Volume Title: Developing Country Debt and Economic Performance, Volume 2: The Country Studies -- Argentina, Bolivia, Brazil, Mexico

Volume Author/Editor: Jeffrey D. Sachs, editor

Volume Publisher: University of Chicago Press, 1990

Volume ISBN: 0-226-73333-5

Volume URL: http://www.nber.org/books/sach90-1

Conference Date: September 21-23, 1987

Publication Date: January 1990

Chapter Title: From Martinez de Hoz to Alfonsin

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Chapter URL: http://www.nber.org/chapters/c8925

Chapter pages in book: (p. 64 - 76)

3 From Martinez de Hoz to Alfonsín

In this chapter, we review the central phase of Argentine debt accumulation. Between 1976 and 1981, the gross external debt increased by $27 billion. The debt/income ratio increased from less than 20 percent to nearly 50 percent. Near the end of the 1970s, the growth of debt was primarily the counterpart of capital flight. In the 1980s it resulted from the mechanics of debt accumulation—interest on debt rolled over (at high real interest rates) into an ever-growing indebtedness.

Table 3.1 lists the presidents and economics ministers of the various administrations in this period. Politically, these years can be divided into the Martinez de Hoz phase (1976–81), the transition from military to democratic regime, and the Alfonsín regime. In the Martinez de Hoz period, it is common to distinguish the years through January 1979 from the rest which are characterized by the administration of an exchange rate *tablita*. In the transition period, the main events are the Malvinas War and the great debt liquidation under Economics Minister J. M. Dagnino Pastore and Central Bank President Domingo Cavallo in August 1982. Finally, in the Alfonsín administration, three phases are apparent: an initial mismanagement under Economics Minister Grinspun, the Austral Plan, and the subsequent drift toward renewed inflation and loss of control. In this chapter we will discuss the period through the Austral Plan, and will highlight the chief macroeconomic events and their reflection in the external buildup of debt. We focus on the Martinez de Hoz period because it is central to the buildup of external debt via capital flight.

3.1 Martinez de Hoz

When the military coup overthrew the Peronist regime in March 1976, the country was on the verge of hyperinflation. Consumer price inflation declined

Table 3.1 **Presidents and Economics Ministers, 1976–88**

President	Period	Economics Minister	Period
Videla*	3/1976–3/1981	Martinez de Hoz	3/1976–3/1981
Viola*	3/1981–12/1981	Sigaut	3/1981–12/1981
Galtieri*	12/1981–6/1982	Alemann	12/1981–6/1982
Bignone*	7/1982–12/1983	Dagnino Pastore	7/1982–8/1982
		Wehbe	8/1982–12/1983
Alfonsín	12/1983–	Grinspun	12/1983–2/1985
		Sourrouille	2/1985–6/1989

Note: An asterisk (*) denotes a military government.

from nearly 40 percent per month in March 1976 to less than 3 percent by June, but by the end of the year inflation had risen to 150–200 percent per year (table 3.2). Inflation fighting would thus become a constant preoccupation of the Martinez de Hoz administration.

Among the policies of the Martinez de Hoz administration, two measures stand out. One is the financial market reform, initiated in June 1977; the other is the exchange rate *tablita*, which was introduced in January 1979 and lasted until early 1981.

3.1.1 Financial Reform

In the Peronist period interest rates had been regulated and, by the end, were significantly negative. Financial repression had been an important means of financing large budget deficits. Under the new rules, the budget deficit was to be financed in the capital market rather than by money creation. Banks were free to offer interest rates and deposits and to charge for services.

