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COMMENTS TO THE SPEECH

"ADJUSTMENT PROCESS AND DEVELOPMENT PERSPECTIVES"

OF DR. ALDO FERRER

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During the past months I have had the responsibility of addressing distinguished audiences in various forums in my country as well as on an international level. On this occasion, I have the honor of commenting on the speech of a highly respected economist in Latin-American academic circles, a man who is distinguished not only for his intellectual merits, but also for his renowned vocation for defending economic policy strategies that seek the preservation or conquest of political democracy in our Continent. Consequently, it is not surprising that his speech is framed within this tradition of social and ethical concern. The author surpasses me in his ability of expressing himself straight to the point. As Ex-Ministers Aldo Ferrer and Eduardo Weisner -the latter Head of the Western Hemisphere Department of the IMF at the present time- can well confirm, this is a freedom which is not fully enjoyed by government officials, particularly, governors of central banks.

The author develops his analysis starting with the relationship between the actual situation of the external debt, fiscal deficit, money supply and inflation, thereby arriving to conclusions on the causality relationship between external debt and inflation and finally introducing alternative proposals. I will allow myself instead to approach a simplified representation of the origin of the external debt process and its linkage to the main characteristics of small open economies.

There is no doubt that the difficult situation faced by our economies is the direct result of a series of causes of an internal as well as an external nature. In the internal aspect, we spent more than what our resources allow to and the use of these funds was not the most productive. We incurred in fiscal deficits, issued money without backing, graciously accepted loans which were offered to us -resulting in an indebtedness beyond our payment capacity-, depleted our international reserves and had tremendous capital flights. In the external order, we were faced with price increases, raises in interest rates, deterioration in terms of trade and economic recession in industrialized nations. All these factors negatively affected our economic situation, which has brought us to a serious crisis. It is very difficult to establish criteria which would enable us to determine whether the origin of our actual problems lies in the adoption of erroneous economic policies or, on the contrary, if they are a result of the external factors affecting us.

An analysis carried out by William Cline¹ points out that the external indebtedness of developing countries, net importers of oil, obeys to the negative impact suffered by the economies as a result of shocks of an external nature. William Cline indicates that the negative impact has been approximately 401.0 billion dollars during the 1981-82 period, distributed in the following

1 William Cline - International Debt. Institute of International Economy. M.I.T. Press. Washington, D.C.

manner:

260.0 Due to increase in oil prices. (1973-82)
41.0 Due to increase in interest rates. (1981-82)
79.0 Due to losses incurred in terms of trade (1981-82)
21.0 Due to losses in export volume due to international
recession. (1981-82)

401.0 Total

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In the same order of ideas, Cline points out that the external debt of developing countries reached 612 billion in 1982, while in 1973, it amounted to 130 billion, which implies that during the 1973-82 period, the external debt of these countries increased by \$482 billion, a figure very similar to the losses generated by the external impact.

The system emanated from Bretton Woods which contributed to economic growth and price stabilization after the postwar years, was the fruit of the political desire of industrialized countries and the rest of the world. A large number of the objectives pursued in that Conference were achieved and the monetary system at an international level functioned adequately for many years. The fixed exchange rate system was one of the successes of the Bretton Woods Conference. Nevertheless, fixed rates started to weaken in the early '70's and, subsequently

-during the decade of the eighties- the system became critical. In this sense we must remember that the IMF was one of the two multilateral institutions created immediately after the said Conference and, precisely, Article I of the Constitutive Agreement of that Institution indicates as one of its functions to "foment exchange stability, in an effort to achieve that member countries maintain orderly exchange systems and avoid competitive exchange rate depreciation". That objective is not presently being fulfilled and, it is obvious, that the international financial system is suffering from great problems, all of which has been reconfirmed by the persistence of the present crisis. It is worthwhile then to ask oneself, to what extent are the present deficiencies in the monetary system and international trade -which are not the making of developing countries- responsible for the crisis we are facing. All of this leads me to point out that the present situation affecting us has been the result of a combination of internal and external factors. Consequently, we must improve our domestic economic policies, but we must bear in mind as a present and true reality, the fact that a large portion of the external factors that have negatively affected us will continue to exist. This means that, in political terms, not only the magnitude of the present crisis should be well understood but also the existence at the international level of economic factors that will prevail and a system that will not vary significantly its actual policies. The acknowledgement of this circumstance is necessary so as not to waste time and to be able to face with realism the harsh situation

that confronts us.

