

International Finance Discussion Papers

Number 203

February 1982

HOW TO BORROW REASONABLY

by

Yves Maroni

NOTE: International Finance Discussion Papers are preliminary materials circulated to stimulate discussion and critical comment. References in publications to International Finance Discussion Papers (other than an acknowledgment by a writer that he has had access to unpublished material) should be cleared with the author or authors.

## How to Borrow Reasonably<sup>1/</sup>

by  
Yves Maroni

It is axiomatic that a developing country, with a limited ability to increase domestic savings, may step up its rate of real economic growth by borrowing some of the savings of other countries to supplement its own. With these borrowings, such a country may increase its imports of goods and services to undertake additional development projects. As a result, a developing country attempting to step up growth is likely to have a deficit in the current account of its balance of payments and a net capital inflow.

But it is well known that some countries pursuing growth through external borrowings run into balance-of-payments difficulties. This happens when the current-account deficit exceeds the net capital inflow and there are not enough accumulated international reserves on hand to fill the gap.

The strategy of growth through external borrowings clearly has its limits, and the question then becomes how to maintain an approximate balance between the current-account deficit and the net capital inflow. Common sense suggests and experience has shown that the answer lies in a combination of five separate lines of action that the borrowing country should take.

### Five Guidelines

The first guideline is that the stepped up external borrowings should be used, either directly or indirectly, for productive purposes, not for consumption. Otherwise, the borrowing country may not generate the capacity to service the additional external debt. In principle, the returns

---

<sup>1/</sup> Paper presented at a conference on Latin American external debt and economic growth, Florida International University, Miami, Florida, February 24-25, 1982. The views expressed are the author's only and should not be interpreted as representing those of the Board of Governors of the Federal Reserve System or of other members of its staff.

expected from the proposed use of the borrowed funds should be economically attractive: the expected rate of return should be at least equal to the cost of foreign borrowing. If foreign funds are used to help finance an enterprise that will sell goods or services, that enterprise must be able to stand on its own feet, without the help of highly protective tariff or non-tariff barriers that will keep out competing products. Otherwise, the borrowing country may find itself saddled with an activity that not only fails to enhance its capacity to service external debts, but also imposes new external burdens. These new burdens may arise if the real value of the project's output falls short of the cost of imported materials and spare parts needed to keep the enterprise going and also fails to cover the cost of importing the additional goods and services that the newly employed labor is sure to demand with its enlarged disposable income.

The second guideline is that a country pursuing growth through external borrowings must maintain a realistic exchange rate to prevent erosion of its international competitiveness. If it is able to hold its domestic rate of inflation roughly in line with the rate of inflation in its major trading partners, it may be able to peg its currency to that of a major trading partner country, or to a basket of the major currencies. But, if there is a significant differential between the domestic and foreign inflation rates, it will be desirable to adopt a crawling or floating exchange rate system to offset this differential and to insulate the balance of payments from its consequences. Otherwise, if domestic inflation exceeds foreign inflation for any length of time, the currency will become overvalued, exports will be discouraged, imports will be stimulated, and speculative capital outflows will be encouraged as it becomes increasingly obvious

that a substantial devaluation is inevitable and cannot long be postponed. Both the deterioration of the current-account position and the capital outflows damage the borrowing country's capacity to service its external debts. The erosion of international competitiveness also works to hold down the rate of economic growth, since it hurts both import-competing activities and exports.

The third guideline is that a country pursuing growth through external borrowings must maintain realistic interest rates, that is, rates that are high enough to act as a disincentive to an outflow of domestic capital and as a magnet for foreign funds. Rates at such levels would have the added advantage of attracting domestic savings to the banking system where they can be more efficiently allocated to finance productive investments and thereby promote economic growth. Otherwise, domestic savings might be held in speculative forms, such as real estate, excess inventories, or precious metals as well as foreign balances and other assets located abroad. Moreover, realistic interest rates would serve to discourage investments in projects which carry an insufficient expected rate of return. They would also reduce the temptation to rely on non-price considerations, such as political or personal influence, in allocating credit, as often happens when interest rates are subject to ceilings set below market-related levels.

