

# CEPAL

## Review

*Executive Secretary of ECLAC*  
Gert Rosenthal

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Andrés Bianchi

*Director of the Review*  
Aníbal Pinto

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UNITED NATIONS  
ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARIBBEAN

SANTIAGO, CHILE, APRIL 1989

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#### Notes and explanation of symbols

The following symbols are used in tables in the *Review*:

Three dots (...) indicate that data are not available or are not separately reported.

A dash (—) indicates that the amount is nil or negligible.

A blank space in a table means that the item in question is not applicable.

A minus sign (-) indicates a deficit or decrease, unless otherwise specified.

A point (.) is used to indicate decimals.

A slash (/) indicates a crop year or fiscal year, e.g., 1970/1971.

Use of a hyphen (-) between years, e.g., 1971-1973, indicates reference to the complete number of calendar years involved, including the beginning and end years.

Reference to "tons" mean metric tons, and to "dollars", United States dollars, unless otherwise stated.

Unless otherwise stated, references to annual rates of growth or variation signify compound annual rates.

Individual figures and percentages in tables do not necessarily add up to corresponding totals, because of rounding.

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## Review

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### CONTENTS

The conduct of Latin America's creditor banks. <i>Michael Mortimore.</i>	7
Options for tackling the external debt problem. <i>Robert Devlin.</i>	27
Latin America's prospects in the financial markets. <i>Alfred J. Watkins.</i>	45
Criticisms and suggestions on the cross-conditionality of the IMF and the World Bank. <i>Patricio Meller.</i>	65
Options for regional integration. <i>Eduardo Gana and Augusto Bermúdez.</i>	79
A new integration strategy. <i>Carlos Massad.</i>	95
The old logics of the new international economic order. <i>Vivianne Ventura Dias.</i>	105
Participation and concentration in social policies. <i>Carlos Franco.</i>	123
The heterogeneity of poverty. The case of Montevideo. <i>Rubén Kaztman.</i>	131
Key conceptual issues in the privatization of state-owned enterprises. <i>Raymond Vernon.</i>	143
Some recent ECLAC publications.	151
Guidelines for contributors to CEPAL Review.	159

# Options for tackling the external debt problem

Robert Devlin\*

This paper will briefly overview the current situation of debtors and creditors and evaluate some of the difficult issues concerning the international management of Latin America's payment problems. Section 1 of the paper itemizes the achievements and setbacks in the international debt management programme since 1982 and finds that while the creditor countries have, on balance, done reasonably well for themselves over the last few years, the debtor countries in contrast have found themselves in a crisis of deepening proportions. Section 2 explores the reasons for the debtors' poor economic performance; it points out that in many instances it is difficult to isolate the question of the quality of domestic effort to adjust from the perverse effect of an adverse external environment, and in particular, from the outward net transfer of financial resources from the debtor countries to the creditor countries. Indeed, Section 3 concludes that if there is any generalized cause for the poor performance of the region, it is the half-hearted international public policy that has been in place since 1982, which has given priority to an outward transfer of resources instead of supporting efficient socioeconomic restructuring in Latin America. Section 4 argues that to correct this tendency, there must be a much more ambitious production of international public goods designed to ensure new credit and reduce the external debt of Latin America in volumes that are macroeconomically significant. It is concluded that in the absence of this, more debtors in the region will opt for unilateral limits on their debt service, and that moreover, if the debtor countries display more sophistication in the deployment of this technique, self-designed debt-relief can support sustained economic growth.

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Paper presented to the International Colloquium on "Development Strategies in Latin American Countries", sponsored by the Fundación Raúl Prebisch, El Colegio de México and the Instituto Tecnológico Autónomo de México in Mexico City, 18-21 October 1988. It expands on a memorandum prepared for a meeting of the Working Group on Economic Issues of the Inter-American Dialogue in Washington, D.C., on 9 September 1988. The author wishes to thank Oscar Altimir, Andrés Bianchi, Isaac Cohen, Arturo O'Connell, Joseph Ramos and Javier Villanueva for their comments on an earlier version. The views expressed here are those of the author and do not necessarily reflect those of the Commission or the individuals mentioned above.

## I

### The current situation

#### 1. Searching for progress

Looking to the North, one sees the OECD economies out of recession, and indeed enjoying one of the longest periods of non-inflationary economic expansion in their modern history.<sup>1</sup> A highly decentralized international lender-of-last-resort facility (composed of the IMF, World Bank, Bank for International Settlements, OECD central banks, treasuries, export credit agencies, and the private banks themselves) has proved its effectiveness in averting the destabilizing defaults in Latin America that threatened to emerge from the systemic payments crisis of that region.<sup>2</sup> Thus, in the middle of the worst financial crisis since the 1930s, private banks have generally performed remarkably well. For example, throughout the crisis years of 1982-1986 the international earnings of United States banks remained buoyant, and indeed their overall growth of net income accelerated as these institutions diversified into new profit opportunities at home (table 1). Negative earnings manifested themselves only in 1987, on account of the first large-scale allocation of reserves against possible losses on the Latin

<sup>1</sup>During 1983-1988 growth of GNP in the industrialized countries averaged 3.5% per annum. Given the voters' preference for continuity in the political leadership of the North, this rate of growth would seem to be satisfactory. However, as Sidney Dell remarked to the author, the performance is not satisfactory when viewed from the needs of an interdependent world: OECD economic growth has been highly volatile, uncertain as to its sustainability, and has imparted relatively little buoyancy to the debtor's terms of trade. The growth rate is calculated from data in IMF, *World Economic Outlook*, Washington, D.C., Advance Copy, 25 September 1988, p. 71.

<sup>2</sup>For an analysis of these international facilities see Philip Wellons, *Passing the Buck* (Boston: Harvard Business School Press, 1987), Chapter 7. For an analysis of how these facilities were applied during the Latin American crisis see ECLAC, *External Debt in Latin America* (Boulder, Colorado: Lynne Rienner Publishers, 1985), chapter 3 and ECLAC, *The evolution of the external debt problem in Latin America and the Caribbean*. Estudios e Informes de la CEPAL series, No. 72 (LC/G.1487/Rev.1-P), Santiago, Chile, 1988, United Nations publication, Sales No.: E.88.II.G.10, chapter 1.

Table 1

## UNITED STATES BANKING: SELECTED INDICATORS

(Percentage of total average assets)

	1980	1981	1982	1983	1984	1985	1986	1987
Net interest revenue	2.8	2.8	3.1	3.3	3.4	3.6	3.6	3.4
Money centre banks	2.4	2.4	2.8	2.9	3.1	3.2	3.2	2.9
Regional banks	3.4	3.3	3.4	3.7	3.9	4.1	4.0	3.0
Net income	0.62	0.59	0.59	0.67	0.65	0.66	0.67	-0.31
Money centre banks	0.51	0.52	0.54	0.64	0.60	0.69	0.70	-0.65
Regional banks	0.76	0.67	0.66	0.69	0.70	0.64	0.65	0.01
International Earnings	-	-	-	-	-	-	-	-
Money centre banks	0.27	0.30	0.32	0.29	0.27	0.26	0.22	-1.33
Regional banks	-	-	-	-	-	-	-	-

Source: ECLAC, on the basis of data in Thomas Hanley *et al.*, *A Review of Bank Performance* (various editions) New York: Salomon Brothers.

