1994

The Political Economy of External Debt: A Case Study of Latin America

Elisabeth Ann Johnson

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HYPOTHESIS:

I believe that high external debt service requirements act as a restraint on economic growth and aggravate macroeconomic and microeconomic imbalances within an economy. Large future repayments act as a tax on investment, both foreign and domestic, encourage capital flight, and decrease savings. Inflation increases due to currency devaluations that result from the promotion of export goods and services in international markets to repay the debt and uncertainty in the domestic financial markets. Austerity measures, designed to correct fiscal problems, decrease public expenditures and private consumption. The final result is a lack of economic growth and a decline in the country's standard of living.

The goal of this thesis is to explain the effects of high external debt on the Latin American region during the late 1970's and throughout the decade of the 1980's. The large debt had a negative economic effect on Latin America and placed both the countries involved and the commercial banking industry in danger of financial crisis. This thesis explains the effects of official United States government and multilateral banking policy on the debt crisis and the actions that three individual countries to resolve their
economic imbalances. The analysis enclosed does not claim that 100% of the negative effects were caused by high debt, only that a strong positive correlation exists between the high debt and the negative effects.

In Chapter 1, I discuss the regional effects that a decade of high outward transfers, combined with required internal adjustment programs, had on the primary economic indicators: GDP; investment; inflation; and employment. In addition, I examine the effects of the debt on consumption, income distribution, and inequality.

Chapter 2 is a chronological guide to the debt crisis. It is necessary to explain how the crisis occurred in order to understand the actions taken by the Latin American region to resolve the crisis. Each of the primary players in the debt crisis is examined and the interests that they represented explained.

In Chapter 3, I show how Argentina, Brazil, and Mexico rejected the IMF austerity plans and instituted reform programs designed to correct their economic imbalances, streamline the public sector, bring inflation under control, and provide consumer goods and services for their populations. At one point, all three countries informally suspended interest payments on their loans to focus attention on domestic problems and to force their creditors
to restructure the outstanding debts. Mexico and Argentina have been successful, Brazil has not.

Finally, in chapter 4, I discuss alternative solutions, both theoretical and applied, that are available to the debtor and creditor countries to help resolve the current debt problem.
CHAPTER 1

THE LOST DECADE:

The 1980's is considered a "lost decade" for Latin America. The region's $400 billion debt set in motion a series of events that led to the deterioration of economic conditions within Latin America. The enormous debt overhang required 4-5% of it's economic output (GDP) to be transferred annually to service the $400 billion debt. On average, the region's combined income from exports totaled $95 billion, and interest payments amounted to $40 billion: a debt service ratio of 42 percent. In Argentina, Brazil, Chile, and Mexico the proportion was even higher. The high debt service-to-exports ratio impacted the credit rating of debtor countries and their ability to obtain more loans. (Chart 1.1) In addition, with the primary focus of the economy on export production (to facilitate debt service payments) the region's ability to withstand external changes or to implement necessary internal adjustments was handicapped.

To compete in the international export market, countries had to refocus their priorities from domestic needs and invest their available capital in export

1 Debt Service Ratio: Interest + Principal payments
Export of Goods and Services
production. National currencies were devalued to make export goods more attractive and import levels were reduced to conserve the foreign capital required to purchase raw materials and service the debt.

Chart 1.1

<table>
<thead>
<tr>
<th>DEBT AS A % OF EXPORTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
</tr>
<tr>
<td>ARGENTINA</td>
</tr>
<tr>
<td>BRAZIL</td>
</tr>
<tr>
<td>MEXICO</td>
</tr>
<tr>
<td>AVERAGE</td>
</tr>
</tbody>
</table>

(MIDDLE INCOME)

Source: World Bank. (The Economist 1993, 14)

The Latin American nations actually grew poorer in terms of per capita GDP and investment. Regional GDP growth declined between 1980 and 1990. By 1988, the region's per capita gross domestic product was 7% below the 1980 figure (Devlin 1989, 218). Investment, as a share of the GDP, fell from nearly 24% in the late 1970's to 16% from 1983-89

The figures for the three case studies:

<table>
<thead>
<tr>
<th>GDP GROWTH</th>
<th>Argentina</th>
<th>Brazil</th>
<th>Mexico</th>
</tr>
</thead>
<tbody>
<tr>
<td>1973-80</td>
<td>2.1</td>
<td>6.4</td>
<td>6.2</td>
</tr>
<tr>
<td>1980-90</td>
<td>-0.5</td>
<td>2.8</td>
<td>1.0</td>
</tr>
<tr>
<td>1989</td>
<td>-4.6</td>
<td>3.6</td>
<td>3.1</td>
</tr>
<tr>
<td>1990</td>
<td>-0.7</td>
<td>-4.0</td>
<td>3.9</td>
</tr>
<tr>
<td>% Change</td>
<td>-2.8%</td>
<td>-10.4%</td>
<td>-2.3%</td>
</tr>
</tbody>
</table>

**See Appendix A for more figures.**
The decline in investment can be partially explained by the deteriorating internal economic (and political) conditions within Latin America. Domestically, wealthy citizens moved their money to safer havens outside of Latin America in the form of capital flight. Estimates show that the total amount of capital flight that left Latin American equaled the increase in the external debt (Economist 1993). (Chart 1.2) Direct foreign investment also declined in response to the growing economic problems of the region. The lack of available capital impeded economic growth by handicapping investments and decreased the government’s ability to borrow against the investment capital.

Chart 1.2

<table>
<thead>
<tr>
<th>CAPITAL FLIGHT ASSETS (1987)</th>
<th>% OF DEBT</th>
</tr>
</thead>
<tbody>
<tr>
<td>ARGENTINA $46 BILLION</td>
<td>111%</td>
</tr>
<tr>
<td>BOLIVIA $2 BILLION</td>
<td>178%</td>
</tr>
<tr>
<td>BRAZIL $31 BILLION</td>
<td>46%</td>
</tr>
<tr>
<td>CHILE $2 BILLION</td>
<td>17%</td>
</tr>
<tr>
<td>COLOMBIA $7 BILLION</td>
<td>103%</td>
</tr>
<tr>
<td>MEXICO $84 BILLION</td>
<td>114%</td>
</tr>
<tr>
<td>PERU $2 BILLION</td>
<td>27%</td>
</tr>
<tr>
<td>URUGUAY $4 BILLION</td>
<td>109%</td>
</tr>
<tr>
<td>VENEZUELA $50 BILLION</td>
<td>240%</td>
</tr>
</tbody>
</table>


****

1See Appendix B for investment figures.
Inflation rates in Latin America rose sharply in the period from 1980 to 1988. Argentina and Brazil ended the 1980's in severe hyper-inflation. (Chart 1.3) A partial explanation of the inflation can be found in the short term liquidity problems experienced by several of the Latin American countries. The decrease in investment coupled with the emphasis on exports left the Latin American countries unable to repay their short-term loans. To meet their obligations, they printed more money. They used the rising inflation to finance the monetary expansion, but without increasing reserves or current account holdings. By the mid-1980's, double digit inflation was common in the non-oil producing countries. The inflation eroded real wages and purchasing power and exacerbated the macroeconomic problems within the countries.