The fourth guideline is that the borrowing country must minimize the use of price controls and subsidies. These measures tend to encourage overconsumption and to distort the allocation of productive resources. Price controls also tend to discourage domestic production and to result in shortages that may impair the efficient functioning of the economy and hence its debt servicing capacity. Subsidies may result in a widening

of the fiscal deficit and may weaken the efforts to fight inflation, causing possible repercussions over other elements of economic policy and indirectly over the country's international credit standing.

The fifth guideline is that the borrowing country must follow domestic fiscal and monetary policies that inspire confidence in international financial markets. In particular, such a country must be willing to take fiscal and monetary policy steps to adjust its balance of payments when it is subjected to external shocks, so that the period during which external borrowings may have to be devoted, in part, to the maintenance of consumption, in violation of the first guideline, will be minimized. More generally, whether there be external shocks or domestic disturbances of an economic or political nature, the borrowing country must be willing to take fiscal and monetary policy steps to limit its current-account deficit to a level corresponding to the amount that can reasonably be expected to be available from external sources of financing. In the absence of such steps, the entire burden of adjustment would have to be borne by the exchange rate and, through it, by the export and import-competing sectors of the economy. This would be likely to cause distortions that would impair the efficient functioning of the economy, weaken the confidence that the country inspires in world financial markets, and limit its access to external financing. In theory, quantitative import restrictions and exchange controls could be used to adjust the balance of payments or to limit the size of the current-account deficit. But this would not be likely to inspire confidence in international financial markets, because it would not deal with the domestic causes of the external disequilibrium and would generate concern over the possibility that the controls might interfere with debt service payments.

Adherence to these five guidelines should go a long way toward enabling a developing country to pursue growth through external borrowings without running into balance of payments difficulties. A look at the experience of two Latin American countries over the last ten years will help to show that when countries disregard these guidelines they pose a greater risk for the lenders, create greater uncertainty about their continuing access to foreign capital, and, in the end, fail to step up their economic growth on a sustainable basis.

In what follows, we shall focus on the second, third, and fifth guidelines.

#### The Brazilian Experience

Consider first the case of Brazil. In 1973, Brazil was in the sixth year of its economic miracle. The growth of its real GDP had averaged more than 11 percent per year since 1968. The rate of inflation had been held to less than 20 percent since 1970, after fluctuating in a much higher range during the late fifties and the sixties. Its current-account deficit had increased from less than \$200 million in 1966 to more than \$2 billion in 1973, for a cumulative eight-year total of more than \$7.5 billion, but its net capital inflow had increased even more and on a cumulative basis totalled nearly \$13 billion during the same eight years. Its external medium- and long-term public and private debt had risen to about \$12.5 billion at the end of 1973 from about \$3 billion six years earlier, but its official international reserves (excluding gold) exceeded \$6 billion, compared with only \$150 million at the end of 1967.

This remarkable record owed much to the policies Brazil had adopted and in particular to the crawling peg exchange rate policy instituted in

August 1968 and to the use of an indexation coefficient to bring the real return on many financial instruments to a realistic, market-related level. These policies conformed with the second and third of the five guidelines just discussed. In addition, industry paid market interest rates and monetary policy was tight enough to give it an interest rate incentive to seek financing abroad. However, agriculture, small business, and exports obtained credit at subsidized interest rates, helping to fuel monetary expansion and distorting resource allocation.

