Percentages except for maturities)

Year	LIBOR	Spreads			Maturities(months)	
		France	All LDCs	Brazil	Prime Borrowers	Brazil
1974	11.32	0.58	1.13	1.23 <sup>a/</sup>	96	118 <sup>a/</sup>
1975	7.74	1.42	1.68	1.70	66	75
1976	6.26	1.09	1.72	1.91	69	70
1977	6.54	0.92	1.55	1.96	80	68
1978	9.48	0.63	1.20	1.59	101	85
1979	12.12	0.36	0.87	1.16 <sup>b/</sup>	108	111 <sup>b/</sup>

a/ refers to the last three quarters of the year only.

b/ refers to the first half of the year only.

Sources: First three columns obtained from the World Bank, World Development Report, 1980, Washington D.C., August 1980, p.27. Brazilian data obtained from Paulo Nogueira Baptista Jr., "Divida externa brasileira", Conjuntura Econômic<sup>a</sup>, April 1980, volume 34, number 4, pp. 86-92. Data on "prime borrowers" obtained from Kengo Inoue, "Determinants of market conditions in the eurocurrency market; why a "borrowers" market?", BIS Working Papers, Number 1, April 1980, Table 1. Spreads exclude fees.

Besides this "front-end" fee, borrowers usually are committed to pay a facility fee at an annual rate on undrawn portions of a credit; this may range between 0.25 and 0.75 percent. It is said that some borrowers trade off higher front-end fees for lower spreads, for the sake of prestige.

Neither spreads nor fees, however, bear the full brunt of rationing credit; banks prefer to discourage or limit some potential borrowers rather than charge them unusually high spreads or fees. Credit rationing can be explained even for domestic markets as a result of asymmetric information between creditors and debtors. If only interest rates were used to allocate credit, those intending to default (expecting to get around legal penalties) would borrow as much as possible regardless of interest rates; this is the adverse selection market imperfection. Banks try to protect themselves against dishonest borrowers both by investigating all customers and by limiting exposure to any one of them. In international lending adverse selection is compounded by sovereign or country risk, because national bankruptcy laws and penalties do not apply.<sup>17bis/</sup>

Even with the addition of fees, the charges shown in Table 9 appear ex-post quite attractive for average LDC borrowers, bearing in mind that dollar unit values for non-oil LDC exports rose during 1972-80 at an average annual rate of nearly 15 percent, while those for LDC imports rose at more than 16 percent per annum.<sup>18/</sup> One should note, however, that the price increases were highly irregular from year to year, and across commodities and countries. Yet these ex-post results compare quite favorably with interest charges of around 5 percent on the Argentine external debt of 1900-14, at a time when international

inflation averaged less than 2 percent per annum. The ex-post average borrowing costs for 1973-80 also compare favorably with reasonable estimates for the real return to investment in LDCs.

As noted earlier, about two-thirds of non-oil Western Hemisphere developing countries is owed to private creditors, mainly banks, which is subject to service charges and conditions similar to those described in Table 9 and in previous paragraphs. It is not surprising that in those countries fluctuations in LIBOR and spreads have joined variations in the prices for oil and export staples as front page news. LIBOR fluctuations are followed by some LDC monetary authorities for another reason: a good share of their international reserves are deposited in international banks paying interest around LIBOR. For those countries the cost of holding reserves is thus approximately given by spreads. Given the secrecy surrounding reserve management, it is not known how many countries follow such relatively bold policy.

Ten banks are said to have arranged half of all publicized Eurocredits in 1976 and 1977, providing about one-quarter of the money themselves; 20 banks arranged two-thirds of the total while providing one-third of the money.<sup>19/</sup> Similar estimates for all international bank lending are not available. During 1978 and 1979 contradictory trends influenced the competitiveness of international banking. The freeze of Iranian assets deposited in U.S.-owned banks (regardless of banks' location) decreed by the U.S. government, and the resulting legal complications frightened smaller banks away from international lending. Rivalry among banks of different nationalities increased, however. There was a sharp rise in the market share of banks not owned by U.S. residents, as may be seen in Table 10. For the five Latin American countries shown in Table 10, U.S. banks provided only 11 percent

TABLE 10

Some Outstanding International Claims of Banks Reporting to the BIS

(Billion Current U.S. dollars)

Countries	December 1977			June 1979		
	Total	Non-U.S. Banks	U.S. Banks	Total	Non U.S. Banks	U.S. Banks
Argentina	4.8	1.9	2.9	9.4	5.8	3.5
Brazil	23.8	11.7	12.1	33.9	20.0	13.9
Chile	1.6	0.7	1.0	3.3	1.5	1.8
Colombia	1.7	0.4	1.3	2.6	1.1	1.6
Mexico	<u>19.9</u>	<u>8.0</u>	<u>11.9</u>	<u>26.0</u>	<u>15.0</u>	<u>11.0</u>
--subtotal	51.8	22.6	29.2	75.2	43.4	31.8
--All oil exporters and non-oil LDCs	137.9	71.1	66.8	194.3	122.1	72.2
--World total excluding claims on the U.S.	650.0	424.0	226.0	876.0	624.0	252.0

Sources: Board of Governors of the Federal Reserve System Federal Reserve Bulletin, Table 3.20, issues beginning June 1979; and BIS, reports on international banking.

of the net increase in lending between December 1977 and June 1979. For all LDCs, including oil-exporters, the corresponding share is somewhat smaller (near 10 percent). Japanese and Italian banks are reported to have experienced an acceleration in their international lending; French, Dutch, Swiss, Canadian, British and German banks are also expanding their lending to LDCs. OPEC has been exploring the financial linkages generated by its staple; banks owned by major oil-producing nations appear to be expanding fast. Following its demands for more of a share in refining oil, OPEC strives now to do more of the "refining" of its petrodollars.<sup>20/</sup> Even banks owned by non-oil LDC residents appear to have increased their international activities.

On the whole, international banking has remained fairly competitive. The number of actors on both sides of the market is not very large, so there is a considerable presence of "customer relationships" between banks and countries. But actual and potential new entrants hovering at the fringes of this market have at least provoked complaints from international bankers that competition is excessive.

#### E. Other Lenders

Important shares of the debt of non-oil Western Hemisphere LDCs are still held by foreign governments and international lending agencies, as well as by private creditors other than financial institutions. The former debt averages more favorable servicing conditions, i.e., longer maturities and lower and fixed interest rates. Other private creditors include bondholders and others who lent at fixed interest rates.

