# CEPAL

# Review

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# CEPAL

**Review**

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CEPAL REVIEW No. 27

# External debt and crisis: the decline of the orthodox strategy

*Robert Devlin**

This article presents a general view of the reschedulings of Latin American debts with the private banking system during the period 1982-1985. The marked worsening of the conditions of indebtedness experienced by the debtors in the first round of negotiations in 1982-1983 has gradually given way to more favourable terms, above all in the most recent rescheduling (1984-1985). The creditors use market concepts to explain this phenomenon: the better terms represent a reward for good behaviour and the consequent lessening of risk.

The present analysis propounds another conceptual framework for interpreting the facts, based on the notion of bilateral monopoly. According to this view, the favourable trend of the terms of rescheduling was due not so much to some objective fundamental change in the image of creditworthiness of the borrowers as to their increased bargaining power, which enabled them to capture the monopoly rents obtained by the banks in the initial rounds of negotiation. The study goes on to analyse the North-South debate on the heavy transfer of resources from the region to the creditor banks, concluding that this cannot be justified by the conventional criteria of economic theory. Finally, within the framework of the bilateral monopoly, the study suggests various options that would permit the countries to reduce the transfer to the banks and thus give greater support to their own growth and development.

*Staff member of the ECLAC Economic Development Division. A more extensive version of this study was prepared for the Latin American Economic Research Corporation (CIEPLAN) during the author's tour of duty as a Visiting Researcher in the Research Programme on the Economy and International Relations of that corporation, which enjoys the support of the Ford Foundation. The author wishes to express his gratitude for the comments offered by José De Gregorio, Enrique de la Piedra, Ricardo Ffrench-Davis, Adolfo Gurrieri, Manuel Marfan, Oscar Muñoz and Joseph Ramos. Guillermo Mundt provided valuable statistical assistance.

## I

## Rescheduling the debt: the first three rounds

The multiple reschedulings of the debt in Latin America in recent years have followed a well-defined course. In the first round, which began in August 1982, the debtor countries rescheduled obligations maturing in a term of 12 to 36 months. At the same time, in the case of a great many countries, the banks agreed to grant new credits for 1983, which represented an *ex ante* expansion of around 7% of the creditors' loan portfolio[1] (see table 1). The negotiated cost of this exercise —defined in broad terms as including the spread over LIBOR, the amortization period and the commissions— was extremely high. In general, the countries had to pay a spread of over 2%, obtaining amortization periods of only six to eight years and facing fixed commissions of 1.25% or more {see table 2). In comparison with the credit terms negotiated by the same countries in the Eurocurrency market before the onset of the crisis, the rescheduling conditions represented a serious reverse. In effect, using a combined index based on the spreads over LIBOR, the amortization period and the commissions, it is estimated that most of the debtors suffered a deterioration in the negotiated cost of credit of between 100% and 250% (see table 3).

The first round of reschedulings was followed almost at once by another in 1983-1984, to reprogramme the 1984 maturities of some countries and to determine the amount of new resources that the banks would lend for that year. Although the terms imposed in the transactions remained relatively severe, they were somewhat better than those negotiated in the reschedulings of the first round. In general, the spreads were 0.3 to 0.5 percentage points lower, the amortization periods were lengthened by one or two years and the commisions dropped to under 1% (see table 2). The volume of new credits granted by the banks for 1984, however, was in general lower in value than the loans authorized for the previous year[2] (see table 1).

[1]The figure of 7% was reached by general agreement with the IMF (ECLAC, 1984a, p. 56),

[2]The new set of loans for Brazil was bigger than in 1983, but this rise was intended to compensate the country for the loss of short-term credit lines during 1982 and 1983.

Table 1

LATÍN AMERICA: RESCHEDULING OF THE BANK DEBT 19821985[a]

*(Millions of dollars)*

| Countries | First round 1982/1983 | | | Second round 1983/1984 | | | Third round 1984/1985 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Maturities | | New credits | Maturities | | New credits | Maturities[1]* | | New credits |
| | Amount | Years | Amount | Amount | Years | Amount | Amount | Years | Amount |
| Argentina | 13 000' | Sept. 82-83[1] | 1 500[t] | | | | 13 400 | 82-85 | 4 200 |
| Brazil | 4 800 | 83 | 4 400 | 5 400 | 84 | 6 500 | | | |
| Costa Rica | 650 | 82-84 | 225 | — | 84 | — | 280 | 85-86 | 75 |
| Cuba | 130 | Sept. 82-83 | —'' | 103 | 84 | — | 94 | 85 | — |
| Chile | 3 424 | 83-84 | 1 300 | — | — | 780 | 5 932 | 85-87 | 714; 371[d] |
| Ecuador | 1 970 | Nov. 82-83 | 431 | 900 | 84 | — | 4811 | 85-89 | 200 |
| Honduras | 121 | .82-84 | — | — | — | — | 220 | 85-86 | — |
| Mexico | 23 700 | Aug. 82-84 | 5 000 | 12 000[e] | 82-84 | 3 800 | 48 700 | 85-90 | — |
| Panama | 180 | 83 | 100 | — | — | — | 603 | 85-86 | 60 |
| Peru | 400 | 83 | 450 | 662 | 84-Jul.85 | — | | | |
| Dominican Republic | 568[c] | 82-83' | — | — | — | — | 868 | 82-85 | — |
| Uruguay | 630 | 83-84 | 240 | — | — | — | | | |
| Venezuela | — | — | — | — | — | — | 21 200 | 83-88 | — |

*Source:* ECLAC, Economic Development Division.

[a] Refers to the value of the rescheduled amortization commitments and the years to which they correspond, plus the new credits granted by the banks as an integral part of this restructuring. The table does not include information on the maintenance of short-term credit lines and the bridging credits authorized by the United States Treasury, the Bank for International Settlements, etc.

[b] In some cases these incorporate maturities already rescheduled in 1982/1983.

[c] The agreement was never signed and the maturities were incorporated into the new agreement of 1984/1985.

[d] The values correspond to 1985 and 1986 respectively. They include US$ 150 million guaranteed by the World Bank.

[c] Private sector Commitments.

Table 2
LATIN AMERICA: CONDITIONS FOR RESCHEDULING BANK DEBT*

| Countries | First round 1982/1983 | | | Second round 1983/1984 | | | Third round 19!34/1985 | | |
|---|---|---|---|---|---|---|---|---|---|
| | M | P | C | M | P | C | M | P | C |
| Argentina | 2.16[b] | 6.8[b] | 1.25[b] | — | — | — | 1.44 | 11.5 | 0.15 |
| Brazil | 2.32 | 8.0 | 1.50 | 2.00 | 9.0 | 1.00 | | | |
| Costa Rica | 2.25 | 8.0 | 1.00 | — | — | — | 1.65 | 9.5 | 1.0 |
| Cuba | 2.25 | 7.0 | 1.25 | 1.88 | 9.0 | 0.88 | | | |
| Chile | 2.16 | 7.0 | 1.25 | 1.75 | 9.0 | 0.63 | 1.42 | 12.0 | 0.08 |
| Ecuador | 2.28 | 6.7 | 1.25 | 1.75 | 9.0 | 0.88 | 1.39 | 11.9 | |
| Honduras | 2.38 | 7.0 | 1.38 | — | — | — | 1.58 | 11.0 | 0.88 |
| Mexico | 1.95 | 7.6 | 1.05 | 1.50 | 10.0 | 0.63 | 1.13 | 14.0 | — |
| Panama | 2.25 | 6.0 | 1.50 | — | — | — | 1.40 | 11.7 | 0.50 |
| Peru | 2.25 | 8.0 | 1.25 | 1.75[e] | 9.0[1] | 0.75[e] | | | |
| Dominican Republic | 2.25[b] | 6.0[b] | 1.25[b] | — | — | — | | | |
| Uruguay | 2.25 | 6.0 | 1.41 | — | — | — | | | |
| Venezuela | — | — | — | — | — | — | 1.13 | 12.5 | - |

*Source:* ECLAC, Economic Development Division.