In order to make the transition from the repressed system to the new, free market approach, extensive banking regulation was required. Specifically, reserve requirements had to be set high enough to ensure that the banking system would be required to hold the stock of government debt already in its portfolio. This was accomplished by setting high reserve requirements, initially at 45 percent. But these requirements implied a large spread between active and passive rates. To circumvent this problem, the Central Bank introduced a system called the *Cuenta de Regulación Monetaria*, which compensated banks for reserves. There was also a charge levied on that part of demand deposits not covered by reserve requirements.[1] A number of factors combined to make the *cuenta* run deficits: high market interest rates and hence a high ratio of M2 to M1, and a charge on demand deposits based on an estimate of expected inflation. As a result, the deficit of the *cuenta* averaged 1 percent of GDP during 1977–81 and reached 2.8 percent of GDP in 1978.

The effect of financial liberalization on real, active interest rates can be seen in figure 3.1. Until 1977 real interest rates were overwhelmingly negative. Following the financial reform, real rates became more nearly positive, particularly in 1980.

Calvo (1987) has argued that the financial reform was an important reason for the real exchange rate appreciation seen earlier in figure 1.3. Restraint of

Table 3.2 **Economic Change in the Martinez de Hoz Period (percent per year)**

	1976:I	1976:II	1977	1978	1979	1980
Inflation	706	182	176	176	160	101
Growth	−1.1	2.0	6.3	−3.4	6.6	1.1

Source: Carta Económico.

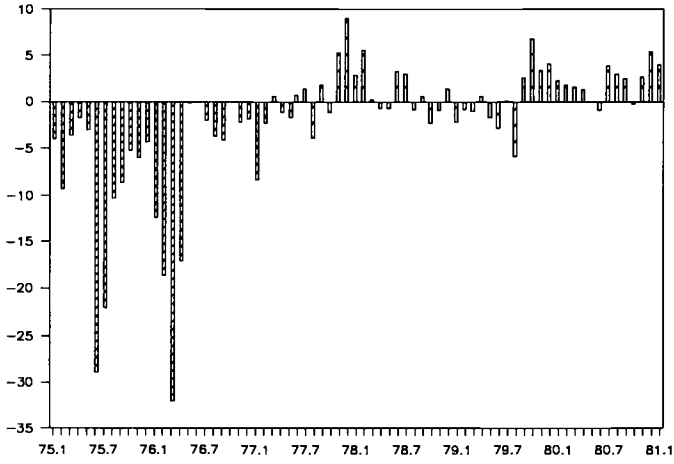

Fig. 3.1 Active real interest rates (percent per month)

domestic credit creation, combined with a deficit in the budget, which was no longer financed by the Central Bank, implied that both the private and public sector were borrowing abroad. Calvo interpreted this as the country borrowing abroad to put foreign exchange in the Central Bank, which then by monetization of the reserve inflow would provide domestic money. Thus the policy amounted to a strict application of the monetary approach to the balance of payments.

Table 3.3 shows the balance of payments statistics. The Calvo interpretation certainly correctly represents the period up to 1979–80. Following financial reform, and given high average real interest rates, firms preferred to borrow abroad rather than in the home market. In this period, the increase in the gross external debt has a counterpart in capital imports by firms and reserve gains by the Central Bank. This pattern is particularly clear in 1979.

Table 3.3 The Balance of Payments and Gross External Debt (in billions of $U.S.)

	1977	1978	1979	1980	1981	1982
Current account	1.3	1.8	−0.5	−4.7	−4.7	−2.4
Noninterest	1.8	2.6	0.6	−2.6	−0.9	2.6
Capital inflows	1.3	1.3	4.7	2.6	1.5	−2.3
Firms	1.1	0.7	4.2	2.0	−1.1	−3.1
Banks	0.2	0.1	−0.0	−0.4	0.0	1.1
Government	−0.0	0.5	0.5	0.9	2.5	−0.4
Balance of payments	2.5	3.2	4.4	−2.5	−3.4	−5.1
Gross external debt	9.7	12.5	19.0	27.2	35.7	43.6

Source: Indicadores de Coyuntura, various issues.

Financial reform was not the only reason for capital inflows—the *tablita* certainly was part of the attraction.

