Viewpoints of the AFL-CIO

on the

Latin American International Debt Problem

presented by

Henry B. Schechter

Deputy Director, Department of Economic Research

American Federation of Labor and Congress of Industrial Organizations

at the

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Highlights and Recommendations

For two years, Latin American countries have suffered from a combination of debt and economic crises. The increase in external debt of the countries accelerated after 1973 when large private banks located in industrialized countries were recycling the surplus petrodollars that the OPEC countries had accumulated after they raised oil prices. As Latin American countries borrowed, their external debt increasingly was owed to private bankers, instead of to other governments and multilateral public institutions. Also, more and more of the loan interest rates were adjustable in accordance with changes in recognized commercial loan market rates, such as the U.S. prime rate or the LIBOR rate.

The OPEC oil price shocks in 1973 and 1979 helped to set off inflationary pressures in industrial as well as developing countries. Toward the end of the seventies and in the early eighties, the United States adopted tight money policies in attempts to fight inflation, generating high interest rates. In 1981, there was also a reduction in U.S. budgetary expenditures for social programs, which combined with high interest rates to reduce economic demands. The U.S. economy went into a deep recession in 1981 which continued through almost all of 1982 and spread to other industrialized countries.

Economies of Latin American countries also were hurt by a decline in demands from the U.S. for agricultural, mineral, and manufactured goods, decreasing their exports to the U.S. at the same time that their debt service payment requirements increased because the adjustable interest rates on their loans were rising. Increasing unemployment and a deficit trade balance led to the combined debt and economic crises in Latin America. The economic declines in the U.S. and Latin America fed upon each other, as both experienced declines in demands for their exports.
A slowdown of economic growth affected both the large and small countries of Latin America in 1981, followed by actual declines of gross domestic product in 1982 and 1983.

By the end of 1983, the combined outstanding Latin American external debt was $336 billion, of which 86 percent was concentrated in the seven largest countries. The smaller countries, however, also suffered the hardships of high debt burdens and austerity adjustment programs. That was illustrated by the unrest focused on ransacking of food stores in the Dominican Republic, as well as in Brazil, and by the economic chaos which led to default on its external debt by Bolivia.

Efforts to remedy the situation have included a restructuring of a country's outstanding external debt, negotiated by the government with the private bank creditors and with participation by the International Monetary Fund. The bankers, almost invariably, will not agree to any debt restructuring plan until the country has agreed to an IMF-approved economic adjustment plan. Since the debtor countries are in need of debt restructuring in order to avoid loan default and a cutoff from international credit, they have little choice but to accept many conditions for an austerity economic adjustment program which the IMF recommends.

Workers in the affected countries had little or nothing to say about the terms and growth of the debt or of subsequent adjustment programs. Yet, through increased unemployment and reduced real wages, workers have borne the brunt of adjustment program austerity. Workers in industrial countries have also suffered increased unemployment, and the head of the IMF, based on a partial analysis of factors involved and many dubious assumptions, has said that the wages of workers in industrial countries have increased too much to be compatible with more socially acceptable levels of employment. This is an unjustified conclusion.
It is believed that, armed with appropriate information and understanding of the processes which created and carry forward the current crises, the labor movements of the various countries can influence their governments, and through them the international public entities involved, to pursue less harsh and more effective remedial policies and programs. Toward that end, the AFL-CIO analysis of the origins and magnitudes of the debt problem, the adjustment processes and their effect, and proposed modified and supplementary remedial measures are presented in the full paper. In the rest of my allotted time, I will briefly describe the recommendations.

Judging from the record, the attempts over the last few years to cure Latin American debt problems have thus far managed to avert default in all but one country. It is doubtful, however, whether any Latin American country with a serious external debt problem is out of danger of having to default on loans or of having a social upheaval that would precede debt repudiation. In order to improve the possibilities for a lasting emergence from present debt and economic crises for countries in those conditions, and for countries that might in the future encounter such problems, certain changes in policies and remedial programs by all the parties involved are in order.

First, in addressing the conditions of countries presently under economic adjustment and restructured debt programs, but still facing critical financial, economic, and social problems, as well as for future applicants for such programs, consideration must be given to salutary basic policy and program changes to be adopted where appropriate. It must be recognized that IMF adjustment programs which include cutbacks in real wages and rigid restrictions upon imports are not the only possible approach to an attempted restoration of stable economic growth and the ability to meet debt repayment obligations. In fact, the success rate of that
approach in Latin America is still to be established; and it may turn out to be counterproductive in a number of cases.

An alternative approach, designed to increase real economic growth, would often require debt restructuring that includes grace periods on principal repayments, longer loan repayment periods, limitations on spreads above LIBOR or U.S. prime interest rates and on commissions or fees for restructuring and refinancing. Also, to promote capability to carry out economic adjustment and development programs, annual debt service payments should be in a fixed amount. That can be arranged either through fixed interest rate financing, or provisions to capitalize any increase in required interest payments and commensurately increase the maturity of the loan. Such provisions have been proposed recently by some of the larger Latin American countries in their proposals for debt restructuring. As the Bank for International Settlements has indicated, it would be in the best interest of the private bank creditors to increase loan amounts and maturities to countries that have improved their current accounts. It would also help in other cases.

With such more liberal restructured debt arrangements, economic adjustment program modifications could be adopted that would reduce the risk of pushing countries beyond the bounds of political tolerance. Modifications could be designed to inject more equity and economic balance into adjustment programs and, thus, increase the likelihood of inducing more stable economic growth. To help maintain domestic economic demand and avoid a contraction in the economy and in employment, programs should avoid cutbacks in already low consumption patterns. To the extent that debt restructuring and economic recovery will permit, there should be upward wage adjustments to restore real wages to levels that prevailed before cutbacks under economic adjustment programs; and workers should be free to bargain for wage increases as increased productivity increases the national real
income. An expanded domestic market would then serve to encourage further investment and economic growth. As the total gross national product increases, there would also be more savings for investment and more products for export, to provide foreign exchange for external debt repayments.

In order to make adjustment programs more politically tolerable, and effective for purposes of combatting inflation and providing more revenue for repayment of public debt, the governments being assisted should be induced by the IMF to improve the tax structure, to make it more equitable and more effective. That would require changes in tax laws, to reduce exemptions and deductions, so that the progressive personal income tax schedules and corporate income tax rates would be meaningful. Equally or more important, there should be increased tax enforcement and tax collections should be improved.

Economic growth should not be so hampered by adjustment program restrictions upon imports that necessities for industrial operation and for human health become scarce and hamper the maintenance and growth of economic output. In that connection, excessive devaluation of the currency, which gives rise to a combination of reduced purchasing power of wages and to price inflation, should not be called for by an adjustment program. Devaluations that cause prices of imported goods to rise, not only restrict imports but also spur inflation, which will cause anticipations of further currency devaluations and encourage the flight of capital to other countries. Rising prices of imports also will mean reductions of imports from industrial countries, causing them to have increased unemployment and possibly economic recessions. There is then a rebound effect upon the less industrialized countries as demand for their exports falls off.

To prevent capital flight, which is apt to follow currency devaluation and anticipation of further devaluation, the adjustment program should provide for hard
rules against such capital flight and for machinery to enforce them. Enforcement could be greatly enhanced if the IMF would use its good offices with its member governments and the banking community to establish international cooperation for enforcement of rules against capital flight that are established by any country. The cooperating countries and banks throughout the world should be prepared to refuse to accept capital inflows that represent illegal capital flight from other countries.

To achieve an alignment of international exchange values of currencies that will not lead to great trade imbalances and worldwide recession, an international forum is needed for continuous consultation by the monetary authorities of significant international trading nations. The objective of such consultations would be for countries to cooperatively make such periodic coordinated adjustments in domestic monetary policies affecting interest rates and currency values, that it would also create an equilibrium of international exchange rates that would preclude great trade imbalances which lead to trade curtailments and recession. The IMF already has an obligation to maintain surveillance of international exchange rates. It should, with the encouragement and cooperation of leading economic nations, move forward to establish the necessary international cooperative monetary policy forum that is needed.

Assuming that the foregoing monetary and exchange rate policy remedies are adopted and implemented, a good deal of current competitive disadvantage for American industry would be overcome, particularly in relation to major industrial trading partners. With respect to less developed industrial countries, however, the competitive pricing gap would not be wholly closed because of a huge wage gap relative to countries where wages amount to only a minor fraction of wages paid for comparable work in the United States.
If increasing penetration of the U.S. market by products from such countries continues, it would mean a continuing and growing high level of unemployment in the United States and a contraction of the U.S. economy. Since the U.S. domestic market is the largest market in the world, when it contracts, the developing countries have a reduced market for their materials and manufactured products, and their economies decline. This was illustrated during the 1981-82 recession. It probably will be necessary, therefore, after all the monetary policy and supplementary remedies to improve U.S. competitiveness have been adopted, for the U.S. to adopt some quota or other protectionist measures against products from countries whose very low wage levels leave an insurmountable remaining price gap.