The basic hypothesis which we formulate is that, in the medium term, the main determining factor of the level of domestic expenditure is the foreign trade performance. In small and open economies there is a level of public expenditure which may be consistent with balance of payments equilibrium. This level of expenditure is called "level of expenditure warranted by foreign trade".

This level of expenditure has steadily tended to fall in Latin America, as a result of stagnant export and increasing import requirements. This has been the result, apparently paradoxical, of the strategy of industrialization through import substitution.

If we go back to the basic writings of the Latin-American structuralist school, that is, the Economic Commission for Latin America (ECLA), as well as to the pioneer works of Prebisch, we shall see that the behavior of foreign trade is not something accidental but, rather, it responds to the same structural characteristics of output and trade of the economies of the Continent. In general, the products exported by Latin-American countries are characterized by low income elasticity in international markets while their imports have high income-elasticity of demand. In essence, this implies that the rate of economic growth and its corresponding warranted expenditure are low so as

to be able to maintain external balance.

In the absence of net unilateral transfers and direct flows of foreign investment, we will logically experience an inevitable process of external indebtedness, in order to maintain high rates of growth.

With respect to domestic imbalance factors, fiscal deficits -presently turned into fiscal crisis- are due not only to the increase in expenditure above the so-called warranted expenditure that is consistent with equilibrium in the balance of payments, but also to a gamut of transfers ^{to} of the private business sector in the form of tax exemptions as well as other types of subsidies which have been excessively liberal.

The latter has been part of the policy designed and applied for decades in our countries to stimulate investment in selected sectors of the economy. But the effects of the incentives on investment and on output have not compensated for the reduction of the tax rate resulting from applying the incentives in all their extent. In reality, the nominal value of taxes has been less than the transfers assigned to these sectors. In the absence of an effective tax policy, the level of public expenditure could only be maintained through the creation of money and through indebtedness. The level of warranted expenditure could have been increased through devaluation policies which would stimulate exports and reduce the penetration of imports. Nevertheless,

this alternative was not adopted and then the majority of our countries chose the easy way of foreign indebtedness and/or loss of international reserves.

If the above is accepted, it would then seem that the line of causality originates from foreign-trade performance, from incentive and exchange rate policies and its relation to fiscal deficit, as well as from the expansion of bank credit.

As Dr. Ferrer correctly points out, in the case of Brazil, Mexico and Argentina the balance of trade surpluses represent ratios between 4% and 7% of the GDP of each one of these countries. However, at the same time, one can observe a deep economic recession which is reflected in low utilization of productive capacity and high levels of unemployment. For the Caribbean and Central-American economies that do not possess the productive potential to generate the capacity for shifting their productive forces towards the foreign market of internationally tradeable goods, nor do they count with a significant sector in import substitution, the results in terms of economic growth to maintain trade surpluses are unsustainable. The pretention of the international financial community that these economies can generate and maintain net financial transfers to pay interest and principal at the expenses of an acceptable level of economic growth, under a global recessive context, resembles the impositions by the allied nations to the German State in the Treaty of Versailles, lucidly described and criticized by Lord Keynes in

his famous essay "Economic Consequences of Peace". With due respect to historical and geographical differences, what is at stake today in Latin America is political and social stability, as was yesterday's defense of the values of democratic coexistence.