3.1.2 The *Tablita*

The disappointing progress toward disinflation led the government to announce a disinflation strategy based on reduced, preannounced rates of disinflation in December 1978. The theory behind this disinflation policy relied on the Chicago School "law of one price," popularized by Harry Johnson and Robert Mundell. This view held that prices in any country were strongly linked to the world price level. Given this link, a policy of depreciation inevitably meant inflation, thereby requiring further depreciation which, in turn, would lead to continuing inflation.

In order to break this vicious cycle of inflation and depreciation, policymakers opted to set a path of reduced exchange depreciation, hoping that it would feed through into reduced inflation. At the same time, targets were set for public sector wages and prices as well as for the expansion of domestic credit. The Plan of December 20th had these specific announcements:[2]

- Public sector wages and prices were to rise at a monthly rate of 4 percent over the following eight months.
- Domestic credit was to grow at 4 percent per month during the first semester of 1979.
- The exchange depreciation was to be 5.4 percent for January 1979, and would decline from that level by 0.2 percent per month until August 1981.

Three linkages from depreciation to inflation were anticipated. First, expectations of depreciation were built automatically into pricing. Reducing the rate of depreciation would lead firms to reduce their inflation forecasts and hence their price increases. Second, the rate of increase of import prices would be dampened by reduced depreciation. Third, firms competing with importables would be forced into price discipline. As can be seen, therefore, reduced depreciation was thought to bring down inflation through various channels.

Particular emphasis was placed on the expectations channel. To reinforce this effect, the future path of the exchange rate was preannounced. Thus in December 1978, the authorities announced that depreciation rates would fall from 5.2 to 4 percent per month over the next eight months. This procedure was followed until early 1981 when the system broke down as a result of the progressive overvaluation shown in figure 3.2.

The law of one price was also expected to apply to interest rates. Hence pre-fixing the rate of depreciation was thought to rapidly reduce domestic interest rates to the level of those prevailing abroad, adjusted of course for the rate of depreciation. With an interest rate (including spread) in New York

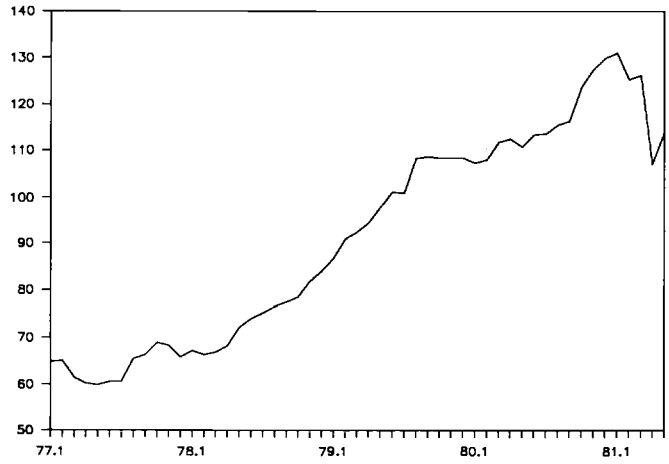

Fig. 3.2 The real exchange rate (index 1980–82 = 100)

of 0.15 percent per month, for example, and a depreciation rate of 4 percent per month, the Argentine interest rate should be 5.6 percent.

Table 3.4 shows the quarterly monthly rates of depreciation, the CPI inflation rate, the nominal interest rate, and the real exchange rate. There are two margins to consider. One is between the nominal interest rate and the rate of depreciation. This margin, if announcements are believed, directs the choice between borrowing in Argentina or abroad. When the Argentine interest rate exceeds the announced rate of depreciation, there should be borrowing in the world market. The relation between the nominal interest rate and the rate of inflation tells us about the profitability of borrowing or the accumulation of real debts.