The U.S. economy was able to grow over the last two centuries because as the country became increasingly industrialized and productivity increased, the increased income was widely distributed in higher wages. Unionization helped in this process. Distribution of income, therefore, was such that there was a balance between production and purchasing power, although interrupted periodically for business cycle adjustments. Now that the U.S. is part of an interdependent international economy, it can be adversely affected by the growth restricting effects of a very skewed income distribution that prevails in newly industrializing countries, especially where governments do not permit free union efforts to obtain an income distribution that would support balanced growth. There may be temporary benefit to those countries with extremely low wages in steadily increasing their shares of domestic product markets in the U.S. and other industrial countries. As such penetration of markets in countries with less income inequality increases, however, it will cause unemployment and contraction of the industrial economies, who will suffer a contraction of the major market for the exports. The rebound effects will weaken the economies of the developing countries and of the world economy.
In the 1984 international economy, a balance between demand supported by adequate purchasing power and the supply of goods and services produced is necessary in order to have stable economic growth. It is not possible to achieve such a balance and such growth as long as workers, wherever they may be, receive wages equal to an inequitable, low fraction of the selling price of goods and services that they produce. Desired equity generally cannot be achieved in the absence of a democracy in which free unions can bargain for the workers.

Introduction

The ongoing Latin American debt crisis passed its second anniversary in August 1984. It is accompanied by national economic crises as repeated debt renegotiations go on in one country after another. A usual prerequisite for debt restructuring by bank creditors is the institution of an economic adjustment program approved by the International Monetary Fund (IMF). Adverse economic effects of required increased debt service payments and economic adjustment programs have been felt in the countries of the debtors and in the countries of their bank creditors. In both, the workers have suffered related unemployment.

Under the IMF-approved economic adjustment programs, placed in effect during the past few years, the Latin American countries with large debts had to restrict imports and consumption to a degree which caused declines of people's purchasing power and total economic activity. Unemployment increased; and there was explosive social unrest, including the ransacking of food stores in Brazil and in the Dominican Republic, which led to the death of dozens of people. In the United
States, the leading trading partner of Latin America, there also was related unemployment because of drastic reductions of imports from the U.S. by Latin American countries.

Workers have borne the brunt of the accumulated debt problems and the negotiated adjustment programs. They had little or nothing to say about the terms and cumulative growth of the debt or the subsequent adjustment programs. Yet, adjustment programs have been framed to require reduced real wages and living standards for workers in debtor countries without calling for equitable sharing of sacrifice from other social groups. Continued deep recessions and import restrictions in the countries under adjustment programs has meant a higher level of unemployment than would otherwise prevail for workers in the countries of the creditors. The latter have then also been subjected to pressures from domestic and international sources that their real wages should be restricted to enhance the return to capital and thereby encourage investment.

It is believed that, armed with appropriate information and understanding of the processes which created and carry forward the current crisis, the labor movements of the various affected countries can influence their governments, and through them the international public entities involved, to pursue less harsh and more effective remedial policies and programs. Toward that end, the AFL-CIO analysis of the origins and magnitudes of the debt problem, the adjustment processes and their effect, and proposed modified and supplementary remedial measures are presented in this paper.

**Latin America: The Region**

The nineteen countries which are included in most of the economic data shown for Latin America (in Table 1) increased in total population from 303 to 369 million between 1975 and 1983. That represented an average annual increase in population of 2.7 percent, which was also the percentage increase for 1982-83.
## TABLE 1

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<td><strong>Latin America: Main Economic Indicators</strong></td>
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<td><strong>Gross Domestic Product at Market Prices (Billions of Dollars at 1970 Prices)</strong></td>
<td>263</td>
<td>292</td>
<td>305</td>
<td>326</td>
<td>345</td>
<td>350</td>
<td>347</td>
<td>335</td>
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<td><strong>Population (Millions)</strong></td>
<td>303</td>
<td>318</td>
<td>326</td>
<td>334</td>
<td>343</td>
<td>351</td>
<td>359</td>
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<td><strong>Per Capita Gross Domestic Product (Dollars at 1970 Prices)</strong></td>
<td>868</td>
<td>916</td>
<td>936</td>
<td>974</td>
<td>1,007</td>
<td>997</td>
<td>965</td>
<td>911</td>
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<td><strong>Per Capita Gross National Income (Dollars at 1970 Prices)</strong></td>
<td>867</td>
<td>918</td>
<td>929</td>
<td>972</td>
<td>1,009</td>
<td>985</td>
<td>938</td>
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<td><strong>Growth Rates</strong></td>
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<td>Gross Domestic Product</td>
<td>3.7</td>
<td>5.0</td>
<td>4.7</td>
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<td>5.9</td>
<td>1.5</td>
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<td>2.4</td>
<td>2.2</td>
<td>4.0</td>
<td>3.4</td>
<td>-0.9</td>
<td>-3.3</td>
<td>-5.6</td>
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<tr>
<td>Per Capita Gross National Income</td>
<td>-0.3</td>
<td>2.5</td>
<td>1.3</td>
<td>4.6</td>
<td>3.8</td>
<td>-2.4</td>
<td>-4.8</td>
<td>-5.9</td>
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<td>Consumer Prices</td>
<td>57.8</td>
<td>40.0</td>
<td>39.0</td>
<td>56.1</td>
<td>52.8</td>
<td>60.8</td>
<td>85.6</td>
<td>132.9</td>
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<td>Terms of Trade (Goods)</td>
<td>-14.0</td>
<td>6.0</td>
<td>-10.9</td>
<td>4.4</td>
<td>4.2</td>
<td>-7.3</td>
<td>-7.0</td>
<td>-7.2</td>
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<td>Current Value of Exports of Goods</td>
<td>-7.1</td>
<td>18.9</td>
<td>7.3</td>
<td>34.3</td>
<td>30.1</td>
<td>7.0</td>
<td>-8.5</td>
<td>-1.3</td>
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<tr>
<td>Current Value of Imports of Goods</td>
<td>7.0</td>
<td>14.8</td>
<td>13.8</td>
<td>25.8</td>
<td>30.1</td>
<td>7.6</td>
<td>-19.9</td>
<td>-28.7</td>
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</table>

### Notes:

**A/** The figures for the product, population, and income relate to the following countries: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, and Venezuela. The consumer price figures refer to all the above countries, plus Barbados, Guyana, Jamaica and Trinidad and Tobago (with the exception of Guyana in 1982 and Guyana and Haiti in 1983). The data for the external sector refer to all the countries listed other than Jamaica, except in the case of the figures for the external debt, which also exclude Barbados and Trinidad and Tobago.

**B/** Preliminary estimates, subject to revision.

**C/** Variation from December to December.

**D/** Includes net unrequited private transfer payments.

**E/** Includes long- and short-term capital, unrequited official transfer payments, and errors and omissions.

**F/** Corresponds to the variation in international reserves (with the opposite sign) plus counterpart entries.

**G/** Includes public and state-guaranteed private external debt plus the long- and short-term non-guaranteed debt with financial institutions reporting to the Bank for International Settlements. Excludes both guaranteed and non-guaranteed debts with other commercial banks, as well as suppliers' credit without state guarantees. The 1981-1983 period includes official estimates of the total external debt; the figures therefore have a broader coverage and cannot, in a strict sense, be compared with those of the preceding period.

Unlike the population, the regional economy did not follow a steady growth trend throughout the 1975-83 period. The Gross Domestic Product, adjusted for price changes, rose by an average of 6.2 percent a year in the 5 years from 1975 to 1980. In the following year, however, the increase in GDP was less than 2 percent; in 1982, it declined by 1 percent; and in 1983, it declined by 3.5 percent. On a per capita basis, the GDP began to decline after 1980, with the decline averaging more than 3 percent a year between 1980 and 1983.

There was an even sharper decline in the per capita national income measured in constant prices, which declined by more than 4 percent per year between 1980 and 1983. Furthermore, the level of the per capita national income, adjusted for price changes, peaked in 1980 at $1,009 and then declined each year after that, to $833 in 1983. All of the foregoing regional data are based on figures shown in Table 1.