[4] Short-term credits are not considered. The symbols are:
M = spread over LIBOR;
P = total period (in years) of amortization; and
C = fixed commissions expressed as a percentage of the total value of the credit.
Each column shows the conditions agreed with the banks for the reprogrammed maturities and the new credits. In cases where a country negotiated in a round both a reprogramming of maturities and the granting of new resources, the figure represents a weighted average of the two transactions. For more detailed information on these credit exercises, see ECLAC (1984b), tables 15 and 16,andEci.Ac(1985),pp. 67 to 72.

[b] This agreement never came into force. The corresponding maturities were incorporated in the agreement which formed part of the third round.

[c] This agreement is in suspense.

Shortly after the end of the second round of reschedulings, the countries met again to discuss the restructuring of the maturities falling due from 1985 onwards. In this third round, which continued during 1985, a new improvement was observable —very marked this time— in the negotiated cost of credit. The spreads over LIBOR continued to display the declining trend noted in the second round; the amortization periods were extended (10 to 14 years) and the commissions were sharply reduced, falling even to zero in the cases of Ecuador, Mexico and Venezuela (see table 2). In fact, it is evident that the credit terms achieved in the third round, taken as a whole, were somewhat better than those obtained in the Eurocurrency market prior to the crisis (see table 3). This result was also facilitated by the willingness of the creditors to extend the maturity rescheduling horizon from a maximum of two or three years to between three and six years[3]. On the other hand, the banks have obviously become more restrictive with the new credits, since these were much scarcer in the third round[4] (see table 1).

In these three rounds of reprogramming, the private banking system has carried out the most massive restructuring of debts in the history

[3]Other innovations were the option offered to the borrowing country to transfer its loans from the Prime rate to the lower LIBOR rate, and to incorporate the debt reprogrammed in the first round into the more favourable conditions of the third.

[4]Some countries did not ask for new credits, partly because they wished to improve their image of creditworthiness with a view to returning to the autonomous credit market.

Table 3

LATIN AMERICA: CONDITIONS OF INDEBTEDNESS WITH THE PRIVATE BANKS[ab]

*(index: 1980-1981 = 100)*

| Country | Autonomous credit market | Rescheduling of the debt | | |
|---|---|---|---|---|
| | 1980-June 1981 | First round 1982/1983 | Second round 1983/1984 | Third round 1984/1985 |
| Argentina | 100 | 317 | — | 166 |
| Brazil | 100 | 144 | 108 | |
| Costa Rica | 100 | 133 | — | 83[c] |
| Cuba | 100 | 148 | 93' | |
| Chile | 100 | 250 | 151 | 89' |
| Ecuador | 100 | 342 | 191 | 109 |
| Honduras | 100 | 153 | — | 63( |
| Mexico | 100 | 281 | 160 | 83' |
| Panama | 100 | 274 | — | 81' |
| Peru | 100 | 197 | 133 | |
| Dominican Republic | 100 | 235 | — | |
| Uruguay | 100 | 349 | — | |
| Venezuela | 100 | — | — | 68' |

*Source:* Devlin (1983), p. 108; ECLAC (1985), pp. 67 to 69; and data provided by the Economic Development Division of ECLAC.

[a] Based on an index of the elements of credit cost subject to rescheduling. The formula used is the following;

$$\frac{\frac{C_1}{P_1} + M_1}{\frac{C_0}{P_0} + M_0} \times 100$$

where: C = commissions; P = period of amortization and M = spread over LIBOR, and where the subscript 1 refers to the terms existing in the respective rounds of reschedulings and the subscript 0 to those which existed in the normal credit market of 1980-June 1981. All the elements of the formula refer to the reprogrammed debt and to the new credits and are weighted by the amount of credit. Note that the relative deterioration is strongly influenced by the initial position of the borrower as regards the spreads, amortization periods and commissions contracted in the market between 1980 and June 1981.

In the reschedulings the State frequently had to give its guarantee in respect of the private sector's debt which previously did not carry this guarantee. This deterioration is not incorporated in the index.

Improvement.

of modern international finance. Besides this, the banks took great care to watch over their own interests in incorporating new credits into the rescheduling exercises, a procedure to which they had traditionally been opposed[5]. Nevertheless, even with the alleviation of the debt, the borrower countries have not succeeded in avoiding serious obstacles to their economic growth and development. Perhaps the statistic which best sums up the difficult situation besetting the region is the per capita income: in 1984 it was 9% lower than that recorded in 1980, and this regional average conceals even worse conditions for some countries (ECLAC, 1984, table 1). At the same time, despite the obvious softening of the terms negotiated in the third round of rescheduling, the growth prospects of the region are far from good. In fact, even the most optimistic observers acknowledge that the 1980s will be a lost decade for Latin America, and project a per capita income in 1990 which in the best of cases will be only slightly higher than that of 1980 (Cline, 1984a, p. 195). Using less favourable assumptions, it is estimated that even the 1980 level of income might not be regained.

[5]The subject of the new credits in the reprogramming arrangements is dealt with in more detail further on.

Table 4

LATIN AMERICA: NET CAPITAL INFLOW AND TRANSFER OF RESOURCES

*(Billions of dollars and percentages)*

| | Net effective inflow of capital[4] | Non-registered transactions'" | Net inflow of capital | Net payments of profits and interest | Transfers of resources | | Transfers, as a percentage of exports (x) | |
|---|---|---|---|---|---|---|---|---|
| | | | | | (1-4) | (3-4) | 5/x | 6/x |
| | (0 | (2) | (3) | (4) | (5) | (6) | (7) | (8) |
| 1970 | 3.8 | 0.1 | 3.9 | 2.8 | 1.0 | 1.1 | 5.9 | 6.5 |
| 1971 | 4.5 | -0.2 | 4.7 | 3.0 | 1.5 | 1.7 | 8.5 | 9.6 |
| 1972 | 6.0 | 1.0 | 7.0 | 3.1 | 2.9 | 3.9 | 14.1 | 19.0 |
| 1973 | 8.5 | -0.7 | 7.8 | 4.2 | 4.3 | 3.6 | 14.9 | 12.5 |
| 1974 | 12.7 | -1.3 | 11.4 | 5.0 | 7.7 | 6.4 | 17.7 | 14.7 |
| 1975 | 16.0 | -1.8 | 14,2 | 5.5 | 10.5 | 8.7 | 25.5 | 21.2 |
| 1976 | 18.9 | -0.7 | 18.2 | 6.8 | 12.1 | 11.4 | 25.6 | 24.1 |
| 1977 | 15.4 | 1.6 | 17.0 | 8.2 | 7.2 | 8.8 | 12.9 | 15.7 |
| 1978 | 24.4 | 1.7 | 26.1 | 10.2 | 14.2 | 15.9 | 23.1 | 25.9 |
| 1979 | 26.9 | 1,7 | 28.6 | 13.6 | 13.3 | 15.0 | 16.2 | 18.3 |
| 1980 | 35.5 | -5.5 | 30.0 | 18.0 | 17.5 | 12.0 | 16.5 | 11.3 |
| 1981 | 48.3 | -10.6 | 37.7 | 27.7 | 20.6 | 10.0 | 18.1 | 8.8 |
| 1982 | 30.0 | -10.8 | 19.2 | 37.6 | -7.6 | -18.4 | -7.5 | -18.1 |
| 1983 | 11.1 | -6.7 | 4.4 | 34.5 | -23.4 | -30.1 | -23.3 | -30.0 |
| 1984[c] | | | 10.6 | 37.3 | | -26.7 | | -23.8 |

