
External Debt and Macroeconomic Performance in Latin America and East Asia

JEFFREY D. SACHS

SINCE THE ONSET of the international debt crisis in the early 1980s, the dismal economic performance of the Latin American debtor countries has been frequently contrasted with the strong performance of their East Asian counterparts. Throughout East Asia, with the exception of the Philippines, the developing countries have maintained strong growth rates and low inflation. None but the Philippines has been forced to reschedule its foreign debt. On the other hand, throughout Latin America, with the partial exception of Colombia, national incomes have grown slowly or have declined, inflation has surged, and debtors have been forced to reschedule their outstanding debts.

Many analysts have already tackled the problem of explaining why Latin America's record is so poor compared with East Asia's. Each has pointed to different "lessons" to be learned. Some argue that the Asian record is better because the external shocks that hit the Asian countries in the early 1980s were less severe than those that buffeted Latin America. Others suggest that the Latin American countries simply overborrowed. Some analysts point to exchange rate management and the trade regime as being crucial. Supply-siders contend that the Asian economies have flourished under lower tax rates, and many other economists join them in arguing that the Asian economies have been market-oriented, while the Latin American economies have not.

The available empirical evidence can help to discriminate among these alternative views.

This report is divided into three sections. In the first, I examine some of the leading hypotheses concerning the Latin American—East Asian economic record and show the importance of export growth in explaining the differential performance of the two regions. In the second section, I speculate on some of the political developments that turned the Asian economies toward export promotion and the Latin American countries toward import substitution. The third section

looks briefly at the current political economy of trade in Latin America to show how political paralysis is contributing to the continued economic paralysis.

Explanations for Performance in East Asia and Latin America

The debt crisis of the early 1980s was triggered by a combination of global economic events and domestic developments in the debtor countries. The best evidence for the contribution of global events is the simultaneous onset of the crisis in more than forty developing countries. The best evidence for the role of distinctively national developments is the success of many debtor countries in surmounting the external shocks without an emergency debt rescheduling. The Latin American countries rescheduled, while the East Asian countries, by and large, did not.

The Role of External Shocks

The simplest explanation for the differences in performance is that the global shocks hit the Latin American countries with greater force. Two possibilities are often raised: first, that the commodity terms of trade deteriorated more sharply in Latin America than in Asia, and, second, that the Latin American countries had a higher proportion of debt in variable interest rate loans, and thus felt the effect of rising interest rates sooner.

Based on GDP weights for 1975–80, the terms of trade actually rose in both regions, but less sharply in Latin America than in Asia. Clearly, the terms of trade do not well explain “success” and “failure” in handling external debt in the early 1980s, since three of the six crisis cases in Latin America enjoyed terms-of-trade gains, while two of the four successful adjusters in Asia had terms-of-trade declines. The improvement in Latin America is not surprising, in view of the fact that Mexico and Venezuela are major oil exporters, while Argentina and Peru also export oil (the terms of trade for all of these countries except Peru improved during 1979–83). In Asia, Indonesia is a major oil exporter. Although real oil prices fell in 1982–83, the decrease was not nearly as large as the increase of the preceding four years. Note that the terms-of-trade experience of Colombia was below the Latin American average.

The second external shock of this period was the sustained rise in U.S. interest rates that began at the end of 1979. Higher interest rates affected not only the costs of new borrowing, but also the interest charges on existing debt, since a significant fraction of LDC debt was contracted at variable interest rates. Typically, syndicated commercial bank loans tie interest payments to a short-term dollar rate, such as the London interbank offer rate (LIBOR) or the U.S. prime rate, on a quarterly or semiannual basis. The extent of borrowing at variable interest rates differs widely across debtor countries. It is much higher in Latin America than in Asia (with the exception of Korea), since a higher fraction of the Asian debt is nonbank borrowing, originating instead from official creditors such as export credit agencies of the developed countries.

To measure the interest rate shock as a proportion of GDP, I multiply the change in the real interest rate by a debt-GDP ratio taken as a fraction of GDP for the year 1980. The real interest rate shock is large and negative only for Brazil, Chile, and Korea.

The inescapable conclusion is that macroeconomic performance and the need to reschedule are not closely tied to the magnitude of the external shocks as a proportion of GDP. Argentina, Mexico, and Venezuela had positive (that is, beneficial) net shocks. Korea and Thailand, on the other hand, had very large negative shocks relative to GDP, but both maintained strong economic performance. Part of the answer to this puzzle, we shall see, is that in Latin America, the debt servicing burden became very large as a fraction of exports, though not necessarily large relative to GDP.