It was seen earlier that even floating interest rates did not on average keep up with inflation during the 1970s. Beyond this, debt negotiated at fixed interest rates before international inflationary

expectations became widespread (say before 1974) generated capital gains for borrowers. About 45 percent of non-oil Western Hemisphere debt was to official creditors at the end of 1973. Countries like Colombia obtained significant benefits from a debt structure heavy with fixed-interest obligations. On the other hand, a share of such debt was negotiated in currencies other than U.S. dollars; effective interest rates will be influenced by fluctuations in, say, dollar/Deutsche Mark exchange rates. Assuming both purchasing power and interest rate parities to hold between the U.S. and Germany over the long run will not lessen short-and-medium term uncertainties regarding debt service magnitudes.

Average interest and amortization charges for a given country will then depend on the exact mix of debt which is old and new, public and private. Average debt maturity could shorten even as Eurocurrency loans to a country extend theirs. A rough idea of average interest and maturity conditions for the whole debt of non-oil Western Hemisphere countries and Brazil may be obtained comparing interest and amortization payments to the stock of outstanding debt. This is done in Table 11. For Latin America as a group, the average interest charges of Table 11 are of course more favorable than those shown in Table 9.

We have shown that during 1973-80 as a whole average interest rates on the Latin American debt were no higher than plausible estimates for annual increases in dollar prices for the region's exports and imports. This indicates that inflation-proof accounting would include at least all registered interest payments in the capital account of the balance of payments as amortizations. Excluding all interest payments from the current account would yield the following estimates of the



TABLE 11

Average Conditions of Official and Officially Guaranteed Debt

<u>Year</u>	<u>Interest (percentages)</u>		<u>Amortization Payments as Percentages of Debt</u>
	<u>Non-oil Western Hemisphere</u>	<u>Brazil</u>	<u>Non-oil Western Hemisphere</u>
1974	6.6	10.4	12.1
1975	6.7	12.0	9.9
1976	6.2	9.9	10.9
1977	6.1	9.0	13.2
1978	7.1	10.1	15.2
1979	7.6	13.3	13.6

Sources and Definitions: Average interest is the ratio of all interest payments in a given year to debt outstanding at the end of the previous year, expressed as a percentage. A similar calculation is made for amortization payments. Non-oil Western Hemisphere data obtained from the World Bank debt reporting system and the IMF; Brazilian data from Paulo Nogueira Baptista Jr., op cit., p.91

deficit of non-oil Latin America as percentages of goods and services  
(figures in parentheses reproduce the corresponding estimates of Table 2):

1973:	10 (17 percent)
1974:	36 (44 percent)
1975:	40 (52 percent)
1976:	18 (30 percent)
1977:	6 (18 percent)
1978:	7 (20 percent)
1979:	16 (27 percent)

The nature and conditions of loans from multilateral official sources have also evolved during the 1970s, although more slowly than those from private sources. The world and regional banks have devised new forms of associating their loans to private capital, whether from banks or private direct investors. In politically-sensitive areas, such as energy and mineral projects, this association is likely to grow in the future. The World Bank can be expected to move toward program lending, perhaps in combination with the IMF. These trends respond to pressures on the international financial system generated not only by OPEC but also by changes in bargaining power between LDCs and foreign investors. We now turn to examination of some of these systemic issues.

#### V. Systemic Issues for the 1980s

The expansion of international capital markets, the adoption of floating exchange rates and the macroeconomic difficulties of many industrialized countries have encouraged the reexamination of academic and practical orthodoxies, as well as some Southern heterodoxies. Already during the late 1950s Northern academic centers witnessed a rebirth of interest in monetary and financial topics. Northern macroeconomic and monetary theories underwent sharp debates during the 1960s, leading to a surge of neomonetarist and neoclassical positions in the 1970s. It would be difficult to talk about a monolithic Northern academic or even practical orthodoxy on such issues as the desirability of flexible

exchange rates, optimum controls over capital movements, the correct strategy to combat inflation, the necessity of regulation over the Euro-currency market, or indeed over national banking systems. In these matters there is a "great disorder under heaven". Under these circumstances one may hear Raul Prebisch castigate the evils of international inflation with greater vigor than James Tobin, and find that Robert Mundell defends fixed exchange rates with greater ardor than Antonio Delfim Netto. Many Northern economists discuss both inflation and balance of payments deficits using structural approaches similar to those emanating from Latin America during the 1950s. Supply-side economics are invoked in favoring more conservative policies within the North, and in favoring easier IMF lending conditions for LDC borrowers. At a more practical level it is not unusual to find Southern exporters together with Northern bankers, worried about debt service, singing the praises of freer world trade, while Northern trade unionists, together with their "progressive" academic advisers, rediscover all sorts of heterodox arguments for protection.

This section, after restating the major advantages which international financial markets of the 1970s offered some peripheral countries, will evaluate criticisms and flaws in those markets. Those critical evaluations can be subdivided according to whether they are made independently of the second OPEC shock of 1979-80, or whether they flow from that price increase and accompanying circumstances. The section will then sketch some scenarios and proposals to reform financial markets in the 1980s, and will discuss the dilemmas they present for major LDC borrowers.

The Eurocurrency market and international bank lending during the 1970s displayed a number of features which compare favorably with earlier capital market arrangements from the viewpoint of at least some

important semiindustrialized countries, as well as several socialist countries. Probably no international capital market in history has had a lower degree of political interference to the dismay of "strategic minds" like Dr. Henry Kissinger. As already noted, competition among banks has been keen and ex post interest rates and charges do not seem unreasonable. At the same time one should note that private bankers have had their enterprise and risk-taking rewarded; their businesses have expanded and so far no one has gone bankrupt lending to LDCs. In contrast with pre-1929 Brazilian experience in the New York market, members of the "Bogota group", which combines major coffee producers, have borrowed freely to finance their price stabilization operations. Officials in several semi-industrialized countries have been able to ignore IMF advice without seeing their external credit lines dry up. Several oil-importing LDCs were able to avoid abrupt and deflationary adjustment to post-1973 circumstances, a type of adjustment of doubtful desirability either from their national or an international viewpoint; without the credit resources made available by international financial markets this policy option would have been less feasible. The funds lent by international banks, in contrast with those available under either concessional finance or suppliers' credits, are untied to either goods or countries. The more transparent and unpackaged nature of bank loans may have reduced frictions and recriminations between debtor and creditor countries.