Nineteen seventy-nine is a typical year for the combination of policies to attract capital inflows. Interest rates are very high relative to the rate of depreciation. The return from borrowing in New York and lending in Buenos Aires in December 1979, for example, is above 50 percent per year! Moreover, because of high (and growing) reserves, the policy is believable. The moderate current account deficit supports the idea that the exchange rate policy is sustainable. As a result, capital inflows are exceptionally high throughout the year. The increase in external debt exceeds the capital flows, but not by a wide margin. In 1980 real interest rates turned sharply positive, which suggests that financial market integration is as imperfect as goods market integration since the government could implement a tight domestic money strategy even under a pre-fixed exchange rate regime.

3.1.3 The Collapse

The large discrepancy between depreciation and inflation meant gradual appreciation of the real exchange rate. Between March 1976 and December

Table 3.4 **The *Tablita* Period (quarterly percentage rates, except as noted)**

			Interest		Real Exchange Rate	
	Depreciation	Inflation	Passive	Active	Morgan Guaranty	P_D/P_M
1978						
I	21.4	28.1	27.7	37.8	82	71
II	11.5	26.3	22.3	26.9	87	80
III	8.3	19.4	20.7	25.0	93	89
IV	15.5	27.8	21.5	24.6	100	100
1979						
I	15.5	31.5	20.7	23.3	110	109
II	14.2	27.0	20.9	23.0	120	109
III	12.2	27.3	23.2	25.7	130	117
IV	10.2	11.0	20.6	23.5	133	115
1980						
I	8.3	14.2	16.6	19.4	134	110
II	6.5	15.5	15.0	18.1	137	114
III	4.5	9.7	16.2	19.9	141	116
IV	3.1	14.2	15.1	18.8	156	114
1981						
I	17.6	14.0	21.7	26.7	157	107

Sources: Fernandez (1985) and Morgan Guaranty.

Note: The inflation rate refers to nonagricultural wholesale prices. The real exchange rate is an index with base 1978: IV = 100. The measure of Morgan Guaranty compares nonfood wholesale prices in Argentina to the trade weighted average abroad. The second measure of the real exchange rate refers to the relative wholesale price of domestic goods and imports, P_D/P_M.

1978, the real exchange rate (as shown in fig. 3.2) had already appreciated by 20 percent. During the first year of the *tablita*, real appreciation amounted to 33 percent and was an additional 17 percent in 1980. Only in 1980 did it become widely apparent that the disinflation strategy might fail. Inflation had declined, but not by an amount sufficient to justify a belief that exchange rate–based disinflation could be pursued long enough to bring inflation down to tolerable levels.

The increasingly apparent overvaluation was not the only reason for unrest. The failure of major banks, resulting from dishonesty in management, created financial uncertainty and forced the government to take over these institutions. Due to very high real interest rates that persisted for an extended period, the government had started accumulating internal debts. This combination of factors brought about a wave of capital outflows. Beginning in the second quarter of 1980, the Central Bank experienced reserve losses. For the year, these losses came to nearly $3 billion, as shown in figure 3.3. In the first quarter of 1981 reserve losses were $3 billion.

The current account deteriorated in a major way beginning in 1980. The main reason for the worsening was a large increase in imports. The huge real appreciation, along with some trade liberalization, led to an increase in imports of nearly $4 billion. Interest payments rose, but the rise in exports

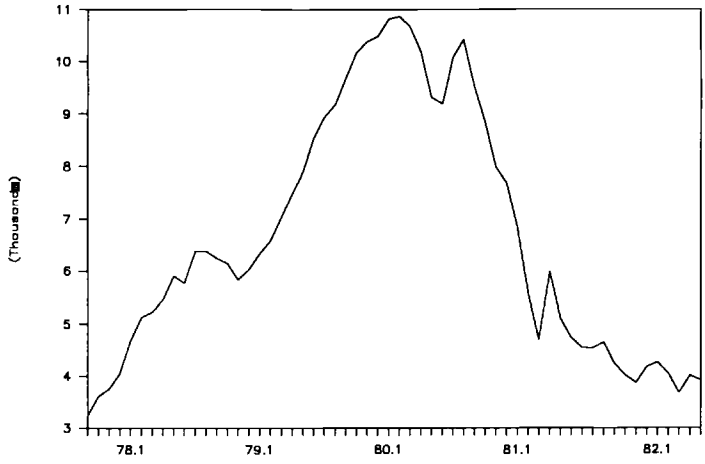

Fig. 3.3 International reserves (in millions of $U.S.)