American portfolio.<sup>3</sup> The industry, however, rebounded in the first half of 1988, reporting a strong recovery of earnings.<sup>4</sup>

Moreover, behind this strong earnings performance an impressive "growth-oriented adjustment" of the banks' loan portfolio in Latin America is underway. Again the United States banks are illustrative: by March 1988, they had reduced their absolute exposure in the region by 12% with respect to June 1982 (table 2), while doubling their primary capital, all of which enabled them to cut in half their Latin American loan-to-capital ratio, from a precarious 124% to a much more manageable 58% (table 3). United States money centre banks now have 25-30% of their LDC portfolio backed by loan loss reserves, while many United States regional and continental European banks have a corresponding coverage of 50% or more

(table 4).<sup>5</sup> In sum, the international management of the payments difficulties in Latin America has helped the bankers to convert a situation which was originally, for them, a severe "crisis" into something more akin to a "problem". Indeed, the success of the bankers' adjustment is reflected in signs of complacency in financial circles about the Latin American situation: in the view of some experts, a refusal to pay by any one of the major debtors—Brazil, Mexico, Argentina or Venezuela— would not now create undue stress in the world banking system.<sup>6</sup>

The creditors' diagnosis of the problem in Latin America is also certainly more realistic now than it was at the outset. Gone are the rosy scenarios about a short-term liquidity crisis; most creditors now recognize that the problem in Latin America is structural, because time-consuming internal economic and social transformations are needed in most debtor countries to competitively produce and sell the tradeable goods required to generate foreign exchange for normal servicing of the debt. Likewise, there is now recognition that protracted belt tightening in the debtor

<sup>3</sup>The increase in loan loss reserves was induced by actions of Citibank, which raised reserves by US\$3 billion in the second quarter of 1987. For competitive reasons, most other United States banks with Latin American exposure copied Citibank to one degree or another. Consequently, United States banks reported US\$11 billion in losses in the second quarter, which represented the industry's worst performance since the 1930s. See ECLAC, "Economic Survey of the United States of America", Washington Office, 24 August 1988, p. 29, published later as *Economic Survey of the United States, 1987* (LC/G.1477; LC/WAS/L.3/Rev.1), Santiago, Chile, February 1989.

<sup>4</sup>See Thomas Hanley *et al.*, *Developing Country Exposures—Have Investors Recognized the Degree of Progress Made by Money Center Banks?*, New York, Salomon Brothers, 21 July 1988, p. 2.

<sup>5</sup>For the situation of European banks, see Gunner Wiegand, *Western Europe and the Latin American Debt Crisis*, Working Paper No. 12, Madrid, 1988, p. 20.

<sup>6</sup>*Daily Telegraph* (U.K.), "Time to Break the Cycle of Third World Debt", 30 August 1988.

Table 2  
EXPOSURE OF UNITED STATES BANKS IN LATIN AMERICA

	Millions of dollars												Annual growth rates (total exposure)					
	June 1982						December 1987						March 1988			1986	1987	March 88/ June 82
	Top 9	Rest	Total	Top 9	Rest	Total	Top 9	Rest	Total	Top 9	Rest	Total	Rest	Total	1986	1987	March 88/ June 82	
<b>Latin America</b>	48 714	33 368	82 082	49 757	24 720	74 477	49 015	23 116	72 311				23 116	72 311	-3.0	-5.4	-11.9	
<b>Oil-exporting countries</b>	23 567	17 285	40 852	20 699	12 446	33 145	20 066	11 621	31 867				11 621	31 867	-6.0	-6.7	-22.0	
Bolivia	231	137	368	39	24	63	38	20	58				20	58	-13.6	-29.2	-84.2	
Ecuador	1 257	910	2 167	1 137	650	1 787	1 119	586	1 705				586	1 705	3.1	-11.4	-21.3	
Mexico	13 602	11 619	25 221	13 396	9 002	22 398	12 848	8 240	21 088				8 240	21 088	-3.7	-4.9	-16.4	
Peru	1 330	1 017	2 347	441	400	841	390	392	782				392	782	-23.2	-27.4	-66.7	
Venezuela	7 147	3 602	10 749	5 686	2 370	8 056	5 671	2 383	8 054				2 383	8 054	-10.8	-7.8	-25.1	
<b>Non-oil-exporting countries</b>	25 147	16 083	41 230	29 058	12 274	41 332	28 949	11 495	40 444				11 495	40 444	-0.3	-4.2	-1.9	
Argentina	5 595	3 212	8 807	6 709	2 521	9 230	6 766	2 452	9 218				2 452	9 218	3.5	2.0	4.7	
Brazil	12 336	8 179	20 515	15 763	6 507	22 270	15 754	5 986	21 740				5 986	21 740	0.2	-5.7	6.0	
Colombia	2 075	961	3 036	1 398	675	2 073	1 350	700	2 050				700	2 050	-15.0	-3.8	-32.5	
Costa Rica	221	259	480	178	139	317	176	133	309				133	309	-5.2	-20.6	-25.6	
Chile	3 314	2 761	6 075	3 907	1 964	5 871	3 841	1 778	5 619				1 778	5 619	0.1	-6.1	-7.5	
El Salvador	53	16	69	8	41	49	6	46	52				46	52	12.2	-10.9	-24.6	
Guatemala	96	53	149	29	19	48	29	12	41				12	41	-32.4	4.3	-72.5	
Honduras	139	64	203	42	64	106	36	68	104				68	104	-9.3	-	-48.8	
Nicaragua	257	168	425	13	30	43	13	28	41				28	41	-26.7	-34.8	-90.3	
Paraguay	299	28	327	60	17	77	58	12	70				12	70	-37.4	-28.0	-78.6	
<b>Dominican Republic</b>	338	108	446	263	80	343	263	82	345				82	345	-6.6	-14.0	-22.6	
Uruguay	424	274	698	688	217	905	657	198	855				198	855	0.8	1.8	22.5	

Source: ECLAC, on the basis of United States Federal Financial Institutions Examination Council, *Statistical Release*, various numbers.

Table 3

**UNITED STATES BANKING: LATIN AMERICAN EXPOSURE  
AS A PERCENTAGE OF PRIMARY CAPITAL**

	June 1982			March 1988		
	Top 9	Rest	Total	Top 9	Rest	Total
Latin America	180.0	85.4	124.0	96.7	31.8	57.7
Oil-exporters	87.1	44.2	61.8	40.2	16.1	25.7
Non-oil-exporters	93.0	41.2	62.2	56.5	15.7	32.0
Memo Item:						
Primary capital <sup>a</sup>	27.1	39.1	66.2	51.5	77.7	129.1

Source: ECLAC, on the basis of data from the United States Federal Financial Institutions Examination Council, *Statistical Release*, various numbers.

<sup>a</sup> Billions of dollars.

Table 4

**UNITED STATES BANKING: RESERVES SET ASIDE ON LDC PORTFOLIO**

*(Millions of dollars)*

	Reserving 1987			Total estimated reserves	Percentage of LDC portfolio
	II quarter	IV quarter	Total		
<b>Money centre banks</b>					
Bankers Trust	700	-	700	1 000	25
Chase Manhattan	1 600	-	1 600	2 000	25
Chemical Bank	1 100	-	1 100	1 360	25
Citicorp	3 000	-	3 000	3 325	25
Manufacturers Hanover	1 700	-	1 700	1 787	25
J.P. Morgan and Co.	850	-	850	1 330	25
Republic N.Y. Corp.	100	10	110	200	40
Bank of Boston Corp.	300	200	500	430 <sup>a</sup>	55 <sup>a</sup>
First Chicago	780	240	1 020	1 132	39
<b>Selected regional banks</b>					
Bank of New England	97	100	197	192 <sup>a</sup>	75 <sup>a</sup>
Midlantic Corp.	30	25	55	54 <sup>a</sup>	63 <sup>a</sup>
Mellon Bank	290	180	470	621 <sup>a</sup>	45 <sup>a</sup>
Banc One Corp.	53	-	53	7	67
NBD Bancorp.	54	-	54	106	50
Sovran Financial	-	-	-	44	45
First Union Corp.	25	-	25	28	49
First Republic Bank	275	-	275	350	26
Bank America Corp.	1 100	-	1 100	2 004	20
First Interstate	500	180	680	612 <sup>a</sup>	54 <sup>a</sup>
Security Pacific	558	350	908	980 <sup>a</sup>	54 <sup>a</sup>
Wells Fargo	550	39	589	850 <sup>a</sup>	50 <sup>a</sup>
First Wachovia Corp.	50	31	81	55	60

Source: ECLAC, on the basis of data in Thomas Hanley and others, *A Review of Bank Performance: 1988 Edition*, New York, Salomon Brothers, 1988.