Even before the 1979-80 oil price increases, several criticisms were levied at private international capital markets. The poorest LDCs were not regarded as creditworthy, so they received very little of the funds made available by international banking. It has also been argued that private financial markets have a number of important gaps, limiting their usefulness even to semi-industrialized countries. 21/ It is true

that one cannot expect private banks to depart far from behavior dictated by profit maximization under limited risk-taking and short time horizons so, particularly under conditions of persistent and erratic inflation in the central currency in international payments, the maturity transformation the banks can be expected to perform will be limited. Under these circumstances, long-term investments have been financed with short- or medium-term credits which are rolled over, a far from ideal arrangement.

As Eurocurrency banks can create credit by the beep of a computer, and as they are not subject to official reserve requirements, fears of explosive credit multipliers originating in those banks were often expressed during the 1970s. Closer analysis has shown that leaks from Eurocurrency markets to national credit systems sharply limit their aggregate credit-creating potential, especially when major Central Banks abstain from depositing their reserves with Eurocurrency banks, as has been the case for several years. The Eurocurrency market can be said to have increased the efficiency of worldwide financial intermediation, so that by making possible a more efficient use of a given world monetary base it does add to international liquidity. But it is now generally concluded that estimates of world money supply with or without a Eurocurrency market would differ only by a few percentage points; therefore, proposals for macroeconomic controls over bank lending such as a universal reserve requirement have been recently downplayed.<sup>22/</sup>

Financial panics during the 1930s led many industrialized countries, notably the United States, to insure depositors against the consequences of bank failures. This policy aimed at avoiding the chain-effects of runs on banks, and consequent credit collapses. National central banks, as ultimate insurers of deposits and as lenders of last

resort, in turn demanded to inspect and regulate the lending activities of private banks. This made good sense, as private banks would otherwise have tended to undertake excessive risks, resting on the security provided by the new policies. The aim was to make the financial system less prone to massive failures while maintaining discipline and lending standards, or what in the literature is known as limiting the problem of "moral hazard" intrinsic in any insurance scheme. Some observers have argued that international banks have tended to be careless in making loans to LDCs, encouraged by explicit or implicit insurance of Northern governments for their depositors and for their politically-important borrowers; this calls in their view for greater regulation of the lending practices of those banks. Note that this alleged market failure offsets (whether partly or more than fully is moot) lending restrictions generated by the adverse selection and country risk problems. It is debatable whether the U.S. government is less likely to appear insuring the bank debts of Chrysler Corporation than of Turkey or South Korea, but these critics note that the supervision over Eurocurrency lending has been less than that exercised over domestic lending. Other gloomier critics argue that while banks' overconfident perceptions have indeed led to overlending, the international community does not in fact have very clear and explicit rules about who should act as lender of last resort at times of acute financial stress, and such a situation could lead to a major financial crash.

Discussions of imperfections in international financial markets, flaws which in some cases favored LDC borrowers, had become attenuated shortly before the 1979-80 oil price increases. Although the new current account deficits foreseen for non-oil LDCs are lower relative to their GNPs or exports than those of 1974-75, they come on top of significant debt accumulation and at a time of less favorable growth prospects

domestically and abroad, so there has been renewed anxieties about financial markets. The outlook for the early 1980s depends on a few crucial variables, which can be discussed with the help of a flow model sketched in Figure 2, focusing on the interactions of GNP (or GNP growth), current account positions, and the preferences of international financial intermediaries.

Assume the world is divided into three regions: OPEC, OECD, and non-OPEC LDCs. Assume further that OPEC GNP (or its growth) is exogenously given by the development plans of those countries, and that the real oil price is also given. The OPEC current account surplus (OA) will then depend on non-OPEC GNP (or its growth, from now on denoted as Y), and its composition between LDC Y and OECD Y.

The negatively sloping line YY' gives the OPEC surplus corresponding to a given non-OPEC Y; if oil requirements per unit of Y were equal in LDCs and OECD the line would be vertical. For each non-OPEC Y there will be a different line YY. The vertical axis gives LDC Y relative to OECD Y; as this ratio increases (maintaining constant their weighted sum to yield a given non-OPEC Y) it is assumed that the OPEC surplus will decline, i.e., that there is a greater use of oil per unit of Y in OECD than in LDCs.

The positively sloping lines in the diagram show the LDC current account deficit. The difference between those two lines represents the LDC deficit with OPEC. The LDC deficit with OECD is assumed to depend solely on the ratio of LDC Y to OECD Y. The LDC deficit with OPEC will increase as LDC Y increases, so the total LDC deficit will surely increase as LDC Y increases with a given non-OPEC Y. The diagram supposes that