still more than compensated. As 1981 began, the growth in world interest rates started to have a strong effect on the current account.

These actual and prospective reserve losses reinforced the belief that the exchange rate policy could not be sustained, and thus led to even more capital flight. Another factor was important, namely, the change from one president to another. In October 1980 the presidency of Roberto Viola was announced, and, from that time on, Martinez de Hoz was a lame duck economics minister. The new president was unwilling to commit himself, ahead of time, to Martinez de Hoz–style policy. As a result, there was an overt ambiguity about continuity in the domestic economy. The public drew the obvious lesson and shifted their monies into foreign assets. The large capital flight, only incompletely offset by public sector borrowing in world markets, implied unsustainable reserve losses. By late 1980 the exchange rate announcements ceased to be believed, and in February 1981 Martinez de Hoz was forced to violate the precommitted exchange rate targets by a 10 percent devaluation on top of the 2 percent preannounced depreciation.

It is interesting to ask why the program failed. For some, the answer is as obvious as why a car on square wheels cannot move. But at a deeper level, the program was supported by at least a tendency toward the law of one price and a tendency for interest arbitrage to occur. A model suggested by Rodriguez and Sjaastad (1979) and Dornbusch (1982) gives the essential elements. We focus the discussion here using a diagram, while in appendix A we develop the necessary equations. Two variables are at the center of attention, the real exchange rate ($R = P_N/e$) and the rate of price inflation of nontraded goods (π). The vertical schedule in figure 3.4 shows a pre-fixed (constant) rate of depreciation (λ_o). The rate of traded goods price inflation is

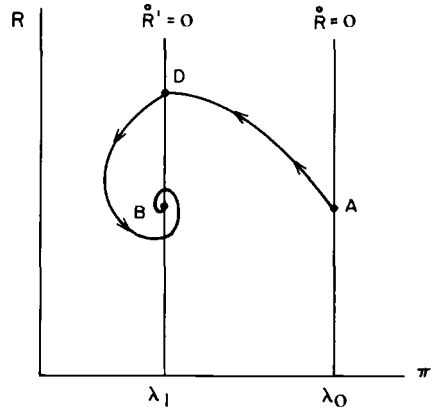

Fig. 3.4 The adjustment process under a *tablita*

assumed to be equal to the rate of depreciation. The real exchange rate is appreciating to the right of the vertical schedule and depreciating to the left.

We assume that the rate of home goods price inflation increases whenever the real exchange rate depreciates. We also assume that the level of the real exchange rate and of the real interest rate affects home goods price inflation. A high relative price of home goods slows down inflation because of excess supply, as does a high real interest rate.

In figure 3.4 we see the process of adjustment to a reduction in the rate of depreciation. We start at point A and the rate of depreciation is permanently reduced from λ_o to λ_1. The immediate effect of reduced depreciation is to slow the rate of inflation of traded goods. Home goods price inflation is affected through two separate channels: on one hand, there is a reduced rate of inflation via expectations effects, and on the other, the decline in the nominal interest rate resulting from international interest arbitrage would increase demand. We assume the former effect dominates so that inflation immediately starts slowing down.[3] But, as is apparent from the figure, the slowing of inflation is only gradual, while the reduction in depreciation has moved ahead. Hence the real exchange rate is appreciating. Over time, inflation and the real exchange rate follow the path indicated by the arrows. Inflation does fall, but the real exchange rate keeps appreciating.