<sup>a</sup> Medium and long-term loans.



countries is counterproductive: in order to politically legitimize necessary reforms and to raise the mass of domestic savings available for investment and debt service, countries clearly must achieve a sustained expansion of their economies.

The more realistic diagnosis has also led to more realistic responses. Some banks, recognizing that the "time" implicit in the restructuring process erodes some of the present value of the income stream of their assets in Latin America, began in 1987 to more aggressively adjust downward the valuation of their loans in the region.<sup>7</sup> Moreover, the devaluation of assets has sometimes resulted in relief for the debtors as banks now show an increasing willingness to accept formal debt reduction schemes through direct or indirect participation in debt-equity swaps,<sup>8</sup> the purchase of below market interest rate exit bonds,<sup>9</sup> the conversion of debt into bonds at a discount,<sup>10</sup> direct buybacks,<sup>11</sup> etc.

The new diagnosis likewise has induced better responses from the multilateral lenders. The recognition of the structural problem has brought the World Bank from the background of the international debt strategy to the centre of

the playing field.<sup>12</sup> Meanwhile, the IMF has accommodated to the new realities by extending its adjustment programmes to up to four years, lengthening the period of review of its performance criteria to six months, as well as creating a new expanded contingency financing facility.

Turning South, one finds that the crisis has coincided with some positive changes in Latin America. There are today thirteen democratic governments in the region compared to only four in the late 1970s.<sup>13</sup> On the economic front, the severity of the crisis in Latin America has certainly broken the back of the dogmatism sometimes attached to import substitution development strategies and so-called inward-looking development. Indeed, one senses the emergence of a new pragmatism in the formulation of development policy. While eschewing some of the more simplistic prescriptions for economic liberalization emanating from the North, the achievement of international competitiveness is now a central preoccupation of the authorities of the region. Most countries are manifestly eager to learn the art of producing and selling for highly competitive international markets. The popular notion of the State as the handmaiden of development also has undergone reassessment; there is a general awareness that government resources are inefficiently deployed and that private initiative offers more potential for development.<sup>14</sup>

Good intentions obviously are not enough. However, while Latin America's efforts to alter the direction of its development policy and restore creditworthiness do not warrant

<sup>7</sup> At the beginning of 1988 this process further intensified. In April-June 1988 the largest United States banks had loan charge-offs of US\$0.9 billion, up from US\$0.6 billion in the first quarter of the year. See T. Hanley and others, *op. cit.*, p. 2.

<sup>8</sup> Debt/equity swaps in Argentina, Brazil, Chile and Mexico totalled US\$5 billion in 1987. Peter Truett, "Cutting Losses", *Wall Street Journal*, 23 September 1988, Supplement, p. 10 R.

<sup>9</sup> In the 1988 debt rescheduling of Brazil roughly 100 banks subscribed to exit bonds amounting to about US\$1 billion. The bonds carried a 6% interest rate for 25 years.

<sup>10</sup> Early in 1988 Mexico converted US\$3.67 billion of commercial bank debt into US\$2.56 billion of bonds, which represented a 30% discount. The bonds had a single 20-year maturity and carried an interest rate of 1.63% over LIBOR. The principal of the bond was secured by the government's purchase of a 20-year United States Treasury zero-coupon bond for an amount equivalent to the outstanding Mexican government bonds.

<sup>11</sup> In March 1988 Bolivia arranged to buy back US\$318 million of its public commercial bank debt—nearly 50% of the total with these lenders—at a price of 11 cents on the dollar. The resources for the buyback arrangement came from OECD countries. The operation was facilitated by the establishment of a special escrow account in the IMF for the depositing of OECD contributions. Meanwhile, in mid-1988 Chile negotiated with its banks an arrangement to use up to US\$500 million of its international reserves to buy back bank debt at a discount. In November 1988 Chile bought back US\$299 of bank debt at 56 cents on the dollar.

<sup>12</sup> The most recent manifestation of this was the willingness of the World Bank to sponsor a restructuring loan for the Government of Argentina even though the Argentine economic authorities could not reach prior terms with the IMF for a standby agreement. See Stephen Fidler, "World Bank Agrees Argentine Loan", *Financial Times*, 26 September 1988.

<sup>13</sup> The four democratic governments in the 1970s were Colombia, Costa Rica, the Dominican Republic and Venezuela. It should be added that Ecuador's democratic institutions were restored in April 1979.

<sup>14</sup> Commercial bankers recognize the emergence of this new consensus in the region. See, for instance, John Reed, "New Money in New Ways", *International Economy*, October/November 1987, p. 50.

unreserved applause, it would be equally unfair to ignore the great adjustments that have actually been undertaken and the sacrifices they have involved. Between 1982 and 1988 the region transferred US\$179 billion to its creditor countries.<sup>15</sup> Moreover, that outward net transfer of resources from Latin America was policy-induced, for it was made possible only because the region rapidly converted a long-standing trade deficit—averaging nearly US\$2 billion per annum in 1978-1981—into a massive trade surplus that averaged US\$26 billion per annum

in 1982-1988. The trade surpluses, in turn, could not have come about without exchange rate devaluations, adjustments of domestic interest rates, fiscal correction (including the selling off of State enterprises), compression of real wages, etc.<sup>16</sup> Also, the domestic effort must be evaluated in the light of an unhelpful external environment. Aside from protectionism, exports have been hindered by historically low average unit prices, which have caused the value of exports to expand by only a small fraction of the recorded growth of export volume (table 5).

Table 5

## LATIN AMERICA: EXPORTS OF GOODS

(Index, 1980 = 100)

	Value			Volume			Variation <sup>a</sup>
	Annual averages		1988 <sup>b</sup>	Annual averages		1988 <sup>b</sup>	Value
	1978-1981	1982-1987		1978-1981	1982-1987		Volume
Latin America	85	99	115	96	126	156	52.7
Oil-exporters	82	95	87	95	125	152	50.5
Bolivia	86	70	56	99	74	69	(73.7)
Ecuador	87	95	89	102	128	159	35.7
Mexico	81	131	134	93	181	228	65.2
Peru	81	75	68	98	94	71	(180.5)
Venezuela	82	70	54	104	85	106	(79.8)
Non-oil-exporters	88	103	139	98	127	159	57.8
Argentina	97	94	94	114	124	131	...
Brazil	89	119	166	95	144	197	65.3
Colombia	86	103	150	95	114	174	99.0
Costa Rica	95	97	120	107	114	121	32.3
Chile	79	87	146	93	130	158	23.1
El Salvador	88	66	59	96	79	78	(141.2)
Guatemala	84	71	73	91	83	83	(176.1)
Haiti	76	93	83	85	112	82	70.4
Honduras	89	92	115	95	96	106	309.1
Nicaragua	123	76	48	144	87	45	(102.3)
Panama	...	...	...	...	...	...	...
Paraguay	96	136	251	93	132	239	99.5
Dominican Republic	96	80	85	103	103	107	...
Uruguay	89	102	130	97	121	130	59.1

Source: Calculated from data of ECLAC Division of Statistics and Quantitative Analysis.

<sup>a</sup>Variation between annual average of 1978-1981 and 1982-1987. Numbers in parenthesis refer to cases where both value and volume declined over the two periods.