Available data for 1979 as to the per capita Gross National Product (GNP) for individual countries show that the highest per capita output among the larger Latin American countries was achieved in those countries which have natural resources for extraction or growth of large quantities of exportable commodities. Thus, the highest per capita GNP was in oil-exporting Venezuela, which at that time had a per capita figure of $2,763. The second highest was in wheat-exporting Argentina, with $2,530. Brazil, the largest country in the region had a per capita GNP of $1,677; and Chile and Mexico were slightly under $1,500. (Mexico benefited from the increase in oil prices after 1979 when it initiated its large oil exports.) In Colombia and Peru, the comparable figure was less than $1,000.1

Table 2 shows some of the main economic indicators, separately for the seven large debtor countries, identified as the selected countries, and for the other Latin American countries, for the years 1978-83. Although both groups experienced a
### TABLE 2

Main Economic Indicators 1978-83 for Selected Countries and Other Countries of Latin America

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<tbody>
<tr>
<td>GDP Growth (%)</td>
<td>4.5</td>
<td>6.7</td>
<td>6.0</td>
<td>1.2</td>
<td>-1.2</td>
<td>-3.5</td>
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</table>

#### Balance of Payments (U.S. $ millions)

- **current account**: -14,453 -14,456 -22,138 -33,304 -31,274 -11,429
- **trade**: -1,684 1,780 116 630 10,992 26,819
- **nonfinancial services**: -4,402 -5,797 -7,600 -10,612 -9,008 -5,609
- **financial services**: -8,617 -11,634 -13,093 -23,881 -33,444 -33,146
- **transfers**: 155 218 439 560 189 507

#### Total External Debt (U.S. $ millions)

- 126,839 157,185 199,081 243,738 271,943 291,397

#### External Debt Service (U.S. $ millions)

- **debt service ratio (%)**: 46.1 46.9 42.0 47.8 65.1 68.2
- **interest payments (%)**: 17.8 20.6 23.0 28.8 37.1 39.3

#### Total External Borrowing (U.S. $ millions)

- 31,880 34,362 46,459 50,694 32,965 22,697

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<tr>
<td>GDP Growth (%)</td>
<td>5.0</td>
<td>2.7</td>
<td>4.1</td>
<td>1.6</td>
<td>-2.3</td>
<td>-6.1</td>
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</table>

#### Balance of Payments (U.S. $ millions)

- **current account**: -2,958 -3,271 -4,305 -5,580 -5,057 -4,986
- **trade**: -1,829 -2,171 -2,665 -3,403 -2,425 -1,481
- **nonfinancial services**: 137 -64 -602 -689 246 234
- **financial services**: 1,483 1,781 -2,845 -3,547 -3,237 -3,740
- **transfers**: 486 742 603 680 356 0

#### Total External Debt (U.S. $ millions)

- 25,136 27,008 29,973 35,959 42,415 44,833

#### External Debt Service (U.S. $ millions)

- **debt service ratio (%)**: 27.9 29.7 23.3 25.8 32.8 45.1
- **interest payments (%)**: 11.9 13.6 13.7 15.9 22.1 29.5

#### Total External Borrowing (U.S. $ millions)

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<tr>
<td>7,918</td>
<td>3,057</td>
<td>4,469</td>
<td>7,500</td>
<td>9,020</td>
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<tr>
<td>6,913</td>
<td>1,872</td>
<td>2,965</td>
<td>5,986</td>
<td>6,455</td>
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<td>1,491</td>
<td>1,927</td>
<td>2,107</td>
<td>2,194</td>
<td>2,921</td>
<td>2,000</td>
</tr>
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* Includes Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela
# Preliminary

similar pattern of high economic growth in the years 1978-80, a slowdown in 1981, and negative growth in 1982-83, the smaller countries did not achieve as high growth rates as the larger, selected countries and experienced relatively greater economic decline. It is also evident that as far as the external debt, debt service, and external borrowing are concerned, the seven selected countries are responsible for a great major part of the related responsibilities and problems. That does not mean, however, that the workers and other people of the smaller countries do not feel similar burdens.

**Evolution of the Debt Problem**

By the end of 1983, the combined outstanding external debt of the Latin American countries was estimated at $336 billion. However, 86 percent of that total amount is concentrated in seven selected, larger countries: Brazil, 27 percent; Mexico, 26 percent; Argentina, 12 percent; Venezuela, 10 percent; Chile, 5 percent; Colombia, 3 percent; and Peru, 3 percent. Other Latin American countries which owe smaller proportions of the total external debt of the region include Costa Rica, the Dominican Republic, Ecuador, Bolivia, Jamaica, Nicaragua, and Uruguay.

During the decade of the sixties, the Latin American economies progressed smoothly. External resources obtained through borrowing were relatively moderate, to finance investments needed for economic development. The annual growth of Gross Domestic Product (GDP) averaged 5.5 percent for all Latin American countries, somewhat higher for the larger countries and somewhat lower for the smaller countries. For the entire region, during the decade, domestic demand was just about equal to GDP, reflecting balanced economic growth and only modest expansions of current account balance deficits.
TABLE 3

Latin America: GDP, Domestic Demand and Current Account of Balance of Payments, 1960-83 (percentages)

I. Average annual variation in GOP

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<tr>
<td>Selected countries</td>
<td>5.7</td>
<td>7.4</td>
<td>5.2</td>
<td>6.0</td>
<td>1.2</td>
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<tr>
<td>Argentina</td>
<td>4.3</td>
<td>3.7</td>
<td>1.9</td>
<td>1.1</td>
<td>-5.9</td>
<td>-5.4</td>
<td>1.3</td>
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<td>Brazil</td>
<td>5.8</td>
<td>11.3</td>
<td>6.4</td>
<td>7.9</td>
<td>-1.9</td>
<td>---</td>
<td>-6.2</td>
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<tr>
<td>Chile</td>
<td>4.5</td>
<td>1.1</td>
<td>3.4</td>
<td>7.8</td>
<td>5.7</td>
<td>-14.3</td>
<td>-2.7</td>
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<td>Colombia</td>
<td>5.1</td>
<td>6.8</td>
<td>5.0</td>
<td>4.1</td>
<td>2.3</td>
<td>0.9</td>
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<td>Mexico</td>
<td>7.0</td>
<td>6.8</td>
<td>6.1</td>
<td>8.3</td>
<td>7.9</td>
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<td>Peru</td>
<td>5.0</td>
<td>6.3</td>
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<td>Venezuela</td>
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<td>5.4</td>
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<td>0.4</td>
<td>0.6</td>
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<td>Latin America</td>
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<td>1.2</td>
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<td>-3.7</td>
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</tbody>
</table>

II. Domestic demand as a percentage of GDP

<table>
<thead>
<tr>
<th></th>
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<th></th>
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</tr>
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<td>101.6</td>
<td>102.9</td>
<td>104.6</td>
<td>106.1</td>
<td>103.4</td>
<td>99.1</td>
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<td>100.2</td>
<td>97.8</td>
<td>104.0</td>
<td>102.7</td>
<td>96.1</td>
<td>98.0</td>
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<tr>
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<td>99.8</td>
<td>101.8</td>
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<td>102.9</td>
<td>104.0</td>
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<td>107.3</td>
<td>104.9</td>
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<td>101.5</td>
<td>101.7</td>
<td>105.2</td>
<td>107.0</td>
<td>99.8</td>
<td>96.8</td>
</tr>
<tr>
<td>Peru</td>
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<td>100.5</td>
<td>98.5</td>
<td>103.9</td>
<td>98.5</td>
<td>97.1</td>
</tr>
<tr>
<td>Venezuela</td>
<td>87.1</td>
<td>97.6</td>
<td>121.9</td>
<td>133.5</td>
<td>124.0</td>
<td>124.9</td>
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<tr>
<td>Other countries</td>
<td>103.3</td>
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<td>103.0</td>
<td>102.6</td>
<td>100.9</td>
<td>98.9</td>
<td>100.7</td>
</tr>
<tr>
<td>Latin America</td>
<td>99.7</td>
<td>101.8</td>
<td>102.9</td>
<td>104.4</td>
<td>105.5</td>
<td>102.9</td>
<td>99.3</td>
</tr>
</tbody>
</table>

1 Preliminary estimates, based on information available as of Dec. 1983.
2 Calculated on the basis of figures at constant prices.
3 Sum of consumption expenditure (private and public) and gross domestic investment.

Source: IDB, in accordance with official statistics of the member countries.

During 1970-74, domestic demand for goods and services for consumption plus investment in Latin American countries began to exceed the Gross Domestic Product. The increasing gap between domestic demand and total resources devoted to consumption plus investment, as indicated by the figures in panel II of Table 3, resulted in an increased external trade deficit, supported by increased borrowing.
The latter part of this period was marked by the formation of OPEC and the oil price shock, which was bound to have an effect upon the non-oil producing countries of Latin America. It also marked the beginning of the recycling of petrodollars. The nondeveloped, oil producing countries of the world benefited from the greatly increasing oil prices and accumulated large surpluses of hard currencies, primarily dollars. The surplus funds were invested in securities, in bank deposits, and in real estate of the leading industrial countries. The leading banks of those countries then undertook to recycle the dollars by making loans to developing countries around the world. The lending of these funds, including a significant amount that went into Latin American countries and continued through the second half of the seventies, has been described as follows:

"The financial permissiveness shown by the international private banking system in the second half of the 1970s and the intense and persistent efforts it made to loan its financial surpluses to Latin America encouraged a policy of external indebtedness on a scale without any precedent in the region in the last half century. There were few countries in Latin America which did not follow this policy in order to finance domestic policies with widely varying aims, ranging from some which involved large investments that even overestimated the future expansion of domestic and international markets to others which promoted an exaggerated expansion of consumption -- especially of imported goods -- or a big increase in defense spending. In recent years, furthermore, a considerable and growing proportion of external financing was used to pay the servicing costs of the accumulated debt, so that this situation was accompanied in practice by a reduction in the real transfer of resources to Latin America."  

There was also an important change in the composition of the debt which should be noted. In 1975, 21.5 percent of the total outstanding Latin American debt was owed to either foreign governments or multi-lateral organizations, such as the World Bank; and 78.5 percent was owed to private creditors, with 69 percent being owed to private banks. In 1981, the non-private creditor proportion had decreased to 11.7 percent, and the private portion had grown to 88.3 percent, with 82.1 percent being owed to private banks. The change in debt composition and terms over the
entire decade of the seventies was even greater, because at the beginning about 40 percent of the credit flows were private, and a decade later 80 percent were private; maturities were shortened, and there was a shift from fixed to variable rates. It is believed that in 1983 and in 1984, as new debt restructuring plans had gone into effect, there has been a further increase in the proportion owed to private banks, which had to increase their outstanding loan amounts, along with advances by the IMF, so that the debtors could continue to pay interest.

