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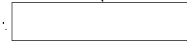

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Latin America and an Evolving International Debt Strategy

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A Research Paper

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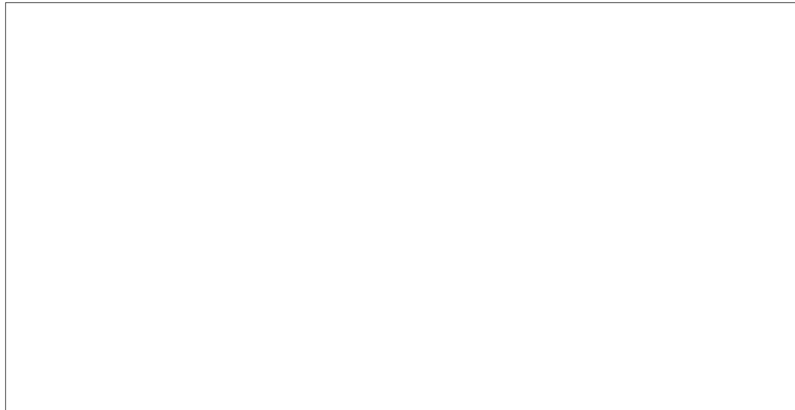

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Latin America and an Evolving International Debt Strategy

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A Research Paper

This paper was prepared by [redacted] Office of African and Latin American Analysis, and [redacted] Office of Global Issues. Comments and queries are welcome and may be directed to the Chief, South America–Caribbean Division, ALA [redacted]

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Latin America and an Evolving International Debt Strategy

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Scope Note

As part of an effort by the Directorate of Intelligence to monitor the Third World debt situation, this Research Paper examines the complex problem of Latin American debt for nonexperts. In particular, it discusses the importance of Latin American debt for the United States, identifies the reasons why the international debt strategy is undergoing change, describes the new US initiative on debt, and assesses what is likely to happen next on the Latin American debt scene.

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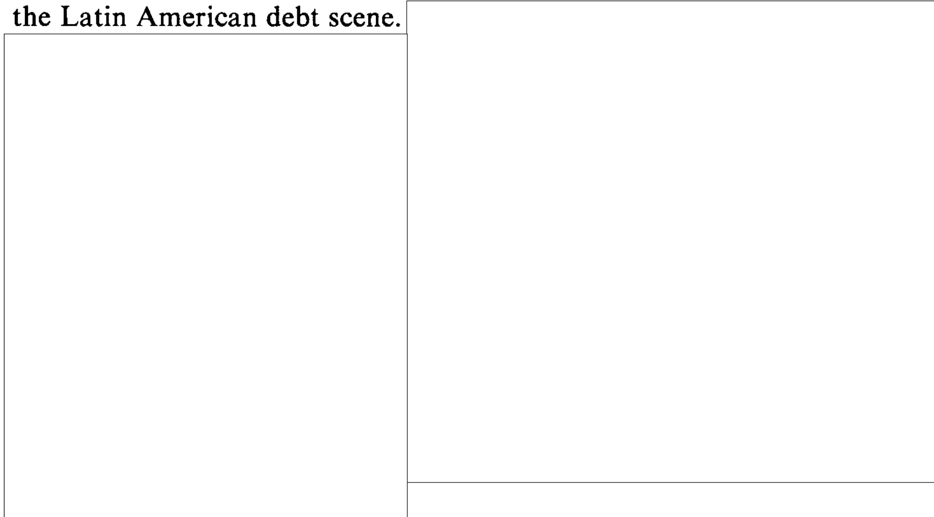

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Latin America and an Evolving International Debt Strategy

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Summary

Information available as of 1 June 1989 was used in this report.

US Treasury Secretary Brady announced a new initiative on Third World debt in March 1989 that emphasizes the reduction of commercial bank debt and debt servicing instead of large-scale new bank lending. By May, governments of other major industrial countries had agreed to the new approach in principle. The US initiative provides a framework for encouraging creditor banks to undertake substantially greater voluntary debt reduction by drawing upon official resources in the IMF and the World Bank. Under the plan, the extent of actual debt or interest payment reductions cannot be dictated by creditor governments or international financial institutions but must be worked out in negotiations between the debtors and commercial banks.

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The US initiative was taken to strengthen a faltering debt strategy. Efforts made by creditors and debtors to ease the debt crisis since it broke in late 1982 have met with only limited success because of a disappointing global economic environment, a lackluster push by the Latin Americans for domestic economic reform, and a strong reluctance by commercial banks to extend new loans. Accordingly, the region has suffered serious economic deterioration, with stagnant growth, soaring inflation, and declining living standards. Economic and debt problems have emerged as a major political issue in many Latin American countries and are important factors in numerous national elections. Debt also had created or added to tensions in Washington's bilateral relations with some Latin American countries.

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To become a workable plan of action, the US initiative must gain the support of other industrial country governments, the international financial community, and debtor governments. Important differences persist among these three groups on the desired levels of reduction in debt servicing; the appropriate means of achieving the reductions; the amount of public funds that should be used to support the reductions; the effects of debt reduction on new lending; and the extent to which economic policy reform by debtor governments should be a condition. For example, many international banks insist they will have difficulty reducing debt or debt servicing as much as contemplated by the US initiative—not to speak of the reduction sought by debtor governments—because of insufficient financial support from industrial country governments. Many of these governments, however, strongly oppose contributing additional taxpayer money.