<sup>b</sup>1988 data estimate from ECLAC, *Preliminary Overview of the Latin American Economy*, (LC/G.1536), Santiago, Chile, January 1989, table 8.

<sup>15</sup>See ECLAC, *Preliminary Overview of the Latin American Economy, 1988* (LC/G.1536), Santiago, Chile, 3 January 1989, table 15.

<sup>16</sup>For a detailed analysis of the process of adjustment in Latin America, see Andrés Bianchi, Robert Devlin and Joseph Ramos, "El Proceso de Ajuste en la América Latina", *El Trimestre Económico*, vol. LIV, No. 216, October/December 1987.

Table 6

15 BAKER PLAN COUNTRIES: MEDIUM-TERM BANK CREDITS, 1986-1988<sup>a</sup>*(Millions of dollars)*

	1986	1987	January-August 1988
Total	483	10 004	6 250
Argentina	17	2 110	-
Bolivia	-	-	-
Brazil	-	-	5 200
Chile	-	- <sup>a</sup>	-
Colombia	201	87	1 000
Cote d'Ivoire	-	-	-
Ecuador	220	32;(300) <sup>b</sup>	-
Mexico	-	7 700	-
Morocco	-	25	50
Nigeria	-	-	-
Peru	-	-	-
Philippines	-	-	-
Uruguay	45	-	-
Venezuela	-	30	-
Yugoslavia	-	20	-

Source: OECD, *Financial Statistics Monthly*, various numbers, Paris, and ECLAC, Economic Development Division.

<sup>a</sup>In a rescheduling in 1987 Chile secured a "retiming" of its interest payments which saved the country about US\$450 million in 1988.

<sup>b</sup>Cancelled.

## 2. Itemizing the setbacks

While there have been signs of progress on some fronts, there have also been setbacks of major importance. In the last six years, the North has lost export markets,<sup>17</sup> and hence jobs and GNP growth, due to a reduced capacity to import in Latin America. OECD firms with direct investments in Latin America have not been able to escape the crisis; their profitability has fallen and corporate uncertainties in Latin America are certainly up.<sup>18</sup> United States banks, which are those with the greatest exposure in Latin

America, have lost ground in the international race for dominance of financial markets: expansion into a world of financial liberalization is a capital-intensive endeavour, and the time and resources United States banks must allocate to propping up their slumping Latin American portfolio has clearly put them at a competitive disadvantage. Moreover, although it is difficult to prove definite links, it is also suspected that the increased supply of illicit drugs from Latin America is at least partially linked to shortages of foreign exchange in the region.

The North may also have suffered a serious erosion of the value of its "goodwill" in Latin America. On the one hand, creditors have repeatedly failed to keep their promises of new financing for the debtors; most recently the Baker Plan's 1985 commitment to mobilize US\$20 billion of new bank finance and US\$9 billion of official loans over three years has remained unfulfilled. Multilateral net disbursements to the region have declined rather than increased, while private bank loans have been few and far between, and heavily concentrated in the hands of only a lucky few within the so-called Baker 15 (tables 6 and 7).

<sup>17</sup>One study has shown that by 1985 United States exports to Latin America were 28% below levels recorded in 1981 and 47% below the potential export level. The latter is defined as maintenance of a constant export share *vis-à-vis* GDP. See Joint Economic Committee, United States Congress, "Trade Deficits, Foreign Debt and Sagging Growth", Washington, D.C., September 1986, table 6.

<sup>18</sup>For example, rates of return on United States direct investment in Latin America declined from an average of 17% in 1980-1981 to 6% in 1982-1985. See United Nations Centre on Transnational Corporations, *Transnational Corporations in World Development: Trends and Prospects* (ST/CYC/89), New York, 1988, United Nations publication, Sales No. 88.II.A.7, p. 82.

Table 7  
IMF, WORLD BANK AND IDB: NET TRANSFERS TO LATIN AMERICA  
(Billions of dollars)

	1980	1981	1982	1983	1984	1985	1986	1987
1. Net disbursements	2.3	2.7	4.0	8.8	7.4	5.3	4.4	2.1
IMF	-0.1	0.1	1.2	5.7	3.3	1.5	0.2	-0.5
World Bank	1.2	1.3	1.4	1.7	2.1	1.9	2.7	1.6
IDB	1.2	1.3	1.4	1.4	2.0	1.9	1.5	1.0
2. Interest charges	1.0	1.2	1.3	1.7	2.2	2.7	3.6	4.0
IMF	0.1	0.1	0.1	0.3	0.6	0.9	0.9	0.8
World Bank	0.6	0.7	0.8	0.9	1.0	1.1	1.7	2.1
IDB	0.3	0.4	0.4	0.5	0.6	0.7	1.0	1.1
3. Net transfers (1-2) <sup>a</sup>	1.1	1.5	2.8	7.2	5.2	2.6	0.7	-1.9
IMF	-0.2	-	1.2	5.4	2.7	0.6	-0.8	-1.3
World Bank	0.5	0.6	0.6	0.8	1.1	0.8	1.0	-0.5
IDB	0.8	0.9	1.0	1.0	1.4	1.2	0.5	-0.1

Source: Calculated from data provided by SEIA.

<sup>a</sup> May not sum properly due to rounding.

Table 8  
LATIN AMERICA: PARTICIPATION IN MULTILATERAL  
ADJUSTMENT PROGRAMMES

	IMF		World Bank	
	1982-1983	1987	1982-1983	1987
Total	13	6	1	9
Oil-exporters	3	2	-	3
Bolivia	-	x	-	x
Ecuador	x	-	-	x
Mexico	x	x	-	x
Peru	x	-	-	-
Venezuela	-	-	-	-
Non-oil-exporters	10	4	1	6
Argentina	x	x <sup>a</sup>	-	x
Brazil	x	- <sup>b</sup>	x	x
Colombia	-	-	-	x
Costa Rica	x	x	-	x
Chile	x	x	-	x
El Salvador	-	-	-	-
Guatemala	x	-	-	-
Haiti	x	-	-	-
Honduras	x	-	-	-
Nicaragua	-	-	-	-
Panama	x	-	-	-
Paraguay	-	-	-	-
Dominican Republic	x	-	-	-
Uruguay	x	x	-	x

Source: ECLAC, Economic Development Division, based on the respective institution's data.

<sup>a</sup> "Out", at least transitorily in 1988.

<sup>b</sup> "In" in 1988.

Table 9  
GROSS DOMESTIC SAVINGS AND INVESTMENT IN LATIN AMERICA<sup>a</sup>

	Savings Index 1980 = 100		Investment Index 1980 = 100	
	1978-1982	1982-1987	1978-1981	1982-1987
Latin America	96	107	94	73
Oil-exporters	...	...	...	...
Bolivia	91	57	129	64
Ecuador	92	114	93	74
Mexico	94	113	92	69
Peru	95	79	89	80
Venezuela	107	83	117	74
Non-oil-exporters	...	...	...	...
Argentina	112	104	88	51
Brazil	90	110	91	78
Colombia	97	113	99	110
Costa Rica	103	184	85	70
Chile	82	122	90	57
El Salvador	85	74	134	85
Guatemala	94	98	117	77
Haiti	91	150	96	107
Honduras	101	83	98	63
Nicaragua	...	...	93	134
Panama	80	100	94	86
Paraguay	83	69	93	85
Dominican Republic	107	151	92	95
Uruguay	123	155	91	50

Source: Calculated from data of ECLAC, Division of Statistics and Quantitative Analysis.

<sup>a</sup>Market prices and 1980 dollars.

Meanwhile, the IMF's credibility has been further tarnished over the last few years because its programmes continue to be associated with economic recession; this has caused more countries to distance themselves from the Fund exactly when in principle the need for its guidance is greater than ever (table 8). The 1988 Toronto Summit's priority attention to Africa's debt problem, contrasting with the continued inertia on the Latin American front, was also not very helpful.<sup>19</sup> Finally, the United States administration's often unconstructive approach to the Inter-American Development Bank's

problems has been a severe source of contention in hemispheric relations.