Chart 1.3

<table>
<thead>
<tr>
<th>INFLATION (CONSUMER PRICE INDEX) % per year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965-73</td>
</tr>
<tr>
<td>1973-80</td>
</tr>
<tr>
<td>1980-88</td>
</tr>
<tr>
<td>1989</td>
</tr>
<tr>
<td>1990</td>
</tr>
</tbody>
</table>
Unemployment figures reached as high as 50% during the 1980's. In Mexico, the labor force increased by 4 million, yet no new jobs were created between 1981 and 1984. Between 1982 and 1985, the public sector lost 780,000 jobs and the private sector lost 250,000 jobs due to cuts in the government budget. Informal sector employment and underemployment rose 39% between 1980 and 1985 and many households held additional jobs to make ends meet. Approximately 50% of the region's population earned less than minimum wage and real wage rates dropped an average of 16% between 1980 and 1985 (Roddick 1988, 85) (Chart 1.3).

Chart 1.4

<table>
<thead>
<tr>
<th>MINIMUM WAGE (1970=100%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ARGENTINA</td>
</tr>
<tr>
<td>BRAZIL</td>
</tr>
<tr>
<td>CHILE</td>
</tr>
<tr>
<td>MEXICO</td>
</tr>
<tr>
<td>VENEZUELA</td>
</tr>
</tbody>
</table>

Source: ILO-PREALC, Mas Alla de la Crisis, Santiago, 1985. (Roddick 1988, 90)

Austerity measures, necessary to correct fiscal imbalances, required the elimination of many public services. Health and education expenditures were reduced and infrastructure spending halted. Subsidies were slashed,
which decreased consumer purchasing power already impacted by bouts of hyper-inflation and high interest rates. (Chart 1.4)

Chart 1.5

<table>
<thead>
<tr>
<th></th>
<th>Argentina</th>
<th>Brazil</th>
<th>Mexico</th>
</tr>
</thead>
<tbody>
<tr>
<td>1973</td>
<td>79.2</td>
<td>78.0</td>
<td>79.9</td>
</tr>
<tr>
<td></td>
<td>(67.3/11.8)</td>
<td>(57.1/10.9)</td>
<td>(71.6/8.2)</td>
</tr>
<tr>
<td>1980</td>
<td>79.4</td>
<td>78.9</td>
<td>75.1</td>
</tr>
<tr>
<td></td>
<td>(66.2/13.2)</td>
<td>(67.5/10.4)</td>
<td>(65.1/10.0)</td>
</tr>
<tr>
<td>1988</td>
<td>79.9</td>
<td>73.3</td>
<td>76.7</td>
</tr>
<tr>
<td></td>
<td>(69.4/10.5)</td>
<td>(69.8/9.2)</td>
<td>(68.4/8.3)</td>
</tr>
<tr>
<td>1989</td>
<td>83.0</td>
<td>71.7</td>
<td>76.3</td>
</tr>
<tr>
<td></td>
<td>(77.3/5.7)</td>
<td>(61.2/12.1)</td>
<td>(65.8/10.3)</td>
</tr>
<tr>
<td>1990</td>
<td>84.4</td>
<td>77.4</td>
<td>81.8</td>
</tr>
<tr>
<td></td>
<td>(80.5/3.9)</td>
<td>(59.8/11.9)</td>
<td>(70.4/11.5)</td>
</tr>
</tbody>
</table>

Standards of living declined during the 1980’s. The middle class and poor were hit the hardest by decreases in GDP and real wages, coupled with soaring inflation rates. The percentage of the population living in poverty increased from 40% to 44% and unequal income distributions further exacerbated the problem. Inequality rose between different sectors of the population with the upper 20% controlling approximately 50% of the total income. (Chart 1.5) However, the numbers do not show the complete effects of the economic problem. Many families only escaped the poverty statistics by working more hours or taking on additional jobs.
### Chart 1.6

#### INCOME DISTRIBUTION—SELECTED MIDDLE INCOME COUNTRIES (1988)

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>LOWEST 40%</th>
<th>HIGHEST 20%</th>
<th>RATIO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>14.1</td>
<td>50.3</td>
<td>.442</td>
</tr>
<tr>
<td>Brazil</td>
<td>8.1</td>
<td>62.6</td>
<td>.569</td>
</tr>
<tr>
<td>Colombia</td>
<td>12.7</td>
<td>53.0</td>
<td>.469</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>11.6</td>
<td>56.5</td>
<td>.485</td>
</tr>
<tr>
<td>Mexico</td>
<td>9.9</td>
<td>57.7</td>
<td>.523</td>
</tr>
<tr>
<td>Peru</td>
<td>12.9</td>
<td>51.9</td>
<td>.458</td>
</tr>
<tr>
<td>Uruguay</td>
<td>14.3</td>
<td>47.4</td>
<td>.423</td>
</tr>
<tr>
<td>Venezuela</td>
<td>13.9</td>
<td>50.6</td>
<td>.441</td>
</tr>
<tr>
<td>United States</td>
<td>15.7</td>
<td>41.9</td>
<td>.369</td>
</tr>
</tbody>
</table>


1Gini Concentration Ratio: 0 = perfect equality  
1= perfect inequality
CHAPTER 2

ORIGINS OF THE DEBT CRISIS

During the 1970's, commercial banks recycled billions of OPEC dollars in the form of loans to the Third World countries. The enormous flow of revenues generated from the increased world price of oil forced international banks to scramble to find new borrowers. The banks granted generous terms: longer maturities, longer grace periods, and lower origination costs which made the loans attractive to the Latin American borrowers. As long as growth remained high, interest rates were low, and export revenues remained constant, the countries could borrow without increasing their debt service ratio. External debt in the region rose from less than $100 billion in 1972 to more than $600 billion in 1981 (Economist 1993).

