THE DEVELOPMENT CRISIS: BLUEPRINT FOR CHANGE

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CARLOS GERALDO LANGONI

FOREWORD BY PAUL A. VOLCKER

INTERNATIONAL CENTER FOR ECONOMIC GROWTH

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Executive Summary

THE DEVELOPMENT CRISIS:

Blueprint for Change

by

Carlos Geraldo Langoni

Foreword by Paul A. Volcker

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About the Author

Carlos Geraldo Langoni was Brazil's principal representative at its 1982-83 debt negotiations. He was at the time 35 years old, the youngest ever president of his country's Central Bank. Currently he is professor at the Getulio Vargas Foundation Graduate School of Economics, Sao Paulo, and director of its Center for World Economy.

Preface

Difficulties in finding solutions to the LDC debt crisis are aggravated by conflicting perceptions of what the essence of the crisis is. The developed countries see the problem as a debt crisis, while the LDCs themselves see it as a crisis in development. *The Development Crisis: Blueprint for Change* reflects this important LDC viewpoint.

In publishing this book, the International Center for Economic Growth makes available to the English-speaking policy audiences an important new perspective on the present quandary. Carlos Geraldo Langoni's outlook is that of a former LDC central bank president who led his country's debt rescheduling negotiations and managed its monetary policy through a year of the crisis. The book was originally published in Portuguese for an audience in the author's native Brazil. It has been expanded and updated to reflect recent events and to address the interests of a worldwide audience.

Although Mr. Langoni centers his attention on the Brazilian experience, he shows the extent to which the debt crisis is part of a major, worldwide economic adjustment. This adjustment has involved and affected all nations, as well as the international public and private financial institutions. The major burden, however, has fallen on the LDCs. Langoni argues that restoring economic growth and human development will require adjustments by the LDCs and complementary, consistent, and coherent actions by the developed countries and the international financial institutions.

ICEG offers this book as a contribution to strengthening the partnership among countries and institutions that understand the importance of economic growth as a means to improve the lives of individuals and the balance of wealth among nations. This is an executive summary of the original book published by ICEG.

Nicolás Ardito-Barletta
General Director
International Center for
Economic Growth

Panama City, Panama
July, 1988

Foreword

Carlos Langoni has qualifications that, in combination, are uniquely suited to making intelligent analysis of the international debt crisis accessible to a large readership.

He is, to start with, a solidly-trained economist. He was head of the central bank of Brazil—Latin America's largest country and largest debtor—in 1982 when the crisis struck, and was engaged first-hand in the efforts to contain and diffuse it. His present position as Director of the Getulio Vargas Foundation, the leading Brazilian economic research center, has provided a vantage point for both reflection and analysis. He is, at the same time, an advisor and participant in financial markets, a practical man of affairs, aware of the opportunities as well as the pressures emerging from the debt crisis. He is, not least for present purposes, articulate in English!

Readers of the Development Crisis: Blueprint for Change are the beneficiaries of Mr. Langoni's talents and experience in all these respects. He places the debt crisis against the larger backdrop of the development strategy adopted by most of Latin America in the earlier post-war period-a strategy that, he emphasizes, was becoming exhausted by the 1980s. As Mr. Langoni sees it, the crisis has forced a rethinking of the older approach characterized by heavy governmental intervention in the economy, widespread subsidies and protectionism, all supported by large borrowings. He looks toward a new approach, toward growth consistent with greater economic and political freedom.

But if that promise is to be fulfilled, more than internal reform will be required. Ways and means will have to be found to deal constructively with external economic and financial restraints. Mr. Langoni offers specific suggestions to that end.

One need not agree with every one of his proposals and recommendations to recognize the relevance of the issues he raises; the technical sophistication with which he considers the detailed institutional, negotiating, and financial issues; and his understanding of the larger economic and political setting—within and without Latin America—in which these more technical questions need to be resolved.

To my (possibly prejudiced!) mind, Mr. Langoni's broad approach is consistent with the objectives and precepts of the "debt strategy" as adopted in 1982 and particularly as reinforced in 1985 by Secretary Baker at the IMF-World Bank meetings in Seoul. And I found it both interesting and encouraging that some of his specific points about the role of the IMF and World Bank and the potential of certain financial techniques (such as debt-equity swaps) are precursors of some themes emphasized at the Washington IMF-IBRD meetings a few weeks ago.