Since 1973, Brazil has had to absorb the impact of two oil shocks, two world recessions, and the sharp rise in world interest rates. In 1974, it tried to maintain its high growth rate and to finance the resulting increase in its current-account deficit. But the required amount of external resources was greater than it could raise in external markets without incurring interest costs that would have exceeded what it was willing to pay, and its reserves turned down. This convinced the Brazilian authorities of the need to embark on an adjustment effort. Late in 1974, they tightened fiscal and monetary policies and, as an alternative to a faster currency depreciation, they introduced export subsidies and raised import duties. They accepted a lower rate of real GDP growth, although there was some backsliding in 1976, after which fiscal and monetary restraint was renewed and the growth rate fell again. The combined effect of slower growth and the trade policy steps was to reduce the current-account deficit from \$7.5 billion in 1974 to about \$5 billion in 1977.

These efforts conformed with the fifth guideline and evidently encouraged the international financial community. As a result, the net capital inflow in this period was substantial. By 1976, it was again exceeding

the current-account deficit and reserves had turned up. Brazil's success in attracting foreign resources was especially notable in 1978, when the net capital inflow topped \$11 billion, compared with an annual average of \$7 billion during the previous four years, and Brazil took advantage of this situation to adopt a somewhat more stimulative fiscal and monetary policy that year. The result was a moderately higher rate of real GDP growth and a larger current-account deficit. Even so, more than \$4 billion was added to reserves.

Brazil met the second oil shock as it had the first one, by postponing adjustment measures and attempting to finance the resulting increase in the current-account deficit. Indeed, departing from the fifth guideline, the authorities stepped up the rate of growth in this period and allowed the economy to become overheated. In 1980, real GDP growth reached 8 percent and the rate of inflation, which was around 40 percent in 1978, soared to 110 percent. In this period, Brazil also deviated from the second and third guidelines, and abandoned some of the policies that had served the country so well in earlier years. First, bank interest rates on deposits and on loans to industry, which had been market-related, were placed under ceilings that became increasingly unrealistic as inflation accelerated. Second, the depreciation rate under the crawling peg exchange rate system and the indexation coefficient, both of which had been set so as to compensate for the inflation differential, both were frozen at levels that were announced in advance, first for six months, then for twelve months. Both were set to correspond with what the government hoped would be the future differential between domestic and foreign inflation. But, when domestic inflation accelerated sharply, they became increasingly unrealistic. In real terms, the cruzeiro appreciated, thereby eroding the international competitiveness of Brazilian industry and setting the stage for possible speculative capital movements.

In 1980, the current-account deficit surged to nearly \$13 billion, nearly twice as much as two years earlier. Brazil's 1980 oil import bill was about \$10 billion, some two-and-a-half times the 1978 level, and interest payments on the external debt reached about \$7.5 billion in 1980, more than twice as much as two years earlier. That the deficit did not rise further in this period stemmed from a \$4 billion increase in the non-oil trade surplus, in part owing to improved harvests and to the completion and coming-on-stream of a number of important projects the output of which substituted for imports.

The overheating of the Brazilian economy and the erosion of its international competitiveness when the balance of payments was already severely constrained by a heavy oil import bill and very large interest payments weakened international confidence in Brazil. Late in 1979 and early in 1980, the spreads over LIBOR that Brazilian borrowers were asked to pay on Euro-currency credits rose sharply. Toward the end of 1980, market apprehension about Brazil began to impair the country's ability to obtain new credits. While the total net capital inflow of 1979-80 amounted to about \$16 billion, this fell more than \$7 billion short of the cumulative current-account deficit of these two years, and reserves fell sharply in both years. The sheer size of the external debt<sup>1/</sup> also caused concern because of the very large amounts maturing each year and requiring either a rollover or new credits to cover them.