The model suggests that given enough time the economy will converge to a point where the real exchange rate has declined to the initial level. Note, however, that at the very moment when inflation is first reduced to the target rate, at point *D*, victory on the inflation front comes at a price. Now the real exchange rate is highly overvalued, and the disinflation process must continue. Inflation has to fall below the rate of depreciation (via recession in the economy) until competitiveness is restored. Only at

that point (at *B*) will inflation settle down to the lower rate of depreciation and real interest rates return to the initial level. The problem is that on the way, at a point such as *D*, the large real appreciation poses credibility problems. Reserve losses can emerge because of fear that the authorities will not sit out the full adjustment. This is, in fact, what occurred in late 1980 and early 1981.

The difficulty with what Fernandez (1985) has called the "expectations management approach" is primarily that the adjustment is not rapid and hence may not survive changes of regime. There is also, of course, the difficulty of accumulating current account deficits, which affects the long-run sustainable real exchange rate.

The data in table 3.4 confirm the pattern of real appreciation, but do not support the decline in real interest rates predicted by this model. Thus, incomplete integration of the capital market is as much of a difficulty as the poor integration of goods markets. Of course, if capital markets were more integrated, the sharp reduction in the real interest rate could make disinflation more difficult.

The slow disinflation is explained here in terms of inflation inertia, but we must also mention separately the issue of the budget. Budget deficits continued to be large, and hence on the fiscal side there was certainly no support to disinflation. Moreover, a point Carlos Díaz Alejandro (1964) makes comes into play. He argues that in a situation of real depreciation, the income effects and income redistribution appear rapidly, and the substitution effects work only gradually. He concludes that, as a result, a real depreciation tends to have recessionary effects. The converse, of course, applies in the situation of real appreciation which we are discussing here. The rise in the standard of living that comes from real depreciation sustains prosperity (*la plata dulce*) for a while before substitution effects take over and create unemployment and trade problems.

3.2 Estimates of Capital Flight

The extent of private capital outflows in this episode cannot be measured unambiguously. The balance of payments statistics and the debt are imperfect. Moreover, the current account statistics may misrepresent true trade transactions because of misinvoicing (for purposes of tax evasion or capital flight), and they certainly understate military imports.

A possible method to calculate the increase in Argentine private assets abroad would use the debt and balance of payments statistics as follows.[4] The increase in assets has to be financed. The sources for this financing are the increase in debt plus the change in reserves minus the current account deficit and foreign direct investment in Argentina. Using equation (1), which shows the counterpart of the increase in debt, we calculate the increase in private assets abroad (other private capital outflows) as a residual item:

(1) Increase in debt = Current account deficit
− Direct and long-term capital inflows
+ Official reserve increases
+ Other private capital outflows.

Table 3.5 gives the calculation for the period 1978–82 and shows that interest payments were financed almost entirely by the noninterest surplus. Thus virtually the entire increase in external debt has as a counterpart private accumulation of assets abroad, i.e., capital flight.

Various estimates of capital flight from Argentina are reported in Rodriguez (1987) and Cumby and Levich (1987). These estimates, although the authors use different methodologies, broadly support the same conclusion: Argentina external debt has as a counterpart substantial private assets accumulated abroad. Moreover, when these asset estimates are combined with accumulated interest, they come close in magnitude to the entire external debt.

Figure 2.4 above already showed the debt/income ratio of Argentina since 1970. The striking fact of the period under discussion is the dramatic rise in debt due not to conditions in the world economy which raised debt service or deteriorated commodity prices—that came later—but rather to capital flight arising from domestic macroeconomic and political experiments which backfired. It would be wrong to argue that Martinez de Hoz's experiments are exclusively responsible for Argentina's debt problems today, but his policies certainly reinforced the precarious financial position inherited from the Peronist period. They also left a severe mortgage for subsequent administrations. In retrospect, the Martinez de Hoz program is so striking because it reveals an arrogance of power of which only totalitarian regimes are capable.