Evolution of Economic Crises

As can be seen in Table 3, the excess of demand over Gross Domestic Product continued to grow larger in the first two years of the 1980s. There had been another significant boost in the oil prices in 1979 which helped to stimulate worldwide inflation and greatly increased the borrowing needs of the non-oil producing, developing countries, marking the end of the 1970s and the beginning of the 1980s. In the leading Western industrial countries, there were continuing high interest rates, reinforced in the United States by a tight money policy that was adopted to counter inflation.

Added to the tight monetary policy, in 1981 there was a change in fiscal policy in the United States. It involved a tax reduction program which was to take place mostly in 1982 and 1983. It also involved a cutback in budgetary expenditures for social programs. The latter measure reduced the purchasing power of many low-income families. That effect was combined with the continuing high interest rates, which discourage investment and initially tend to raise prices as business borrowers try to recoup higher costs of credit in higher prices. The U.S. economy went into a deep recession during the second half of 1981 and almost all of 1982.

These significant economic changes in the United States during the early 1980s had an impact upon the Latin American countries. Most of the outstanding
debt owed by governments and private borrowers in Latin America was in **floating interest rate loans**, tied to either the U.S. prime rate or the London Inter-Bank Offering Rate (LIBOR). As these interest rates rose, the interest rates on the Latin American debt also rose and increased the debt service required. At the same time, as the U.S. economy succumbed to the continued burden of high interest rates, with many business failures and increasing unemployment, the demands for U.S. imports of agricultural, mineral, and manufactured products from other countries declined.

What followed highlights the interdependence of different national economies in a world economy which has become much more integrated. The Latin American countries, especially the leading countries which had been exporting a good deal to the United States, faced drastic declines in such export trade (as did countries in other parts of the world). Consequently, Latin American international product sales fell off. Urban unemployment rose in Argentina from 2.0 percent in 1979 to 4.5 percent in 1981, and 4.9 percent in 1983; in Brazil, over the same years, it went from 6.4 percent to 7.9 percent and then down to 6.8 percent; in Bolivia, from 6.2 percent to 9.7 percent to 12.6 percent; in Columbia, from 8.9 percent to 8.2 percent to 11.0 percent; in Chile, from 13.4 percent to 9.0 percent to 19.7 percent; Mexico, from 5.7 percent to 4.2 percent to 12.5 percent; and in Peru, from 6.5 percent to 6.8 percent to 8.8 percent.2/ The foregoing figures related only to urban unemployment and, in some instances, are based on reports for only a few large cities. There are indications of much greater unemployment in the countries than is reflected in those figures. In August 1984, it is reported that the unemployment rate in Brazil is 13 percent; but DIEESE, the union research institute of Brazil, calculated that it would take eight more years to restore employment to the 1980 level, while a million young Brazilians join the job market every year.9/
Another 1984 report, on Bolivia, which has a relatively modest foreign debt of U.S. $4.5 billion and a 1983 urban unemployment rate of 12.6 percent, mentions that in three years of economic decline since 1980, the per capita income has fallen by one-quarter. Inflation is running at about 35 percent a month. It would require an amount equal to 40 percent of the value of this year's exports to service the foreign debt. The government has been seeking an IMF standby credit of $350 million, which is about as much as the World Bank would then lend it. However, that would require acceptance of a tough economic adjustment program, as a condition for a private debt restructuring program. The conditionality reportedly included devaluing the peso from 500 to 2,000 against the dollar, removal of all food subsidies, and a 400 percent increase in domestic gasoline prices. There was some question of the approval of the program by IMF, however, because in April Bolivia had permitted an inflation compensatory award of $24 a month, more symbolic than realistic. The workers, however, want wages indexed to inflation and a moratorium on debt repayments until Bolivia can afford to make them. There are also observers who claim that the proposed devaluation of the peso would increase inflation from 320 percent in 1983 to 2,000 percent in 1984. At one point, Bolivia just managed to pull itself back from default on its international loans.

At its height, unemployment in the United States towards the end of 1982 was at a 10.7 percent rate, representing about 12 million unemployed. Today, the United States has a 7.4 percent unemployment rate, representing some 8½ million fully unemployed, besides several million involuntarily employed only part time. Part of the high U.S. unemployment relates to conditions of the IMF debt restructuring programs.
The Latin American countries, particularly as they adopted adjustment programs negotiated with the International Monetary Fund as part of the debt restructuring programs, severely cut back their imports. That was a factor in a huge U.S. negative balance of merchandise trade, which amounted to $69 billion in 1983 and is running at an annual rate of $120 billion in 1984. Thus, the decline of the U.S. economy led to a reduced external demand for Latin American products, weakening the economies of that region; contracting economies plus austerity programs in the Latin American debtor nations, reacted adversely upon the demand for U.S. products. There has to be balance in domestic economies, as well as in the international economy, if the national and international economies are to have stable growth.

As the Latin American countries suffered increased deficits in their trade and current account balances and consequently did not have enough to pay even the interest on outstanding debts, let alone the scheduled repayments of principal, more had to be borrowed from banks in the creditor countries; and the increase in the outstanding debt accelerated in the last few years.

The effects of the current economic crisis in Latin America were described by one authority on the region as follows:

"Per capita income has actually been falling in most countries. Whiplashed by the global recession, governments are under tremendous pressures to cut back on social welfare programs. Already meager social provisions are being withdrawn at the very moment when real wages are falling and unemployment lines are lengthening. Beggars are reappearing in Latin capitals where they had become only a sad memory, infant malnutrition is rising, and typhoid, malaria, and other diseases are spreading where medicines are in short supply. In brief, the gains in social welfare accumulated in Latin America over a generation are being undone by a cruel international economy.

"Latin America today is littered with underutilized machines and men. This wasted capacity and the resulting lost output can never be recovered."

As indicated by figures on the per capita income in 1979, which were cited earlier, ranging from less than $1,000 in Colombia and Peru to a high of about $2,800 in Venezuela, incomes in the Latin American countries are relatively limited even in a prosperous year. In the current years of economic crisis, the limited purchasing power of a high proportion of the population is reduced even further. Prevailing high interest rates, combined with the reduction of demand for goods and services is bound to discourage investment and economic growth. Increased levels of investment and production are not likely to be an enduring characteristic of most of the Latin American economies, because of the great inequality of income distribution as well as the low level of incomes, which limit opportunities for the growth of market demand to stimulate increased capital investment and growth of productivity. Table 4 presents in summary fashion the available data on income distribution in 7 Latin American countries and in the United States. The figures for the various countries are for different years; and there probably have been subsequent changes, as indicated by the change between 2 years for which United States data are shown. The figures, therefore, cannot be used for accurate inter-country comparisons or as current measures of inequality. However, as the U.S. figures for 1972 and 1981 indicate, the changes probably have not been great and the suggested great differences in relative inequality among countries permit some inferences to be drawn.

The measures of inequality shown are the percentage share of income of the poorest 40 percent of households and the ratio of the share of the highest 20 percent to the share of the lowest 20 percent of households. Among the Latin American countries for which data are available, only Argentina and Chile come close to the United States in having relatively less income inequality than most
TABLE 4

Comparisons of Income Inequality for Certain Latin American Countries, South Korea, and the United States

<table>
<thead>
<tr>
<th>Country</th>
<th>Data Year</th>
<th>Percentage Share of Income of Poorest 40% of Households</th>
<th>Ratio of Share of Income of Highest 20% to Share of Lowest 20% of Households</th>
</tr>
</thead>
<tbody>
<tr>
<td>Colombia</td>
<td>1974</td>
<td>11</td>
<td>17</td>
</tr>
<tr>
<td>Argentina</td>
<td>1970</td>
<td>14</td>
<td>11</td>
</tr>
<tr>
<td>Chile</td>
<td>1968</td>
<td>13</td>
<td>12</td>
</tr>
<tr>
<td>Venezuela</td>
<td>1971</td>
<td>13</td>
<td>14</td>
</tr>
<tr>
<td>Peru</td>
<td>1972</td>
<td>7</td>
<td>32</td>
</tr>
<tr>
<td>Brazil</td>
<td>1980</td>
<td>10</td>
<td>20</td>
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<tr>
<td>Mexico</td>
<td>1977</td>
<td>10</td>
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<td>United States</td>
<td>1972</td>
<td>15</td>
<td>10</td>
</tr>
<tr>
<td>United States</td>
<td>1981</td>
<td>14</td>
<td>11</td>
</tr>
</tbody>
</table>

**SOURCES:**


countries. The Chilean figures may be most significantly out of date, given the radical change in government and economic policies since 1973. The two largest Latin American countries, Brazil and Mexico, have much greater inequality than the United States. Thus, in the United States, the bottom 40 percent of the households accounted for 15 percent of household income in 1972 and 14 percent in 1981. In Brazil, they accounted for only 10 percent of the total income in 1980; and in Mexico, 10 percent in 1977. Also, while in the United States the top 20 percent of the households have a share of total income 10 times as great as that of the bottom 20 percent in 1972 and 11 times as great in 1981, in Brazil the comparable multiple in 1972 was 20 times; and in Mexico in 1977 it was 17 times as great.

