

DEBT - THE CASE OF CHILE

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Most Latin American countries are confronted by a serious problem of foreign debts. The effects of this external shock on the economies of the debtor nations are varied. The diversity of effects depends upon the magnitude and rapidity of increase that characterizes the state of indebtedness of a given country, and the strategy that country adopts for development and borrowing. It is, in fact, this last that determines the level of development at which the crisis over foreign debt hits each country. In some nations the economy has stagnated or gone backwards over the last decade, as happened in Chile, while in others it grew vigorously on the basis of the abundant credit then available to them on the international markets.

The drop in export earnings and the problems with gaining access to markets in the industrialized countries combined to produce the most violent external shock to economies in Latin America in the last 50 years.

A HISTORY

The Chilean economy suffered from very low productivity in the period 1973-82. At the same time, there was a spectacular process of concentration of wealth and income. This was significantly linked with the foreign trade and financial policies imposed at the time: an indiscriminate liberalization of imports and the financial system. Such policy management resulted in indebtedness to foreign banks rising at an accelerated rate about 60 percent a year from 1977 to 1981. The excessive increase in debt, rather than helping the process of internal capital formation,

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led to its being discouraged. There were powerful reasons for this:

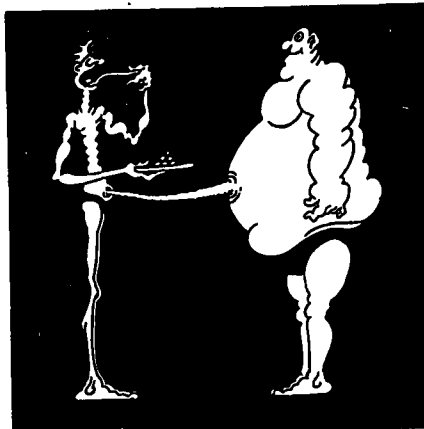
- the rapid and indiscriminate liberalization of imports, especially consumer goods.

- the lag (appreciation) in exchange rates (A situation where in a rapid inflation the government devalues its currency against the US dollar slower than the rate of inflation so that US dollars – and consequently, imports – are cheap compared to local products);

- the persistence of high rates of real interest on the internal market; and

- the absolute liberty given to the "market" in determining the volume and application of Chilean and foreign funds, and the difficulty in identifying comparative market advantages or opportunities for productive investment.

All of this took place in market conditions determined by the application of a model distin-



guished by its extremism and the authoritarian setting in which it was possible to maintain it for so many years.

DESTINY AND DEBT

In 1982, the Chilean economy underwent a drastic readjustment involving a drop in the GNP of 14 percent. Since then the situation has been critical and depended upon the course of events connected to the foreign debt problem.

Although the Chilean foreign trade sector, from 1977 on, showed a high and rising deficit on current account, the large net inflow of capital permitted the accumulation of sizeable foreign currency reserves until 1981. The largest inflow was induced by the expansion of foreign trade, particularly imports of nonessential consumer goods. Capital movement concentrated to an alarming extent on bank credits to the private sector, given without any state guarantee. The total debt service reached 70 percent of goods and services exported in 1981 and 88 percent in 1982; this is three times the coefficient for debt service in the years 1970 - 1974.

In 1981, more than 80 percent of the foreign debt was owed to banks and financial institutions; in 1974 their share was only 19 percent. Among nonpetroleum-exporting developing countries, Chile has become one of the major debtors in international private capital markets. In 1976 it ranked eleventh, but reached fifth place by 1981. In the overall Latin American context, the bank debts of Chile exceeded US\$ 1000 per person, as compared with a regional average of US\$ 600, and around US\$ 500 for Brazil. On the other hand, Chile's bank debts grew at a rate of 57 percent a year from 1977 to 1981, compared with an overall average for developing countries of 28 percent. As might well be imagined, neither percentage was bearable for any length of time. The responsibility for this situation must be laid at the door of debtors and creditors alike. The creditors often pressured the debtor countries to accept more credit and liberalize their indebtedness.

Such a massive process of contracting foreign debt as the one which occurred from 1977 to 1981 produces significant effects in numerous areas of the national economy. The effects in Chile were intense: it contributed to a spectacular concentration of wealth, altered the operation of the savings and investment process, and had a decisive effect upon monetary and exchange policies.

The initial impact of the expansion of the foreign debt involved an increase in the availability of foreign currency. In fact, up to 1981 the net inflow of capital was greater than could be absorbed by the national economy.

The deficit on current account grew constantly by large amounts. In 1980, the use of foreign capital reached an amount equivalent to 9 percent of the GNP compared to an average of 5 percent for Latin America. Despite this figure, the inflow of capital to private borrowers grew at an even faster rate. The resulting surplus (difference between amounts received and those spent) led to an increase in foreign reserves being registered until 1980.

This rapid accumulation of reserves had substantial effects upon monetary and exchange policy management, while the deficit on current account rose by leaps and bounds. At the same time, the large-scale movements of capital, both for use to finance increased expenditure on imports and what went to increasing the foreign currency reserves, meant that a very large share of all credit available in the economy originated in foreign funds.