*Source:* ECLAC (1984a), p. 11; ECLAC (1984b), table 12, and data supplied by the ECLAC Division of Statistics and Quantitative Analysis.

"Equals the net capital inflow less non-registered transactions.

[b]Corresponds to the item "errors and omissions" in the balance of payments.

•preliminary figures.

The nub of the matter lies in the fact that, even after this relief of the debt burden (including the new credits), Latin America will continue making enormous transfers of financial resources to the creditor countries. Table 4 shows that the net balance between the entry of new capital and the outflow of resources in respect of factor services (which represent almost entirely interest payments) was very negative in 1982-1984, with a transfer to the exterior which fluctuated between the equivalent of 18% and 30% of the region's exports of goods and services. Such a transfer of resources was possible thanks to the rapid transformation, in the debtor countries, of a trade deficit into substantial surpluses. Nonetheless, the latter were almost entirely achieved through the contraction of Latin America's imports, whose value fell by close on 40% in the course of those three years. With this abrupt reduction of foreign purchases, there was an inevitable collapse of economic activity and a fall in the gross domestic product in absolute terms.

What was the reason for the large transfer which unleashed this adverse sequence of events? It was due to unprecedented world interest rates, with an average LIBOR rate of between 10% and 13%; unprecedented negotiated costs (spreads, amortization periods, commissions) on the rescheduled debts and the new loans; and a massive drop in the net inflow of capital, which during the 1970s had been more than sufficient to cover the deficit on factor services. This latter phenomenon was caused by the reluctance of the private banks to grant new loans to the Latin American countries after 1982 and to the considerable flight of capital belonging to private economic agents[6].

The debt and the problems of the transfer of resources will certainly affect Latin America's development policy in the coming years. In the

[6]A rough idea of the effect of the flight of capital is given in column 2 of table 4, derived from the item "errors and omissions" of the balance of payments.

absence of international public action to alleviate the financial burden of these countries,[7] the region will have to continue its ceaseless negotiations with the private banks, while the countries seek new formulas that will enable them to minimize the payments and free resources for investment and growth. In these circumstances it is important to examine the options which are open to the debtors, establishing in the first place the framework for the negotiation process.

# II

# The framework for negotiations between creditors and debtors[8]

### 1. *Are market forces at work?*

In evaluating their own policies regarding the debt reschedulings, bankers frequently recur to market concepts. This is most evident in their arguments concerning the pricing of the rescheduling exercises. For instance, in the first round of reschedulings the creditors used one or more of the following to justify the sharp rise in the negotiated price of credit.

*Price elasticities.* It was argued that the higher price would induce the refinancing of amortization and the extension of net credit. As Gasser and Roberts (1982, p. 28) argued, "Clearly the more attractive the terms of the restructured or rescheduled debt, the more willing will be the participation of all banks, and a reasonably early resumption of lending will be more likely".

*Risk.* Another argument frequently used to explain the higher price of credit was the greater risk involved in extending maturities beyond the dates originally agreed to in the loan contract: i.e., the greater price compensated for the greater risk.

*Moral hazard.* Drawing from the literature on health insurance, some argued that the higher price was needed in order to provide the borrowers with a disincentive for pursuing policies which might lead to the need for rescheduling[9]. In other words, debtors had to be penalized, for otherwise they would be tempted to behave in ways which would lead to repeated repayment problems.

All of the above arguments are market-oriented and in one way or another imply that the supply curve was shifting upward and to the left in the first round of reschedulings, making credit more expensive. The improvement of the terms in the second round of the reschedulings was justified by the bankers on the ground that the debtors behaved well in the adjustment process, reducing risks and moral hazard; in other words, the supply curve began to shift down and to the right again. The third round represented another downward shift in the supply curve. Thus, all developments are explained in terms of the "magic of the marketplace". But one must be suspicious of "ad hocery" when three arguments are employed simultaneously to explain a single phenomenon. Indeed, none of the arguments hold up under scrutiny.

With regard to price elasticities, there is no empirical evidence to support the notion that a bank's willingness to reschedule debt is linked to a higher negotiated price of credit. It is almost

[7]For an analytical summary of the different proposals for solving the debt crisis, see Guergutl (1984).

[8]This section is a synthesis of a more extensive and theoretical analysis found in Devlin (1985). The same article contains the related supporting documentation and bibliographical material. The 1985 article represents a further development of Devlin (1984 and 1983a).

[9]In the health insurance literature it is pointed out that the way a cliente behaves influences the need for services. After a premium is paid, the cost of health care is zero. This could induce an economic agent to behave in ways which would consume more health services than if there were positive marginal costs. Thus, to avoid moral hazard, most insurance companies require insured customers to pay a deductible amount on each claim.

self-evident that banks reschedule not to make profits, but to avoid the large capital losses that would result if the borrower fell into open default. As for net credit, studies have shown that the reaction of banks to a rescheduling —even when the negotiated price has risen sharply— is to cut back exposure, not expand it.

It is true that during the current series of reschedulings banks have extended new credits. But these new credits are really a disguised rescheduling of interest payments. In effect, borrowers have faced unsustainable interest payments equivalent to 30% or more of their export earnings. If banks had not extended the new loans, most borrowers would have ceased to pay interest, negating the commercial viability of the whole rescheduling exercise. In sum, the new credits are simply part of the overall administration of old debt and their appearance is due to the need to avoid capital losses rather than to the attractiveness of the price of the operation.

There are of course many banks which were latecomers in the expansive phase of Latin America's credit cycle. These banks have a relatively smaller exposure in the region and perhaps were tempted to resist new lending even in the face of potential default. But their participation in the new credit packages was not due to the higher price; indeed, these banks were at their maximum point of credit rationing, at which no price would voluntarily elicit a supply. Their willingness to lend was basically due to coercion from the bigger banks, Central Bank authorities, the IMF, etc. This is confirmed by the fact that the smaller lenders took any opportunity they could to sneak out of the new loan packages even though the negotiated price of credit was at record levels.

With regard to risk, there was no increase of this upon rescheduling debt. What the lenders faced in 1982 was the materialization of the risk that they had evaluated in the 1970s and for which they had charged a risk premium. In fact, the reschedulings actually lowered risk because without them the original default risk and consequent losses would have appeared on the banks' balance sheets. Moreover, risk was further reduced by the monitoring of the economies by the IMF and by the ability of the banks to force governments to guarantee the debts of the debtor country's private sector.