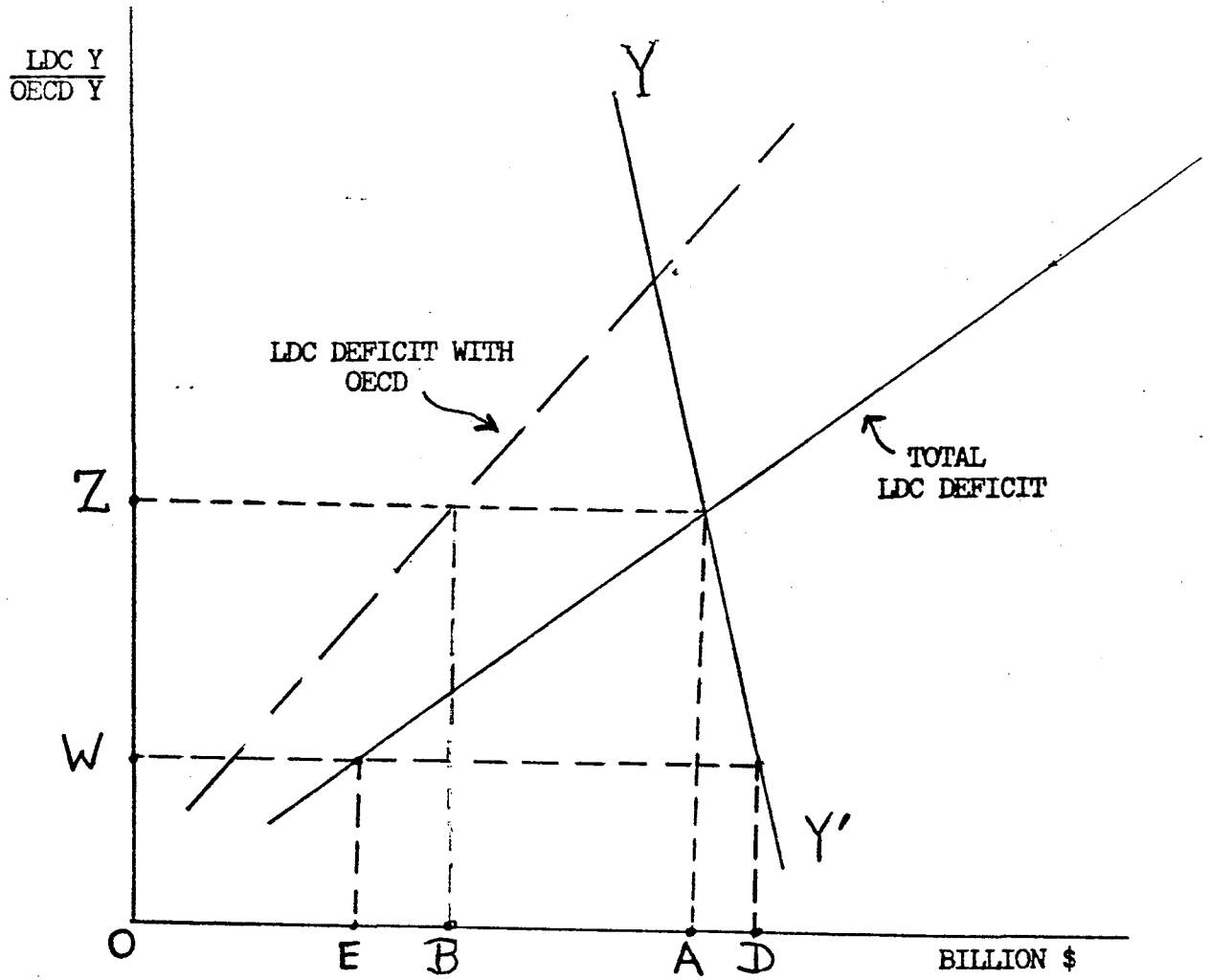


FIGURE 2



during the time span relevant for our analysis adjustment mechanisms other than changes in Y can do little to affect the structure of world current account deficits and surpluses.

Consider first a borderline situation when the OPEC surplus OA is exactly matched by an LDC overall deficit of equal amount, made up of an LDC deficit with OECD of OB and an LDC deficit with OPEC of BA. OECD then has a deficit with OPEC of OB. Supposing that all capital movements are handled by international financial intermediaries (i.e., assume away grants, direct investments etc.), those institutions will witness an increase in their net claims on non-OPEC LDCs equal to OA, matched by increased OPEC claims on the intermediaries.

Consider now a situation when after several years of accumulating claims on LDCs, the financial intermediaries decide that it would be "imprudent" to maintain the same rate of accumulation. A possible outcome, for a given non-OPEC Y, would be a reduction in LDC Y and an increase in OECD Y, from OZ to OW. In the new situation financial intermediaries would reduce their accumulation of LDC debts to OE, while accumulating more reliable OECD paper at a rate of ED. The OECD will become a capital importer. A more likely possibility avoiding an increase in the OPEC surplus would involve both a reduction of non-OPEC Y (leading to a shift of YY to the left) and a reduction of LDC Y relative to OECD Y.

For a given non-OPEC Y, an increase in the real price of oil would be depicted in Figure 2 by a shift to the right of YY'. An opposite shift would result from an increase in the development plans of OPEC. Neither an increase in oil prices nor in OPEC Y would shift the line showing the LDC deficit with OECD, but would of course shift (to the right for oil price increases, to the left for OPEC Y increase) the

line showing the overall LDC deficit, reflecting changes in the balance of payments between LDCs and OPEC. The shifts in the line depicting the overall LDC deficit would be horizontally smaller than the YY' shifts.

More vigorous conservation policies would shift YY' to the left; its slope will change if those efforts are proportionally different in LDCs and OECD. LDC conservation efforts would also be reflected in a leftward shift in the line indicating its total current account deficit.

The discussion centered on Figure 2 has said nothing so far about the price at which finance is extended. International credit conditions will be determined by the market sketched in Figure 1, where stocks of financial assets and liabilities, not just annual flows, are taken into account. One of the major uncertainties for LDC borrowers looking at the 1980s is whether the low or even negative real rates of interest prevailing during the 1970s will continue. Long-term theories of interest rates would indicate that the 1970s situation was anomalous, the result of unexpected inflation. This view is strengthened by noting that OPEC countries will prefer to leave appreciating oil underground unless they can obtain similar rates of return on their financial investments. OPEC calculations plus a desire to control inflation, to check balance of payments deficits, and to maintain the position of the dollar as the dominant international currency would induce the United States to follow tighter credit policies in the 1980s. Given a high degree of international capital mobility, all major industrialized countries would follow similar policies; indeed, some of them already did during the 1970s. Up until recently most LDC borrowing was denominated in dollars; had it been denominated in German marks ex post real interest rates would have been higher. The argument is that during the 1980s LDC borrowing conditions will tighten partly because more of the borrowing will be denominated in marks and other hard currencies, and partly because

U.S. monetary policy will be more to the liking of Arabs and Germans. Finally, Chinese borrowing during the 1980s could add substantial demand pressure on financial markets.

Perhaps. Negative real rates of interest, especially after tax, have managed to last in many countries for long periods. Macroeconomic disturbances may call for negative interest rates as part of the adjustment mechanism, contrary to long run considerations; such macroeconomic short-runs, put back to back, can stretch out for many years. Some of those making OPEC production decisions may be maximizing family wealth placed in London or Zurich rather than their countries' social wealth. Political considerations will place lower as well as upper bounds on oil production; consider the famous scenario in which low returns on financial surpluses induces OPEC to cut oil output, leading to price increases which, given inelastic demand, raise investible financial surpluses, motivating further production cutbacks and so on. It is unlikely that such ~~the~~ <sup>an</sup> ~~abandonment~~ <sup>abandonment</sup> could proceed very far without political repercussions.

On balance there is a presumption that real interest rates during the 1980s will be higher than during the 1970s, but as with other variables, the uncertainty regarding such forecast is high.

Higher spreads over prime rates for LDC borrowers are also foreseen by some. The argument is that major international banks have already allocated what they, or their regulators, regard as a high share of their portfolio to LDC debt, so any further increase (if forthcoming at all) has to be compensated by higher rewards for risk-taking. During 1979-80 the financial press and some authorities have called attention to deteriorating capital-asset ratios of banks engaged in international lending. Typically, it is concluded that higher spreads and profit margins are needed to expand banking capital.