However, the banks overlooked the region's history of loan default during the Great Depression and hastily issued the new loans based on the "stability" of the individual governments as guarantors of both public and private debt. The banks also ignored the instability inherent in Latin American governments and the military dictators agreed to pay variable rates of interest based on the U.S. prime lending rate—not fixed rates. Interest rates were low in
the 1970's and it was not until the 1980's, when interest rates rose sharply, that the Latin American countries realized that an increase of 1.5% in the prime rate added approximately 4.5 billion dollars to the debt (Burns 1990, 319).

The second oil-price shock in the early 1980's signaled the end of the honeymoon between the creditors and the debtors. The governments of the industrial world reversed their policies and tightened monetary policy to combat high inflation. At the same time, the United States shifted to a practice of supply side economics. World capital became enormously expensive. Interest rates in the United States rose as the government and other U.S. debtors tried to attract money from the rest of the world. The initial rise in the U.S. prime rate cost the debtor countries $20 billion in interest between 1980 and 1981. This coincided with a deterioration in the terms of trade which cost them a further $79 billion and a fall in the real volume of exports because of the recession in the West. The final figure over two years was $141 billion--all externally produced (Roddick 1988, 135).

The Latin American countries faced an additional crisis. They could not cover short-term obligations due the creditors without more loans and the International banking community refused to loan more money to the debtor nations.
When the Latin American governments ran into financial difficulties and could not finance their budgets and current account deficits, they resorted to printing money to cover short-term obligations. This monetary expansion fueled inflation. Savings and investment decreased. A drop in foreign demand for exports coupled with reduced domestic consumption (due to the inflation rate and unattainability of financing options) further decreased government revenues and made debt servicing impossible (Economist 1993). The debt crisis had accelerated.

In 1982, the International banking community found itself in a panic when Mexico announced that it could no longer service its debt. A default by Argentina, Brazil, Chile, or Mexico would threaten the solvency of the banking industry and potentially cause several of the large U.S. banks to collapse. The IMF stepped in to forestall the threat of imminent default (or repudiation). It arranged deals using its own money to encourage reluctant banks to continue their flow of lending while borrowers implemented new structural policies (Economist 1993). U.S. Government response, designed to protect the banking industry, insisted on full debt repayment. "Debt Management" and IMF austerity measures forced recalcitrant debtors to continue debt service payments in order to receive new monies from the
commercial and multilateral lenders. It was not until 1989, when the United States government introduced the Brady Plan,\(^1\) that the idea of full debt recovery was abandoned. This new approach accepted that the countries could not achieve economic recovery without debt reduction and rescheduling of both commercial and multilateral debt.

**IMF/WORLD BANK**

The IMF and the World Bank are the principal lenders to developing counties. Both face the daunting task of making loans to countries that other lending institutions consider not creditworthy. The primary role of the World Bank is to finance economic development programs in Third World countries. The IMF loans money to stabilize domestic currencies to those countries facing a balance of payments crisis.

With the advent of the debt crisis, the IMF was "cast in the dual role of crisis manager and policeman" (Roddick 1988, 201). In this new role, the IMF has become the last resort for many of the Third world countries. IMF approval is required before the World Bank, multilateral, bilateral, or commercial lenders will issue new loans to heavily

***

\(^1\)See Chapter 2—**Banks**, for a full explanation of the Brady plan.
indebted countries. The IMF provides credits equal to the balance of the country's gold deposit or foreign exchange, or twenty-five percent of its initial quota to member nations with balance of payment problems. When a country needs to borrow in excess of the reserve amount, they must agree to criteria designed to promote currency and price stability. Thus, "Fund Conditionality" preserves the revolving nature of the IMF program but, requires debtor countries to impose harsh austerity measures and create an export-oriented economy to secure new loans (Nafziger 1993, 101).

There are four basic requirements to IMF adjustment: 1) the government must practice "demand management"--a reduction in the consumption of all kinds of goods and services; 2) public spending must be reduced which means fewer health and education services and the elimination of government subsidies; 3) wage ceilings must be imposed and taxes and interest rates increased; and 4) the country's currency must be devalued to boost the attractiveness of the country's exports on the world market (George 1988, 3). In short, the IMF requires a country to create a recession to meet debt payments. In many of the Latin American countries, IMF austerity undermines fragile democracies by undercutting support of the governments. With a tradition of military intervention at the least economic provocation,
Latin American government leaders have an added risk factor when enacting reforms. They must find a way to resolve the current debt servicing quagmire, maintain national dignity, achieve economic progress, and remain in power.

**BANKS:**

In 1982, the U.S. government's response was designed to prevent the wholesale collapse of the banking industry that would have occurred if even one of the major Latin American countries defaulted on its loans. By March of 1988, the banks had decreased their exposure rate from 124% to 57.7%. In a movement initiated by Citicorp in 1987, the banks increased their loan loss reserves to cover approximately 50% of their LDC portfolios. Therefore, by early 1988, the potential banking crisis had been averted.
## Chart 2.1

<table>
<thead>
<tr>
<th></th>
<th>End 1982</th>
<th>End 1986</th>
<th>End 1988</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>9 MAJOR</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>DEVELOPED</td>
<td>287.7%</td>
<td>153.9%</td>
<td>108.0%</td>
</tr>
<tr>
<td>LATIN AMERICA</td>
<td>176.5%</td>
<td>110.2%</td>
<td>83.6%</td>
</tr>
<tr>
<td><strong>ALL OTHER</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>DEVELOPED</td>
<td>116.0%</td>
<td>55.0%</td>
<td>32.2%</td>
</tr>
<tr>
<td>LATIN AMERICA</td>
<td>78.6%</td>
<td>39.7%</td>
<td>21.8%</td>
</tr>
<tr>
<td><strong>TOTAL (IN BILLIONS)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9 MAJOR</td>
<td>29.0</td>
<td>46.7</td>
<td>55.8</td>
</tr>
<tr>
<td>ALL OTHER</td>
<td>41.6</td>
<td>69.4</td>
<td>79.8</td>
</tr>
</tbody>
</table>


Today, all of the major U.S. banks have significantly raised their loan loss reserves against possible Latin American losses. (Chart 2.2). In 1989 the chairman of the FDIC in a statement to Congress affirmed this new stability and acknowledged that even if six of the major debtors were to completely wipe out their debt it "wouldn't mean a penny of damage to the FDIC" (Sachs, 1990).

The blame for the debt crisis should fall equally on the creditors and the debtors. The banks are in the profit making business--they had to recycle the OPEC deposits to ensure enough profit to cover administrative costs and interest payments on the deposits. The banks assumed that
the loans were guaranteed by credible governments (a very dubious assumption in many cases) and issued several questionable loans. The Latin American countries saw the opportunities afforded by the loans for capital and social improvements and took advantage of the money. Their economies were expanding and debt service ratios were small. The oil shocks were considered to be temporary and structural changes were not enacted.