Perhaps Mr. Langoni would not agree with so positive an assessment of the present strategy, conscious as he is of the extent to which past efforts to deal with the debt crisis, however benign the objectives, have in implementation fallen short in important areas. Nor would I, for one, agree with the wisdom or practicality of every suggestion in his new book. But I think thoughtful readers will come away with a better sense of the nature and size of the challenge, of the enormous stakes in terms of Latin American growth and prosperity, and of the basic ingredients for a successful resolution.

Paul A. Volcker
October 5, 1987

Executive Summary

Roots of The Crisis

- Starting in early 1970s, developing countries were exposed to precarious economic conditions that had a negative impact on their balance of payments and domestic economies—among which were a wide fluctuation of inflation rates, cycles of recovery interspersed with recession, and extreme variation of interest rates and major commodity prices.
- Despite such economic uncertainty, large commercial banks in developed countries made numerous loans to developing countries eager to finance growth and build foreign reserves. Banks persisted with the illusion that they were financing self-sustaining growth—with high yield, low risk loans—when in fact developing countries were already using loans to finance their debt payments during much of that period.
- During the 1970s, when a number of developing countries were accumulating large debts, neither the banks, multilateral institutions such as the IMF, nor the countries themselves, were taking steps to prevent future catastrophe. By the time Mexico defaulted on international loans in 1982, some major banks had assets in a handful of developing countries that were three to four times greater than their own capital, and a number of countries were already burdened with debts on which they could no longer pay even the interest.

Rescheduling Debt

- Mexico's default triggered a panic among lending institutions, which feared that other developing countries would either default or not be able to repay loans. Their principal concern, one that was supported by the actions of the International Monetary Fund and governments in developed countries, was to reduce loans to levels that would guarantee that countries could meet interest payments on their debts, thereby reducing bank exposure to further danger.

- Developing countries, whose concerns ranged beyond immediate payment of debts to maintenance of political stability and economic growth, had to survive with drastic reductions in access to foreign exchange and trade credit. Those with the biggest debts — among whom were Argentina, Brazil, Mexico, Philippines, Poland — were obligated to renegotiate their debt payment with the seal of approval of the International Monetary Fund. Increases in foreign reserves, which developing countries needed in order to purchase imports for domestic production and consumption, would no longer come from loans but from improvements in their balance of trade.

- The International Monetary Fund, controlled in large part by the small group of developed countries that possess the majority of votes in the organization, has been the principal negotiating body between debtor countries and the banks. With limited funds of its own—contributed by member countries—the IMF has been able to provide some loans to help countries meet their debt payments. Its primary concern has been to make sure that countries meet interest payments on their debts, thus protecting the banks, and that they take drastic actions to make their economies less dependent on foreign loans while correcting internal imbalances due to high inflation rates.

- For developing countries, agreements with the IMF have required enormous sacrifices. IMF requirements have forced certain developing countries to reduce inflation levels to meet targets that are often unrealistic. Imports have been reduced in many cases, wages reduced, and government spending cut. Many economic adjustments have been expected much sooner than developing countries have been able to make them. When they fail to meet requirements, countries are faced with a further squeeze on their access to credit and loans. Often, such austerity measures carry great political risks in developing countries, with the threat of civil disruption from groups in society that are either unwilling or unable to live with them.

Summary of Recommendations for the Future

- We should move from debt refinancing to a new and more realistic stage of debt restructuring. This should be the result of negotiations among all the partners of the world financial system—the debtor national governments, lender nation governments, lending banks, and multilateral institutions. The program should be part of a long-term plan to restore the financial market for the debtor country, solve the problem of its external debt, and put the country on a path to economic growth. Lender countries must accept that developing countries will need to be able to run a certain level of current account deficit to sustain growth, and be willing to consider the effects of its own economic policies on developing countries.
- The relative success of developing country efforts to meet adjustment goals should be measured by quality of performance. The program should be judged on the consistency of policies and their implementation with the adjustment goals rather than on short-term quantitative measurements.
- The financial market for debtor countries needs to be restored. Industrialized country policies will have to be changed to meet this goal, multilateral institutions—particularly the IMF acting cooperatively with the World Bank—will have to initiate innovations that will take account of debtor country needs for development and economic growth, and new mechanisms will have to be created to deal with short-term liquidity problems and long-term restructuring of debt. Logical connections will have to be established between short-and long-term policies, between temporary adaptation and structural changes, and between adjustment and growth.