The considerations appear to assume that entry of new banks into international lending is slow, and that banking capital cannot grow by other means than the reinvestment of profit. These assumptions are debatable. It can also be noted the the microeconomic rationale for rigid rules-of-thumb about capital-asset ratios, or ceilings on portfolio shares, are obscure at best. In practice U.S. and non-U.S. banks have very different ceilings and ratios; even with the U.S. there exist substantial differences in the capital-asset ratios of money center banks and other banks. In the rapidly changing international banking industry those actors following, or being forced to follow, rigid rules-of-thumb are more likely to lose market shares than to influence spreads decisively. Yet in the short-run considerable inconvenience may be inflicted on some borrowers by the existence of such rules. The Managing Director of the IMF, in an address during October 1980, warned that prudential regulations or balance of payments measures in industrialized countries should avoid disrupting international financial intermediation. He also observed that there has been no serious decline in average capital ratios for banks in major financial centers in recent years; that the share in banks' gross external assets represented by loans to non-oil LDCs did not rise significantly during the last decade (remaining around 17 percent); that the loan-loss experience in lending to LDCs has been as good as or better than that on domestic lending; and that the safeguards to the underlying stability of the financial system seem today stronger than a decade ago. <sup>23/</sup>

The 1980 war between Iraq and Iran has highlighted the vulnerability of economic forecasts to the delicate political situation in the Middle East. A number of proposals have been accumulated in recent years to increase the robustness of the international financial system to such shocks. The variety in motivations and specifics is

large; here it will be enough to focus on some proposals which give special cause for concern to major LDC borrowers.

One worrisome scenario is suggested by the fact that in contrast with, say, international non-oil commodity markets, nowadays market imperfections in the international loan market are discussed and perceived more clearly in the North than among the major Southern borrowing countries. At first sight it is remarkable how some private bankers, arguing that "the market is out of (their) control", plead for more official lending to LDCs, i.e., seek actions which can take business away from them, and argue in favor of greater bureaucratic supervision such as a larger IMF role in the lending process. Often the same bankers will argue that Central Banks should stay out of the foreign exchange markets. One may contrast this puzzle with that generated by OPEC exhorting its customers to conserve oil. What they appear to seek is a "rationalization" of lending under IMF planning to reduce "cutthroat" competition. Note that this has already been achieved for state-subsidized and insured export credits, with OECD countries agreeing to guidelines on interest floors, maximum credit periods and minimum cash payments. These controlled credits, tied to the sale of each OECD country's products are expected by some observers to grow during the 1980s at a faster rate than untied private bank loans. Northern practical and academic orthodoxies has suddenly unearthed all sorts of externalities, distortions and market imperfections to justify increased regulation of private financial flows to non-oil LDCs. OPEC members with the largest financial surpluses could be induced to form a coalition to regulate world capital markets, perhaps under the IMF and World Bank umbrellas. OPEC participants

would obtain "sound and remunerative financial assets" while Northern private banks would enjoy "orderly market conditions" in which higher interest costs and spreads could be passed on to borrowers with nowhere to go. Industrial countries would obtain steadier oil flows as OPEC trades oil underground for the safe financial asset. The Fourth World could be induced, with modest side payments, to give an appearance of legitimacy to such a reestablishment of centralized Northern control over international financial flows. Note that part of the motivation for the proposed Substitution Account at the IMF was to meet OPEC's dissatisfaction with available financial assets.<sup>24/</sup> This scenario would be the counterpart of the coalition between OPEC and the traditional oil multinationals, which operates with great tensions and frictions but has been enormously profitable for both sides so far.

Unless a major international political crisis threatens to induce an old-fashioned financial panic, a thoroughgoing cartelization of capital markets is unlikely to be realized. As with transnational corporations, banks of different nationalities maintain rivalries which are not easily reconciled. Episodes such as those in 1974 involving the Herstatt Bank of Cologne and the Franklin National Bank of New York established the precedent that the Central Bank of each country would take care of the problems of banks owned by its citizens, no matter where those banks are located. This approach does not provide a fail-proof lender of last resort at the international level, but eliminates the most salient brittleness of international banking. Naturally, this commitment by Central Banks has been accompanied by a closer supervision of the portfolios of private banks, and the insistence that banks provide consolidated balance sheets covering all of their worldwide operations.

During the late 1970s the IMF was on the whole an ineffective bystander in the process of recycling oil surplus to major LDC borrowers. Years of obtuse and dogmatic IMF staff work, especially in its Western Hemisphere department, induced key LDCs to stay away. Only countries without options sought resources from the Fund; such adverse selection reinforced that institution's wicked-witch image. One important side effect of the 1970s expansion of international financial markets was to put pressure on the bureaucracies of the IMF (and to a lesser extent on those of the IBRD and regional banks) to rethink rigid policies, under pain of losing their legitimacy by having no dealings with some of the most important LDCs. It is moot whether Brazil needs the IMF more than the IMF needs Brazil.

An IMF with more flexible lending conditions seems to be emerging during 1980; it will be also necessary for it to obtain greater resources before it becomes an attractive major lender to large LDCs with several borrowing options. The Fourth World, however, could benefit quickly from the new IMF. The IBRD and regional banks are also planning new mechanisms, especially connected with investments in energy and natural resources, to expand the resource flows to LDCs. Pleas for more concessional finance to the Fourth World continue to be heard.

So long as those trends do not significantly limit the options opened to LDC borrowers by private international financial markets, i.e., threaten to move in the direction of an international credit cartel, major LDC borrowers could benefit from them. The major benefit would

probably be in the insurance they could provide against major financial panics, and the influence such insurance would exert on the supply price of credit. Uncertainties surrounding the process of rolling over the debt to private banks, one of the major sources of preoccupation for LDC borrowers, could be alleviated.

Exactly how institutions such as the IMF and the IBRD impinge on capital markets will remain of major importance for LDC borrowers. Countries such as Argentina, Brazil, Mexico, Spain and Venezuela are not "small countries" in those markets and could have, especially if they acted together, a significant influence in framing new policies for the IMF and IBRD, as well as in the process of setting rules of the game for the 1980s financial flows.