In the frame of the simplified general model previously described, let us analyze the interrelationship between the present economic situation of the Latin American economies and the IMF stabilization programs. To date, a large majority of the Latin American economies have adopted strong adjustment policies recommended by the international financial community, without having produced an increase in the net flows of external capital. Even with the seal of approval of the IMF, the expected results of increasing the flow of resources have not been all that positive. This, together with the recession in international demand, has brought as a consequence that the warranted domestic expenditure (i.e. that compatible with a feasible and sustainable position in the balance of payments) is presently at a level corresponding to a rate of growth well below what is socially desirable.

We must point out that, in some of our countries, the outcome obtained by reducing the deficit in the current account of the balance of payments as a result of the application foreign exchange policies, together with strong monetary and public expenditure restrictions, make the IMF stabilization programs questionable with respect to their permanence. This is so, because what has occurred has taken place at the expense of a severe contraction of certain imports which are vital for the good performance of our economies, without even having carried

out an export stimulation process. In the meantime, there exists a greater degree of inflation and under-employment of the installed productive capacity, which, in turn, has generated a lower standard of living for the country and higher unemployment rates. These are factors which are creating adverse political, economic and social conditions for the continuity of the stabilization programs.

We nevertheless recognize the need for stabilization policies and discipline recommended by the IMF. However, what should be debated and what we have questioned in the IMF programs is the manner in which this adjustment should be carried out, in what period of time it should be executed, what instruments of economic policy should be used, and what type and amount of external flows are necessary.

Our greatest concern within the actual scheme of the stabilization process is the importance given to the balance of payments objective, diminishing other aspects such as stability, growth and income distribution.

To pretend to carry out the adjustment process by achieving equilibrium in external accounts basically through a reduction in the global demand, is a dream which can only hinder the adjustment process itself. The deficit in the balance of payments, which is the main obstacle for improving the level of production and employment, must necessarily be overcome through export expansion, which is the main road to increasing the rate of growth of the economy and avoiding further deterioration in the balance of payments.

We believe that it is necessary to find a balance between policies of a restrictive nature and growth policies. This balance will be accomplished by applying to consumption the necessary reductions; while protecting and maintaining the other component of the aggregate demand, that is, investment, at an acceptable level.

Therefore, under the present circumstances, maintaining a warranted level of expenditure in the economies of developing countries would permit keeping public investment at a level that would maintain rates of economic growth at a socially acceptable level. For the achievement of this objective, it is also required that certain exogenous conditions improve. Among these are that interest rates and the conditions for the access of our products to international markets register a favorable evolution. The countries of the European Economic Community and Japan would have to apply expansionist fiscal and monetary policies, while the United States should advocate to reduce its fiscal deficit. These measures should be accompanied by trade policies that benefit the financially weaker economies.

Another indispensable requirement for this growth is the relief of the external debt burden together with a substantial flow of additional resources. Most of our countries have negotiated their debt. But, nonetheless, the result has been that the debtor countries have converted paradoxically from net importers to net exporters of capital, in spite of the critical situation which our countries are experiencing.

In times like this, commercial banks as well as international financial institutions have to play a more effective role in the supply of funds. It is inconceivable that, under these circumstances, the World Bank presents for the coming years a negative net flow towards countries that have undertaken serious adjustment efforts. Such is the case of the Dominican Republic. In this sense, it is imperative for the International Monetary Fund and the World Bank to have better coordination and to implement more expeditious mechanisms, opening new windows with facilities that have been proposed and enlarging those already existing, thereby contributing to softening the adjustment process and the debt burden. It is questionable that precisely under these circumstances the Fund has reduced its limits on access to its resources from 105-125% of the 1984 quota to 95-115% in 1985, and what is even worse, in most stand-by agreements approved by the International Monetary Fund in 1985, the amount authorized has always been well below the minimum limit of 95% of the annual quota. We feel that the Fund should grant a larger volume of resources for the high conditionality programs it supports.