The setbacks for Latin America since the outbreak of the crisis have been very dramatic. Who would have imagined back in 1982 that by 1988 Latin America's per capita gross domestic product would be nearly 7% below the 1980 figure?<sup>20</sup> While domestic savings have been higher than ever before, since 1982 the region's domestic investment —vital to any serious campaign to make Latin America's goods and services more internationally competitive— has been 22% below the average annual level recorded in 1978-1981 (table 9). On a per capita basis the investment performance has been even worse: in 1987 such outlays were the highest of the six years of the crisis, yet even so per capita investment in that year was the lowest since

<sup>19</sup>The scheme for African debtors allows creditor governments to write off one third of the debts, or cut interest rates by half or 3.5 percentage points, or lengthen the amortization period to 25 years. The plan has been criticized as not being radical enough for these problem debtors. See *Financial Times*, "Africa's debt burden", 30 September 1988, p. 18.

<sup>20</sup>ECLAC, *Preliminary Overview ...*, *op. cit.*, table 3.

1971!<sup>21</sup> Inflation has increased spectacularly in Latin America; the regional average was nearly 500% in 1988, with rates reaching three digits for two countries (Argentina and Brazil) and four digits for another two (Nicaragua and Peru). Real wages have for the most part been depressed, while official unemployment is disturbingly high.<sup>22</sup> Although the social repercussions of the crisis are hard to quantify, there are studies which suggest an important deterioration on many fronts and confirm what

the casual observer senses when visiting almost any Latin American capital city.<sup>23</sup>

Finally, the evolution of the debt burden indicators has not been entirely encouraging. After seven years of costly adjustments the region's debt-to-export ratio in 1988 (339%) was 60% higher than in 1980. On the other hand, the interest/exports ratio had fallen to 28% by 1988, and although that was still extremely burdensome, it was nevertheless the lowest level recorded since 1981 (table 10).

Table 10

## LATIN AMERICA: EXTERNAL DEBT

	Debt <sup>a</sup>	Debt export		Debt/GDP		Interest exports		Arrears	
	1988 <sup>b</sup>	1981	1988 <sup>b</sup>	1981	1988	1981	1988 <sup>b</sup>	1987	Sept.1988
Latin America	401.4	247	339	46	53	28	28	x	x
Oil-exporters	159.2	220	343	...	...	23	28	x	x
Bolivia	3.9	348	595	...	...	35	35	x	x
Ecuador	10.5	202	388	51	80	23	33	x	x
Mexico	96.7	259	339	52	62	29	29	-	-
Peru	16.2	239	442	45	70	24	22	x	x
Venezuela	31.9	160	290	56	49	13	26	-	-
Non-oil-exporters	242.1	273	337	...	...	34	28	x	x
Argentina	56.8	329	541	55	81	36	40	-	x
Brazil	114.6	313	321	39	42	40	30	x	-
Colombia	15.9	199	218	24	33	22	21	-	-
Costa Rica	4.1	229	260	90	108	28	20	x	x
Chile	19.1	311	236	73	74	39	23	-	-
Cuba	(5.7) <sup>c</sup>	...	...	...	...	...	...	x	x
El Salvador	1.9	174	185	...	...	8	10	-	-
Guatemala	2.8	96	225	...	...	8	13	x	x
Haiti	0.8	155	276	...	...	3	7	...	x
Honduras	3.2	180	290	...	...	14	14	x	x
Nicaragua	6.7	464	2 068	...	...	37	103	x	x
Panama	4.2	92	...	...	...	...	...	-	x
Paraguay	2.2	171	324	...	...	15	12	x	x
Dominican Republic	3.8	168	220	...	...	19	13	x	x
Uruguay	6.1	183	354	51	97	13	23	-	-

Source: ECLAC, Economic Development Division.

<sup>a</sup> Billions of dollars.

<sup>b</sup> ECLAC, *Preliminary Overview of the Latin American Economy, 1988* (LC/G.1536), Santiago, Chile, January 1989.

<sup>c</sup> Excluded from totals. Represents debt with so-called market countries in 1987.

<sup>21</sup> ECLAC, Division of Statistics and Quantitative Analysis.

<sup>22</sup> Data from ECLAC, *Preliminary Overview ...*, *op. cit.*

<sup>23</sup> World Bank, "Poverty in Latin America: The Impact of Depression", Washington, D.C., 1986.

## II

### Why the skewed distribution of costs between creditors and debtors?

The review of the situation since 1982 suggests some improvements, but also points to serious setbacks for the creditor and debtor countries alike. Yet the review also highlights a distribution of benefits and costs that is clearly skewed against the debtor countries. In effect, thanks to a growth-oriented adjustment, private banks now only have a problem in Latin America; the countries of the region, in contrast, have a development crisis of ever deepening proportions. Why?

Impatient creditors often point to: i) bad economic policies in the debtor countries, coupled with their excessive debt accumulation in the 1970s; and ii) an unwillingness in the 1980s to make and persist with the hard economic decisions needed to turn the Latin American economies around. Moreover, there often exists by implication the notion that if creditors provide comprehensive relief for the debtors this will raise moral hazard, as well as giving rise to a tendency to abuse the degrees of freedom won thanks to the relaxation of the efforts to restructure the region's economies and make them more competitive internationally.

The debtors, on the other hand, tend to focus on the harsh external environment and the weight of the outward transfer of resources.<sup>24</sup> The argument is by now well developed. Expenditure switching policies normally take a great deal of time to work their way through the economies, especially in structurally uncompetitive ones. Thus, the large trade surplus needed to effectively service debts at high real rates of interest can be achieved in the

short term only with a disproportionate amount of import compression and domestic economic recession. Moreover, since it is inherently difficult for developing countries to quickly raise domestic savings (especially during an economic slowdown), the outward transfer of resources tends to have its counterpart in reduced investment and social expenditure, which is counterproductive, because it hampers economic restructuring and future capacity to service debts. Furthermore, the changing of relative prices for the purpose of making an external transfer tends to aggravate inflationary pressures. This situation is complicated by the fact that debt servicing is largely the responsibility of the public sector, giving rise to an internal budgetary transfer problem. As demonstrated even in the United States, tax and public expenditure decisions belong in extremely delicate political terrain. If there is no broad domestic political consensus to accept a decisive increase in taxes and a lowering of public expenditure to accommodate the transfer, the State must mobilize the necessary resources through an inflationary tax. This is a risky strategy that can easily degenerate into hyperinflation.<sup>25</sup>

As in most polarizing issues, the truth probably lies in between the extremes of the arguments of the two groups. To overcome the development crisis and put Latin American debtors back on track, adequate and sustained internal effort is unquestionably a necessary first step in a successful restructuring process. Thus far the internal efforts have been of varying intensity and duration in the region, but such efforts have certainly been made. As mentioned earlier, domestic policy has induced a transfer of resources to the creditor countries of US\$179

<sup>24</sup>For a more complete analysis see ECLAC, *Restrictions on Sustained Development in Latin America and the Caribbean and the Requisites for Overcoming Them* (LC/G.1488(SES.22/3)/Rev. 1), Santiago, Chile, 9 February 1988. The study that helped to shift the analytical focus of the debt debate to the question of the transfer problem is Helmut Reisen and Axel Van Trotsenberg, *The Budgetary and Transfer Problem*, Paris, Organization for Economic Co-operation and Development (OECD), 1988.