Where did the loan money go? Governments took advantage of the loans to maintain the existing government services and upgrade their infrastructure. The low interest rates provided cheap investment dollars and low inflation and future expectations of continued export revenues prompted large-scale borrowing. Yet, the loans were not used to expand or create industry. Instead, many of the countries used the money to cover existing budgetary shortages and improve their infrastructure: roads, ports, government buildings, parks, dams, and power plants. Dictators financed build-ups in military strength and corrupt politicians and businessmen sent billions of dollars to personal bank accounts in New York and Geneva.

Neither party anticipated the recessionary effects on Latin American trade and the region's inability to repay the loans. However, when the situation became a "crisis", the banks were not held accountable for their role in causing
the crisis and the burden of the crisis fell on the debtor countries. Through the 1980's, with government and multilateral backing, the banks were allowed to continue the policy of full debt recovery and force compliance from the debtor countries—despite statistics that show that in terms of net transfers, the debt was repaid several times over, even allowing for inflation and for the repayment of a what was considered a "normal" interest rate (Branford 1).

In 1982, to forestall against an immediate international crisis and to protect the banks against possible failure, the IMF and the World Bank stepped in to mediate the crisis. Under the Reagan administration, the IMF was subjected to a conditionality freeze (Roddick 1988, 42). This restricted the IMF to using only "conditionality" funds to bail out Latin America and assign longer repayment terms. Non-compliance by the IMF to these edicts would result in a U.S. veto of the proposed loan. In addition, U.S. law worked in favor of the banks. Under U.S. law, loans on which interest had not been paid within 90 days were legally non-performing. This meant that interest payments could not be credited to a bank's account. After six months, loans became value impaired and the full value of the loan could not be counted among the banks assets. To forestall against potential losses, the government used a
variety of means to force reluctant debtors into paying their arrears. Emergency loans were issued by the IMF and World Bank for International Settlements, export-import credits were frozen, shipments of basic goods were detained (Argentina was threatened with the freezing of insulin shipments), and negotiations for rescheduling of debt were threatened to be sidelined or vetoed if cooperation was not immediate. As long as the banking industry had the full attention of the U.S. Government, their profits were virtually assured.

The banks have exercised a monopoly power in their dealings with Latin American debt—all sanctioned by the creditor governments and multi-lateral institutions—and as profit-maximizers were reluctant to give up any possible remaining gains. In 1985, Citicorp posted $285 million in pre-tax profits from Latin America and the Caribbean, a full 25% of their pre-tax earnings. New loans carried a risk premium of 0.5-1% and a commission of 1% of the total. Floating interest rates were adjusted every six months, penalties are written into the contracts for early repayment, and banks often refused to renegotiate existing loans, preferring instead to issue new loans with shorter terms at higher variable rates (plus more fees). The banking industry also scored a major coup by forcing the Latin American counties to guarantee private sector debt
(issued by Latin American banks backed by U.S. investment dollars). The nations now had to keep the non-profitable banks in business or risk cancellation of new loans.

When Mexico, Brazil, Argentina, and Chile all temporarily suspended interest payments, the United States Government finally tried to institute policy reforms. The first plan was the Baker plan in 1985. It proposed rescheduling of current debt payments, but only for those countries already making their payments. It also encouraged the banking industry to become further involved in the region with new loans and renegotiation packages. The plan was not successful. The banks balked at the idea of becoming further enmeshed at a time when they were desperately trying to decrease their Latin American exposure. They also refused to consider any kind of a blanket proposal that encouraged restructuring of existing loans. To that point, all renegotiation had been handled on a case-by-case basis to try to discourage a unified movement by the debtor countries to reduce the debt servicing payments. The Brady plan introduced in 1989, suggested that in exchange for guarantees that some of the debt would be repaid, the banks would forgive a major portion of the Latin American loans. The remaining debt would be guaranteed by conditionality. The implication the World Bank and IMF and
subjected to strict IMF was that if the banks were willing to give up the myth of full debt recovery, they would at least recover whatever the countries were able to realistically pay. The plan was accepted, in part, by the banks who were at least willing to feign cooperation rather than risk losing the government support on delinquent payments. Mexico and Costa Rico were early recipients of the benefits of the Brady plan and both Argentina and Brazil were able to negotiate somewhat better terms on new loans.

U.S. POLICY:

According to John Williamson, the Washington^ agenda regarding Latin American adjustment includes: Macroeconomic prudence by the Latin American countries; outward-oriented trade policies; and domestic liberalization. Within this consensus, policy-makers address the following areas of concern: 1) Fiscal deficits--There is a broad agreement that large and sustained fiscal deficits are a primary source of macroeconomic dislocation in the forms of inflation, payments deficits, and capital flight. An operational budget in excess of around 1-2% of GDP is considered prima facie evidence of policy failure. The

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1Washington is defined as: IMF; World Bank; U.S. Executive Branch; Inter-American Development Bank (IDB); Members of Congress; and think tanks concerned with economic policy. Source: Williamson 1992, 7
policy recommendation is to cut public expenditures in the forms of subsidies, education and health, and public investment. 2) **Tax reform**--Experts view increasing taxes to raise revenue as inferior to cutting expenditures. However, tax evasion is widespread in Latin America and the tax base is very narrow. The policy recommendation is to widen the tax base and establish moderate marginal tax rates. 3) **Interest rates**--Interest rates should be market determined and should be positive. 4) **Exchange rate**--The exchange rate should be market determined and competitive to promote a rate of export growth. Stability is important and countries should promote outward-oriented trade policies rather than import substitution policies. 5) **Foreign direct investment**--The removal of restrictions on foreign investment will increase capital flows through direct investment, portfolio investment, and debt-equity swaps. 6) **Privatization**--Privatizing inefficient industries will decrease public expenditures and generate additional revenue. 7) **Deregulation**--Deregulation will promote competition. 8) **Property rights**--Legislation is required to establish secure property rights.

The United States plays a large role in Latin American economic affairs. The U.S. is the region's largest market for export goods, has over $80 billion in investments, provides economic and military aid of over $300 million, and
uses aid to influence political events by withholding assistance. Politically, the U.S. has traditionally intervened in Latin American affairs and historically considers the region an extended "sphere of influence." Consequently, U.S. policy initiatives directly impact Latin American interests and at times pre-empt or override sovereign policies.

At the advent of the debt crisis, the United States used its majority position in the multilateral lending institutions to protect U.S. banking interests at the expense of the debtor nations. The policy of "Debt Repayment" assumed full remittance of all principal and interest payments due to the commercial and multilateral institutions.