It must be noted that in Brazil (from 1970 to 1980) and in Mexico (from 1963 to 1977) there had not been any dramatic changes in household income distribution. However, there had been increases in the average real income in each country. In Brazil, the price-adjusted average monthly income had increased from 8,013 to 11,940 cruzeiros. It was also remarked that, "The observed increase in literacy, the expansion and increased distributional equality, improved sanitation facilities, and increased household possession of consumer goods and services, all suggest substantial improvements in living standards and welfare over the decade of the 1970s." Nevertheless, the average per capita annual income of the economically active members of the population (excluding those with zero income) in 1980 was $2,622 in U.S. dollar terms, with an average of $639 for the bottom 40 percent and $12,600 for the top 10 percent. 12/

Data are available for Mexico for the years 1963, 1968, 1975, and 1977. Except for a temporary shift toward greater inequality in 1975, the same relative inequality seems to have prevailed. However, a general rise in income levels is indicated by the average real income for the lowest 40 percent in the household
income distribution, which rose (under one method of adjustment for underreporting) in 1977 U.S. dollars, from $565 in 1963 to $944 in 1977. Over the same period, the number of households with real income less than the 1977 minimum wage declined from 4.2 to 3.4 million; and the percentage of all households represented by those numbers declined from 57.2 to 30.3 percent.¹³/

In the United States there is some compensatory redistribution of income through the tax system with a progressive income tax schedule and a relatively good tax collection record, which has made it possible for the government to use revenues in support of social programs, such as health care, food assistance, public housing, and education. This provided a better balanced economy than the before-tax income distribution would permit and supported balanced economic growth. (The Reagan Administration has moved back from these policies.)

Latin American countries, by and large, have lower income levels and greater inequality of income distribution than the United States. They have a progressive personal income tax schedule but also have serious regressive features of their tax system. Brazil's personal income tax schedule, with rates ranging upward from 5 to 55 percent as incomes increase, is fairly illustrative of the progressive individual income tax schedules in the leading Latin American countries.¹⁴/ However, there are large deductions and exemptions in Brazil. There is a standard deduction amount, adjusted from year to year. Also capital gains, severance pay, gifts, and inheritances are deductible. There are deductions for dependents, and 25 percent of gross income in lieu of itemized deductions; also, there are deductions for social security, education, and medical expenses. On the revenue raising side, there is a sales tax of 11 to 14 percent and a tax of 3 to 15 percent on industrial products, which in most years produce much of the revenue.¹⁵/ Corporations have a 35 percent income tax rate plus surcharges above certain levels. They receive certain
tax rebates on the FOB value of exports. In Brazil, anyone engaged in export sales can have an export sales deduction equal to taxable income multiplied by a ratio of export revenues to total revenues. In addition, an employer can deduct twice the amount of expenses related to improved employee training programs and meals provided to employees, limited to 10 percent of income tax due.

In Argentina, the individual income tax rates range from 7 to 45 percent. The exemptions or deductions include interest income on savings and interest on government bonds, dividend income, and a minimum deduction for all. They have a value added tax on imported goods and on sale of local products goods of 20 percent, excluding food and medicine. Mexico, in addition to the regular income tax with standard types of deductions, also has a value added tax on the transfer of goods, services, and rentals with rates ranging between 6 and 20 percent. Peru, in addition to the individual tax, has a 16 percent general service tax.

In summary, the tax structure pattern in Latin America seems to be a progressive income tax schedule, but with deductions and exemptions that are most beneficial to the higher income groups, and high sales or value added taxes which must be paid directly or indirectly at the same rate by households of all income levels.

In addition to the resultant inequity of the total tax structure, there is also a question of the efficacy of tax collection systems. There was an interesting attempt at tax reform in Colombia by the Lopez administration in 1974 and 1975. It was hailed for its potential for raising government revenue and increasing the equity and progressivity of the tax system. In addition to increasing progressivity by changes in the income, sales, and other taxes, administrability -- for more effective collection -- was improved. It has been estimated that between 1974 and 1975 tax revenue as a percent of GNP increased from 9.0 to 10.5 percent and that
the incidence of the increased tax collections fell almost entirely on the top 20 percent of the income distribution. In 1976, revenues declined in relation to national income as the government back pedalled, and there was increasing tax evasion. The authors who recount this bit of history conclude by stating that, "Had the Lopez administration's fiscal hopes been met, the increased revenues made available by the reform would have permitted both fiscal balance and a substantial increase in expenditures directed towards the poor."16/

It has generally been recognized that in many Latin American countries, a good part of income is unreported for tax purposes, and collections are lax. This factor was given recognition in a recent speech by Argentina Economy Minister Bernardo Grinspun. Mr. Grinspun has been arguing against a provision in a proposed IMF program which would require a reduction of real wages. He argued against such austerity measures but said that the government would continue efforts to reduce tax evasions and make Argentina's tax system more progressive.17/ Of course, such improved tax collection would help reduce the government budget deficit and thereby help to hold down inflation and interest rates in the domestic economy so that more capital would be available for repayment of international debts. At the same time, by maintaining or allowing some increase in real wages, the domestic market could expand to support greater production that would permit lower unit costs through economies of scale. There also would be more potential for increased exports from a larger total national production without reductions of domestic consumption. Increased export earnings would facilitate the earning of foreign exchange with which to pay debts.

Regardless of the type of program that is adopted to bring about a better balance of payments and accumulation of foreign exchange to meet external debt service requirements, such gains are offset to the extent that there is capital flight
from a country. One international debt scholar has written that, "Perhaps one-third of foreign debt in Argentina and Venezuela, and one-fifth of that in Mexico, was caused by private capital-flight."¹⁸/ Mexico has been praised for its austerity programs and establishment of a positive merchandise trade balance --although achieved primarily by cutting imports, rather than increasing exports. Nevertheless, in a dispatch from Mexico City, published June 29¹⁹/ and in another Mexico City news story of July 22,²⁰/ there are discussions of capital flight. The June 29 dispatch mentions expectations of a further peso devaluation, because of higher than expected inflation, which is causing capital flight, much of it hidden. The U.S. Federal Reserve reportedly estimated that $1.8 billion was deposited by Mexicans in U.S. banks in the five quarters ending March 1984. Mexican exporters, it was reported, as a common practice, present underreported export invoices to the central bank and directly deposit the unreported portion in foreign banks. There also is increasing reliance on cash transactions, especially along the Mexican-U.S. border zone, allowing money to be transported north or to be converted into dollars without any paper evidence. In addition to the U.S., Mexican funds reportedly are deposited in high-secrecy banking centers in other countries. In the Cayman Islands, for example, banking authorities report more than U.S. $3 billion in Mexican bank accounts. Such estimates do not include the value of real estate investments in the U.S. and elsewhere. The July 22 news story mentions that the "errors and omissions" in the Bank of Mexico's international payments statement is viewed as an indication of capital flight. The figure reached $1.054 billion in the first quarter of 1984. It also mentioned that although the Bank of Mexico has been intervening in exchange markets to stabilize the peso at 200 to the dollar, every morning people line up before banks to change the daily maximum of $500 in pesos to dollars.
A news story from Caracas, published July 27, 1984,\(^{21/}\) points out that currency devaluation and high interest rates have brought on capital flight, and that the Bank for International Settlement had reported last year that Venezuelans had more than $17 billion deposited abroad.

The U.S. economy was able to grow over the past two centuries because of two basic factors that affected income distribution and growth. Preceding the accelerated industrial growth of the country, there had been widespread land distribution, under government sponsorship. From 1785, government land had been available for farming at $1 an acre; and in 1862, a Homestead Act was passed to give 160 acres free to anyone who would cultivate and live on the land. When industrial growth gathered momentum during the second half of the nineteenth century, there was a large base of small farm owners who, with the aid of government-sponsored research, free education, and credit programs, improved their productivity. With their earnings, they could increase their own investment in equipment and also support a growth market for manufactured goods for their farming operations and for household consumption. They also began to acquire some wealth and liquid assets that could provide some of the needed U.S. investment capital.

Then, as industrial productivity in the United States improved, the increased income was widely distributed in increased wages. Unionization helped this process, as the country became increasingly industrialized. Distribution of income, therefore, was such that there was a balance between production and purchasing power which fostered balanced economic growth, although interrupted periodically for business cycle adjustments when a temporary imbalance developed.

The two largest, and most other, Latin American countries do not have the widespread agricultural land distribution and cultivation that the U.S. had before
its accelerated industrialization got underway. The AFL-CIO's American Institute for Free Labor Development has provided technical assistance in the struggle for land reform in Latin American countries, and two of its representatives engaged in that effort in El Salvador were murdered. Most Latin American countries also have not had the widespread education and literacy of their population such as was true in the United States. They, therefore, do not have a large base of agricultural entrepreneurs with relatively good incomes, that would be reflected in a less unequal income distribution than they now have, and could support a domestic growth market for increased industrial production.