The moral hazard argument also is spurious. In a fair environment premiums for moral hazard are determined in a competitive framework and economic agents are aware of costs upon signing a contract. To charge a premium for this concept during a rescheduling exercise is arbitrary and equivalent to informing a patient of his health insurance premium after he is sick. Furthermore, in the economic literature it is well known that jacking up the price of credit —especially when borrowers are under stress— can increase moral hazard, not reduce it. On the one hand, borrowers must undertake more risky behaviour to meet the higher service payments. On the other, if the borrower is dishonest, the higher price of credit raises the benefits of open default.

Indeed, the price of credit is not the true incentive to good behaviour. No country wants to enter into a rescheduling, because it means the interruption of its credits flows and external savings, which have a high rate of return. And as mentioned, if the borrower is inclined to default, the higher pricejust raises incentives for this type of action. In fact, the behaviour of economic agents cannot be controlled by economic incentives alone. The sign of a successful economic system is a sufficient trust between the principal economic agent and the subordinate so that the former assumes that the latter will not act in bad faith even if it were rational to do so. In other words, an integrated and efficient economic system cannot be based on a *homo economicus* assumption, where all behaviour is based on a pure cost-benefit calculus.

It is in this light that one can interpret the great responsibility with which most Latin American countries have confronted their debt obligations, even when to do so has involved tremendous social costs and political risks. In effect, Latin American countries are integrated into the world capitalist system and largely share its values. Yet the enormous burden of the debt is working contrary to the continued economic integration of the region and threatens to underpin political forces which wish to close the economies and reduce commitments to the international capitalist system. It is precisely for this reason that there is an urgent need for new and more equitable ways of managing the debt problem.

2. *The monopoly power of the banks*

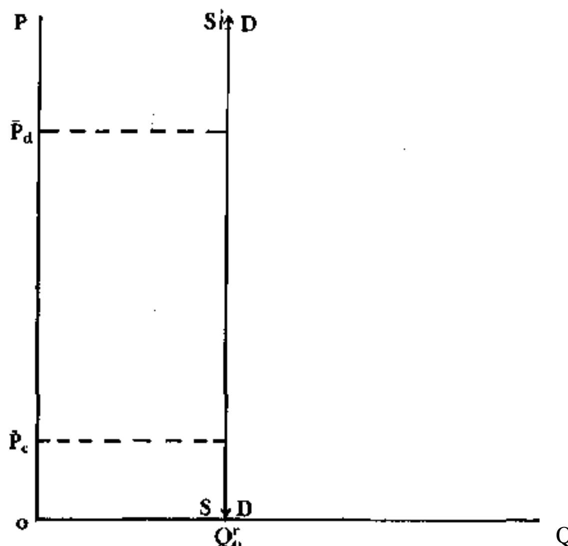
We have seen that the banks' interpretation of the three rounds of reschedulings was conceptually related to the market mechanism. But in reality there was no competitive market; indeed, if the market had been functioning debtor countries would have received relief via the classic market risk sharing device —default and devaluation of the banks' assets— much as they did in the 1930s. But in fact, in the first round ofthe reschedulings the banks avoided competition and losses by joining together to negotiate *en bloc* and by using the resulting monopoly power to pass the costs of their faulty risk evaluation ofthe 1970s onto the borrowers.

At the same time, the *ex-post* rise in the cost of debt that was imposed by the banks in the first round of reschedulings was a monopoly rent, or superprofit. A rent is a payment above that which is required for an economic agent to do what it does. In this case, the banks charged more for an administrative operation (the rescheduling of amortization and refinancing of interest) which was in any event necessary to avoid large capital losses. Moreover, the nearly uniform reduction in credit terms in the second round of the reschedulings is a good empirical indicator of the rents obtained in the first round. In effect, many countries won concessions without any objective improvement in their underlying economic situation and indeed some were accumulating arrears which the new credits were in part designed to eliminate. The fact that most countries are paying terms in the third round which are *better* than those they contracted during the normal credit market of 1980/1981 is another good indication that monopoly rents were won by the banks during their management of the crisis.

The rescheduling of debt and refinancing of interest payments in fact cannot be evaluated as a market transaction where there is a price for a determinate flow. The exercise takes place in the framework of a bilateral monopoly. The outcome is theoretically imprecise and depends on the bargaining strength ofthe two parties. To the extent that the banks manage to impose rescheduling terms that permit them to elude the devaluation of their assets and losses that would come about from the free play of market forces, they are earning rents. These rents can be captured by the borrowers and are in fact now being captured by them.

The situation can be illustrated in the manner shown in figure I, which assumes that there is only rescheduling of capital that otherwise would be in default. It also excludes externalities, or demonstration effects.

**Figure I**




Prf — Maximum price accepted by the debtor to avoid default.
Pc = Minimum price accepted by the creditor to avoid default.
Qu = Credit to refinance/reschedule unpayable amortizations.
S = Supply.
D = Demand.

It can be seen from the figure that in a bilateral monopoly the supply and demand curves are superimposed upon one another over the amount of debt subject to reschedulings (Qo). The demand curve DD is perfectly inelastic because the debtor is insensitive to the price of credit in order to gain loans (Qo) sufficient to avoid default. Likewise, the creditor too is not precise about the price of a rescheduling because of the need to avoid default and the losses that would be confronted in the absence of a restructuring. For this reason the creditor also has a wide range of prices that are acceptable for lending QJ,.

Nevertheless, the debtor will have a max-

imum price for credit $P_d$ above which it will be preferable to default. The creditor also will have a minimum price $P_c$ below which it would be inclined to call a default. Thus there is a range of prices $P_c$ - $P_d$ for which an acceptable agreement can be reached. The result does not depend on the forces of supply and demand, but rather on the relative bargaining strength of the parties.

In the first round of reschedulings the borrowers unwittingly accepted the banks' conceptual framework and the price of credit approached $P_d$, providing the banks with large monopoly rents. $P_d$ and the rents fell in the second and above all in the third round of the reschedulings. This had to do with the gradual improvement of the borrowers'joint bargaining power. On the one hand, there was consternation in many circles of the North and South owing to the exorbitant cost of the reschedulings; indeed, even the United States Congress called for a softening of terms in a public law it passed concerning increased quotas for the IMF. On the other hand, debtor countries began to mobilize themselves, first in regional meetings, such as the Latin American Economic Conference in Quito in January 1984, followed by the joint declaration of the presidents of Argentina, Brazil, Colombia and Mexico in May 1984, which condemned the high level of world interest rates. This last initiative eventually gave rise to a meeting of 11 Latin American ministers in Cartagena, Colombia, in June 1984.

While the debtor countries vigorously denied any intention of forming a Debtors' Club, the banks became concerned about the growing solidarity among the borrowers and its potential for the formation of such a cartel. They therefore attempted to neutralize the new movement and offered to Mexico and later Brazil —the two most powerful debtors in the group)— the significantly better terms that formed part of the third round of reschedulings[10]. Later, other debtors received roughly similar treatment.