- In developing countries, control of the state needs to be returned to society. The role of the public sector in the economy needs to be greatly reduced. The state must return to its role as a social agent, as an instrument consolidating the economic infrastructure, and as a vehicle supporting the research necessary for economic innovation and future growth.

- The key for a successful transition out of the debt age is a simultaneous process of internal reforms among debtor countries that will ensure permanent control of inflation and of profound changes in the way that creditor countries and international banks are handling the servicing of existing debt.

- The recent trend among major banks to increase loan-loss reserves reflects a positive step in the direction of sound, realistic solutions. It creates concrete opportunities for the implementation of new innovative schemes: Different forms of interest capitalization and even a voluntary reduction in the debt stock through the issue of a new class of long-term bonds with real collateral, rather than just IMF programs, would allow countries to internalize some of the current debt discounts quoted in the secondary market. The Mexican securitization program is a first step in this direction.

- The working of market forces alone will not be powerful enough to offer an orderly and speedy solution of the debt problem. Swift, democratic changes will require a certain degree of the creditor governments' direct or indirect intervention. This book describes a variety of different mechanisms that can be readily implemented: in particular, a flexible, negotiated, external interest rate with automatic capitalization of the differences between the market rate and a long-term shadow rate to be applied to rescheduling.

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The Development Crisis

The End of an Illusion

When Mexico defaulted on its international loans in 1982, the international economic community was forced to face up to something it had been avoiding for quite some time: An era of liberal and carefree bank lending to national governments was over. By then, the situation was already critical for some lending institutions. Assets held in a handful of developing countries were three to four times greater than their own capital. A halt in interest payments could easily turn a highly profitable situation into a loss.

The situation had not come about suddenly. For several years major banks in the developed countries had engaged in heavy competition to loan large sums of money to developing countries, convinced that they had found the perfect opportunity of high yield loans with low risk. Even when evidence began to suggest otherwise, banks continued to delude themselves into believing they were lending money to self-financing growth projects, when in fact countries were already using the loans to pay the interest on their international debts.

Between 1973 and 1982, the period when much of the lending took place, the precarious economic conditions which contributed so heavily to the debt crisis were already a fact of life for developing countries: the wide fluctuation of inflation rates, cycles of recovery interspersed with recession, and the extreme variation of both interest rates and major commodity prices.

Such was the environment in which bank lending was conducted. But while the prospect of default may have been a predictable outcome of such uncertainty, there was little evidence that it was giving either developing countries or lending institutions reason to pause. By 1982, over a decade of aggressive lending by international banks and the reluctance of the International Monetary Fund (IMF) and developing nation central banks to intervene with corrective measures when needed had left a growing number of countries with debts they could not pay on time. Major banks were overexposed and became preoccupied with rescheduling foreign debts that could no longer be serviced.

Borrowing countries, for their part, were willing partners in the lending game with the banks. In the late 1960s conditions in the world's financial markets and a growing United States external imbalance created conditions for greater involvement of commercial banks in lending to sovereign governments. Before the period of heavy borrowing that began in the late 1960s, economic growth in developing countries occurred with limited borrowing from international banks, which restricted their business for the most part to short-term commercial loans. Credits were obtained from foreign governments and export agencies, and development funds were available through the World Bank or Inter-American Development Bank (IDB). The colossal debts so common today were non-existent. In Brazil, now one of the world's most indebted countries, the current accounts deficit was no more than one percent of the country's Gross Domestic Product (GDP) during most of the 1960s.

Then in 1967, the Brazilian government gave public and private corporations permission to borrow from banks abroad. The move, intended to provide funds for continued economic growth in the country, initiated a descent into debt that has since become one of Brazil's overwhelming preoccupations. By borrowing from banks in Europe and the United States, Brazil was able to build up its foreign currency reserves, which were then used as collateral to secure more loans. In the first four years of borrowing, from 1967 to 1973, the country's foreign debt increased from \$3.3 billion to \$12.6 billion. But that was only the beginning.