The prevailing conditions in the world economy and the internal market, maintained a process of rising indebtedness, which, in turn, made Chile's foreign trade increasingly vulnerable. The behaviour of the real net debt, the ease with which further credit was to be had, and low rates of real interest on the international market induced a complacent attitude in many countries during the 1970s and the beginning of the 1980s. This was reinforced by the prevailing belief in Chilean official circles that since most of the debt was privately contracted, it would be efficiently used: the "magic of the marketplace" would see things right. The result was that the Chilean economy became increasingly accustomed to a massive inflow of financial capital.

Meanwhile, what was going on in the production area was the opposite of what it was officially supposed to be. In fact, the rates of savings and investment were manifestly lower than those attained in the 1960s; the gross rate of fixed capital formation only reached an average of 15.5 percent of the GNP from 1974 to 1982, and in the best year (1981) it failed to rise above 20.2 percent, the average recorded in the 1960s. A growing share of resources went for the consumption of imported goods, replacing expenditure on Chilean goods and internal savings. Except for some sectors which are intensive in their use of natural resources and luxury construction, investment ran into severe difficulty in identifying "comparative advantages".

When international financial problems arose in 1981, the deficit on the commercial account had risen to 11 percent or so of the GNP and the deficit on the current account to 21 percent. Consequently, the international financial and commercial situation deteriorated at just the time when the need to reduce the imbalance in foreign trade became inescapable.

Chile's difficulties in obtaining foreign credit coincided with a deterioration in the price of copper (a product which accounts for half of Chile's exports) and with an internal situation in which the need for new funds was very high. The government had dismantled the machinery for economic regulation, trusting that the dollar would regulate everything. The productive machinery was weakened and over-indebted. The result was that the effects of the external shock of 1981 multiplied inside the economy, and the GNP dropped 14 percent in 1982.

RESCHEDULING THE DEBTS

Chile found it increasingly difficult to gain access to financial markets, while its reserves, which were initially high, began to drop rapidly. Despite repeated announcements that there was no need to reschedule foreign debt, a long process of negotiation was initiated. The rescheduling was negotiated by the Chilean government, although most of the debt was owed by the private sector, and had no public guarantee.

As is usually the case in most rescheduling done in the last three years, this was preceded by an agreement with the International Monetary Fund (IMF). The terms in time and interest agreed with a committee representing the hundreds of creditor banks were similar to those granted to Argentina, Brazil, and Mexico. To outward appearances, then, there is no substantial difference with the results obtained by Chile. However, the similarity of the terms obtained in the various cases contrasts with the fact that in Chile most of the debt was not covered by a government guarantee. This particular feature must have been a major element in the rescheduling process. Even more so if the private sector debtors were in no condition to amortize their debts over the period covered by the rescheduling. The truth is that the Chilean government granted a guarantee to cover 1983-1984 payments on the debt of Chilean financial undertakings not previously so covered, and yet did not thus obtain markedly more favourable conditions than other countries. From this one can deduce that the best card Chile had for getting better terms was thrown away.

The level of over-indebtedness in Chile is so serious that payment of interest and amortization, despite the rescheduling, absorbed about 12 percent of the GNP in 1983 and 1984. The tendency is, moreover, for the problem to worsen, since the amortization payments are scheduled to rise disproportionately in 1985. For the two-year period 1985-1986 the amortization payments will be 50 percent higher than they would have been without the 1983-1984 rescheduling. The increase is primarily due to credits used from 1979 to 1981. Furthermore, if the conditions prevailing at the end of 1984 continue, interest payments scheduled for the next three-year period would amount to about 8 percent of the GNP. It is obvious that the mid-1983 rescheduling faces up to only part of the problem created by the present economic policy. Combined with the deterioration that has occurred in international financial markets, it does not solve the problem posed by the size of the debt service which, from 1985, will keep

the Chilean economy in a permanent state of uncertainty and dominated by questions of finance, at the expense of urgent and serious social problems and production.

OUTLOOK

The outlook for the years to come is negative. As is the case with developing countries in general, available projections indicate that Chile will experience a negative transfer of resources. That is, net credits will be less than interest payments. In conditions in which the "debt cycle" operates normally, it is to be expected that debtor nations will eventually find themselves in a situation in which their net credits are less than their interest payments, and respond by reducing the volume of debt.

However, in this case, the situation is abnormal, since the negative flow of resources results from a sharp drop in the supply of credit and an unexpected increase in the rates of interest. The suddenness of the change and the fact that it was unexpected have also certainly been counterproductive, because it has caused a decline in economic activity, employment, and investment in the debtor countries. The future that emerges is one of great scarcity of foreign credits and a drop in the capacity for growth over the medium term.

The serious problem confronting Chile over the foreign debt will require both internal and external action. The internal market must be set going again and reactivated; there must be a large element of Chilean content in what is done; and a selective import policy must be put in place. This must be coupled with an export drive, a "realistic" exchange policy and an active search for newmarkets for non-traditional products. Regardless of the success of such efforts, the debt service is still an excessive burden. An economy weighed down by such a burden of debt, ultimately cannot develop and must finally, become incapable of servicing the debt.

Consequently, the total debt balance must be reprogrammed (with some natural exceptions), rates of interest applied, and a large part of the payments must thus be refinanced.