The strategy of the creditors temporarily paid off, as subsequent meetings of the 11 ministers (now denominated the Cartagena Consensus) in Santo Domingo and Mar del Plata were extremely dull affairs. However, in mid-1985 the creditors appear once again to be under pressure to reduce their rents. The slowdown of the United States economy has damaged prospects of relief via world recovery and turned off the light, faint though it was, that some debtors had perceived at the end of the debt crisis tunnel. Moreover, the Government of Cuba has taken the initiative on the debt problem, promoting in the region the idea that the debt cannot be paid and should therefore be forgiven by the North as one component in the restoration of a New International Economic Order. Also, new democratic governments, such as those in Brazil and Peru, have been displaying their profound displeasures with the orthodox management of the debt problem.

In any event, is it possible to be somewhat more precise about $P_c$ in figure I the limit below which a declaration of default becomes the preferred alternative of the bank? In the absence of externalities, it would be the price that brought losses just below those which would be incurred in the event of an open default. The determination of this price is quite difficult because of the reluctance of banks to enter into secondary trading of loan paper and because of the strong influence of bank regulatory authorities in the valuation of assets. But it is evident that $P_c$ is well below the price agreed to in the first three rounds of reschedulings and indeed could even be negative[11].

The introduction of externalities greatly complicates the analysis. Without considering

[10] Brazil never signed its rescheduling agreement and continues negotiating with the banks and the IMF.

[11] For example, suppose a bank had to call a default on loans worth USf 100 million. It could enter a small secondary market to sell the paper. At the beginning of the crisis, Latin American paper experienced discounts of up to 20%. With a cost of funds of 10%, the loss to the bank would be 20% of principal ($ 20 million) plus 10% ($ 10 million). The return therefore is -30% [100 (1 + X) = 70]. In this case any agreement which offered a loss of less than 30% would be attractive to the creditor. A return higher than the market valuation would be a rent. One can arrive at similar conclusions by making assumptions about the behaviour of banking supervisors regarding their valuation of the bank's assets. In all probability the supervisors would spread the losses over time. Finally, it is worth mentioning that in early 1985 the discounts registered in secondary trading of Latin American paper were as follows: Argentina (30%); Brazil (20%); Bolivia (80%); Chile (35%); Mexico (15%); Nicaragua (90%); Peru (50%) and Venezuela (10%).

the action of other debtors, the creditors would perhaps accept a price for rescheduling debt that was well below a commercial rate. But the creditor knows that if debts are rescheduled at less than a commercial rate, other debtors might demand similar treatment. So the effective loss registered on *one* rescheduling could in fact be multiplied many times by the action of other debtors. In the light of this $P_c$ would be considerably higher than that outlined in the example contained in the last footnote. Whether it is below the price registered in the third round of reschedulings is a matter of conjecture. But one suspects there is further room to reduce the rents; indeed, some countries such as Peru, Bolivia and Nicaragua have in fact so far managed to drive the effective price down below that of the third rescheduling exercise by accumulating arrears.

The same framework of a bilateral monopoly can be used to evaluate the possibility of forcing new credits from the banks. In effect, the new credits are indistinguishable from the old debt because they keep interest payments current and avoid a writedown of the portfolio. I have a shown elsewhere (Devlin, 1985) that a borrower is more likely to be able to force new credits from the banks, the bigger its debt with them and the greater the reduction in the probability of default after the loan is extended. Thus new forced lending is easiest to achieve in a context of illiquidity and much more difficult to realize in a state of insolvency[12]. Moreover, an illiquid borrower which is co-operative and inclined to compress its imports as much as is necessary to pay the debt is, ironically, less likely to obtain new credits than an illiquid borrower which is tough and threatens default if a high percentage of interest payments are not covered by new loans.

Finally, the readiness to lend greatly depends on the collective action of the banks, since no institution would have incentives to grant credits in isolation. It is precisely in its role of co-ordinator that the Bank Steering Committee is a "public good". Unfortunately, it has been noted that this group also has had its collusive aspect: it enabled the banks to act *en bloc* against isolated debtors in order to transfer to them the greater part of the costs of the crisis.

# III

# Strategies for shielding development from the burden of the debt

It has already been observed that the financial crisis has had a devastating impact on Latin America's economic activity and per capita product. A central factor in the situation was the transfer of financial resources from the debtor countries, which has resulted in a dramatic reduction in imports. This outflow is mainly due to two phenomena; i) the procyclical behaviour of the banks; and ii) the flight of capital. But, as will be seen further on, the second phenomenon cannot be entirely disassociated from the first.

## 1. *Transfers of resources to the private banks*

### a) *Good or bad?*

The Mexican financial crisis in August 1982 brought with it a paralysation of bank credit to Latin America, which in the 1970s had been expanding at an annual rate of 30% or more[13]. In the face of the collapse of the autonomous credit supply, the creditor banks came to an agreement among themselves to provide new loans to the debtors as an integral part of the rescheduling of the debt.

In the first round, the general formula of the

[12]Strictly speaking, the terms illiquidity and insolvency are commercial concepts not applicable to countries. Here the terms are used loosely to distinguish between debtors which have prospects of adjusting in a medium-term period and those which must undergo long-term restructuring of their economies in order to regain their creditworthiness.

[13]Morgan Guaranty Trust Co. (1983, p. 6) and Ffrench-Davis (1985, p. 2).

creditors was to expand the loans by around 7%. Nevertheless, the interest rates at that time were on average somewhere in the region of 12% (including the spreads), which meant a programmed transfer to the banks equal to 5% of the existing obligations. This had a serious adverse effect on the debtors, since just before the crisis they were receiving a positive contribution from the banks equivalent to close on 6% of these obligations, so that there was in fact a total programmed turnaround of 11% in credit flows[14].

The transfer of financial resources to the banks was and continues to be a very controversial topic. Latin American analysts—for example ECLAC (1983 and 1984a); Prebisch (1985), p. 50; Ffrench-Davis and Molina (1985), pp. Ill 10 to 13; and Ferrer (1984), pp. 309 to 311 — have vigorously criticized the process. On one occasion ECLAC (1983, p. 9) even called it "perverse", in that it was premature in relation to the level of the region's development.

On the other hand, many analysts from the North are accustomed to defend the negative transfers as the only way of "solving" the financial crisis of the region. By way of example, Cline (1984a, p. 175) —one of the most influential researchers in this field— recently criticized ECLAC'S concern over the net outflow of resources. According to him, the substantial net payments to creditors are not "perverse" but a healthy sign, since they promote the reduction of the debt in relative terms and speed up the arrival of the day on which the Latin American countries will recover their image of creditworthiness and their normal access to credit. It is also argued that the anxiety about the negative transfers and the contraction of imports is misplaced, since the adjustment policies will promote the production of tradeable goods and especially of exports. In their turn the growth of the latter will increase the capacity to import, even with the transfer of resources to creditors.

This argument has some validity in the medium term, but it falls down through its deficient consideration of the time factor in the adjustment process. In fact, in the short run the price-elasticities of exports and imports are frequently low, because of rigidities in the reallocation of resources to tradeable goods[15]. Thus, a debtor country tackling the adjustment without adequate external financing will be forced to generate a trade surplus by a disproportionate compression of its imports and a reduction of its economic activity. This negative adjustment is magnified in so far as the world economy is in recession and their is no dynamic external demand. The foregoing well describes what happened to Latin America in 1982-1983: there was an overestimation of the effects of resource reallocation and an underestimation of the need for credit, which resulted in an abrupt fall in imports and per capita income. It is precisely in this context that the negative transfers and the adjustment they required were "perverse" and socially inefficient.