Until OPEC raised oil prices in 1973, bank lending to developing countries looked like a foolproof scheme from almost everyone's point of view. It was a brief era of what looked to many like universal economic growth, low inflation, and an expansion of trade. But OPEC's price increases forced many developing countries into further debt as they borrowed money from the countries from which they bought their oil. The fear of growing inflation toward the end of the 1980 prompted developed countries to adjust their economic policies and to reduce their own borrowing. Developing countries, interested in continued economic growth, took advantage of the reduced competition for loans and financed their own domestic disequilibrium with continued borrowing—and increasing debt.

By late 1982, the total external debts of developing countries—short, medium, and long term—was estimated by the World Bank at $747 billion. Private lenders accounted for 62 percent of the long-term debt, with the remainder divided between governments (24 percent) and multilateral institutions (14 percent). The debt was heavily concentrated in non-oil-producing developing countries, which owed 82 percent of the total. About 60 to 70 percent of the developing country debt—around $500 billion—was owed by countries that had accumulated arrears in debt service payments, many of which were rescheduling debts with the IMF. Some 85 percent of the countries rated "in trouble" with their debts are in Latin America and Africa. Since 1982, more than 30 countries have gone through painful debt rescheduling.

The external debt-to-GDP ratio is roughly the same for Latin America and Africa—around 50 percent. The principal difference is that Latin America has enjoyed greater access to private banks, which therefore account for a larger share of its debt. This makes Latin America more sensitive to interest rate fluctuations. Interest payments for Latin America in 1983 were estimated at 36 percent of exports. In Africa, countries are heavily reliant on a handful of commodity exports and suffer the effect of general import restrictions on internal consumption of food.

In Asia, the Philippines are caught in a predicament that is similar to that of Latin American countries, with a high interest-to-exports ratio and strained relations with banks and the IMF. South Korea, on the other hand, has managed to preserve access to international financial markets by implementing a voluntary adjustment program.

The socialist bloc countries of Eastern Europe—in particular East Germany, Rumania and Hungary—suffered from market constraints following the Polish default in 1981. By the end of 1983, the external debt of socialist bloc countries in Eastern Europe was estimated at $60 billion, half of which was owed by Poland. Clearly, the debt problem was not restricted to capitalist countries. It could not be dismissed as part of the "crisis of capitalism."

The Inhibition of State Control

Generally, the debt crisis has had far less to do with whether a country practices capitalism or socialism than it does with the tendency of national governments to assume increasing control of national economies and borrow money to fund their intervention— something that self-proclaimed capitalists and socialists alike have done. In that light, the Brazilian debt crisis of the 1980s—as well as those of other countries—should be understood as the end of an era. It is more than a cyclical crisis, and it is more than just a liquidity crunch. It is symptomatic of profound imbalances in the country's social and economic structure.

During the past twenty years, Brazil, like many developing countries and like most of Latin America, has pursued a development strategy aimed at rapid growth financed by external resources and governed by direct and indirect state intervention Early in this period, subsidies and price controls were introduced. Over the years the state gradually enlarged its scope of direct intervention by mobilizing domestic savings and moving to the forefront of investment activity in a variety of key sectors. Through its unique ability to unite economic resources and political power, the state expanded its activity from correcting market distortions to broad intervention. It thus became the main internal source of economic disequilibrium.

Government regulation and control of key industries in many developing countries has inhibited economic growth, often depriving the country of an economy vigorous enough to generate the diversity of goods needed to expand trade or respond to internal need. Foreign currency borrowed abroad was eventually needed more to finance government bureaucracies and pay interest on the debt than to stimulate real economic growth.

The Cost of Illusion

The pain and uncertainty of the readjustments that started in 1982 were underscored by a sobering realization: At the time, there was no worldwide institutional framework for dealing with the crisis in an orderly fashion. Following the Mexican default, credit markets shrank as lenders pulled back to reduce their exposure. It was a trend that could not be reversed by adjustment policies or even by announcements of agreements with the International Monetary Fund (IMF). In October 1982, Brazil announced a series of measures designed to cut its current account deficit in half, and in December it reached an agreement with the IMF. But the country still lost about $4 billion in interbank deposits and $2 to 3 billion in trade credit lines. External liquidity was rapidly disappearing, even for those making an honest attempt to cope.