Brazil, Mexico, and Argentina were experiencing deficit merchandise trade balances in 1981; and in 1982, only Argentina had been able to achieve a surplus of exports over imports. Government and private borrowers in all of the aforementioned countries had been assuming additional debt between 1970 and 1980, and the average interest rates they had to pay had almost doubled from a range of 7 to 8 percent in 1970 to 12 to 15 percent in 1982. This serves to reinforce the point of the interdependence of national economies in the world of the 1980s. Not only is weakened economic demand in the highly industrialized countries transmitted to other less industrialized countries and vice-versa, but the effects of fluctuations in levels of interest rates will be transmitted directly through international financial transactions.

Another indirect effect of monetary policies and interest rate levels in highly industrialized countries, particularly in the United States, has impacted upon international merchandise trade balances. The pursuit of a restrictive U.S. monetary policy by the Federal Reserve Board for intermittent extended periods since the latter part of 1979, combined with the need to finance increasingly large U.S. budget deficits, helped to sustain interest rates within a range of double digit
rates during most of the 1980-84 period. This, in turn, led to significant increases in the value of the dollar relative to the value of other currencies as people from other countries exchanged their money for dollars to be invested in U.S. deposits or securities, in order to obtain high returns. The "overvaluation" of the dollar has continued during the 1983-84 U.S. economic recovery as the growth of U.S. private business and consumer credit demands caused U.S. nominal interest rates to remain high; and after inflation had declined, real interest rates were at historically high levels. In addition to causing a sharp rise in the debt service burdens of many developing countries, the continual high U.S. interest rates led to increases of between 300 and 1,300 percent in the international exchange value of the U.S. dollar relative to that of currencies of Latin American currencies between 1981 and mid-1984. During that period, the international exchange value of the dollar also appreciated 15 to 20 percent against various currencies of leading industrialized countries.

As a consequence, foreign producers, who could obtain more units of their own currency for a dollar than before, could sell their merchandise at a lower dollar price than U.S. producers in international markets and in the United States. The U.S. negative merchandise trade balance which had been at about $25 billion in 1980 rose in the next three years to $28 billion, $36 billion, and $69 billion. In the first 6 months of 1984, the cumulative deficit was $60 billion, and it is expected to be about $125 billion for the year. This experience contributed, first, to the deep U.S. recession which at that time caused a severe cutback in U.S. imports from Latin America, and currently contributes to a civilian unemployment rate of 7.5 percent, representing 8.5 million people in the U.S.

There is a need to overcome the U.S. trading disadvantage arising from an overvaluation of the dollar relative to other currencies. Cognizance of this factor
by the Federal Reserve in administering monetary policy, continuing negotiations
with other major industrial countries, and periodic coordinated market intervention
is necessary. Increased tax revenue from higher income groups to reduce the large
U.S. budget deficit and Federal borrowing is also needed to lower interest rates and
the value of the dollar.

Assuming that the foregoing monetary, fiscal, and exchange rate policy
remedies are adopted and implemented, a great deal of the competitiveness
disadvantage for American industry will be overcome, particularly in relation to
major industrial trading partners. With respect to less developed industrial
countries, however, the competitive pricing gap will not be wholly closed because
of a huge wage gap in countries where wages amount to only a minor fraction of
wages paid for comparable work in the United States.

If increasing penetration of the U.S. market by products from such countries
continues, it would mean a continuing and growing high level of unemployment in
the United States and a contraction of the U.S. economy. Not only would those
who are primarily affected by the imports, because they had been producing such
products, become unemployed, there would also be a secondary unemployment
effect because of the reduced demand for all sorts of products in the United
States, as those directly affected and unemployed had to cut back on their
purchases of goods and services. Furthermore, the U.S. domestic market is the
largest market in the world. When it contracts, the developing countries have a
reduced market for their materials and manufactured products, and their
economies decline. This was illustrated during the 1981-82 recession. It probably
will be necessary, therefore, after all the monetary policy and supplementary
remedies to improve U.S. competitiveness have been adopted, for the U.S. to
adopt some quota or other protectionist measures against products from countries
whose very low wage levels leave an insurmountable remaining price gap.
The U.S. economy was able to grow over the last two centuries because as productivity increased, the increased income was widely distributed in higher wages. Unionization helped this process, as the country became increasingly industrialized. Distribution of income, therefore, was such that there was a balance between production and purchasing power, although interrupted periodically for necessary business cycle adjustments when a temporary imbalance developed. Now that there is an international economy in which the U.S. plays a central role, it will be necessary to avoid the growth restricting effects of a very skewed income distribution that prevails in newly industrializing countries, especially under governments which do not permit free union efforts to obtain an income distribution that would support balanced growth. While there may be temporary benefit to those countries in steadily increasing their shares of U.S. and other industrial country domestic product markets, as they cause unemployment and contraction of the U.S. economy, there will also be a contraction of the major market for their exports. The rebound effects will also weaken the economies of the developing countries and of the world economy.

In the international economy, a balance between demand supported by adequate purchasing power and the supply of goods and services produced is necessary in order to have stable economic growth. It is not possible to achieve such a balance and such growth as long as workers, wherever they may be, receive wages equal to an inequitable, low fraction of the selling price of goods and services that they produce. Desired equity generally cannot be achieved in the absence of a democracy in which free unions can bargain for the workers.

International Monetary Fund Loans and Adjustment Programs

Most of the countries of the world, 146 of them, are members of the International Monetary Fund (IMF). When a member requests a loan, the IMF staff
studies the economy of the country seeking assistance and then negotiates with the
government of that country to establish an economic adjustment program. Private
banks, who are creditors of the government and/or private borrowers in the country
seeking assistance, are also involved, since they probably will have to rewrite
outstanding loans to allow longer maturities, perhaps a grace period on principal
repayments, and also extend additional credit to the debtors so that they can make
interest payments. The bankers, almost invariably, will not go into the proposed
refinancing program until the country has agreed to an IMF-approved economic
adjustment program.

The IMF approval of an adjustment program, therefore, has been of great
importance to a country to whom additional financing or more favorable repayment
terms are necessary if it is to avoid default and a cutoff from international credit.
Most countries seeking IMF and private loans or restructuring of debt repayment
schedules, therefore, are not in a strong negotiating position with regard to the
type of economic adjustment program to be adopted. Although the IMF claim that
it does not impose austerity on its members through economic adjustment programs
is literally true, it hides the reality of the situation. In recent years, most of the
debtor countries have had little choice but to accept the type of adjustment
program desired by the IMF.

Conditions to be observed by the debtor country as part of the program,
generally referred to as IMF "conditionality," are designed to enable that country
to meet a debt repayment schedule by achieving a positive balance of exports over
imports and by new borrowing. Some of the conditions often included are a
devaluation of the national currency; a reduction in budget deficits, which
generally entails reducing social programs; and tighter monetary and credit
policies.
In addition, the agreed upon adjustment program may often contain a provision for a reduction in workers' real wages by reducing established adjustments for inflation that are designed to protect workers against erosion of purchasing power. Thus, before the 1983 IMF-approved program for Brazil was adopted, it was subject to a revision of the wage adjustment law, to reduce the adjustment from 100 percent to 80 percent of the inflation rate. Although the Brazilian Congress objected, the proposal was adopted by the government. Resultant social pressures arising from the very stringent wage adjustment measure, in the face of continuing high inflation, led to rioting and burning of crops by sugar cane workers in Guariba on May 18, 1984; the workers were given an increase in their piece work rates. At the Fiat plant in Betim, 12,000 workers staged a strike for higher pay which was declared illegal. Government teachers and health workers also have been involved in disputes. As of early August 1984, Argentina has been negotiating with the IMF for months, but no agreement has been reached because the democratic government that took office at the end of 1983 has refused to adopt measures to lower real wages.

The IMF defends the type of conditionality which it wishes to have in economic adjustment programs that it will approve by stating that "countries have little hope of achieving higher employment and long-term growth if they seek to avoid or postpone needed adjustment." There can be little dispute with that assertion, but it does not mean that the only type of adjustment which will succeed is one which focuses primarily upon achieving debt repayment as soon as possible, and includes measures to reduce wages and imports, leading to inequitable reductions of consumption and restricted economic growth for extended periods. Experience indicates that programs with such conditionality have not given adequate weight to the question of political tolerance for programs which cause
great hardship for workers and other people of limited income. They also seem to neglect alternative types of conditions which could lead to a slowdown of inflation and encourage balanced growth by spreading the burden of austerity to other portions of the society. The IMF could gain more popular support for its programs if it included changes in law and enforcement of laws to increase taxation of upper income households and businesses, and to improve the tax collections in the countries being assisted. Also, since the banks are a third party in the negotiations, in view of their interest in the outstanding debt and the need to arrive at a viable debt restructuring plan, they should be brought into the process to help work out an international system to prevent the flight of capital from countries faced with serious debt problems. The IMF could use its good offices to encourage all countries to adopt and enforce the necessary rules to preclude capital flight when it is contrary to an agreed-upon adjustment program.