These ominous signs convinced the Brazilian authorities of the need to change course near the end of 1980. They abandoned the preannounced depreciation rate and indexation coefficient and reverted to the previous policy of

---

<sup>1/</sup> At the end of 1980, the medium- and long-term public and private debt was nearly \$54 billion. To this should be added the short-term debt that may be estimated at around \$13 billion at that time.

attempting to compensate for the inflation differential. They eliminated the ceilings on interest rates introduced 18 months earlier.<sup>1/</sup> They imposed severe restrictions on spending by state enterprises and tightened monetary policy. The result was a virtual halt in real GDP growth last year, a heavy price for the overheating of the economy in 1980, but there also was some easing of inflation and a \$2 billion reduction in the current-account deficit. The latter was achieved in spite of a further sharp increase in interest payments and resulted mainly from a \$4 billion turn-around in the merchandise trade position--from a \$2.8 billion deficit to a \$1.2 billion surplus. These developments, stemming directly from the renewed adherence to the second, third and fifth guidelines, were not lost on the international financial community whose willingness to increase lending to Brazil improved markedly during the year. In the end, last year's net capital inflow exceeded the current-account deficit and reserves turned up. The stage was set for a possible resumption of economic growth in 1982.

During the past eight years, Brazil struggled to maintain approximate balance between the current-account deficit and the net capital inflow. The pressures on its balance of payments were not entirely of external origin, as domestic desires to speed up economic growth led to several bouts of overheating. But the authorities were willing, albeit with some delay, to take balance-of-payments adjustment measures, including those leading to a lowering of the rate of economic growth. In the eight years 1974-81, the rate of real GDP growth in Brazil averaged 6 percent per year, compared to about 11 percent during the previous six years. Given the exceptionally rapid growth achieved during the "miracle years", the virtual halving of that rate in the ensuing

<sup>1/</sup> However interest rates on loans to agriculture, small business, and exports remain heavily subsidized.

eight years still left the country with a growth rate that is quite respectable, even when the rate of growth of population, in excess of 3 percent per year, is taken into account. Only when it deviated from the second, third and fifth guidelines did Brazil encounter resistance to its efforts to obtain external financing and did it suffer a virtual halt to economic growth. In the end, it avoided extreme payments difficulties that might have called for extraordinary relief measures thanks to a timely resumption of adherence to these guidelines. Because of its relatively low international reserves, it remains vulnerable to possible new external and internal shocks and it has only limited room in which to reconcile its drive for growth and its balance of payments constraints.

#### The Peruvian Experience

For a different kind of experience, consider now the case of Peru. In the six years ending in 1973, Peru had an average rate of real GDP growth of almost 5 percent per year, an average rate of inflation of about 8 percent per year, and an average current-account deficit of less than \$25 million. In these six years, the net capital inflow averaged about \$120 million per year and international reserves rose steadily. The currency had been pegged to the dollar at a fixed rate in 1967, following a 30 percent devaluation, and this rate was still in effect at the end of 1973.

In 1973, the Peruvian government undertook an ambitious development program and arranged for a considerable amount of external financing, much of it from foreign banks. The financing was forthcoming mainly because Peru was thought, overoptimistically as it turned out, to have strong export prospects over the long run as a result of recent oil discoveries and planned investments in mining. In implementing the development program, the Peruvian government allowed the public sector fiscal deficit to rise to more than 10 percent of GDP

in 1975 and increasingly resorted to the domestic financial system to finance it. As inflation accelerated, official subsidization of imported foodstuffs and petroleum products increased, in violation of the fourth guideline. This further widened the fiscal deficit, and credit expanded more rapidly. The rate of inflation rose to about 25 percent in 1975, but interest rates on savings instruments remained fixed in the 7-10 percent range, in violation of the third guideline. In this range, interest rates did not attract resources to the banking system and indeed encouraged domestic capital to leave the country. Moreover, the exchange rate established in 1967 continued in effect until the third quarter of 1975, and the 1975 devaluation offset only part of the differential between domestic and foreign inflation accumulated in the intervening years, leaving the currency still overvalued. Since the new exchange rate was again pegged to the dollar and domestic inflation continued to be more rapid than inflation abroad, the real appreciation of the sol was resumed from the new level. That is, the second guideline was also not being followed.

With these policies, imports more than doubled in the span of two years, while exports increased only about 25 percent, and the current-account deficit soared to more than \$1.5 billion in 1975. At this level, the deficit exceeded the net inflow of capital, especially since the latter failed to grow that year in spite of a marked hardening of terms. As a result, reserves, which had continued to rise until early in 1975, dropped sharply.