<sup>25</sup>An analysis of the complex relationship between debt service and inflation can be found in Rudiger Dornbusch, "Debt, Inflation and Growth: The Case of Argentina", Washington, D.C., International Monetary Fund, 16 February 1988.

billion, or more than 4% of GDP per annum. To illustrate the magnitude of the transfer, suffice it to recall that this exceeds the outward net transfer forced on defeated Germany under the 1919 Treaty of Versailles (2.5%) and defeated France under the 1871 Treaty of Frankfurt (2.3%).<sup>26</sup> The debtors also deserve some patience from the creditor countries: to turn around a development strategy that worked reasonably well for 50-odd years is much more than a six-year project.<sup>27</sup> In addition, the economic transformation is being attempted simultaneously with a fragile transition to political democracy. A peripatetic course might be a likely feature of any process of economic transformation built on a very weak and emerging institutional framework.

Moreover, it is always difficult to isolate the contribution made to economic recovery by domestic efforts from the effects of the external environment. If that environment had been

clearly supportive of the debtors' efforts to adjust and restructure, one could more comfortably point an accusing finger at lack of serious domestic effort. But in most respects the external environment has been extremely unsupportive of Latin America's adjustment policies. Of critical importance in this regard is the fact that the region's adjustment process has been badly underfinanced from the outset of the crisis.<sup>28</sup> Indeed, whether it be the formula of 7% annual expansion of bank lending that emerged in 1982, or the Baker Plan's 2 1/2% per annum formula, financing volumes have not satisfied the modest targets that the creditors have variously committed themselves to.<sup>29</sup> Underfinancing for the debtors translates into overtransferring of resources to creditors. The transfer problem is therefore a real one that has undermined the efficiency of the debtor countries' policies for adjustment and restructuring.

### III

## The most conspicuous weak link: half-hearted international public policy

A systemic debt crisis is a collective problem. In these circumstances, negative externalities emanating from the private market are notoriously indiscriminating, drawing into the problem prudent and imprudent lenders/borrowers alike, and even passing serious costs onto those not even remotely involved in the problem.<sup>30</sup> Moreover, rational individual responses to the situation can be very

damaging to the collective good and escalate the costs for all. Hence the need for public intervention in the marketplace, first, to stabilize private expectations, and second to assist in restructuring the market agents (borrowers, lenders or both) in a way that is functional to the renewed solvency of the system

<sup>26</sup>See Bianchi, Devlin and Ramos, *op. cit.*, p. 891.

<sup>27</sup>The per capita GDP in Latin America grew by a respectable 3% per annum over 1950-1980.

<sup>28</sup>Ground has focussed on this issue. Conventional criteria suggest that the transitory components of external shocks should be financed. However, according to Ground's estimates, the external finance made available to Latin America over 1982-1985 covered only 37%, 25%, 36%, and 16% of the respective transitory components of the adverse external shocks in that period. See Richard Ground, "The origin and magnitude of the recessionary adjustment in Latin America", *CEPAL Review*, No. 30 (LC/G.1441), Santiago, Chile, December 1986, p. 72.

<sup>29</sup>When the crisis first broke out, private banks, in conjunction with the IMF, committed themselves to an annual expansion of 7% in their credit exposure in the region. The actual expansion in the first round of reschedulings came closer to 6% and fell dramatically thereafter. Then, in September 1985, Secretary Baker of the United States Treasury established a new target for bank credit expansion of 2 1/2% per annum for 3 years. This goal was not fulfilled; indeed, the response of the banks was to begin a sustained reduction of their exposure in the region. Moreover, the slack was not picked up by multilateral and bilateral lenders.

<sup>30</sup>Columbia is a good illustration of this problem: with a debt-to-export ratio of only a little over 2:1 and a debt-to-GDP ratio of 34%, it has had tremendous difficulty securing fresh credit from the private banks.



and to global recovery with minimum social disruption. Given the opportunities for "free riding" when externalities exist, and its adverse effects on the efficiency of any institutional arrangement, effective public solutions often are to varying degrees coercive in nature.<sup>31</sup> All these principles are usually put into practice when severe financial strain emerges in the domestic markets of the creditor countries.<sup>32</sup>

The international debt crisis that emerged in 1982 has in fact been subject to international public management.<sup>33</sup> Yet, the effectiveness of the latter as an instrument in the promotion of global prosperity and development in an interdependent world has been severely limited. This is because the international debt management strategy has not evolved much beyond a lender-of-last-resort function designed to keep the Northern banking system stable. Indeed, with time it has become increasingly obvious that it is the sporadic threat of a destabilizing default, rather than the sustained requirements of financing economic restructuring in the debtor country, that brings forth new credits. The faster the banks have strengthened their balance sheets, the tighter external financing has become. Meanwhile, however, official lenders have not been given the means to pick up the slack; indeed, they are aggravating the problem as the net flow of resources from these institutions has now turned negative (table 7).

The latest phase of the international debt strategy —the so-called Market Menu Approach— does not rectify the situation. To the extent that it represents a public policy initiative at all, it repeats the basic flaw of the earlier stages: the day to day mechanics of a

supposedly multilateral debt management programme remain biased toward the narrow objective of securing an orderly adjustment of private financial portfolios in the North.

The initial phase of the debt management strategy was characterized by a "holding action" designed to enable the international financial system to avoid accounting losses via commercially priced reschedulings and new money packages. Now, the latest phase is primarily oriented to the gradual adjustment of the banks' asset values and enhanced risk diversification through schemes involving debt swaps and securitization. As for the macroeconomic issue of finance to support economic reforms, investment, growth and restored creditworthiness in the debtor countries, it largely remains a passive residual to this process. It is in this sense that the Market Menu is basically a private creditors' menu.

As ECLAC has shown in a recent study, from the perspective of the debtors' macroeconomic needs the Market Menu may list some interesting "appetizers", but the "main entrées" simply are not there.<sup>34</sup> The market-based approach of the menu relies on the principle of voluntary responses from the individual creditors, with little more than moral support from their governments. However, conventional market financing is procyclical in nature and therefore new capital will be unlikely to flow spontaneously to Latin America in a macroeconomically significant volume as long as potential creditors see big discounts of 50% or more on existing debt.

As for the new and more exotic instruments designed around portfolio adjustments, their natural development will be only gradual. It is well known that private markets operate at the margin and each new instrument must start small even under favourable circumstances.<sup>35</sup> In Latin America advance is further slowed by complex free rider and international legal, tax and accounting problems in the market, as well as many institutional investors' lack of

<sup>31</sup>Detailed analysis of the problems of collective action and public goods can be found in James Buchanan, *The Demand and Supply of Public Goods*, Chicago, Rand McNally and Co., 1968, chapter 5.

<sup>32</sup>The collective nature of the problem even manifests itself in isolated payments crises of individual firms. Because of this, bankruptcy laws often impose collective solutions upon a firm's creditors. See Thomas Jackson, *The Logic and Limits of Bankruptcy Law*, Cambridge, Mass., Harvard University Press, 1986.

<sup>33</sup>By now the nature of the co-ordinated policies of the IMF, OECD Central Banks and Treasuries with the creditor banks and debtor governments is so well known that it is not necessary to summarize it here. If desired, however, details may be found in ECLAC, *External Debt in Latin America*, *op.cit.*, pp. 47-86.

<sup>34</sup>ECLAC, *The Evolution of the . . .*, *op. cit.*, chapter II.

<sup>35</sup>See Mahesh Kotecha, "Repackaging Third World Debt", *Standard and Poor's International Credit Week*, August 1987, p. 9 and Kenneth Telljohann, "Analytical Framework", *Prospects for Securitization of Less Developed Country Loan*, New York, Salomon Brothers, June 1987, p. 11.

familiarity with the region. There are also demand constraints in Latin America as questions of sovereignty and monetary control limit the potential expansion of some of the creditors' preferred instruments in the market menu.<sup>36</sup>

Another consideration is that the bulk of the proposed debt reduction instruments in the menu act on the principal. Since countries are not amortizing debt anyway, the immediate impact of the transaction on the balance of payments is indirect, in the form of reduced interest payments; hence relief will be marginal until the cumulative scope of the reduction of the principal becomes very large.<sup>37</sup> The menu also has the serious drawback that voluntary market transactions are effected only sporadically, making it difficult to predict the timing of conversions, their distribution among the different countries, the amount of relief for the balance of payments, and the effectiveness of the conversion with respect to the support of a domestic programme for economic reform and restructuring.