The general thrust of the adjustment programs has been to achieve a surplus in international accounts as soon as possible, requiring increased exports and reduced imports. The reduced imports, in themselves, can begin to hamper economic growth as it becomes more difficult to import replacements and parts for various types of production machinery, let alone new machinery which can enhance increased production. Increased exports are encouraged and relied upon, largely on an assumption of economic growth in the industrialized countries which would open up those markets for more imports from the debtor countries. There are also other assumptions which have been made by those who strongly endorse the present IMF policies. In a July 1984 article in Challenge, some of the basic assumptions for recovery of the Latin American debtor countries made by one authority who generally endorses the present IMF policies are presented as follows:
OECD growth would average 1½ percent in 1983 and 3 percent thereafter.

2. LIBOR interest rates would decline to 8 percent by 1986.

3. The price of oil would remain at $29 per barrel through 1985.

4. The dollar would depreciate by 5 percent in 1983 and another 10 percent in 1984.

5. Domestic growth in debtor countries is assumed to trend upward from 2½ percent to 4½ percent over the period 1982-86 (with some important exceptions) and cases of major devaluations were taken into account.

These assumptions appear in a July 1984 article adapted from testimony before a Congressional committee on March 28, 1984. There is good reason to doubt that OECD would average 3 percent in 1985 and 1986. In 1983, the OECD growth averaged 2.4 percent, due primarily to growth in the U.S., Japan, and Canada. The same countries are expected by OECD to raise total OECD growth in 1984 to 4½ percent, while most of the European industrial countries remain stagnant and even begin to decline. For 1985, a substantial slowdown is projected by OECD in U.S. economic growth, with smaller declines for other countries, which would bring the OECD average down to 2½ percent.

Interest rates led by those in the U.S. have remained high; and LIBOR, instead of declining toward an 8 percent level to be reached in 1986, has been rising; the 180 day rate increased from 10 5/8 to 12 3/8 percent over the 12 months ending with July 1984. The dollar, instead of depreciating by 5 percent in 1983 and another 10 percent by 1984, rose about 7 percent in 1983 and another 5 percent in the first 7 months of 1984.

It seems quite likely that neither the assumed conditions nor the full solution to the Latin American debt problem will be realized under present adjustment programs and debt structures. In its June 18, 1984 annual report, the Bank for the
International Settlements identifies some of the same problems that have been mentioned in this paper, particularly with regard to the problem of high U.S. interest rates. It sees in them a threat to continued U.S. recovery, stemming in part from a dramatic decline in expected rates of investment return. It notes the distorting effects of such high interest rates on exchange rates and current account balances, and the effect on the burden of indebted countries. It urges that action be taken to reduce the U.S. budget deficit, but offers no specific measures, though mentioning that a change in the U.S. fiscal stance could have an immediate effect on the interest rates. Finally, the BIS report sees some current account deficits of the developing countries as unavoidable and even desirable in terms of the balanced growth of the world economy and suggests that "banks will in one way or another have to accept, in their own interest, some increase in their outstanding claims on those countries which have committed themselves to IMF-managed programs and have demonstrated their ability to implement them." 28

The latter conclusion was also expressed, albeit from a different angle, in the main article of a 1984 Wall Street Journal special section on the world debt crisis: "...current solutions and events are in many cases exacerbating the problem. Somehow developing countries must use less of their foreign exchange to service debts and more to foster growth." 29

Senior staff members of the IMF argue, however, that the limited amount of resources available have to be used, first, to meet repayments; and the additional time needed to foster growth would also mean more credit would have to be extended to the developing countries. 30 Yet, as the BIS report pointed out, banks should recognize the necessity for such extension of credit in their own interest. It might be added that the banks also have to absorb some of the hardship arising from miscalculations as to the economic future when they made the loans.
Another policy, as to terms of loans that are made under IMF adjustment programs, is also noteworthy. The terms have been quite stringent with relatively short maturities, high fees for rewriting the loans, and high spreads above U.S. prime or LIBOR interest rates. The countries with somewhat stronger economies and those who have met terms under a restructuring program have been requesting more favorable terms. The IMF and other adherents to a banker's outlook have been praising those countries who have held to the (austerity) adjustment programs, saying that they, in effect, deserve a reward for good behavior and should be granted easier terms. Since this is not child's play and there would be a better chance for a country to succeed in its program if it initially had some easier terms, it would seem logical to try to have all the debtors obtain the best terms that are being given to any country in order to increase the chances of success. Given the magnitudes of debt involved, it is unlikely that much of an offset against loss can be gained by raising fees or rates another 1 percent; but probably the risk of default can be greatly reduced through lower fees and rates, a reasonable grace period on principal repayment, and a longer maturity term.

As indicated in the Challenge July 1984 article, the debt-to-exports ratio has been declining since 1982 in the 3 major Latin American debtor countries, Brazil, Mexico, and Argentina. It was also noted, however, that this has been achieved mainly through reductions in imports rather than increases in exports. The author of the article also predicates that if the OECD growth averages 2 percent instead of 3 percent in 1984-86, there would be no improvement in the creditworthiness of the debtor countries.

The IMF, itself, apparently begins to sense such a possibility of slower OECD growth. The Managing Director of the IMF in a speech on July 5th noted that over the years 1980-83, "the rate of return on capital investment in manufacturing in the
six largest industrial countries averaged only about half the rate earned during the late 1960s, even allowing for cyclical factors, a clear pattern emerges of a substantial and progressive long-term decline in rates of return of capital. There may be many reasons for this. But there is no doubt that an important contributing factor is to be found in the significant increase over the past twenty years or so in the share of income being absorbed by compensation of employees. Thus, in the four major European countries and Japan, the share of labor in total value added was some 6-10 percentage points larger in 1980-82 than it had been during the 1960s. The rise in the United States, though less, was also sizable. There are now clear indications that in some of the major industrial countries, especially in Europe, the cost of labor may be incompatible with attainment of high employment goals. This points to the need for a gradual reduction in the rate of increase in real wages over the medium term if we are to restore adequate investment incentives and more socially acceptable levels of employment. 31/

That analysis of the reasons for slow growth in industrial countries is based on an examination of return on equity capital in manufacturing and the proportion of value added going to labor. It is suggested that the burden of inducing more investment should be borne by the workers. However, the cost of borrowed capital, interest paid has no doubt been rising over the past two decades in all the industrial countries and is a factor cost which must be met out of the selling price and, therefore, detracts from the return on equity capital.

The IMF Managing Director maintains that the high unemployment rate in many industrial countries is a result of excessive real wage rates. But there is no conclusive evidence to support this assertion. The underlying IMF research on this issue, which was graciously made available by the IMF, 32/ while highly technical, should be viewed with considerable skepticism because of its very tentative and
preliminary nature. The author of this research points out in his paper that many assumptions are made in order to make the problem tractable, limit its scope, or overcome data limitations. Thus, the research should not be used as a basis for sweeping policy recommendations.*

*The IMF's attempts to demonstrate that real wages are too high by estimating a production function, solving it for the real wage rate consistent with high employment labor input, given the existing capital stock, and comparing this so-called warranted wage with the actual real wage. The capital stock is assumed given, and firms are assumed to hire labor up to the point where the marginal product of labor is equal to the real wage rate. This neoclassical view of the way employment and wage decisions are made is an oversimplification and requires the heroic assumption that perfect competition exists. Thus, the basic foundation of the IMF's approach are unrealistic.

In addition, the IMF study forthrightly reveals that the problems of measuring the variables used in the study are considerable. The capital stock is particularly difficult to quantify. In the study, various adjustments were made to reported capital stock measures. These include: the application of an efficiency scalar which is a function of the average age of the capital stock; subtractions for roughly estimated expenditures on pollution abatement; and the assumption that as a result of energy price increases, 10 percent of existing capital was prematurely retired in 1974-76 and in 1980-82.

Similarly, high employment labor input is not directly observable. To quantify this concept, the author relied on the relationship between vacancies and unemployment. The high employment/unemployment rate is assumed to occur when large increases in vacancies result in only small declines in unemployment. Not only is high employment labor input the result of a statistical estimate rather than an observed quantity, measurement of vacancies has proven difficult. For example, reported vacancies are sometimes overstated because firms list a vacancy even though an actual job opening doesn't currently exist.

In addition, the IMF paper points out other problems with the estimate of high employment labor input. These include the need to assume that at each peak in the cycle overall unemployment and manufacturing man-hours have the same relationship and that the relationships between rates of change in high-employment/unemployment and rates of change in the sectoral distribution of employment that took place between 1973-74 and 1979-80 can be extrapolated to the 1980s.

These are only a few of the assumptions, adjustments, extrapolations, and qualifications that underlie the estimates used to support the IMF's assertion that the rate of increase in real wages must be reduced in the industrialized world. The highly tentative nature of this evidence doesn't lend support for such strong policy conclusions; and, at least for the United States, there is evidence that real wages actually declined between 1972 and 1981.
Our concern is that the IMF’s approach focuses only on real wages. Capital costs are not explicitly introduced. But capital costs have risen dramatically over the past decade. For example, Data Resources Inc. estimates that in the U.S. the index of the rental price of capital rose 240 percent from 1969 to 1982. During this period, labor costs rose only 140 percent. Thus, a decline in the capital/labor ratio is more appropriately viewed by DRI as the result of the excessive rise in the cost of capital due to tight money and is not the product of high real wages.