3.3 The Transition

The period between the collapse of the Martinez de Hoz program in March 1981 and the advent of democratic government in December 1983 is primarily one of disarray. Rising inflation and intensifying debt problems, the Malvinas War, and the internal debt crisis characterize this period.

Table 3.5 **Estimate of Capital Flight, 1978–82 (in billions of $U.S.)**

	Current Account		
Increase in Debt	Interest	Noninterest	Increase in External Assets
26.8	−9.3	6.8	23.4

Source: Dornbusch (1985a).

The years from 1981 to 1985 can be best understood by considering the constraints faced by policymakers. First, there was an overriding external constraint. The inability to rollover debt automatically to finance current account deficits in the world market, following the 1982 Malvinas War and the Mexican crisis, meant that there was a permanent foreign exchange crisis. The foreign exchange crisis required high interest rates to prevent capital flight and to keep down the black market rate. It also required a competitive real exchange rate, but such a rate necessitated a reduction in real wages unless public sector prices were reduced to maintain the standard of living. This tradeoff between real wages and competitiveness was a growing source of inflation and budget difficulties in the coming years. Finally, growth could not be neglected. Policy at this time bounced around between objectives of growth and low inflation and the limits provided by the external constraint.

The existing private debt played an important part in the attempt to manage the external constraint. The authorities encountered great difficulties in making private debtors maintain their external indebtedness in the face of real depreciation. Firms with dollar-denominated debts were facing the prospect of large depreciation and were consequently tempted to borrow domestically to pay off the external debt. To avoid the resulting reserve drain, two measures were taken: interest rates were raised dramatically, and exchange rate guarantees were offered.

The high real interest rates led to bankruptcy problems, which we will discuss shortly. The exchange rate guarantees proved exceedingly costly later when they had to be met following a significant depreciation. They resulted in huge financing requirements as the government bought foreign exchange at a high dollar rate to give away cheap to those firms who had accepted the guarantee. Since the dollar purchases were financed by money creation, they provided the fuel for rising inflation.

Another development of this period is the growing nationalization of the external debt. An alternative to exchange rate guarantees was for the government to assume directly external debts, for example, by taking over failing financial institutions. From the end of 1980 to the end of 1983, the external debt increased by $26 billion. The share of the public sector in that debt rose from 52 to 71.8 percent. The large increase in external debt meant increasing burdens on the budget.

The policy of high real interest rates that was used in 1979–82, first as part of the disinflation program and then increasingly to stop capital outflows, led to a sharp rise in private debt. Figure 3.5 shows the hypothetical accumulation of real debt for someone who borrowed 1 peso in July 1977 at the outset of financial liberalization and rolled over the debt continuously at the unregulated active rate. Note, in particular, the extreme increase in indebtedness between late 1979 and mid-1981—a 60 percent rise in the real value of the debt. Such an increase in only two

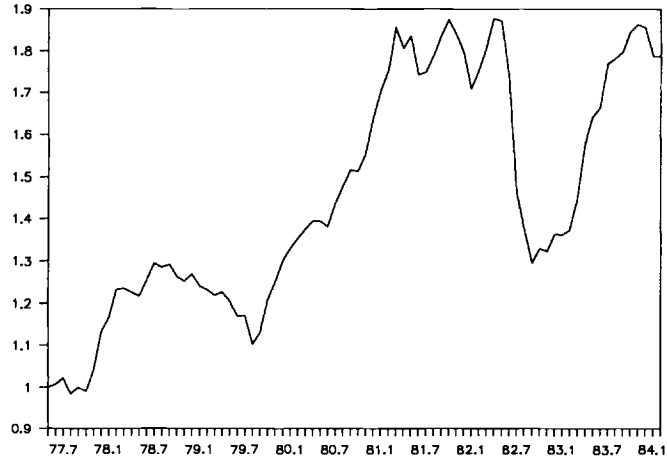

Fig. 3.5 The real value of debts (1977:6 = 1)

years outpaces any possible real return on investment. As a result, firms who had borrowed from banks were progressively moving toward bankruptcy.