The reactions from developed countries were slow, and served for the most part to aggravate the situation further. At an August 1982 IMF meeting in Toronto, developed countries decided there was no need to take special measures to help developing countries, either by reinforcing the capital of multilateral institutions or by guaranteeing continued access to liquidity for those countries that were not yet directly involved. Later, banks would see the advantages of handing over responsibility for long-term financing to multi-lateral institutions supported with co-financing schemes. Such a move would promise them no further increase in exposure to debtor nations and guarantee a full repayment of interest at market rates. But when the crisis first hit, developed countries and their banks put the burden on developing countries. They stressed the need for greater internal adjustments, and anticipated rescue by natural market corrections, presumably the result of lower interest rates and the expected recovery of the world economy.

The major central banks and the governments of industrialized countries bear an important responsibility for the disorderly way the crisis evolved. They continued to take a non-interventionist posture while the market was forcing a complete halt in loans to developing countries. The concept of country-risk usually applied by commercial banks quickly turned into regional risk, covering whole continents—a crude attempt to correct in a few months to overlending of many years. Central banks knew that moves by individual banks to reduce overexposure would eventually be frustrated by the destabilizing effect of these actions on the market as a whole. It was a time for action, not for indecision. Either the debtor countries were going to have to make changes that would ultimately disrupt market activity, or central banks and their governments were going to have to absorb some of the losses.

With little choice, debtor countries started hammering out agreements with the IMF. When hundreds of bankers met at the Plaza Hotel in New York City on December 20, 1982 to reschedule Brazil's debt payments, it was an unprecedented experience for most of them. The market, long an impersonal force in their lives, was suddenly manifest in the direct, nervous contact of debtors and creditors. At the time, Brazil's debt came to $83.2 billion, 84 percent of which was in medium or long term loans. The country's international reserves were less than the interest due on its debt in the second half of the year. But under the new rescheduling agreement that was reached, new money was no longer tied to minimum investment levels defined by debtor countries but rather to bank objectives: to make sure that interest was paid and to keep additional loans at levels substantially lower than the growth rate of their capital base.

In fear of potential losses, bank strategy has been to shrink as far as possible the already reduced provision of additional credit to countries that have rescheduled their debt. Net long-term credit from banks to developing countries has been cut from $91 billion in 1981 to $3 billion in 1986. Banks, sensing that their own survival was on the line, were no longer making loans to countries so that they could build up foreign reserves. They made loans to enable them to service their debts. For borrowers, reserve gains would have to come from an improvement in the balance of trade, with occasional infusions from the IMF.

The Constraints of IMF Agreements

In a time of crisis, the IMF negotiated rescheduling agreements between debtors and the banks. Its primary role was to make sure that a minimum amount of external funding was available to debtor countries so that they could meet interest payments on their loans. At first, that meant short-term bridge loans to get the country through the coming year. But as part of the rescheduling agreements, debtor countries had to agree to other stringent adjustment measures intended to improve their balance of payments and ensure that in the future they could handle debt payments on their own. Those measures have often put unrealistic pressures on developing countries to correct their economic imbalances in a much shorter time than is realistic. While lending banks, concerned with the prospects of default, try to reduce their exposure and thus protect their assets, debtor countries must worry about a more diverse set of long term development issues.

IMF requirements have often prompted a combination of short-term policies in developing countries that end up placing too much emphasis on monetary instruments and too heavy a reliance on the behavior of the interest rate. Reducing inflation has been a basic condition. Often, agreements can lead to some variation of the following scenario.

The formal time restrictions for enforcement of the adjustment program demand unrealistic targets for cutting back inflation. These targets are then included in quarterly performance criteria. But despite compliance with the agreed adjustment measures, there is a short-term difference between observed inflation and projected inflation. As a result, other targets— like an acceptable level of public deficit—are not achieved. The failure to meet these other targets leads to an interruption of IMF disbursements and a halt to credit from commercial banks. An external liquidity crisis is triggered no matter what might be happening to the balance of payments.