A similar conclusion is reached by Harvard Professor Bruce E. Scott. In the context of commenting on a recent study that argues that there has not been a decline of American industrial competitiveness, he writes:

"For a country, the issue is the profitability of its exporting industries on the one hand, and the wages or standard of living of its labor force on the other. The study should have assessed not just market share but profitability and real incomes as well.

"If it had done so, it would have found that the rate of return on total assets in American manufacturing (before interest and taxes) failed to keep up with the rising cost of capital, and roughly from 1975 onward, United States manufacturers on average would have earned more on their assets investing them in corporate bonds than in the production of goods. In addition, inflation-adjusted after-tax earnings for non-agricultural workers fell after peaking in 1972. In 1981, when this series was discontinued by the Commerce Department, real after-tax incomes for American workers had dropped 17 percent from their highs."

Such facts apparently have not been considered in the underlying analysis for the IMF speech quotation, although in the next paragraph of his speech the Managing Director of the Fund does recognize that historically high interest rates are a significant factor in a lower return to capital and in inhibiting additional investment. He does not suggest, however, that the lenders of borrowed capital have been absorbing too great a share and should reduce their share.

In the IMF negotiations which have been going on, generally, nobody bargains for the workers. The IMF, whose "good housekeeping" seal of approval for an
economic adjustment program is necessary in most cases before banks will extend more credit and/or restructure a debt program, negotiates with the government of the debtor country. The IMF, at the same time, must keep a large number of banks involved as continuing loan participants, a factor which is probably reflected in the austerity of adjustment programs, focusing on the quickest possible debt repayment, even at the expense of little or no economic growth — or even negative growth — in initial program periods for the countries involved. The concern of the government about workers' income and equity in an economic adjustment plan will vary with the extent of democracy and freedom for workers' organization. This was vividly illustrated after Argentina changed from a military to a democratic government in late 1973. The government strength in bargaining for less austerity and more opportunity for growth will also vary with its current strength in accumulated foreign exchange reserves, so that it can begin making repayments.

The Managing Director of the IMF, in speaking of the worldwide debt problem, has stated that, "Weak domestic policies and delays in adjustment measures were made possible by relatively easy access to foreign capital, at least until the middle of 1982. By the end of that year, the non-oil producing developing countries had accumulated well over $600 billion of external debt, of which as much as half was on commercial terms. Such a buildup of debt was clearly unsustainable and left many of these countries vulnerable to the change for the worse in external conditions that came in 1981-82."24/

Who was making the "easy access" loans? Those responsible for the loan approvals were lacking in experience or training or judgment, or all three. And, apparently, the bank regulators in the industrial countries where the large international lending banks are resident, also were not alert to the dangers of the accumulating loan burdens of the borrowers and the increasing risk inherent in
loans being made to Latin American countries and developing countries elsewhere. It was about 50 years since there had been a debacle in international credit, including some defaults. Apparently economic and financial history are not a required course for bankers or bank regulators.

And the central bank monetary authorities of the industrial countries, absorbed in the concern for fighting inflation on the domestic front, gave little thought to the effects of rising interest rates upon the heavily indebted developing countries until the debt crisis arrived. Judging from experience during the first half of 1984, even when they are concerned about the worldwide economic dangers inherent in a very strained international debt structure, they do not as yet have a sufficiently flexible set of tools to avoid further rises in interest rates that place the developing countries with huge debt burdens closer to the breaking point.

Finally, the governments that accumulated such large debt burdens must share the blame. In many countries, government policies that fostered extremely low wages and an income distribution of great inequality, plus heavy dependence upon regressive sales and value added taxes for revenue, were restricting the expansion of the domestic market which would have provided more economic balance as national productivity increased and contributed to more stable long-term economic growth. A more equitable income distribution also would have reduced the aggregate of discretionary income that would become part of the capital flight. If stricter measures could have been adopted and enforced to prevent capital flight, it would reduce the severity of the debt crisis. There were also misjudgments about the time and money that it would take to complete certain large development projects.

How are the IMF adjustment programs and the accompanying debt restructuring agreements with the banks working? The most obvious failure has
been in Bolivia where a close near-default occurred. The decline of world tin prices, the main Bolivian export, was a critical factor. However, there were other elements, including currency devaluation, the removal of subsidies, and high fuel prices which drove inflation upward rapidly and severely reduced people’s purchasing power. There has been rising unemployment, and cocaine production in the jungles has become a growth industry. 35/

In Uruguay, all three of the recognized political parties called for debt restructuring of the $5 billion debt in a country of 3 million people where the debt of $5 billion reportedly is equal to 89 percent of the country’s output of goods and services. 36/ The rioting and deaths in the Dominican Republic related to the IMF austerity program have been mentioned earlier.

Early in July, Mexico and Brazil were being praised because they had been experiencing a resumption of growth. 37/ Earlier in this paper, reported social unrest and strikes that have occurred in 1984 in Brazil were cited. This year there has also been the collapse of 7 independent savings banks or building societies in Brazil with total losses of $1.8 billion. Repayment terms on home mortgages have been adjusted upward; the salaries of lower paid workers have not been keeping pace with inflation; and there has been an increase of crime, particularly bank robbers, in certain areas in Brazil. Brazil has been achieving a trade surplus which will amount to $10 to $11 billion this year, but it has been achieved largely through import reductions, and at least $1 billion of that surplus will be eaten up by increased interest rates on outstanding loans. 38/

In Mexico, the inflation rate is running at about 60 percent, reducing the purchasing power of the peso faster than the devaluation that takes place almost daily. It makes the outlook for a further official devaluation in the future more likely and stimulates the flight of capital from Mexico in various ways. 39/
Argentina, under its new domestic government, and Venezuela have been most obstinate in negotiating with the IMF and with bankers about economic adjustment and debt restructuring. Both of these governments are in a better position to negotiate because they have been accumulating foreign exchange reserves from their large exports of oil, in the case of Venezuela, and grain, in the case of Argentina. Argentina expects to increase its agricultural exports and improve its tax collection system as well as making that system more progressive. The new administration in the country has vowed it will not reduce real wages of workers in order to bring about adjustment of the economy. 40

Venezuela has recently given its bank creditors a proposed debt restructuring plan, which reportedly would postpone repayment of about $22 billion in principal that comes due between 1983 and 1990. They would repay these loans over 15 years after a one-year grace period, during which only interest would be paid. Venezuela has also requested that the banks should fix the amount of annual debt payments. Principal payments would increase during the loan repayment period and interest charges would decrease as in repayment of a level payment, fixed interest rate mortgage. If applicable floating loan interest rates increased, the additional payments would be capitalized and the loan maturity increased. 41

At the end of July, there were reports that Mexico and Brazil were both seeking more flexible debt repayment plans. Brazilian spokesmen indicate that they would be seeking longer repayment and grace periods than the 9 and 5 years, respectively, that they obtained during the last restructuring. They would also want lower interest rate spreads and commissions or fees in connection with the loans to be rescheduled. Mexico, reportedly, asked the bankers to reschedule some $45 billion of public sector debt maturing between 1985-89. They want a repayment period of 15 years, including a 5-year grace period, for payment of
principal and a reduction of spreads and margins above a floating loan interest rate such as the U.S. prime or LIBOR. They also are requesting a reduction of the refinancing fees or commissions.\textsuperscript{42/}

In a recent analysis of the Latin debt situation, from Rio de Janeiro, Alan Riding summarizes the relative debt problem in the 4 largest South American countries as follows:

"The real problem countries appear to be Brazil and Mexico, not Argentina and Venezuela.

"Argentina and Venezuela are, in fact, caught up in acute crises of financial management, crises of the kind that bankers readily recognize. But both have large reserves as well as enormous export capacities -- thanks to oil in Venezuela and wheat in Argentina -- which they can mobilize to cover debt obligations without convulsing the rest of their economies.

"Brazil and Mexico, on the other hand, are more vulnerable. They have larger and poorer populations. The two countries have spawned huge trade surpluses mainly by cutting imports and sacrificing growth. They need continued infusions of foreign credit to resume growth, but have become net exporters of capital."\textsuperscript{43/}
FOOTNOTES


4/ Inter-American Development Bank, op. cit., pages 33 and 24-25.


6/ Inter-American Development Bank, op. cit., Table 2, page 14.


10/ Multinational Monitor, June 1984, pages 7-8, News Monitor Section.


14/ All of the information about types of taxes, rates, exemptions, and deductions in Latin American countries are from the Ernst and Whinney International Series of bulletins on taxation for individual countries issued by Ernst and Whinney, International Operations, 153 E. 53rd Street, New York, New York 10022.
15/ Inter-American Development Bank, op. cit., page 203.


23/ ibid. Table 17.


25/ William R. Cline, op. cit., page 12.

26/ Actual and projected data by OECD in its semiannual Economic Outlook (No. 35), published in the IMF Survey of July 2, 1984.


30/ See statements by IMF Senior Staff member Walter Robichek quoted in IMF Survey of July 2, 1984, page 204.


34/ J. de Larosiere, op. cit., page 217.

35/ Multinational Monitor, op. cit.


37/ J. de Larosiere, op. cit., page 218.