The Extent of Foreign Borrowing

It might be supposed that the Latin American debtors have suffered far more because they borrowed far more during the 1970s. Consider first the cumulative current account deficit for the various countries. In a given year, the current account deficit equals the increase in a country's net liabilities to foreigners, subject to an adjustment for capital gains and losses on preexisting stocks of assets and liabilities. The cumulative deficit for the decade should then approximately equal the increase in the country's net liabilities over the course of the decade. There is a large variation in the extent of net borrowing in both regions, and on average the Latin American countries borrowed only slightly more. The variation in net borrowing within each region, compared with the uniformity of results, is striking. In Latin America, Venezuela ran a cumulative current account surplus, and Argentina and Colombia were approximately in balance. The remaining countries ran sizable cumulative deficits. In Asia, Indonesia and Malaysia maintained approximate balance, while Korea ran up a larger proportionate deficit than did any of the other countries in Asia or Latin America. Thailand and the Philippines also ran large current account deficits in the 1970s. It is certainly hard to see a strong link between the size of a nation's current account deficit and whether it suffers a debt crisis.

The difference becomes much more significant only when debt is expressed as a percentage of exports. The higher ratio of debt to exports is most likely the critical factor in making Latin America so vulnerable to the external shocks of the early 1980s.

The contrast between the two regions becomes decisive when the debt service to export ratios are compared. The debt service measure is taken at its most comprehensive level: interest payments on debt of all maturities, plus amortization of principal on medium- and long-term debt, plus complete repayment of all short-term debt. The results are striking, in that in Latin America, debt servicing requirements exceeded total exports, on average, in the years 1980–83, while in Asia (with the notable exception of the Philippines), the debt servicing was well below the level of exports. The higher ratio in Latin America is due to a combination of factors already discussed: higher debt-export ratios; a higher concentration of debt in short maturities; and a higher effective interest rate on the debt, because

of its concentration in variable interest rate bank claims rather than fixed interest rate official credits.

With debt servicing ratios above 100 percent, it was impossible for the Latin American countries to service their debts fully when new lending dropped off in 1982. Debt reschedulings became inevitable. The slowdown in lending itself resulted from several factors: concern over economic mismanagement in the debtor countries; tight monetary conditions in the creditor countries; and the self-fulfilling fragility of the Latin American debt structure in light of the extraordinary debt service ratios. When each lender recognizes that a country will be unable to service its debt if the other lenders stop making loans, a "panic" or "run" on the country becomes possible, as each lender attempts to take out its assets ahead of the other claimants. With debt service ratios in excess of 100 percent, it is easy to see how such a run can occur.

Trade Policies and Exchange Rate Management

Models of optimal borrowing show that capital-scarce developing countries can profitably borrow over the long term, but only if the borrowed resources are invested sufficiently in the tradable goods that ultimately will be used to service the accumulated foreign debt. Over time, as debt is accumulated, the price of tradable goods should rise relative to nontradable goods, to encourage the movement of resources into the tradable goods sectors. Moreover, investment in tradables should be in sectors that are profitable when outputs and inputs are evaluated at world prices, rather than tariff-distorted prices. Latin American economies have violated both dicta in recent years.

It is not easy to get good measures of the size of the tradables sectors over time. The typical recourse is simply to measure the extent of actual exports relative to total income to get an estimate for the growth of the tradables sector. Though admittedly imperfect, the data strongly indicate the rapid growth of exports relative to GDP in East Asia since 1965, compared with a fairly flat pattern in Latin America. In 1965, the Korean export-GDP share was only 9 percent, the Indonesian share 5 percent, evidence that the recent high openness of these countries is a development of the past two decades, rather than a fixed feature of the economies. By 1983, the large debtor countries in Latin America (Argentina, Brazil, and Mexico) had a significantly smaller export base relative to GDP than did the Asian countries.

Another rough indicator of the extent of the tradables sector can be gleaned from data that divide production and employment into agriculture, industry, and services. The tradables sector is often loosely equated with agriculture and industry, the nontradables sector with services. In the absence of extensive trade barriers, this division is plausible. The data suggest that the Latin American countries have a much larger service sector, and hence presumably a much larger non-traded goods sector, than do the Asian economies, and that the growth of the service sector since 1965 has been faster in Latin America (11 percentage points on a weighted average basis) than in East Asia (8 percentage points). It is important to remember, however, that these data likely understate the differences in the two regions by counting heavily protected Latin American industries as part of the tradables base of the economy.