As an example of a specific proposal for greater IMF or IBRD participation in financial intermediation which is unlikely to benefit major LDC borrowers one may mention the idea of having those institutions issue long-term bonds indexed to international inflation. Such a proposal would place a floor under real interest rates, to the delight of lenders. In exchange for such a concession, ultimate LDC borrowers using IMF or IBRD as intermediaries would presumably obtain larger inflows without roll-over headaches, as debt maturities would more closely match real investment gestation periods. There is considerable room in international financial markets, especially in bond markets, for innovation and experimentation, but such initiatives, especially if they involve indexing, are best left to individual borrowers. Giving creditors an assurance of positive real rates of interest, backed by the international community represented by the IMF or IBRD, under the macroeconomic circumstances of the early 1980s appears to be an idea in the interest of neither LDC borrowers nor of most other countries.



The tone of this section has been based on an economic and financial outlook which is of moderate optimism relative to catastrophic scenarios, or of moderate pessimism relative to the 1970s performance. Major LDC borrowers will face less favorable borrowing conditions, and the net capital inflows they will obtain will be less relative to their GNPs. Other LDCs whose indebtedness grew less in the 1970s, however, could expand their borrowing faster in the future. GNP growth rates of major LDC borrowers could decline somewhat even relative to those of 1973-80, while pressure will continue to expand exports and restrain imports. Regardless of financial considerations, the adjustment to higher real energy prices will involve significant costs. Could matters become worse for major LDC borrowers? What if OECD countries allow steep declines in their GNPs, turn to 1930s-style protectionism, or refuse to allow their banks even to roll-over LDC debts? In the spirit of the "scarce currency clause" of the IMF Articles of Agreement, under those circumstances LDCs would have little choice but to suspend, subject to negotiations, the servicing of their debt and to follow more inward-oriented policies, perhaps revitalizing third world integration schemes. Gains from international specialization would decline, but even then many LDCs could maintain reasonable growth rates. The largest semi-industrialized countries would be in a better position to handle such a shock than the smaller LDCs, although the specific energy situation of each country will also heavily influence their performance. Even under these circumstances most LDC debtors will want to maintain substantial commercial, financial, and technological links with Northern economies, enough to discourage them from repudiating their debt.

## VI. Latin American Financial Policies and Problems

Previous sections suggest that on balance semi-industrialized countries were helped by the emergence and expansion of private international financial markets. True enough, the costs of private credits were higher and of a shorter-term nature than official bilateral or multilateral finance. However, volumes were higher, procedures were more expedite and looser strings were attached, both at the political and at the economic policy levels. But the opportunities created by the new international capital markets need not generate welfare gains in borrowing countries; funds may be raised cheaply but spent so foolishly as to create repayment problems, and the availability of external finance can lead to lower domestic savings. Other questions of a socio-economic nature, which we will review briefly in this section, have been raised concerning the 1970s external financial links of Latin America.

Financial intermediation rose to preeminence in some Latin American countries along with blossoming international capital markets. A practical orthodoxy developed preaching that "the more financial intermediation the better". Gurley and Shaw popularized correlation measures between the degree of financial modernization and indexes of economic development. Ronald McKinnon argued vigorously against "financial repression". Some graduates from the University of Chicago rose in the 1970s to policy-making positions in Southern Cone governments and started implementing policies of financial liberalization. Brazil and Mexico followed more pragmatic policy courses, but in both countries foreign finance strongly influenced the rhythm of economic activity and the nature of government policy making during the 1970s.

Evidence on LDC ex-post savings and real capital formation is sketchy for the most recent years; for 1974-77 data indicate a maintenance or an increase in the share of gross domestic investment in GDP relative to 1972-73 for most major groups of LDCs. Available savings rates for major Latin American countries are presented in Table 12. Only three countries show a decline in savings rates relative to the late 1960s; paradoxically, two of those countries (Chile and Uruguay) have undergone financial liberalization. Bearing in mind the likely underestimation of domestic savings due to a lack of inflation-proof Balance of Payments accounting, the performance of Brazil appears reasonable, and those for Argentina, Colombia, Mexico and Venezuela also seem at least adequate for the period covered.

Deregulation of financial markets in Southern Cone countries led to old-style banking losing competitive power to adventuresome but capital-short "financieras". Under these conditions, lack of government insurance of depositors frequently resulted in panics and scandals, the regulatory sequel of which tended to strengthen the oligopolistic character of the local banking sector.

These trends were accompanied by a substantial increase in the share of financial intermediation in the national economies. A tendency towards the centralization of capital in the hands of economic groups with a banking basis seems to have occurred. "Old" industrialists lost economic power to "new" financiers. Some Latin American economists feared that the banking sector would go through a process of denationalization, as multinational banks benefitted from deregulation to enter a market where previously only domestic residents were allowed. However, domestic economic groups proved to be more active than anticipated by these economists; financial liberalization apparently proceeded along with new forms of

TABLE 12

Gross National Savings in Selected Latin American Countries  
(Percentages of gross national product)

	<u>1960-64</u>	<u>1965-69</u>	<u>1970-74</u>	<u>1975-78</u>
Argentina	19.0	19.2	20.5	21.1 <sup>a/</sup>
Brazil	21.1	21.8	23.8	22.3
Chile	13.1	15.0	11.8	6.7
Colombia	17.0	17.3	17.7	21.4
Mexico	17.3	19.4	19.1	21.3 <sup>a/</sup>
Peru	22.8	16.8	14.3	10.1
Uruguay	12.6	13.8	10.2	10.6
Venezuela	32.1	29.4	35.1	34.8

a/ Refers to 1975 through 1977 only.

Sources: Adapted from Table III-2, p.63, in Inter-American Development Bank, Economic and Social Progress in Latin America; 1979 Report, Washington, D.C. Basic data are at current prices in national currencies.

association between domestic and foreign capital rather than with a massive takeover of the former by the latter.

Other economists were concerned with the possibility that the substitution of "financial capital" for "productive capital" would impart a stagnationist bias to Southern Cone financial liberalization policies. We argue below that some Keynesian problems have emerged, but that they are probably of a short to medium term nature, not of a long-run stagnationist variety. Nonetheless, it is hard to see what welfare gains can be generated by speculative activity of the variety witnessed in Argentina during 1976-80. In this context, one should remember the following point of Kenneth J. Arrow: "...in speculative markets such as those for stocks and commodity futures, a large amount invested in the acquisition of new information for private advantage will yield no social gain, only a zero-sum redistribution...We may have very able people who could be useful spending their time in production instead of trying to outwit others,"<sup>25/</sup>

The progressive loss of government control over monetary aggregates in a context of openness to international financial markets confused policy makers and economic analysts alike. Old style monetarists had to recycle themselves to get rid of their preoccupation with active monetary policy, reluctantly accepting the idea of an endogenous money supply. Structuralist economists on the other hand had to wrestle with their old propositions for passive money to become active partisans of sterilization policies in the contest of a financially open economy.