In sum, when left to their own devices, private markets naturally unwind from a large debt overhang only slowly. The amount of debt swapped and converted at a discount into other types of assets will undoubtedly rise markedly in the years ahead.<sup>38</sup> Yet for the immediate future the Market Menu Approach —at least as currently formulated— will only chip away at the corners of the region's problems because it does not address the urgent central macroeconomic issue of today: how to finance in a sustained and predictable way the economic reforms and new investments that Latin America will need to initiate growth now and begin to restore its capacity to service foreign debts. From the standpoint of a collective economic problem and collective solutions, the Market Menu Approach therefore clearly represents unambitious public policy. Indeed, in some essential ways the market menu seems to have thrust us back to the 1930s, when debtor countries and private creditors groped inefficiently for 20 years for a way to unwind from the debt overhang of that period.<sup>39</sup>

## IV

### Where do we go from here?

The Latin American debt problem should be viewed in its proper context, as a collective international problem: at a time when private sources of credit for Latin America have collapsed, the reliance on voluntary private

"micro" responses from the menu to resolve a systemic macroeconomic financial problem promises to delay the adjustment of both debtor and creditor countries and raise costs for the

<sup>36</sup>"Negative side effects" are particularly complex in the popular debt-equity swaps. See Group of Thirty, *Finance for Developing Countries*, New York, 1987.

<sup>37</sup>As an illustration, the original goal of the Mexican-Morgan Guaranty bond operation of early 1988 was to convert US\$20 billion of debt. If this goal had been attained at an average (rather optimistic) discount of 40%, something of the order of US\$350 million of net interest payments would have been saved. While this type of operation had many merits, including the banks' formal recognition of market discounts, its significance as a vehicle for macroeconomic financing is less apparent in view of the US\$7 billion interest burden with the private lenders. In any event, as mentioned in footnote 10, the banks' reception to the plan was less enthusiastic than had originally been hoped for. A detailed analysis of the Mexican bond offer can be found in Kenneth Telljohann and Richard Buckholz, *The Mexican Bond Exchange Offer*, New York, Salomon Brothers, January 1988.

<sup>38</sup>The volume of secondary market trading in 1987 is estimated to have been about US\$12 billion. Some expect that figure to rise to US\$25 billion in 1988. To put these figures in perspective it must be remembered that they include considerable double counting and therefore do not mirror actual debt conversions. The figures also are still small relative to the estimated US\$300-350 billion of problem LDC debt in the international commercial banking system. See Richard Lawrence, "Banker Proposes Solution to Argentina, Brazilian Debt", *Journal of Commerce*, 28 September 1988 and Eugenio Lahera, *La conversión de la deuda externa: antecedentes, evolución y perspectivas* (LC/R.614), UNDP/ECLAC Project "Finance for Development", Santiago, Chile, ECLAC, September 1987.

<sup>39</sup>For a good review of the portfolio adjustments of debtors and creditors in the 1930s and 1940s, see Marilyn Skiles, *Latin American International Loan Defaults in the 1930s: Lessons for the 1980s?*, Federal Reserve Bank of New York, Research Paper No. 8812, April 1988.

international community as a whole. The systemic aspects of the problem give theoretical and practical support to the idea that there is a need for more aggressive production of international public goods designed to accelerate the adjustment of debtor and creditor countries alike, as well as to ensure that costs are distributed in such a way that they can be paid for out of future growth of the global economic system.

The reason why the proposal for a multi-lateral debt conversion facility has repeatedly appeared in the debate about debt, and will not go away despite rather heated rejections by the leaders of the international debt strategy, is that it is the most complete expression of the systemic nature of the debt problem in the Western Hemisphere and the social efficacy of a collective solution.<sup>40</sup> Obviously, many of the details of such a complex facility, as well as auxiliary regulatory, accounting and tax measures, need to be refined, but the basic thrust of the proposed initiative—an orderly and macroeconomically significant reduction of the present value of debt in return for orderly adjustment of economic policy—is in the best spirit of good public economic policy-making in an interdependent world. As an interim step to negotiating such a complex facility, one could envision—under the auspices of IMF-approved exchange restrictions within the context of an official standby programme—an immediate temporary freezing of interest payments (with forced capitalization of the difference) at levels consistent with specified targets of investment and growth in the debtor economies.

A less ambitious public policy could consist simply of the approval of *ad hoc* public guarantees on bank loans and market debt reduction instruments, coupled with supportive

modification of tax and accounting rules for the banks. This could grant the credit enhancement needed to bring a volume of conversions and buybacks sufficient to generate rapid and significant balance-of-payments financing for the debtor countries. Bolivia's recent debt buyback at 11 cents on the dollar is a good example of how ambitious intervention by the international public sector can bring about a quick and substantial reduction of the debt overhang.

*Ad hoc* guarantees, while more effective than the hands-off approach of the current Market Menu, are not without their drawbacks, however. On the one hand, the distribution of relief among countries may be arbitrarily based on political factors, while the timing of that relief remains uncertain. On the other, since *ad hoc* arrangements tackle free rider problems and other negative externalities only in a piecemeal fashion, their cumulative cost over the medium term could be actually more than a full-fledged debt reduction facility today.

Should Latin America promote these and other collective international initiatives? Certainly yes. Should Latin America bank its future development on the imminent emergence of comprehensive public initiatives? Probably not. Collective solutions for a large number of individual economic agents are notoriously difficult to organize when customs, traditions, legal standards, strategies and economic circumstances differ. To act collectively, there must be a common sense of extreme stress. This sense of stress existed in Northern financial circles in 1982 when virtually all national banking systems were vulnerable to defaults in Latin America; this explains the amazingly quick and extraordinarily tight global co-ordination among the creditors to avoid default in the early

<sup>40</sup>In the contemporary debate early proposals were made by Peter Kenen and Richard Weinert. Kenen proposed conversion at a discount, while Weinert proposed conversion at par with below-market interest rates, on the grounds that this would spread the banks' losses over time. See Peter Kenen, "A Bailout for the banks", *The New York Times*, March 1983 and Richard Weinert "Banks and bankruptcy", *Foreign Policy*, No. 50, Second Quarter, 1983, pp. 128-149. Kenen has recently updated and expanded his proposal. See Peter Kenen, "A Proposal for Reducing the Debt Burden of Developing Countries", Princeton, New Jersey, Princeton University, March 1987. Other people proposing a

global debt conversion facility are: John La Falce, "Third World Debt Crises: the Urgent Need to Confront Reality", *Congressional Record*, Washington, D.C., vol. 133, No. 34, 5 March 1987; Don Pease, "A Congressional Plan to Solve the Debt Problem", *International Economy*, March/April 1988, pp. 98-105; James Robinson, "A Comprehensive Agenda for LDC Debt and World Trade Growth", London, American Express Bank, March 1988; Percy Mistry, "Third World Debt", May 1987; and Arjun Sengupta, "A Proposal for a Debt Adjustment Facility", Washington, D.C., IMF, 8 March 1988.

years of the crisis.<sup>41</sup> However, as the banks' vulnerability to default has receded, and as interest in Latin America's markets has become increasingly overshadowed by developments in vibrant Asia, as well as in the emerging new Common Market of Europe and the free trade area of North America, even that limited co-ordination has broken down into an extremely muddled approach, where each creditor is now increasingly set free to cut its own deal. Indeed, in most respects the so-called Market Menu legitimizes the serious *de facto* breakdown in co-ordination among creditors and their governments and multilateral agencies.<sup>42</sup>

Collective solutions also typically have immediate costs, whereas the benefits are spread out more gradually. Serious financial and external adjustment problems limit the United States' ability to respond to difficulties in the hemisphere with new money, at least on the scale that we had become accustomed to in the 1950s and 1960s. Meanwhile, it remains to be seen to what degree Japan and Europe will be willing to fill the financial void in the region, and whether this can be done without creating serious conflict over the traditional distribution of political spheres of influence.