The allocation of resources between tradables and nontradables depends on trade policies, exchange rate management, and aggregate demand management. In considering the relative contribution of each, it is important to work within a framework of at least three sectors: importables, exportables, and nontradables. The three-sector framework helps to guard against an unnecessary and incorrect simplification that is present in the standard two-sector (exportable and importable) model of international trade. In the two-sector model, all policies that protect the import-competing sector necessarily hurt the exporting sector. Protectionism is anti-export biased, since resources pulled into importables must come from exportables. In the three-sector framework, it is immediately evident that protectionist policies can go hand in hand with export-promoting policies if resources are drawn from nontradables into both the tradable sectors. In fact, the export-promotion policies of Korea, Japan, and to a lesser extent Indonesia have had this character: exports have grown rapidly at the same time that import-competing sectors have been protected. In Latin America, on the other hand, the more traditional anti-export bias of protectionism has been present. The combination of expansionary demand policies, protected import-competing sectors, and overvalued currencies has meant that both importables and nontradables have benefited at the expense of exportables. Since the history of the long-term trade policies in the two regions is well documented, exchange rate management dominates the discussion that follows.

Latin American currencies, measured at official parities, became overvalued (with the notable exception of Brazil's and Peru's) in the late 1970s and early 1980s, and Latin American countries have frequently allowed very large premiums to develop in the black market in the face of downward pressure on the official exchange rate. The largest real currency appreciation recorded is that of Argentina (36.9 percent), followed by Mexico, Chile, and Venezuela. Measured by relative consumer price indexes (CPIs), Brazil in fact had a hefty real depreciation, Peru a somewhat smaller one. In Asia, all countries except Indonesia maintained the real exchange rate within 10 percent of the 1976–78 values. Moreover, the Latin American countries have allowed large black market premiums to develop in recent years, particularly after the onset of the debt crisis, while the Asian countries have generally kept small the discrepancies between the official and black market rates.

There are several reasons for the real appreciation throughout Latin America, but I suggest later that common political developments leading to such appreciations, and to their persistence for several years, are at work. In terms of proximate causes, it is necessary to distinguish between the two Southern Cone countries included in the table, Argentina and Chile, and the two major oil exporters, Mexico and Venezuela. The story in the Southern Cone is by now well known: Argentina, Chile, and Uruguay all embarked upon a path of disinflation, with a strong currency policy helping to reduce inflationary expectations. In Mexico, and in Venezuela to a lesser extent, the real appreciation resulted from oil-induced increases in domestic spending that crowded out tradable goods sectors, à la the “Dutch disease.”

It is worth noting that the Asian policy of maintaining the real exchange rate has been extended to encompass a basket of currencies, rather than focusing exclusively on the bilateral rate with the U.S. dollar. During the years when the

Bretton Woods system was in effect, and for several years after its demise, the Asian economies maintained fixed rates against the dollar. However, by 1978, all of the countries in the region were worried about the large fluctuation of the dollar vis-à-vis other industrial country currencies. In rapid succession, Thailand, Korea, Indonesia, and Malaysia all switched from a dollar peg to an exchange rate basket. In Latin America, on the other hand, no country adopted a basket. All continued to peg to the U.S. dollar, either at a fixed parity, as in Mexico, Venezuela, and Chile after 1979, or in a crawling peg, as in Argentina, Brazil, Colombia, and Peru. All suffered, to some extent inadvertently, when the dollar appreciated sharply after 1980.

A Summary

Of all the causes of poor Latin American economic performance considered so far, the most significant seem to be trade and exchange rate policies. Put simply, the Latin debt became burdensome both because of its structure (short maturities, variable interest rate) and because of insufficient exports available to service it. After a decade of rapid foreign borrowing, too many of Latin America's resources were in the nonexporting sector, or abroad. When a financial squeeze in the early 1980s caused banks to draw in their loans, the only way that the Latin countries could maintain debt servicing was through a recession and a sharp reduction in imports combined with debt reschedulings.

The Political Economy of Export-Led Growth

Certain key elements in political and economic organization can help to account for the differing exchange and trade regimes in Latin America and Asia.

Trade restrictions tend to shift income from the agricultural and mineral producing sectors toward the industrial and service sectors. Since the agricultural work force in most middle-income developing countries is typically between 30 percent and 50 percent of the total, and since agriculture and mining account for a quarter or more of domestic GDP in most cases, the political and economic effects of this particular income redistribution can be profound.