In the Southern Cone, the "new Chicago" eventually prevailed over the "old Chicago", and policy makers there, while furthering the processes of trade and financial liberalization, started seeking fixed nominal exchange rates as well as zero budget deficits. Pragmatism continued

to characterize Brazilian and Colombian policy-making. With varying degrees of success, these countries attempted to stick with a crawling peg without explicit targets, and to maintain seignorage over the monetary base by restricting access of domestic residents to international financial markets. Mexico wanted to follow a similar path, but in her case the task of avoiding currency substitution was made much more difficult than in Brazil or Colombia, in view of her geographical and economic proximity to the United States.

We conclude that the existence of a fluid international financial market, by changing the nature of external economic incentives and penalties, nudged Latin American economies into a new mold during the 1970s. In principle, it extended the range of options opened to economic policy making, hence providing new opportunities for economic gain. But it also shaped the system of economic incentives in particular directions and induced some shifts of relative economic power within countries. In this context, the rules of access established by domestic policy makers seem to have been a basic determinant of the short to medium term consequences of financial openness. The returns are not all in yet, but from our present perspective countries which followed a more pragmatic and gradualistic course of action regarding domestic financial liberalization and links with international capital markets (as Brazil and Colombia) seem to have done better than countries which pursued a more doctrinaire policy course (as in the Southern Cone).

The use of indexed government bonds is a characteristic feature of the financial reforms that have accompanied the process of financial openness in the Latin American context. In the remainder of this section, we discuss some Keynesian conundrums evoked by the experience of countries following this policy path.

According to the financial reformers, increased availability of financial paper paying positive real interest rates should both increase the flow of private saving and divert wealth holding away from non-productive uses (land, housing, consumer durables) into productive assets.

Latin-American experiences with financial reform confirm the prediction about the increase in some forms of financial saving; however, private productive investment did not expand. The ex-ante propensity to save may go up but private investment rates are not larger than before. This reaction to financial reform has been accompanied by persistently high inflation rates and lagging exchange rates. Reasons for these Latin-American aberrations are not entirely clear, but some conjectures are worth exploring.

We consider successively stylized versions of the portfolio decisions related to the composition of domestic currency-denominated assets, and of the portfolio decisions concerning the distribution of wealth between domestic and international assets, before and after "financial liberation".

In a financially repressed economy with a history of persistent inflation, wealth is held as money, land, and capital. In relative terms, the first two are homogeneous commodities whereas the latter is a collection of heterogeneous goods. Money is held because of its property as a means of payment; capital, because of its expected yield in use; and land, as a shelter against inflation. Expected land yields may be low but they are strongly correlated with inflation rates, and thus safer to hold than heterogeneous capital. The liquidity of land is higher than capital but much lower than money. The real yield of the latter is strongly negative. Lack of a high yielding asset with a strong secondary market presumably underlies low observed saving propensities. Moreover, a high proportion

of net additions to wealth take the form of unproductive land holdings for "speculative" purposes.

In this context, financial reform-mongers typically propose introducing an indexed government bond as an instrument of financial liberation (in McKinnon's terminology this boils down to paying real interest rates on "money"). In the presence of such an attractive asset with a strong back-up market, saving propensities should increase and a higher proportion of wealth be held as "productive" capital. An implicit hypothesis seems to be that the bond will protect wealth-owners against inflation better than land holdings do. Hence, the required real rate of return on capital will be lower and thus capital accumulation will be favored for a given state of long-term expectations.

As already noted, Latin-American experience supports the presumption regarding some financial savings, but not the expectation on private investment rates. The apparent reason is that indexed bonds tend to replace capital (and money) rather than land in private portfolio holdings. Free-market-oriented financial reforms are accompanied by a general liberalization of interest rates, in the context of a demand-contractionary package of policies. Bankruptcies in the productive sector and panics and scandals in the financial sector are frequent. As a consequence, there is a weakening in the state of confidence with which expectations about future capital values are held. The demand price of capital falls and the rate of investment adjusts downward at a time when saving propensities are on the increase. High short-term interest rates tend to raise the supply price of output in the short-run. Excess supply of money may also obtain, in spite of contractionary monetary policies, if the demand for money (in the appropriate  $M_1$  concept) is sufficiently lowered by the introduction of indexed bonds. Continuing high inflation rates, higher unemployment rates, and lower growth rates of potential output are the short to medium-term consequences of ill-implemented financial reforms.



Similar problems may occur with respect to the portfolio decisions vis-a-vis dollar- and peso-denominated wealth. Capital market reformers correctly expect that the creation of domestic indexed bonds will induce foreign as well as national wealth-owners to shift a higher proportion of their wealth out of dollar and into peso-denominated assets. Experience confirms that foreign financial inflows are larger than before, as predicted by the theory, but also that they do not find a real outlet, as domestic absorption goes down following the mechanism sketched in the previous paragraph. Capital account surpluses are not matched by correspondingly larger full-capacity current account deficits. Official foreign reserves accumulate and exchange rates lag behind purchasing power parities. The "retraso cambiario" establishes itself, weakening exports and strengthening the propensity to import; paradoxically enough, the level of activity in the tradable goods sector shrinks in order to absorb the increased flow of foreign savings.

Portfolio reshuffling favoring government debt is a common characteristic of these examples of financial reform. If the government uses the proceeds of higher bond sales either to increase its own investment or to subsidize private investment, real income growth may be maintained, at the cost of increased government intervention in the economic sphere and expanding foreign debt. If the proceeds of higher bond sales are used to control the growth rate of money supply, inflation rates may subside but the rate of investment and potential output growth do not recover.

Academic orthodoxy, from Maynard Keynes to James Tobin, has taught that the propensity to invest is not coterminous with the propensity to save.

Lack of attention to this basic teaching on the part of practical orthodoxy may explain the failures of recent attempts at financial reform in Latin America. Much research is needed on the patterns of substitution and complementarity among assets, in the context of high and varying rates of inflation characteristic of Latin American countries.

Footnotes

\*We are grateful for comments received during seminars at the Hotel Paineras (March), at PUC (June), at Refsnes Gods (July), and at CIEPLAN (August). Advice from Rudiger Dornbusch and John Williamson is also gratefully acknowledged. The usual caveats apply.