If the debtors' payment problem had been characterized by a lack of liquidity, as the proponents of negative transfers affirmed, the logical prescription would have been very different from what was actually experienced in Latin America. It is well known that the classic process of efficient adjustment based on the reallocation of resources suffers from time-lags which make it evolve in the form of the famous J-curve. To maintain the symmetry, a socially efficient adjustment should include new credit in the form of an inverted J. In other words, there was a logical reason to expect that during the initial phase of the adjustment the transfer from the creditors should have been nil or slightly positive, but not negative. And the coefficient of debt to exports should have tended to rise temporarily and not fall. Only when it had been confirmed that the reallocation of resources obtained the anticipated effect on the overall growth of exports and on the substitution of imports should there have been a commencement of substantial transfers to the creditors and the sustained reduction of the coefficient of debt to exports.

[14]Indeed, the figure was close to 14%. According to Ffrench-Davis (1985, p. 10) the positive transfer of the banks to Latin America in 1981 was US$ 10.5 billion, which is equivalent to 6% of the total bank debt in 1980. The same author estimated the negative flow in 1983 at US$ 18.8 billion, which equals 8% of the total commitments at the beginning of that year.

[15]The bottlenecks are of an economic, social and political nature. Of course, the seriousness and nature of the obstacles vary considerably among the countries.

The root of the problem lies in the fact that during the 1970s the anticyclical components of the international financial system (the international public lenders) shrank excessively, while the procyclical elements (the private banks) expanded far too much. When the crisis broke out in 1982 the system was highly unbalanced and could only tackle the problem in an *ad hoc* manner with makeshift measures. Although the crisis was well handled in the sense that it rescued the international Financial system, the result was achieved at the expense of Latin American development[16].

The dilemma was evident from the start. In the face of the massive procyclical withdrawal of the banks, the IMF —whose relative international position had declined— [17] was in no condition even to begin to fill the gap. In these circumstances it decided to transforms itself rapidly into a catalyst for the mobilization of private funds; acting in conjuction with the large banks, it made many of is stand-by programmes conditional on the aforesaid 7% formula for the expansion of credit. But it has been seen that in face of the rigidity of resource reallocation and the depressive effects of the world recession, the expansion of 7% was not enough to promote a socially efficient adjustment. Furthermore, it is by no means evident that the recent initiatives of the creditors to reduce the new obligations still further have been expedient, since so far there has been no trustworthy evidence that Latin American exports are responding favourably to the adjustment prescribed by the Fund.

Still more disturbing, however, is the Utopian view of these events held by many analysts of the North. The contraction of imports and the fall in economic activity (which implied a reduction in the investment required to reinfource future payment capacity) are assessed positively as an "overperformance" in the process of adjustment (Wallich, 1985, p. 1; Cline, 1984b, p. 15). At the same time there are repeated expressions of "confidence in the appropriateness of the current strategy" (de Larosière, 1985, p. 200). Meanwhile, those who put forward more equitable ways of solving the debt problem —which would imply carrying out fundamental reforms— are considered as mere wet blankets by the supporters of the orthodox strategy.

It is really difficult for an economist concerned with economic development to understand this complacent attitude. The only reason for optimism that there could be in the face of an adjustment which has so ruthlessly violated the most fundamental principles of a social market economy is that, to speak quite frankly, there is in some circles the implied assumption that Latin Americans are irresponsible and that the International Monetary Fund is unable to control them. This would create a need to impose a forced and onerous adjustment. Unfortunately this seems to be the assumption that has guided a large part of the policy of the creditor countries[18].

b) *How can the transfers to the banks be reduced?*

Only economic growth will allow the servicing of the debt. Payment cannot be sustained in circumstances in which the per capita product is falling or stagnant, and in any case it would be counterproductive. On the one hand, without growth the servicing of the debt rapidly ceases to be a technical matter and is converted into a political problem in which, in the last resort, even the authorities most committed to the international system have to take steps in favour of the national public interest[19]. On the other hand,

[16]It is interesting to recall that Marxist theory predicts that in a financial crisis the capitalist system will always tend to sacrifice the value of productive capital on the altar of financial capital (Weeks, 1981, pp. 123 to217). This interpretation seems to have some affinity with the handling of the present crisis in Latin America.

[17]Up to 1970 IMF quotas were approximately equivalent to 10% of the annual value of world trade; when the crisis arose, they had fallen to 4% (Cline, 1984a, p. 124).

[18]The new economic analyses of the debt are often led astray by an exaggerated Benthamism as regards rationality and the calculation of costs and benefits. In other words, according to this theory, if the cost of bad behaviour of a debtor is less than its benefit, the rational debtor will always opt for the former without considering the general welfare. There can be no doubt that this represents a development of the concept of *homo económicas* to a level which undermines its usefulness for diagnosis and subscription.

[19]The industrial countries have reacted in a similar way. For example, during the 1930s the Governments of England and France suspended the servicing of their debt with the United States on the grounds that their obligations to their peoples were more important than their commitments to their foreign creditors (Hardy, 1982, p. 40).

the sacrifice of investment and human capital to pay the debt today only reduces the capacity to pay tomorrow.

The recent reduction in world interest rates has given some relief to the debtors. But the decisive factor for restoring the capacity for payment is an exogenous stimulus which would be achieved with the so deeply desired sustained expansion of the OECD economies and the consequent improvement in the terms of trade for Latin America. However, the possibility of a substantial recovery remains elusive and the outlook is very uncertain. Without a greater advance in this field, the dynamics of economic development and the servicing of the debt will continue in open conflict. In the short term, with a view to increasing domestic economic activity, many of the debtor countries must reduce their transfers to the foreign banks.

Naturally, to reduce the amount of the transfer implies a cost for the creditors. If this cost could not be completely covered by the financial institutions it would have to be shared with the OECD governments, by the application of some type of systematic public intervention in order to mitigate the burden of the debt. This should not be viewed primarily as a bailout of the debtors and the banks, but should be regarded as "sound economic policy"[20]. It should be remembered that the great crises of indebtedness invariably arise in a context of major negative externalities which induce market failure. During the crisis, new negative externalities arise which tend to prolong it. Hence it has been customary for governments to intervene with a view to reestablishing order and confidence in the market. Unfortunately, in economic systems based on private markets, public solutions are scarce goods and frequently do not appear until the costs of the problem have been internalized by the main economic agents. As long as the banks and their governments can externalize the costs of the crisis, passing them on to the debtors, there will be less incentive to apply a public solution. This explains in part why the numerous proposals for public intervention in the crisis have not borne fruit[21].