These distributional effects provide some clues as to why the Latin American countries have chosen to rely on an overvalued currency, a large service sector, and a small export sector, while the Asian economies have lived with the reverse. I believe that long-term differences in the balance of power between urban and rural interests help to account for much of the discrepancy. To a first approximation, the Latin American governments—whether civilian or military, right-wing or left-wing—find their most important constituencies among urban workers and capitalists. For decades, the agricultural sector has been relatively weak, though certainly not powerless, almost everywhere in Latin America, with peasants only loosely organized and, with some exceptions, large-scale agricultural interests unable to hold decisive sway. Moreover, political unrest is most dangerous in the cities, so that urban interests must be bought off first in difficult periods. Interestingly, the opposite seems to be true in most of East Asia. Govern-

ments there, whether Japanese colonial rulers before World War II or nationalist governments, have felt the pressing need to win support of, or at least to appease, the rural sector.

The rural-urban distinction is but one element in a very complicated picture. Ideology, foreign policy, and even national security considerations have also contributed to differences in policy, and, indeed, many distinctions across countries within Latin America and Asia make any overarching generalizations treacherous. Several qualifications are therefore in order. First, there is no historical inevitability to the relative influence of agricultural versus urban interests in the two regions. It is well known that up until the Great Depression, large rural landholders in Latin America provided the dominant political power within the ruling oligarchies. And, indeed, until the Great Depression, trade policies throughout Latin America were stringently liberal, in line with the class interests of the ruling oligarchs. The shift to import substitution and vigorous protection of domestic industries dates from the decline of the relative power of the agricultural sector during the Great Depression. Similarly, in Asia, countries such as Korea and Indonesia pursued an import-substitution policy complete with Latin American-style inflation rates during the 1950s. It is not that rural strength in Asia made an export-promoting strategy inevitable; rather, rural strength helped to tip the balance in that direction in the 1960s, when the East Asian countries began their export drives.

Second, countries within a region differ substantially in their urban-rural balance. Large agricultural interests, particularly in coffee, have remained powerful in Colombia, for example, and were a substantial political force behind Colombia's liberalization in the mid-1960s. Third, intellectual and ideological elements have played a significant role, along with strict economic interests, in defining the trade and exchange rate policies in Latin America and Asia. Dependency theory and opposition to U.S. involvement in local economies have contributed to the strength of protectionist sentiment throughout Latin America. The influence on Latin governments of the Prebisch hypothesis that agriculture and primary products were a losing long-term bet for economic growth also contributed to the formulation of the import-substitution policy.

Some very rough indicators suggest why the hypothesis of greater rural power in Asia is at least plausible. The population in Asia remains largely rural, while the Latin American population is overwhelmingly urban. This difference remains very strong even after controlling statistically for per capita incomes across countries. Korea, now highly urbanized, is the single Asian exception, but it is not in contradiction to the thesis that rural political power is a force for export-oriented trade policies. Korea's decisive devaluations and export-promotion policies were instituted during the five years after 1960, when Korean urban dwellers composed only 28 percent of the nation's total population. Also the Latin American countries are far more unionized than are their Asian counterparts. Since urban workers are a major interest group in favor of overvalued exchange rates, this difference in labor market organization certainly plays an important role in the political calculus.

To tie down the relationship of agricultural political power and export promotion would require a detailed country-by-country study, though an initial examination of the historical record in several countries lends credence to the hypothe-

sis. In Argentina, for example, it is clear that the urban-based political power of Peron, combined with the political weakness of agriculture due to low world prices in the Great Depression, contributed to the decisive shift away from export promotion. (Up to the Great Depression, the agricultural interests had succeeded in maintaining free trade and a competitive exchange rate.)

While the Argentine pattern is familiar throughout Latin America, almost the opposite is true in Asia. In Malaysia, Indonesia, Korea, Taiwan, and Thailand, the governments look to the rural sector as an important element of support. The same was historically true in Japan, and even today, the ruling Liberal Democratic party must bow to agricultural interests in maintaining high domestic prices for food.

The link between rural influence and export promotion is only the first step in the development of a successful export program. Once export-promoting policies get under way, urban-industrial exporters become their own lobbyists and eventually become the dominant political force in favor of an undervalued exchange rate, with rural interests losing their relative influence. Clearly this process is under way in Korea, where an enormous concentration of export-oriented industrialists is a strong force with regard to the exchange rate and trade policy. On the other side, after decades of import substitution in Latin America, manufacturing exporters are so weak politically as to be unable to overturn a strong currency policy, even acting in conjunction with the rural sector. Thus, the political biases of the export-promotion or import-substitution regimes probably feed upon themselves over time, and make it increasingly difficult to change course.

Jeffrey D. Sachs, "External Debt and Macroeconomic Performance in Latin America and East Asia," *Brookings Papers on Economic Activity* 2 (1985): 523–64.