By 1985, Washington realized that high debt service placed limitations on Latin American growth and demand for U.S. imports. U.S. Secretary of Treasury, James Baker proposed a plan to increase commercial and multilateral lending to the highly indebted countries to ease temporary liquidity problems and allowing them to continue debt service. The plan did not reduce or write-off debt, nor did it lower interest rates. According to Nafziger,

the Baker plan stressed saving the U.S. banks at the expense of the IMF, World Bank, multilateral, and Japanese creditors, was under funded, and emphasized middle-income countries. The plan did forestall a major
write-off of Third World debt and prevented the debtors from forming a cartel.

The plan also "enabled the top creditor banks to reduce their LDC exposure, so they could boycott reschedulings and new money packages and insist on full LDC servicing."

(Nafziger 180-81) However, the Brady plan, introduced in 1989, called for debt service reduction and new money packages on a voluntary case-by-case basis. This called for commercial banks to reduce their LDC exposure through voluntary debt reduction or write offs. Also, the IMF and World Bank were to set aside $12 billion for discounted buybacks, with $12 billion matching funds from the commercial banks and $4.5 billion from the Japanese. The Brady plan is still the primary official policy toward Latin America.
CHAPTER 3

CASE STUDIES

This section compares the efforts undertaken by Mexico, Brazil, and Argentina to reduce their debt and restore economic stability to their countries. Each of the three countries experienced different paths to their debt crisis and yet all three have chosen similar methods to resolve the problem. Argentina and Mexico are in a good position to begin the twenty-first century. Brazil has not resolved her problems and faces difficulties restoring growth and stability.

Mexico shows a history of positive growth, low amounts of "social" expenditures, and moderate inflation. Expansionary government practices in the 1970's came to an end in 1982 when rising world interest rates, falling oil prices, and creditor's refusal to roll over short-term debt precipitated a financial crisis.

Both Argentina and Brazil have experienced negative growth and periods of hyper-inflation. Argentina's history of military dictatorships and Peronist-style populism left the democratically elected Alfonsin and Menem governments with large public sectors operating in a deficit status and an enormous debt overhang. Wasteful spending in the 1970's and early 1980's (to finance existing institutions, build
projects for the rich, and fight a war with England) did not leave Argentina with a foundation upon which to initiate economic recovery.

Unlike Argentina, Brazil has the tools for economic recovery. In 1964, the Brazilian military government and civilian elite envisioned turning Brazil into a world power commensurate with its size and abundant natural resources. To accomplish this enormous economic build-up, the government borrowed heavily counting on a trade surplus to cover the new debt. To fuel continued growth, Brazil continued to borrow heavily--having to deposit the money abroad when there was no use for it at home. Brazil showed record levels of GDP growth and industrial output and the economy produced enough export goods to offset the growing debt. In 1983, when the balance of payments turned negative, Brazil was left with the largest foreign debt in Latin America. The rapid build-up created a two class society rife with government corruption and concentrated power in the hands of a select few at the expense of the general population. In 1985, public dissatisfaction with the IMF-induced recession forged a protest movement that lead to direct elections and put an end to two decades of military rule. Long standing public distrust of government and lingering corruption from the two decades of rapid growth
still limits the current leaders' ability to enforce unpopular economic reforms.

MEXICO

The announcement in 1982 was the result of more than a decade of expansionistic import-substitution policies. The Mexican economy was overvalued and dependent on oil revenues to subsidize growth. When world oil prices dropped, Mexico faced a balance of payments problem. Short-term debt to international commercial banks could not be repaid and Mexico could not procure new loans. The International banking community agreed to negotiate only when Mexico threatened to default.

To prevent future liquidity problems, the Mexican Government initiated reforms to stabilize the economy. The peso was devalued, public expenditures were cut, and the government nationalized the banks. Fiscal conditions improved yet, the economy did not grow. High inflation persisted and a lack of public confidence in the government's ability to manage the economy led to increased capital flight and decreased investment.

In 1987, the Mexican leadership implemented an Economic Solidarity Pact (PACTO) between government, labor, farming and business representatives. PACTO's goal was to sharply
reduce the existing triple digit inflation. This was to be accomplished by tightening fiscal and monetary policy, implementing structural reforms, reducing credit subsidies, privatizing 831 small public enterprises, and rapid trade liberalization. The government also initiated incomes policies and froze minimum wages, public sector tariffs, and prices of basic goods. The nominal exchange rate against the dollar was modified and inflation was reduced from 159 percent in 1987 to 52 percent in 1988. This abrupt disinflation was accomplished without a recession and was accompanied by a growth rate of 1.1 percent.

In 1988 the newly elected Salinas Government renewed the PACTO agreement, now called PECE (Pact for Stability and Economic Growth). PECE relaxed the controls on the prices, wages, and the exchange rate. The federal deficit was reduced by implementing tax reforms and slashing expenditures. Privatization of commercial banks, TELEMEX (the state owned telephone company), and the steel industry increased government revenues by over $5.9 billion (U.S. Congress 1992, 549). Also, transportation, shipping, and agriculture were deregulated to further reduce the role of government in the economy.

In 1989, under the Brady Plan, the government initiated negotiations to restructure the external debt (approximately $104 billion). $22.8 billion of the debt was exchanged for
bonds at a fixed rate of 6.25% and $19.8 billion was "bought-back" on the discount market at a rate of 35% of its original value. This debt reduction resulted in a decrease of nearly $4 billion a year in the net transfer of payments from Mexico to her creditors in order to service the debt (a drop from 5.75% of GDP to 2.43% of GDP). Mexico's continued ability to meet her debt obligations has increased the confidence of investors and creditors. This has resulted in large capital inflows and the reopening of international credit markets to Mexican borrowers at progressively more favorable terms (U.S. Congress 1992, 550). Private investment more than doubled after the Mexican government announced that it would allow up to 100% foreign ownership of Mexican industries. Salinas continued to make structural adjustments to correct long-term economic imbalances. Deregulation laws were passed to return the control of the banks and oil industry to the private sector, the stock market was opened to foreign investment, and interest rates were deregulated. After years of import substitution policies and protectionism, Mexico liberalized her trade policies. The average tariff rate dropped from 45% to 9% and trade tripled from 1987 to 1991. The success of the free trade policy inspired the North Atlantic Free Trade Association (NAFTA) with the United States and Canada.
Standardization and anti-trust laws have brought Mexican business practices more in line with her NAFTA partners. In addition, Mexico has taken an unprecedented step for a Third world nation and requested admittance to the Organization for Economic Cooperation and Development (OECD).