New public initiatives therefore could be very slow in emerging, or else they could be of insufficient scale to tackle the development crisis in the region. But this does not mean that the Market Menu is the only game in town. Indeed, the debtors have gradually developed their own menu of options which includes various types of moratoria on debt service payments. Notwithstanding recent developments in Brazil, more than half of the countries in Latin America

are now deploying this latter approach (table 10). It is also important to remember that most of the recent debt restructurings carried out under the official Market Menu have evolved out of concessions by the creditors, designed to either coax a country out of a moratorium, or prevent it from entering one.<sup>43</sup> Moreover, these agreements can represent more than a temporary respite from a threat of future moratorium only to the degree that they adequately address the underlying capacity to pay of the debtor. So far, only the recent Bolivian agreement would unequivocally fall into this category.

The debtors' menu of options should not be underestimated. In the past an organized formal or informal threat to impose full or partial limits on payments has proven difficult partly because of the lack of internal consensus on what to do about the outward net transfer of resources. It is possible to observe, however, a series of interesting shifts in political alliances in a number of important debtor countries which suggest that that consensus may now be emerging in more countries as we move into the seventh year of the development crisis of the region.

In addition, the debtor countries will gradually learn the secrets of how to sustain growth in a state of full or partial moratorium. Most earlier limits on payments evolved out of the force of events, set off by a poor domestic economic policy, or were mistakenly conceived as an end in and of itself, which only served to stimulate self-defeating populism. Now, however, there are signs of greater sophistication. Perhaps because of some recent bad experiences, more countries seem to realize that, in order to be a successful instrument for economic recovery, a temporary moratorium must evolve out of a coherent economic programme designed to vigorously correct internal and external disequilibria. Furthermore, the limit on payments must be partial and conciliatory in nature, with lines of communication to the creditors kept open and

<sup>41</sup> The co-ordination was so good that Latin Americans began to perceive the formation of a creditors' cartel. See OAS, "Desarrollo Integral y Democracia en América Latina y el Caribe: Ideas y Agenda para la Acción", Washington, D.C., 28 September 1987, p. 23.

<sup>42</sup> The breakdown of the cartel reflects itself in the growing disputes among all parties in the creditor bloc about how to share responsibilities in the management of the debt issue. Serious public disagreements have broken out among the private banks, between the banks, their governments and the multilateral lenders, among the creditor governments, between the creditor governments and multilateral lenders, and even between the World Bank and IMF (over the recent World Bank loan programme in Argentina, mentioned in footnote 12). For an analysis of the breakdown of the creditor co-ordination, see ECLAC, *The Evolution of the ...*, *op. cit.*

<sup>43</sup> This manifested itself clearly during the fourth round of reschedulings. See ECLAC, *Economic Survey of Latin America and the Caribbean, 1987: Advance Summary* (LC/G.1511), Santiago, Chile, pp. 42-60.

constructive proposals offered to them for resolving the problem in a context compatible with an explicit growth-oriented economic reform programme of the debtor country. To the extent that debt service is forcibly rechannelled

into a coherent and sustainable economic programme and gratuitous conflict is avoided, the country enhances the possibility of eventually winning a more realistic settlement on the outstanding debt.

## V

### Conclusions

We have seen that the outward transfer of resources from Latin America hinders adjustment, growth and economic restructuring through its aggravation of either the foreign exchange constraint, the savings/fiscal constraint, or both. In the absence of systematic payment guarantees from the creditor governments, the voluntary market options in the Menu Approach promise to reduce that transfer burden only gradually over a long haul and with a high degree of uncertainty regarding the amount and timing of relief, as well as its distribution among the debtors. In the meantime, the external finance requirements for supporting macroeconomic programmes of growth and restructuring remain unsatisfied. It is thus no surprise that there are very few countries in Latin America which have so far been able to sustain a process of adequate growth with price stability.

An international strategy for growth and reconstruction which benefits only a few problem debtors is clearly a half-hearted international public policy. Yet, it could be unproductive for the debtor countries of Latin America to sit back and wait for the creditor governments to rescue them from their plight with more ambitious international public initiatives. We have seen that collective solutions to a systemic problem emerge more out of a sense of urgency than a sense of good will. As long as the Northern financial systems can successfully adjust to the debt overhang with minimum public assistance, and as long as the economic problems of the region do not provoke open manifestations of political radicalization in the debtor countries, it will be difficult for a comprehensive public policy response to emerge

from the heterogeneous bloc of creditor countries. Clearly, then, the solution to Latin America's crisis of debt and development must, more than ever, come from "inside" the region. This approach is moreover aided today by the serious cracks and disputes that have been developing in the creditors' negotiating bloc, coupled with the lessening importance of the Latin American portfolio in the global economy, because this state of affairs affords more freedom to the debtor countries regarding the formulation of policies designed to lower the outward transfer of resources.

Countries undoubtedly will want to approach the reduction of this transfer in different ways. A minority of countries will find it appropriate to work entirely within the official framework of the Market Menu Approach, periodically rescheduling debts on commercial terms, seeking involuntary loans and participating in debt reduction schemes voluntarily sanctioned by the creditors. Other countries, however, will decide, or be forced by events, to limit the transfer through a partial or total stoppage of payments. In some cases the limit (or threat of a limit) on debt service will be a very transitory bargaining tactic designed to achieve more favourable conditions within the officially sanctioned debt management scheme, but in others it will be a longer-term policy stance designed to force the creditors to share in the costs of a medium-term programme of economic growth and restructuring.<sup>44</sup> A prolonged partial or full moratorium will, of

<sup>44</sup>There are various ways a moratorium can be established. For some techniques that draw partially on the experience of the 1930s, see ECLAC, *ibid.*

course, drive down secondary market prices of the debt to the floor and thereby give the countries more leverage in establishing the pace and discounted terms of eventual debt settlements.<sup>45</sup>

As for co-operation among the debtor countries of the region, past experience suggests that this can be only of very limited scope in view of the heterogeneous conditions of the borrowers. However, as the common stress of the development crisis intensifies, the barriers standing in the way of regional co-operation may be overcome, bringing forth more effective joint initiatives to reduce the net outward transfer of resources.

In sum, the classic market mechanism for resolving a debt overhang —default— was

<sup>45</sup> Again, this is what happened in the 1930s. Indeed, some countries stopped debt service to accumulate resources for a buyback of debt at very low market prices. See M. Skiles, *op.cit.*

temporarily suspended by the unprecedented international debt management strategy of the early 1980s. However, as we move through the seventh year of the region's debt servicing difficulties, some of the classic market dynamics of the 1930s seem to be taking hold. Private credit markets have failed and do not discriminate well among the debtors, while new credit is withheld regardless of the countries' economic policies and capacity to pay. Just as in the 1930s, some countries in Latin America are normally servicing their foreign debt without much refinancing, but most are not. Trading of debt paper has accelerated, and secondary market prices reflect large discounts. Some of the debtors' economies manage to overcome the external constraints, while others do not. This is clearly a very unsatisfactory solution to the debt overhang, with unnecessary costs for debtors and creditors alike. However, it is the only realistic option until there is more far-sighted political leadership in the creditor countries.