In view of the obstacles to public solutions, in the immediate future the debtor countries will have to tackle the banks directly on the subject of the transfer of resources. How the countries do this will depend, *inter alia,* on their importance as debtors, on their bargaining power and on their ability to adjust themselves to the debt servicing required.

i) *The cases of illiquidity.* It would still be reasonable to believe that some of the more important debtor countries (for example, Brazil and Mexico) face temporary liquidity problems. Their economies tend to be more closed and industrialized and their markets are relatively better organized and are capable of exporting —and in fact are exporting— manufactured goods with some success. Hence their capacity for adjustment is apparently quite good, even when confronted with a sluggish world economy. Moreover, the authorities of these countries have acted as if they had a problem of liquidity, accepting without serious objections the orthodox programme of commercial rescheduling offered by the creditors as the best way of rapidly recovering the image of creditworthiness required to reenter the Eurocurrency market. This, of course, has meant giving up the idea of obtaining new credits in the third round of rescheduling[22].

moline {1984a, pp. 133 to 135) criticizes the numerous proposals demanding reforms and international public action to give relief to debtors and creditors, because *inter alia* 1) the problem of the debt, according to him, is one of liquidity and not solvency; and 2) the proposals frequently imply losses for the banks and would prejudice future access to credit by the debtors. He forgets, however, that the solution even of liquidity problems may be long delayed, so that the maintenance of the *status quo* will turn out to be a very burdensome and socially inefficient policy. On the other hand, it is not inevitable that public measures to alleviate the crisis will involve losses for the banks; all depends on how this is arranged. Finally, the question of future access to credit ¡s a false dilemma, since even the most optimistic projections of the Latin American balance of payments do not open up prospects of a positive transfer from the creditors for many years.

[21]The only major public solution introduced in the crisis is the participation of the IMF in the adjustment programmes and in the organization of the new credits. Nevertheless, this "public good" has been of much more benefit to the creditors than to the debtors. A more detailed analysis of the role of the Fund appears in Devlin, 1984 (pp. 55 to 57, 66 and 67). Ground ( 1984) has made a critical assessment of the Fund's adjustment programmes.

[22]Mexico did not request new credits in the third round. In 1984 Brazil likewise announced that it would not request new loans. However, the civil government which recently

This good behaviour has been socially very burdensome, since during the period of rescheduling both countries have suffered severe economic depressions. But this cost has been in some degree voluntary, since both borrowers have gigantic debts and a geopolitical importance which gives them considerable bargaining power with the creditors and their governments. In fact, each country in itself alone practically constitutes a debtor carter, which would presumably make them tough contenders in the game of bilateral monopoly described above. Nonetheless, they have exercised this power very selectively, obtaining only marginal advantage in their quest for reincorporation into the autonomous credit market. Their position as quasi-cartels and the hope of achieving a rapid adjustment to restore their image of creditworthiness also help to explain why these countries have been very cautious as to regional co-operation in relation to the debt and above all in regard to the formation of a Debtors' Club.

If these major debtors come to consider that the promised return to the Eurocurrency market is being too long delayed, it is possible that, in the face of prolonged economic stagnation, they may exert greater pressure on the banks to obtain a reduction of the negative transfer. Unless the authorities change their views on the nature of the problem (that is, lack of liquidity), it is improbable that these countries will use their bargaining power to capture a larger amount of the monopoly rents obtained at present by the banks. They will rather tend to be co-operative and will try to negotiate agreements which maintain the commercial character of the rescue arrangements, avoiding manifest losses for the creditors. This might lead to a greater compression of the negotiated cost of credit, which can fall a little more and still appear as commercial. But the real objective will be the procurement of new loans to refinance interest payments.

There seem to be sufficient space for negotiating new involuntary credits. The forced loans to Brazil and Mexico in 1983-1984 were more or less equivalent to *ex ante* expansions of 18% and 13%, respectively, of the outstanding commitments in the biennium; *ex post* they resulted in lower increases (8% and 12%)[23].

Cline's analysis (1984a, pp. 71 to 75) shows that with a firm bargaining position and very little probability of default after obtaining new credit, it is profitable for the banks to grant an expansion of up to 40% in their loan portfolio[24]. Krugman's model (1984, p. 21) is even more explicit in respect of the capacity to obtain new forced loans. According to him, in conditions of lack of liquidity a bank will always have a motive for lending enough to avoid default, provided that the new loans do not exceed the amount of the servicing of the debt[25].

To sum up, the more powerful borrowers, faced with what they consider to be problems of lack of liquidity, could probably reduce transfers to the banks if they were disposed to exercise their bargaining power, by hinting that the alternative to the granting of new loans could be default. According to the analyses of Cline and Krugman, in not requesting these loans they are in fact virtually paying a subsidy to the banks. Hitherto the major debtors have apparently felt that it is worth while to pay the subsidy with a view to achieving their reincorporations into the voluntary credit market —the benefit of which would be, presumably, the positive transfer of resources from the banks, although at a much lower level than that recorded in the 1970s.

ii) *The cases of insolvency.* There are debtors in the region —generally small and medium-sized countries— which present problems that begin to look very like those of insolvency[26]. Without a

took office has hinted that the country might possibly now need to have recourse to new credits.

[23]Bank for International Settlements (1983 and 1985). For the *ex ante* expansion, the new loans for 1983 and 1984 were calculated as a percentage of the pending commitments at the end of 1982 and 1983 respectively. The *ex post* increase simply equals the effective commitments for 1984 divided by those for 1982.

[24]Cline ignores the time factor. It is assumed that the amount of new loans in any year could not exceed the value of the interest payments.

[25]This is expedient for the bank, because in this way it at least receives some return.

[26]There are others, obviously, which fall in a gray area between lack of liquidity and insolvency. It is possible that Argentina is one of these. Its debt is the third largest in the region and it has the greatest burden of interest, with payments equal to more than 50% of its exports (ECLAC, 1984b, table 14). Nevertheless, it is a relatively rich and industrialized

relatively vigorous economic expansion in the OECD area, they could only adjust themselves to debt servicing on commercial terms if they agreed to subject themselves to a profound and politically unacceptable economic depression. (Indeed, some of these borrowers might find the servicing of the debt intolerable even in more favourable external economic conditions.) The growing realization that the problems are persisting strengthens the creditors' reluctance to provide relief by granting new loans. In reality, with the passing of time the banks will be more disposed to risk losses because most of the debtors are not large and because, since 1982, these institutions have been strengthening their balances with a view to coping with such contingencies.

These debtor countries have every incentive to try to capture more fully the monopoly rents of the banks and achieve a greater alleviation of the debt, since their possibilities of returning to the voluntary credit market in the foreseeable future are remote. Ironically, however, it is difficult for them to capture these rents because their individual negotiating power is small and their open economies are relatively vulnerable to reprisals. Nonetheless, something can be done.

The safest way for a debtor country to avoid confrontation with the banks is to informally fall into arrears. The banks can threaten a declaration of default, but it is very improbable that they will do so as long as the country continues to express its good faith, the desire to fulfil its obligations, and a wish to negotiate. To begin with, declarations of default are legally onerous and imply a great loss of time for the banks, with meagre tangible benefits (Kaletsky, 1985). Secondly, the creditors do not wish to create a "martyr", since this might damage their own public image, perhaps provoking reactions of solidarity among the borrowers. Moreover, if the bank supervisors insist on reclassifying the loans, the banks will be in a position to absorb the loss of income which this would imply. In short, unless they are directly provoked, it is most probable that the creditors will turn a blind eye and treat the borrower as another special case. In this way no one comes off too badly.

Under this strategy, the borrower must amortize the short-term credit lines in a normal way so as to minimize the incentive to withdraw them. Some lines will inevitably be lost, but it will always be possible to obtain the essential financing through the mediation of various creditors who foresee possibilities of profit in relatively risk-free trade finance. The selective deposit of international reserves is another way of obtaining commercial credit from the banks. In addition, the borrower must be willing to make periodic nominal payments to the creditors on its medium-term debts to demonstrate his good faith. These payments, however, can be maintained at levels as low as 1% or 2% of the outstanding obligations. At an interest rate of 10% there is a saving of eight to nine points on the remittance of foreign exchange[27]. Although this does not represent a bonanza —especially for countries which have less than 50% of their debt with the banks— it does provide a worthwhile margin of relief which, together with other measures, will help recovery.