Political reform has been limited to agricultural reform. In the late 1980's, when Mexico suddenly become a net importer of basic food products, major agricultural adjustment was required. Article VII of the Constitution, guaranteeing land grants to peasants in the form of communal farms, had created small inefficient ejidos employing 23% of the population but only producing 7% of GDP (Economist 1993, 12). Article VII was removed and private property rights were established allowing land to be sold, rented, or pledged as collateral. To date, electoral reform has not been addressed and the PRI (Mexico's legal political party) still maintains exclusive control of Mexican government. The monopoly of power by Salinas has been beneficial to the reform process and has assured continuity in philosophy and policy that many other Latin American countries, such as Brazil, have yet to achieve.

The outlook for Mexico's continued economic success looks good. GDP growth for 1993 is estimated to be between 5-6%, inflation between 8-10%, and the budget shows a surplus. However, problem areas still need to be addressed.
The inflation rate is too high compared to the United States, foreign investment is largely portfolio rather than direct, and the savings rate is considered too low to sustain a 5-6% growth rate without more foreign direct investment. Imports are beginning to outpace exports due to years of pent up consumer demand and threaten to create a trade balance problem.

Socially, the gap between the rich and the poor has widened. The poor suffered disproportionately when the Mexican economy did not grow between 1982 and 1988. During this time, GDP per head decreased by 2%, inflation peaked at 100%, and real wages decreased by 3% (as wage rates were held artificially low to facilitate competitive export prices). By 1988, the lowest 40% of the population received only 9.9% of the total income while the top 20% controlled 57.7%. Mexico’s GINI coefficient of .523 was one of the highest in Latin America. In an attempt to help the poor rural peasants, Salinas used $16 billion gained from privatization to finance a rural improvement program. The Solidarity program provided water, sewage treatment, lights, clinic, and schools to the rural population. Yet, 70% percent of the country’s four million poor people live in the countryside on small communal ejidos eking out a subsistence living. The average Mexican has only a sixth
grade education.

The continuing challenge for the Mexican Government is to provide social spending to reduce the gap between the rich and the poor, train and educate the Mexican population to be competitive within the NAFTA partnership, maintain current growth, increase foreign investment, diversify the manufacturing and service base, and to attempt to accomplish this without setting off an inflationary spiral.

ARGENTINA

Argentina began the reform process in the midst of a bout of hyperinflation. When Carlos Menem assumed the presidency in 1989, inflation was running between 35% and 40% a month. Forty years of state intervention and deficit spending had produced instability, discouraged domestic savings and investment which led to slow growth, and produced a massive debt overhang, nearly 70% of GDP. Menem immediately passed legislation designed to cut the government fiscal deficit and began the process of deregulation and privatization. Subsidies were suspended, central bank credit was reduced in the private sector, and the base of the value added tax was widened. The government also fixed the exchange rate and enacted wage freezes.

In January 1990, to forestall immanent hyperinflation,
the government forcibly converted virtually all domestic commercial bank time deposits, and a majority of the central bank and treasury's outstanding austral debt into 10-year dollar dominated Treasury Exchange Bonds (BONEX). This measure temporarily stopped the hyperinflation. At the beginning of February 1990, unexpected price adjustments and persistent rumors caused the money demand to collapse and spun the economy into a second period of hyperinflation (Trends 1991, 16).

In early March of 1990 the government responded with structural and fiscal reform measures. Employment in the public sector was reduced, payments were suspended for sixty days on contracts, the banking sector was prohibited from providing any type of public financing, and tax collection measures were stepped up. Inflation dropped from 70-80% a month from the first quarter to 4-6% a month by December.

In 1991 the Congress passed the Convertability Law linking the exchange rate to the dollar. The Austral is convertible at a fixed rate of 10,000 Austral to the dollar. By law, the monetary base must be 100% backed by gold and foreign currency reserves. Under the new monetary guidelines, inflation fell to less than 2% a month and interest rates dropped from 100% to 8% per annum. The sudden availability of domestic credit coupled with price cuts on consumer goods fueled a modest economic recovery.
The economic recovery was accompanied by structural changes. Argentina privatized two television stations, the national telephone company, Aerolíneas Argentinas, long distance cargo lines, the largest distributor of electricity, and several maritime industries. Efforts to streamline and improve the efficiency of revenue collection—traditionally a weakness in the Argentine economic system—have been enacted. In October 1991, Menem announced the complete deregulation of the economy. This move ended industry-wide bargaining agreements, eliminated federal regulatory agencies, cut export taxes, and encouraged imported goods (Dayton Daily 1991, 2A).

While the government focused its attention on reducing the domestic deficit problem, the external debt fell into arrears. At the end of 1991, the outstanding commercial debt stood at $7-8 billion in interest payments and $25 billion in principal. Argentina used $1 billion earned from privatizing the gas industry to buy back $3.5 billion of her commercial debt on the discount market. In March 1992, the IMF granted a three year extended debt facility of $3 billion. A month later, foreign bank creditors agreed to reduce the debt (including the $8 billion in arrears) by $8 billion. After the rescheduling, Argentina’s debt stood at $62 billion.
In a February 1993 interview, Carlos Menem spoke optimistically about economic conditions in Argentina and his future expectations. Argentina privatized the railroad, natural gas, water, and steel industries. Growth was 6% in 1992 and is estimated to be around 6.5% for 1993. Inflation was 17.5% in 1992 and predicted to drop between 5-9% for 1993. There is a budget surplus and over $12 billion in gold and foreign currency reserves. The average tariff rate is at 9%, down from 40%, and the unemployment rate is less than 5%. Menem foresees the new role of the state to be substantially reduced to provide education, public health, justice, and security. He emphasizes the need to increase technical training to compete with First World countries, and he would also like to negotiate a trade agreement with the United States or perhaps join NAFTA.

BRAZIL

Social conditions in Brazil deteriorated during the 1980’s. Per capital income decreased to 10% below the 1980 level and cumulative inflation (1980-1990) was greater than 50 billion percent (Business Week, 1993). In 1993, the cruzeiro lost an average of 1% of its value every 36 hours. Despite Brazil’s status as the eighth largest market based economy, 70% of the population lives in poverty and the
average GDP growth rate of 2.3% during the 1980’s barely outpaced the population growth rate of 2%. Brazil ranks third in the world in unequal income distribution (Great Expectations, 1990) with a GINI coefficient of .569 in 1988.