The reduction in foreign financing and the austerity measures of the IMF agreements affects everybody in the debtor countries, and create conditions that are often politically dangerous. All of Latin America has felt the crunch, not just as a slowdown in development but as an actual shrinkage of its economies. Per capita income decreased 7.5 percent regionwide between 1982 and 1986. Even assuming that growth can be resumed and sustained at a 5 percent rate in real terms-and that is being optimistic—the 1980 per capita income level will not be reached again before 1990. The 1980s will have been a loss for Latin American development.

But the economic crisis has impressed Latin Americans with the need for coordinated action to press for their own terms in negotiations. Because so many of the changes demanded by adjustment programs have such serious social and economic repercussions in debtor countries—such as cutbacks on government spending, wage reductions, and negotiations with international institutions—political considerations are playing an increasing role in management of the debt crisis. In the near future, ministers of foreign affairs will probably sit around renegotiation tables with ministers of finance and central bank presidents. As options for technical adaptation in rescheduling are exhausted, it is likely that politicians will take command of the process.

Beyond Debt Service

If adjustment agreements are going to move beyond the limits of short-sighted demands to service the debt and incorporate the various economic development needs of debtor countries, at least three critical realities must be faced:

First, the degree of economic uncertainty that now prevails among countries striving to adjust to new external conditions must be reduced. This requires a closer coordination between short-run adjustment demands and long-term development objectives.

Second, it is politically impossible to maintain huge trade surpluses and accept a permanent net outflow of capital.

Third, developing countries must be guaranteed an adequate level of capital inflow to sustain economic development. This does not necessarily entail another cycle of indebtedness: Direct investment will probably play a prominent role combined with major changes in rescheduling practices.

For an effective structural adjustment program, the primary emphasis should be on the qualitative aspects of the required changes. The program should be judged on the consistency of measures adopted rather than on their short-term quantitative impacts, which can only be discovered after the fact. Trying to predict these variations accurately is an exercise in frustration. If the measures are consistent, positive results will come about sooner or later, but it is impossible to predict exactly when. As it is, targets are set not for their consistency with the adopted instruments, but to satisfy program formalities governed by a limited time-frame that lead to frequent revisions and undermine credibility.

It is important to note that the IMF's actions reflect the viewpoints of member countries, in particular the small group of industrial countries that hold most of the political power — the 21 countries that have 58 percent of the votes. That group has favored minimal external intervention in the troubled economies of debtor nations and has put pressure on governments of those nations to make severe internal adjustments. The conservative forces, represented by the American, British, and German governments, have also systematically opposed efforts to provide more capital to the IMF or to reassess the system of adjustment conditions. Furthermore, the IMF's power structure makes it impossible for it to intervene with equal forcefulness in the economies of member countries—in particular that of the United States, where monetary and fiscal policies have been chiefly responsible for high interest rates that have placed such burdens on debtor countries. So far, developing countries—which account for an increasing amount of world trade as well as the majority of debtors—have been handicapped by their inability to expand their voting power.

Limited IMF resources and the uncertain maneuvering room that debtor countries have with private banks have resulted in what amounts to "adjustment without liquidity." This has placed a disproportionate share of the burden for correcting a country's disequilibrium on the nation's trade account relative to its service or capital accounts. Greater availability of resources and more operational flexibility are the only means to create sound conditions in place of the current system, in which access to IMF programs can be gained only on a compulsory basis after all other liquidity sources have been exhausted.

Conditions must be created to encourage the more rational alternative of going to the IMF voluntarily in anticipation of future difficulties, and therefore with a minimum loss of external liquidity. The present reluctance of some countries to go to the IMF often comes when the limited availability of the fund's resources is measured against its rigid system of conditions. Countries fear that credit provided by the IMF will not be enough to offset the suspension of international bank credit that normally takes place until negotiation of the adjustment process is complete. The IMF needs more liquidity just to facilitate orderly access to its stabilization programs.

The current dilemma has put some countries into situations where there is little sign of a way out. The expectation that the present disequilibrium will correct itself is made unrealistic by both internal and external factors. Externally, paralysis of the financial market has killed hope for the replenishment of liquidity through the natural working of market forces. Internally, there are no natural mechanisms for self-restraint in the expansion of the public sector. Nor has the adoption of multi-year rescheduling with the banks, which was introduced initially for Mexico but is now common for other countries as well, done the trick. Rescheduling will not by itself reverse the trend toward a net outflow of financial resources—a pattern that is by now chronic.