There followed a succession of abortive attempts at stabilization, each of which faltered after a few months, as the authorities showed reluctance to follow the fifth guideline. The public sector fiscal deficit remained large, as outlays were swollen by subsidies and by military expenditures without a corresponding revenue effort, and domestic credit was allowed to expand

to help finance it. The rate of inflation accelerated and interest rates remained highly negative in real terms, although they were allowed to rise somewhat in nominal terms. The sol was devalued in June 1976 and a crawling peg system was introduced in September of that year. But the crawl process was interrupted on two occasions for extended periods in 1977 and early 1978. While the current-account deficit shrank somewhat in 1976 and 1977, the net capital inflow also diminished, as private lenders became increasingly reluctant to add to their exposure in Peru, and reserves continued to decline in both years. During the first half of 1978, substantial payments arrears on current international transactions began to accumulate, as the authorities preempted a rising proportion of the available foreign exchange to maintain full service on the external public debt.

In May 1978, with default on the external public debt looming ahead, the authorities launched a new stabilization effort and soon afterwards the syndicate of foreign banks to which Peru was heavily indebted agreed to postpone the payments due over the balance of the year until early 1979. There followed agreement with the IMF on a stand-by arrangement and, toward the end of 1978, a formal rescheduling of Peruvian debts to public and private creditors maturing in 1979 and 1980.

From June 1978 until the latter part of 1980, Peru successfully implemented the stabilization program. It was also fortunate in being able to benefit from sharply higher prices in world markets for many of its exports in 1979 and 1980, and restored virtual balance in its current account. It regained access to international credit, and rebuilt its reserves. However, serious new balance of payments strains have since reappeared and reserves fell sharply in 1981.

Over the five-year 1974-78 period, Peru had great difficulty in maintaining balance between its current-account deficit and its net capital inflow and ended up being unable to pay its debts on schedule. Its growth record also was poor. The rate of real GDP growth rose to nearly 7 percent in 1974 from its 5 percent annual average in the six years 1968-73, but thereafter receded below 5 percent, even turning negative in 1977 and 1978. For the five-year period through 1978, the rate of real GDP growth averaged 2.5 percent per year, less than the rate of growth of population, which was above 3 percent. Even during the three years since 1978, the rate of real GDP growth has not risen much above the population growth rate. It is clear that, except for a very brief period, Peru failed to step up economic growth through external borrowings after 1973. It is equally clear that the payments crisis, culminating in an interruption of debt service and debt rescheduling, and the poor growth record of 1976-78 stemmed from the prolonged deviations from the second, third and fifth guidelines. The authorities showed great reluctance to take corrective measures, they tolerated highly negative real interest rates, and their exchange rate policies did not prevent progressive erosion of the economy's international competitiveness, except for short periods.

#### Conclusion

The main difference between the experiences of Brazil and Peru is that Brazil came closer than Peru to following the three policy guidelines on which attention has been focused. Both delayed taking corrective fiscal and monetary action when their external accounts experienced disequilibrium, but Peru did so for a far longer period than Brazil. Peru also deviated over a longer period than Brazil from the realistic exchange rate and interest rate guidelines. As a result, Peru suffered more severe distortions than Brazil and its position deteriorated further than Brazil's.

There are, of course, other differences between the two countries, particularly as regards the structure of their economies and the composition of their exports. These undoubtedly played a role in shaping their respective experiences in the period we have reviewed. But the evidence strongly suggest that adherence to the policies outlined here was a critical factor.

Two cases are not enough to establish beyond any doubt that adherence to these policies is always a necessary condition to the success of a strategy of growth through external borrowings. But evidence to the contrary does not readily come to mind. Until contrary evidence is presented, it seems safe to conclude that severe and prolonged deviations from these policies are likely to provoke financial difficulties and economic instability rather than helping to step up the rate of economic growth on a sustainable basis.