In 1982, the Brazilian Government ran out of foreign reserves. This ended almost two decades of expansionary practices and forced the Government to declare bankruptcy. The international banking community provided emergency funding, but at a steep cost to Brazil. The commercial banks charged a record spread of 2.125% over LIBOR for public loans and 2.5% for private loans. The new loans contained a 1.5% front end fee plus other fees and commissions, a floating interest rate, and a 1% penalty for late payments. In addition, the IMF demanded that the government decrease subsidies, accelerate devaluation of the cruzeiro, eliminate indexation of wages, increase interest rates, and enact wage cuts. To meet the new payment schedule, Brazil had to increase her trade surplus from $6 billion to $12-13 billion in three years. Exports needed to increase by 12% while imports fell by $24 billion. (Roddick 1988, 125-127) By 1986, Brazil’s debt stood at $110 billion. Experts contend that 70% of the total represented interest on old loans. Capital flight had consumed 13% and 65% was owed by state companies.
Despite the high debt, growth continued and Brazil recorded positive trade surpluses. The IMF austerity measures created a recession, primarily affecting the poor. Inflation eroded real wages, already cut under IMF conditionality. Corruption and graft dominated regional and national politics and Government leaders did not make structural adjustments, believing the fiscal problems to be temporary.

When President Fernando Collor de Mello assumed office in 1990, he took an "all or nothing approach" to obliterating Brazil’s inflation spiral. He likened it to "driving a packed bus at 150KM per hour, headed for a cliff...either we put on the brakes and some people get a little bruised up, or we go over the edge and we all die!"
(U.S. News and World Report 1990). The result four years later...everyone is bruised up and the bus is still speeding out of control toward the cliff. President Collor’s economic reforms have been unsupported by necessary structural and monetary changes and have been applied too inconsistently to have much positive impact on the existing

In March 1990, the Collor government implemented a severe stabilization program. Prices were frozen, an 18 month ban was placed on the withdrawal of bank deposits over $1,200 in savings accounts and $600 in overnight deposits, inflation was declared non-existent, a new currency was created, and the government initiated the sale or closure of 188 state-owned industries. Collor’s reforms initially slowed the rate of inflation. However, economic growth fell and unemployment jumped as the government eliminated public sector jobs and froze credit. In response to pressure from anxious citizens and irate business leaders, the government prematurely released a large portion of the assets and by the end of 1990, inflation was up to 90% a month.

A second attempt at reform was initiated in January 1991. Wages and prices were frozen and withdrawals from overnight accounts were heavily taxed to discourage consumption. The speed of privatization was increased and
the government further reduced the size of public sector employment by eliminating another 200,000 federal jobs (World Bank 1991, 56). Failure to reduce the structural deficit, intermittent tightening and loosening of the monetary policy, unfreezing of prices and wages by the third quarter, and unfreezing the remaining assets led to the reappearance of inflation. This also led to a loss of credibility in the government’s ability to control the economy. Corruption allegations and charges of mismanagement forced President Collor to resign and he was later impeached by the Brazilian Congress.

Brazil’s foreign debt is currently $120 billion, 30% of GDP. Brazil stopped payments in July 1989 and accrued $9 billion in interest arrears. Payments resumed in January 1991 at a reduced rate of 30% of the interest payment due. In April 1991, Brazil reached an agreement with the commercial bank creditors to pay 25% of the outstanding arrears in cash and to issue 10-year bonds to cover the remainder of the debt. In March 1993, Brazil paid commercial banks a total of $170 million in overdue interest, one half of the amount due. This was the first of two payments. The second payment was conditional on a 95% commercial banks endorsement of a debt reduction package. Under the conditions of the proposed package, Brazil would pay the banks $44 billion (of the $102 billion owed), the
banks would forgive 35% of the total owed, and would extend the terms over a period of 20 years. In September, the banks agreed to reschedule $35 billion of the outstanding debt—contingent on an (another) agreement with the IMF on a new stabilization/austerity plan; forgive a portion of the loan; and issue bonds with a 30 year maturity period. With 95% concurrence, Brazil has issued the second interest payment plus an additional 10% in overdue interest payments (New York Times 1993, D6).

Cardoso, Brazil’s new foreign minister, proposed another round of reforms. In August 1993, he called in $40 billion in debts owed by the states. Central bank regulations were amended to prevent banks from being coerced into lending beyond their means. He has also squeezed tax evaders to collect delinquent revenues and now wants to revise the constitution to simplify the tax code. In September, he outlined a four part program calling for: rapid privatization; price, wage, and exchange rate freezes for two months; a balanced budget, including tax reform and effective control of the public sector; and a targeted anti-poverty program. The constitutional convention, called in October, plans to include inflation fighting provisions; loosen state control on the telephone, mining, and energy industries; and amend the tax code.
CHAPTER 4

ALTERNATIVE SOLUTIONS:

DEBT REDUCTION/FORGIVENESS: Between 1978-90, 14 OEDC countries cancelled more than $2 billion of concessional debt (mostly under Paris Club auspices). OEDC nations also gave recipients concessional aid to buy commercial bank debt instruments at heavily discounted prices.

RESCHEDULING DEBT: Paris Club nations can cancel or reschedule only official bilateral debt owed over a period of 15-18 months. Commercial Bank debt is usually only rescheduled on a case by case approach when a country can no longer meet its debt servicing obligations.

BUY BACKS: Commercial banks, desiring to extract themselves from LDC debt, sell their loans to the secondary market. The financial markets believe that the debts are unlikely to be repaid in full and the value of the loan is marked down. The discounted rate reflects the percentage expected to be paid on each outstanding dollar of debt. Once the debt has been sold to the secondary market, the banks no longer accrue any benefits if the country repays or buys back its loan.
A heavily indebted country often loses from buying back part of its debt on the secondary market. The market price of debt increases as the outstanding debt falls. However, Mexico and Argentina have been successful with privatization efforts and have bought back a portion of their outstanding commercial debt on the secondary market.

DEBT-FOR-NATURE: Debt is exchanged for preservation of natural habitat. In 1986, Conservation International bought $650,000 of Bolivian debt using a $100,000 grant. Bolivia agreed to protect four million acres of tropical forest land, guarantee the status of each acre, establish an endowment fund of $250,000 to manage the Beni Biosphere reserve, and use Conservation International advisors as consultants. Other Debt-for-Nature proposals have been made to protect the rain forests in Brazil.
DEBT EQUITY SWAPS: Involve an investor exchanging, at the debtor country's central bank, the country's debt purchased at a discount in the secondary market for local currency. This currency is to be used in equity investments within the country and is subject to the country's laws on foreign investment.