There is a real risk that some countries will react to current external constraints by expanding trade barriers and further restricting capital flows. Although this strategy may seem attractive in the short run, over the long run it will narrow the possibilities for sustained development. It requires that the benefits of new production and consumption that result from an involvement in international trade be waived. It also leads to a technological gap—encouraged by isolation—that limits the country's potential for economic growth. Domestically, it may lead to increasing encroachment of the state and the stifling of private initiative. The external debt crisis would thus result in the virtual disappearance of infant market economies that have developed shakily in Latin America over the past twenty years. That is how the financial crisis becomes a development crisis.

Long-term debt restructuring must be carried out in order to establish a logical relationship between sustainable external adjustment and the renewal of growth. This requires setting parameters governed both by long-term shadow interest rates, which are imputed to reflect the long-term price of capital more realistically than market rates, and a minimum growth rate for external credit, which would be linked to realistic targets for the growth of real domestic product. It is also essential that the supply of external resources be coordinated to respond to changes in interest rates. In order for both the supply of long-term resources and the equilibrium interest rate to be attuned to external adjustment and growth, the terms of debt restructuring must be redefined.

The current terms of debt rescheduling rely upon prevailing market rates, which reflect a situation of momentary disequilibrium. The fluctuation in external interest rates has been the major element of vulnerability in the current agreements between debtor countries and commercial banks. Any rescheduling schemes can be disrupted overnight by changes in interest rates. To wait for interest rate deviations to be corrected naturally would prolong unnecessarily the exposure of debtor countries to factors outside their control, thereby generating a climate of uncertainty that is adverse to the recovery of private investment.

What is needed to achieve long-term stability and resume economic growth is a negotiated reduction in interest rates. This would accomplish more than just a multi-year refinancing of debt—it could be expected to generate a stable flow of new money over time.

A number of technical alternatives exists to strike a suitable balance between a more flexible basic interest rate (shadow rate) and stability of the international finance system. What is lacking is a political decision to move in that direction. The specific mechanism suggested here is quite simple: automatic capitalization of differentials between the market rate and a long-term shadow rate that would be applied to rescheduling of the debt.[1]

In addition to establishing a protective net around the external accounts of debtor countries to shelter them from interest rate fluctuations, this new approach would shift to debtor nations some decisionmaking power over the outcome of rescheduling, at present concentrated exclusively in the creditors' hands. Furthermore, by reducing the current profitability of financial assets, this approach serves indirectly as a powerful stimulus for the voluntary transformation of debt into capital. It encourages a natural transition to a stage of debt restructuring alongside the conventional refinancing of the flow of funds. It speeds the move out of the Age of Debt into a more promising and efficient Age of Capital.

Deliberate political action must be taken to modify external and internal conditions and to correct disequilibria by building a solid market economy and stronger ties with the outside world. Recent experience all too painfully proves that the economic model based on growth with indebtedness and an omnipresent state no longer works. A new approach is needed, in which the state returns to its role as social agent. It should be used as an instrument to consolidate the economic infrastructure, and especially as a vehicle for technological innovation through support of research. It must help establish stable conditions for entrepreneurial initiative and creativity that will be the driving force behind a new stage of development.

FOOTNOTE

1. Three alternative proposals are worth mentioning. One is to substitute long-term inflation-indexed bonds for present debt to the banks, with the inflationary components capitalized and debtor countries paying a real rate of interest. Another proposal is to create an institution that would buy, probably at market price, some of the Third World debt, of which the basic funding would be provided by the issuance of special drawing rights.

A third approach, developed by U.S. Senator Bill Bradley, is to convene a summit conference including representatives from all major creditor countries, as well as banks from Europe, the United States, Canada, and Japan. As a goal for a yearly trade relief package to be developed at the summit and offered to eligible countries, the Senator proposes the following: interest rate relief of three percent for one year on all outstanding commercial and bilateral loans, a three percent write-down and forgiveness of principal on all commercial and bilateral loans, and three billion dollars of new multilateral project and structural adjustment loans. The value of each year's trade relief package would depend on each debtor country's use of the previous year's package, evaluated against six criteria for reform including liberalization of trade and improved conditions for internal investment and economic growth.

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