Also, it is of extreme concern that the Fund has reduced to 50% of the quota the drawing capacity under the compensatory financing. This is a special window whose objective, from its origin in 1963, has been to finance the fall in export revenues. This is so because the remaining 33% can only be requested when a country has adopted an adjustment program supported by conditional resources of this institution. All of this leads us to the conclusion that the IMF should grant a larger volume of resources to the high conditionality

programs it supports. It is necessary for the multinational institutions to modify existing criteria for the use of resources as a way to acknowledge the emergency that the developing countries are facing, particularly in Latin America.

In the same manner, the loosening of the conditions that are demanded to undertake the different stabilization programs is an unpostponable necessity. In a complementary manner, mechanisms should be adopted that permit the stabilization program of the IMF to be linked to the requirements of the World Bank in structural adjustment loans. This would allow for a substantial reduction of the time involved in negotiating a program with the IMF only to enter again later on into another period of negotiations with the World Bank, demanding new and higher conditionality. To this, one can add the fact that disbursements, if an agreement is reached, are received much later, thus, not having, in the short term, the desired effect on the adjustment program.

The adjustment process we are carrying out presents a high degree of uncertainty, making it less feasible and less lasting. If we were to have sufficient funds at our disposal when needed, maintaining a socially acceptable level of growth, a bearable exchange rate, and a normal and manageable deficit in our balance of payments current account, the adjustment process incurred would result less traumatic and more effective.

Dr. Ferrer's approach and his current proposal to solve the debt and adjustment problem consists in capitalizing a portion of the

interest owed through the issuance of bonds. This implies the placement of a cap on debt service payments which would be established as a percentage on the volume of exports. As the interest paid would be lower than the interest accrued, there would be a gap consisting of the interest converted into bonds and capitalized.

This proposal poses diverse and serious questions which are pointed out by E. Weisner in his commentaries. One of them is who shall finance the interests and amortization of the bonds issued. On the other hand, I don't think it is feasible, and disagree with Dr. Ferrer in the sense that, under the present world economic and political context progress can be made in achieving acceptance of a proposal of this nature as a scheme for solving the external debt problem. Simply, the international conditions do not exist in developing countries, nor the political will in industrialized countries, to achieve this acceptance.

On the other hand, the position posed by E. Wiesner is that adjustment and repayment of the debt is attainable with adequate economic policies that have as a basis the increase of domestic savings, since the adjustment effort must not be effected with new external indebtedness. I believe, as does E. Weisner, that increasing domestic savings is a cornerstone in this process; nevertheless, and in view of the present situation of economic recession at an international level, to carry out adjustment counting basically with internal savings would turn the adjustment process non-feasible. So as to make this process continuous and

politically and socially feasible, it is indispensable to soften it and, for that reason, it will be necessary to incur a certain degree of indebtedness under soft conditions. These external resources should be mainly destined to modify the present production structure so as to achieve in the medium term an increase in exports. In summary, I do not think it is possible that this adjustment process can be effected and have continuity without substantial external aid under soft conditions. What I am in agreement with both A. Ferrer and E. Weisner, is that economic discipline is an unpostponable task with or without the IMF, with or without external indebtedness. ¹⁾ Within this necessary order, we shall be forced to reduce fiscal deficits, avoid capital flights, have austere monetary policies and realistic exchange policies that will expand our exporting capacity as well as that of other basic sectors of our economy.

The challenge to all of us that are involved in this adjustment process is how to make it feasible and sustainable within the actual economic, political and social context in our region while acknowledging the realities which conform the actual world economic order.

We are convinced that the countries present at this Assembly of the Latin American Association of Financial Development Institutions (ALIDE), many of which are signatories of the Consensus which bears the name of this historic city of Cartagena, and which gathers all these concerns, share our criteria. In effect, there is no

1) Ferrer A., "Poner la Casa en Orden" (To put Your House in Order).
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doubt that all of us could derive multiple advantages from greater financial flexibility of the conditionalities established by the IMF in its programs.

Thank you.

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