To cope with the internal debt problem, Economics Minister Dagnino Pastore and Domingo Cavallo, president of the Central Bank, liquidated debts in July and August 1982. The means used for debt liquidation was the fixing of nominal interest rates far below the rate of inflation. But, as is clear from figure 3.5, the measure provided only temporary relief. Debt accumulation began once again after the new economics team decided that their priority was to use tight money to fight rising inflation and continuing balance of payments deficits. Significant steps to address the problems using fiscal policy never occurred. In fact, the inflation tax was used increasingly to pay exchange rate guarantees, external debt service, and rising real wages in the public sector. We consider that process in more detail in the following chapter.

3.4 Alfonsín

When the Alfonsín administration took office in December 1983, the economy was already in terrible shape. Inflation had risen from only 100 percent in 1980 to more than 400 percent. Real wages had been increased sharply in the final phase of the military government, and the real money stock—the base for the inflation tax—had been progressively eroded. $M1$ had declined to only 4.1 percent of GDP, down from 7.9 percent in 1980. The ratio of $M4$ to GDP had fallen from 27.8 percent in 1980 to only 12.4 percent.

External debt had risen steadily over the period since 1980. Table 3.6 shows the rising debt as well as the sharp increase in the interest bill. Since 1982 half of the interest had been paid using noninterest surpluses. The difficulty of achieving these surpluses was aggravated by sharply declining terms of trade beginning in 1981. In terms of resource transfers, the country had brought about a massive shift in the noninterest current account. Resource transfers that had been inward at the rate of more than 1 percent now moved outward. The shift abroad of resource transfers of 4–6 percent of GDP showed up throughout the macroeconomy in the form of high real interest rates and inflation, which were the means to crowd out enough private spending to free resources for debt service.

Initial policies of the Alfonsín administration failed to effect fundamental changes. Real wages were increased, even as an IMF program was attempted. On the external debt side, the new economics minister, Grinspun, initiated a strong rhetoric that was endorsed by Alfonsín. But rhetoric notwithstanding, resource transfers remained enormous, inflation soared, and any semblance of control disintegrated when in early 1985 the country went to the brink of hyperinflation.

When the Alfonsín administration came into office, expectations and hopes were limitless. By early 1985 output was declining and inflation, which on a December-to-December basis had been nearly 700 percent in 1984, accelerated sharply toward 3,000 percent. The budget deficit financed internally had risen from 6–7 percent in 1981–82 to 12 percent in 1983–84. In the second quarter of 1985 it rose to 23.7 percent.[5]

The government saw no option except to attack the inflation problem head on. But how? Creating a deep recession was politically excluded and economically unpromising. Relying on controls by themselves would not do much, as many previous attempts in Argentina had demonstrated. Hence the search began for a program combining orthodoxy with respect to monetary and fiscal adjustments with heterodoxy in avoiding the recessionary effect of macroeconomic restraint. In chapter 5 we study the Austral Plan, which was supposed to be the answer to the stabilization dilemma; but before doing so, we take a closer look in chapter 4 at the economics of hyperinflation.

Table 3.6 **External Debt and Resource Transfers (in billions of $U.S., except as noted)**

	1980	1981	1982	1983	1984	1985
External debt	27.2	35.7	43.6	44.8	47.8	48.3
Interest due	1.0	3.0	4.4	5.0	5.3	4.9
Current account	−4.8	−4.7	−2.4	−2.5	−2.4	−1.0
Resource transfer (% of GDP)	−3.3	−1.2	3.0	3.9	4.5	6.0

Source: World Bank.