1/ Some writers have claimed that Paris was the strongest financial center in the world before 1914. Kindleberger concludes that the whole question emphasizes the rivalry between France and the United Kingdom, as well as the sensitive political nature of international finance. See Charles P. Kindleberger, Manias, Panics and Crashes; A History of Financial Crisis, New York: Basic Books, Inc. Publishers, 1978, pp. 191-192. For demonstration that direct investments made up an important share of all foreign investments in the Third World even before 1914 see Peter Svedberg, "The portfolio-direct composition of private foreign investment in 1914 revisited", The Economic Journal, December 1978.

2/ See especially Celso Furtado, Formacao Economica da America Latina, Lda Editor S.A., Rio de Janeiro, 1969, Chapter IX.

3/ For a fascinating analysis of the Montagu Mission see Winston Fritsch, 1924, in ANPEC, VII Encontro Nacional de Economia, Vol.2, Atibaia, Sao Paulo, December 11-14 1979, pp. 673-732.

4/ See Charles P. Kindleberger, Manias, Panics, and Crashes, op cit., p.194

5/ See Charles P. Kindleberger, "The cyclical pattern of long-term lending", mimeographed, M.I.T., 1980 pp 6-9.

6/ Marcelo de Paiva Abreu, "O Brasil e a economia mundial 1929-1945", mimeographed, Rio de Janeiro, 1980.

7/ Marcelode Paiva Abreu, "A Missao Niemeyer" Revista de Administracao de Empresas, Rio de Janeiro, July/August 1974, p.15. The United Kingdom abandoned the gold standard on September 1931.

8/ Richard N. Gardiner, Sterling-Dollar Diplomacy in Current Perspective; The Origins and the Prospects of Our International Economic Order, Columbia University Press, New York, 1980, p.xix. Today such a statement would probably be branded "emotional Third World rhetoric" by the U.S. Secretary of the Treasury.

9/ See M.S. Mendelsohn, Money on the Move; The Modern International Capital Market, New York: McGraw Hill Books Company, 1980, p.55.

10/ See Ruben Almonacid and Maria Cristina R. Pinotti, "A inflacao internacional distorce os dados do balanço de pagamentos do Brasil", Conjuntura Economica, January 1980, Vol.34, no.1, Rio de Janeiro, p.84. The uncorrected Brazilian data for current account deficits as percentages of GDP are very close to corresponding figures for all non-oil developing countries, which were 3.2 percent in 1978 and 4.0 percent in 1979. See IMF Survey, September 15, 1980, p.283.

11/ Terms of trade as debt deflators are suggested in Carlos Massad and Roberto Zahler, Dos Estudios sobre Endeudamiento Externo, Cuadernos de la Cepal, Santiago de Chile, 1977, pp.43-60. The theoretical case for the consumer expenditure deflator is presented by Rudiger Dornbusch, "Consumption opportunities and the real value of the external debt", M.I.T., processed, September 1980. See also Charles Freedman, "A note on net interest payments to foreigners under inflationary conditions", Canadian Journal of Economics, May 1979, pp.291-299.

12/ Data for Argentine exports and public debt obtained from Walter M. Beveraggi-Allende, El Servicio del Capital Extranjero y el Control de Cambios, Mexico: Fondo de Cultura Economica, 1954, pp.51 and 60. Exports for 1909 1910 and 1911 were averaged.

13/ Argentine data obtained from M. Beveraggi-Allende, op cit, pp.76 and 97. Those for Australia come from N.G. Butlin, Australian Domestic Product, Investment and Foreign Borrowing, 1861-1938/39, Cambridge, At the University Press, 1962, pp. 436-437. The averages refer to 1904 through 1913, and to 1920/21 through 1928/29. Canadian data come from M.C. Urquhart and K.A.H. Buckley, editors, Historical Statistics of Canada, Cambridge: At the University Press, 1965, pp.159. The averages refer to 1900 through 1913, and to 1920 through 1926. In all cases data refer to net payments on interest and profits.

14/ This paragraph follows M.S. Mendelsohn, Money on the Move: The Modern International Capital Market, New York, McGraw Hill Book Company, 1980, pp.71-72.

15/ M.S. Mendelsohn, op cit, p.76. A margin of no less than 9 percent is said to have been charged to some Turkish borrowers.

16/ See The Wall Street Journal, October 15, 1980, p.32.

17/ This work is being carried out by Mr. Cyrille Briancon, of the Marine Midland Bank, in New York City.

17bis/ See Willem H. Buiter, "Implications for the adjustment process of international asset risks: Exchange controls, intervention and policy risk, and sovereign risk", National Bureau of Economic Research, Inc., Working Paper No. 516, July 1980; and Jonathan Eaton and Mark Gersovitz, "Poor country borrowing in private financial markets and the repudiation issue", processed, Princeton University, 1980

18/ These inflation trends are obtained from World Economic Outlook, op cit, p.91. Annual averages for 1967-72 were 2.4 percent for export dollar unit values and 3.5 percent for import ones.

19/ These estimates are said to be based on "circumstantial evidence"; see M.S. Mendelsohn, Money on the Move: The Modern International Capital Market, New York, McGraw-Hill Book Co., 1980, p.66 and pp.81-82. The five top eurocredit banks were Citicorp, Chase Manhattan, Morgan Guaranty, Bank of America, and Dresdner Bank.

20/ See "Arab banks grow: A tool to control the world's capital", Business Week, October 6, 1980, pp.70-84. The title and tone of this article produced a spirited response from the Secretary General of the Arab Bankers Association, printed in the Business Week issue of November 10, 1980, p.6.

21/ See the report of the Independent Commission on International Development issued under the Chairmanship of Willy Brandt, North-South: A Programme for Survival, London, Pan Books, 1980, Chapters 14 and 15.

22/ For a clear analysis of these issues see Alexander K. Swoboda, Credit creation in the Euromarket: Alternative Theories and Implications for Control, Occasional Papers, No.2, Group of Thirty, New York, 1980.

See also IMF Survey, September 1, 1980, pp.265-266.

23/ See J.de Larosiere, "Recycling needs and the capital markets", IMF Survey November 10, 1980, pp.346-351. See also Henry C. Wallich, "American banks during the 1970s and beyond", Board of Governors of the Federal Reserve System, September 1980, processed, especially pp.2,3, and 13, for the variety in U.S. banks' capital-asset ratios, and remarks on the superior loan loss record of U.S. banks lending to LDCs, relative to their domestic experience.

24/ See the address by J.de Larosiere, Managing Director of the IMF, in the IMF Survey for June 3, 1980, especially pp. 173-174.

25/ See Challenge, September/October 1979, pp. 26-27