INTERNATIONAL DEBT FACILITIES (Theoretical)

Jeffery Sachs advocates that the mechanism best suited for the task of debt reduction is the establishment of an International Debt Facility (IDF) which would work in conjunction with the World Bank. Its primary function would be to buy up medium and long term debt from the commercial banks at rates approximating their secondary market valuations. Debt owed to official creditors (IMF) or owed by the private sector would not be included in this type of arrangement. The IDF would then pass this discount to the debtor nations. For example, if the IDF bought $80 million in Mexican debt for $40 million they would cancel half of the debt by either cutting the principal or reducing the interest rate to one-half of the market rate of the loan.

Countries, however, would not be guaranteed relief identical to the secondary market valuations. Instead, the IDF could work in conjunction with the World Bank. The World Bank possesses the needed developmental strategy
expertise and objectivity to help determine, case by case, what percentage discount should be made. The discount would take into consideration the country's ability to pay and the economic reforms. They could also provide incentives to the countries to fund worthwhile programs. In particular, it has become increasingly obvious that the destruction of the rain forest is not a regional issue, but a cause for world-wide concern. Therefore, in exchange for the preservation of land the IDF could agree to further discount a country's loans. Other programs that the IDF could consider giving discounts for are: human rights advances; cholera reduction programs; and literacy campaigns.

The major technical problem with the establishment of the IDF is how to guarantee bank participation and prevent free riding. The solution to this problem is relatively simple and would not involve mandatory participation. The banks are not interested in remaining in Latin America for the long term. Given the right incentives, their participation would be voluntary. The main reasons countries have not already defaulted on these loans is due to pressure from the various governments and the policy of the IMF to discontinue lending to countries in arrears on their payments. Simply removing this pressure and giving tacit support to default on loans to banks that refuse to participate in the IDF, would go a long way in getting the
banks support. The new loans through the Debt Facility would take precedence over all other loans. Part of this incentive would have to include changing the United State's present accounting regulation to allow the banks to gradually amortize the loss incurred by discounting the debt to the IDF.

The problem then becomes which secondary market values to use. If we use the current figures, countries have an incentive to lie and drive down the market price. To prevent this the IDF could use a 12 month average of the secondary rates. The banks and debtors who want to participate would have to do so from the onset to avoid manipulation of the market and exclude free riders. The International Debt Facility would buy the debt by using the cash raised from issuing bonds guaranteed by the creditor governments. Cash flows from interest payments of the debtor countries would be used to service the bonds. By reselling the debt at a slightly higher rate than what the IDF bought it for would allow the institution to make profits on some countries and protect itself from losses on others.

Participation in financing the facility would include at least the GATT-7 and more than likely all 24 countries in the OECD. The amount of capital required to guarantee the
bonds would be quite small when spread across numerous countries. According to Jeffrey Sachs, with only GATT-7 participation it would take as little as 4% of the United States’ foreign aid appropriation to finance the U.S. share and "would clean up the commercial bank debt crises for 25 countries." (Sachs, 1989)

Commercial banks have largely been unaffected by the debt crisis. Why should they suffer now? The IDF would not be making the banks take new losses, but would force them to recognize their existing losses. Banks that choose to remain heavily involved in Latin American debt sacrifice possible future gains in new capital markets. As long as the present value of the money they receive is greater than the future value of the loans then the banks are actually getting a good deal.

Many economists suggest that these debtor countries are already on the downside of the Laffer curve, so the debt acts as a high marginal tax rate on the country. If the country succeeds in doing better than expected, the main benefits accrue to the creditors. That would make the debtors less willing to take painful or politically difficult measures to improve economic performance. Investment is also hampered since capital is so heavily taxed (Frenkel, 1989). If the debtor countries perceive they are not likely to borrow more and haven’t been able to
get voluntary lending since 1982, they will have a strong incentive to default. It is in the banks' interest to reduce the debt owed and move back along the Laffer curve. This would increase the likelihood of being paid.

Finally, the banks' lending practices are a large part of what created the crisis and should be forced to accept at least part of the consequences. Commercial banks loaned freely in the 1970s because, as Citicorps' Chairman Walter Wriston put it, "Sovereign nations do not go bankrupt." (Madrid, 1990) The banks are responsible for the loans and how the money was spent. Also a question exists on how much of this debt was acquired through legitimate means. When Mexico rescheduled its debt the first time, not only did the banks refuse to grant the debtor nations any concessionary loan terms, they also demanded increased premiums due to increased risks. The bank fees were $260 million. (Madrid, 1990) A U.S. banker put it best, "It is perfectly legal but unethical as can be. There's the corpse of Mexico, and they're pulling gold fillings out of the teeth."

Critics of the IDF proposal suggest that the debtor countries could not repay the IDF if they were unable to pay the commercial banks and the IDF lacks the backbone to enforce the contracts. This criticism ignores the flexibility of the IDF. Its primary concern is not to
profit, but to assist the countries to recover by substantially reducing their debt burden. Countries can be given credit on their debt for undertaking economic reforms and debt can be rescheduled in times of economic shocks.

The problem of the IDF lacking backbone is not a major issue since it will have the support of the major world governments and the World Bank. The threat of discontinuing future lending by the World Bank, and worsening of trade terms by world governments, has proven in the past to be enough to keep even the most rebellious debtors in line and should continue to do so into the future.

Creditworthiness in the future is the only troubling aspect of the International Debt Facility plan. If the commercial banks take large losses on these loans, they will not be eager to lend again. Although the IDF does not directly remedy this, an IDF can not be any worse than current strategies. Since there has been little voluntary lending since 1982, the IDF can only improve things by allowing the debtors to become more viable enterprises.

RECOMMENDATIONS

It is not unreasonable to expect the future world economic system to be concentrated into large regional "blocks"--the EC, an Asian trading block, and an "Americas" block. It is in the interest of the United States to assist
the Latin American region resolve its lingering debt problems and become a strong trading partner. The U.S. needs to adopt an economic policy that promotes stability and economic growth, not traditional austerity. Official policy needs to change the way the banks and multi-lateral institutions view debt servicing. A concerted effort to promote debt reduction versus debt repayment will go a long way toward assisting the highly indebted countries reduce their debt-export ratios and encourage growth.

Mexico and Argentina have made tremendous progress in the last four years and provide a model for the countries just beginning the painful process of individualistic reforms. The individual Latin American countries must continue to make macroeconomic reforms to increase revenues and decrease domestic deficits. Inflation must be kept under control. Finally, political stability must be a priority to attract investment and encourage capital growth.
A look at some figures of the three countries provides a starting point to illustrate the differences in each country’s approach to economic reform.

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Appendix B

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Source: Calculated from data of ECLAC, Division of Statistics and Quantitative Analysis (Devlin 1989, 219)
WORKS CITED


Sachs, Jeffery D. *New Approaches to the Latin American Debt Crises*. Essays in International Finance No. 174, July 1989