The debtor must also be prepared to face possible reprisals. The international reserves will need to be deposited in safe institutions. A firm of lawyers will have to be retained in New York or London to formulate a contingency plan to protect the country's trade from possible legal action and to defend its interests in foreign courts if necessary.

This strategy has proved its feasibility: there are already some borrower countries in a *defacto* situation of default which have managed to avoid reprisals. There are two main disadvantages. First, if many borrowers use the same strategy, the losses of the banks may reach critical levels. Nonetheless, this might turn out to be beneficial, because it would gradually demonstrate that the costs of the crisis were being internalized in the

country, possessing a highly skilled labour force, and it has the ability to generate trade surpluses rapidly. Its heavy debt with the banks (US$ 46 billion) gives it considerable negotiating power. It attempted to make use of this power in 1984 to escape from the orthodox pattern of rescheduling; it failed, however, partly because at that time it had no convincing economic programme to legitimize its bargaining position.

[27] The net saving would be rather less if, in the face of arrears, the interest rate for the credit lines rises. At the same time, this saving should be compared with the possibility (if it exists) of obtaining new credits.

centre, which might stimulate a quest for an integral international public solution to the problem of indebtedness. Second, the borrower will have to be ready to cope with a precarious situation and one of increasing tension with the banks as the arrears accumulate. The uncertainty which this situation implies can in itself be prejudicial to the efforts for economic recovery.

Owing to this second problem, it would certainly be preferable to work out a definite plan of debt relief on non-commercial conditions. The problem is that the banks do not wish to adopt rescheduling projects of this kind through fear of the demonstration effects: if they rescheduled a borrower's debt on non-commercial terms, others might demand the same treatment. The fear of precedent makes it a risky business for small and medium-sized debtors to try to impose a unilateral plan of non-commercial payments on the banks {for example, the issue of long-term bonds at low interest rates). Indeed the banks and their governments might feel sufficiently provoked to face the cost of starting reprisals.

At all events, the feasibility of a unilateral course is greater if it is proposed in very serious and conciliatory terms and is also associated with a serious economic programme which offers some prospect of improvement in the country's external situation. With regard to the payment formulas, whether negotiated or imposed unilaterally, they should be linked *pari passu* with the country's capacity to pay[28]. In this way the banks would have at least the possibility that some day their loans would produce a commercial rate of return and the hope that their sacrifices would not be permanent. At the same time, the formulas should be designed, if possible, to minimize the losses of the banks at any given level of relief. The best formulas will depend on the type of banking legislation in force in the North and will therefore possibly have to be "made to measure", in order to adjust to the particular circumstances of each country.

For the small and medium-sized debtors, any major initiative in the payment programmes should perhaps be made in conjuction with others. The bilateral monopoly framework described above clearly points to co-operation among borrower countries. The banks have shrewdly formed a cartel to protect their own interest and avoid the losses that competition among them would imply. With the exception of the two or three biggest debtors, the monopoly power of the creditors cannot be countered by a country in isolation[29]. Hence, responsible co-operation among debtor countries is a possible form of neutralizing the monopoly power of the banks and reaching a more socially efficient solution to the problem of indebtedness. Moreover, this co-operation need not be regional: two or three debtors together will constitute a formidable negotiating bloc.

The key point to remember regarding co-operation is that the creditors and their governments will not make a present of any concessions to the debtor countries. The capitalist centre of today frequently acts on the basis of cold marginal cost-benefit calculations; as long as the politico-economic cost to themselves of doing nothing about the problem of the debtors is less than the benefits received, the creditors and their governments will most likely support the *status quo.* Only when the crisis of the debtors begins to threaten the centre with higher costs will there be incentives to explore new ways of dealing with the problem. Thus the various forms of co-operation among the debtors are a way of bringing home more clearly to the centre the potential costs of following its current policy, which arbitrarily sacrifices economic development to financial discipline[30].

Finally, it must be stressed that negotiations with the creditors are always improved when the countries —even in the worst situations— show that they are making serious efforts to solve their

[28]For example, it might be specified in the agreement that if the terms of trade recover a normal level x, the debts will be serviced at a commercial rate (e.g., LIBOR plus some spread). Or, alternatively, the payments might be limited to some maximum percentage of exports. A third possibility is to define a reasonable rate of economic growth (for example, 5%) and then allocate the remainder of available foreign exchange to the servicing of the debt.

[29]The banks recognize the benefits of unequal power; this is why they insist so categorically on case-by-case negotiations in the rescheduling.

[30]It is interesting to note that the groups with less economic and political power in the centre have traditionally obtained reforms of the system by using co-operation and protest, as happened, for example, with the trade union movement and the great civil rights campaign in the United States in the 1960s.

main economic imbalances[31]. A coherent policy which steers the economy in the right direction helps the banks to justify their concessions and also encourages regulatory authorities to adopt a flexible attitude with regard to loans.

## 2. *The flight of capital*

We have already seen that another component of negative net transfers of resources is the significant flight of capital. Using the "errors and omissions" item of the balance of payments as a rough indicator of this pehenomenon, table 4 shows that in 1982-1983 alone there was an outflow of close on US$ 18 billion of non-registered capital in the balance of payments, which equals slightly more than a third of the total negative transfer registered in that period.

The flight of capital largely originates in the private sector's traditional profit motive and in the undermined confidence in the public management of the economy, especially as regards exchange rate policy, inflation, domestic interest rates, etc. Moreover, the fact that there have been substantial outflows of non-registered capital since 1980 suggests that the confidence of private capital was declining in some countries long before the official outbreak of the crisis[32].

But the phenomenon of the flight of capital is not wholly independent of the behaviour of the private banking system. First, it was the latter's loans in the 1970s and 1980s which sustained the over-valued exchange rates and the fiscal deficits which have helped to change the expectations of the private economic agents[33]. Second, the procyclical withdrawal of loans in 1982 destabilized the Latin American economies still further, thus accelerating the flow of capital to the exterior. Furthermore, Carlos Diaz-Alejandro (1984, pp. 377 to 380), highlights the complicity of the banks in this flight, through their refusai to disclose interest payments made to their clients and through their active campaign to capture Latin American deposits.

The large amount of capital deposited abroad is a potential source of finance. But it is unlikely that this will return voluntarily until the prospects of growth are restored. Consequently, without the return of autonomous bank loans, or a public solution to the problem of indebtedness which will reduce negative transfers, even that part of the capital which might be subject to repatriation will remain in Europe or the United States, where the profitability is greater than that which could be provided by a Latin America beset by economic depression.

[31]For some unorthodox adjustment policies see ECLAC (1984a) and Gurrieri and Sáinz (1983).

[32]Some estimates of the flight of capital are impressive. The Bank for International Settlements has given a figure of US$ 50 billion between 1978 and 1982 (*The Economist,* 1984, p. 75).

[33]Devlin (1983b) develops and analytical plan to show how the lending policy of the banks in the 1970s contributed endogenously to over-indebtedness and the crisis.

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