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The US initiative could offer debtors significant help in dealing with their financial and economic problems if it encouraged their governments to implement more far-reaching economic reforms and if it supplemented, rather than replaced, new commercial lending. In addition, debt concessions may help to bolster the political standings of the Latin American administrations involved. If the major debtors in the region, especially those such as Mexico and Venezuela that have undertaken serious reforms, fail to gain significant reduction of debt or debt servicing following their high expectations, they are likely to suspend their commercial debt payments—despite potential long-term economic and political costs. They will also resent the failure of Washington and other industrial country governments to ensure satisfactory debt reductions and may be less cooperative on other bilateral issues.

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Latin America and an Evolving International Debt Strategy

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The Importance of Latin American Debt

How Large Is Latin America's External Debt?

Latin America's combined foreign debt totals some $425 billion, nearly half the $1 trillion owed to foreign creditors by all Third World countries. According to the World Bank, 12 of the 16 most highly indebted Third World countries are located in Latin America. These countries carry extraordinarily heavy debt burdens relative to the size of their economies, and their debt servicing obligations are large relative to their capacities for earning foreign exchange. As a share of regional gross domestic product, Latin America's overall foreign debt exceeded 60 percent last year.

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In 1988, Latin America's debtors paid $35 billion in interest to service their debt, compared to only about $12 billion received in net new lending. Their combined ratio of interest payments to exports of goods and services was about 31 percent. Many financial analysts view ratios exceeding 25 percent as a threat to financial stability. Argentina's ratio last year was 42 percent, Brazil's was 39 percent, and Mexico's was 28 percent.

Table 1
Debts of Sixteen Highly Indebted Countries, End of 1988

	Total Foreign Debt *(billion US $)*	Key Debt Ratios: Debt/GNP *(percent)*	Key Debt Ratios: Interest/Exports *(percent)*
Argentina	58	74	42
Bolivia	6	134	44
Brazil	120	39	39
Chile	21	124	27
Colombia	17	50	17
Costa Rica	5	116	18
Ecuador	11	107	33
Ivory Coast	14	144	20
Jamaica	5	176	14
Mexico	104	78	28
Morocco	22	132	17
Nigeria	32	123	23
Peru	19	41	27
Philippines	30	87	19
Uruguay	5	59	18
Venezuela	35	95	22

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Which Countries Have the Biggest Debt Problems?

US concerns regarding foreign debt in Latin America inevitably focus on Argentina, Brazil, Mexico, and Venezuela, even though debt presents serious problems for many other countries in the region as well. These four countries account for about three-quarters of the region's overall debt and are among the Third World's largest debtors. Accordingly, their foreign debts pose risks for regional economic and political stability, the international financial system, and US relations with the region.

Mexico and Venezuela have been suffering acute foreign exchange shortages caused by depressed oil prices and large current account deficits. Both governments seek sizable financial assistance from their creditors and have implemented tough reform measures in cooperation with the IMF to strengthen their cases. These measures, however, have been taken at the short-term cost of economic recession and social restiveness, of which the bloody riots in Caracas in March 1989 provided stark evidence. Mexico and Venezuela potentially are important examples of the international case-by-case debt strategy being applied successfully.

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The economies of Argentina and Brazil are in even more serious straits, mainly because of government mismanagement. Their vacillating leaders have shied

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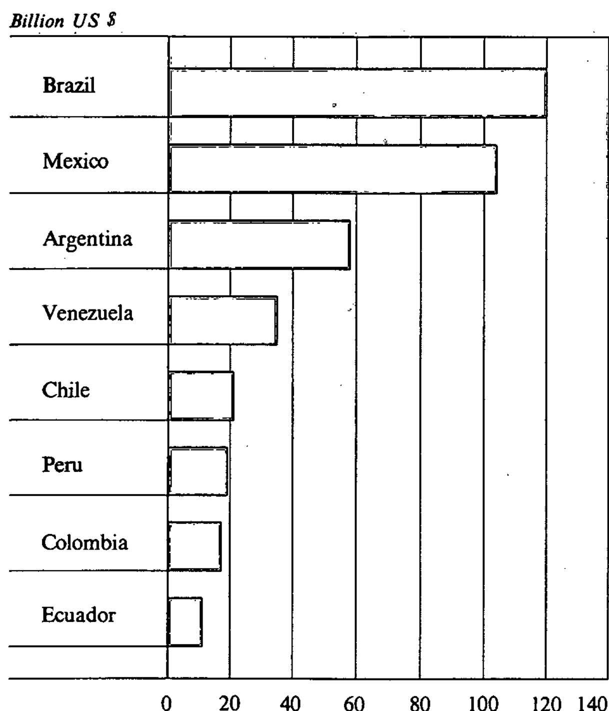
Figure 1
Major Latin American Debtors: Total Debt, 1988



away from the politically unpopular steps needed to put their economies on stronger footings and thus have fallen out of grace with the IMF. Consequently, inflation is soaring, investment is slumping, and growth has ceased. Capital flight has surged as a result of evaporating public confidence in government and is undermining the countries' foreign exchange positions. Poor domestic economic conditions in turn are contributing to political turmoil and opening the way for new waves of populist policies.

Why Did Debt Become a Bigger Problem in Latin America Than Elsewhere?

For a variety of political, cultural, and economic reasons, the Latin American debtors did not adjust to the changing world economic environment as well as some other Third World countries. Many developing countries in East Asia (including South Korea, Taiwan, and Singapore), South Asia (including India), and Europe (including Turkey) also were hit hard by the major oil price increases and global recessions of the mid-1970s and early 1980s, but came to terms with these external shocks reasonably quickly. While these countries restructured their economies, most Latin American countries turned heavily to foreign borrowing to cushion the external shocks rather than try to force changes on politically powerful domestic interest groups.

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After a brief initial slowdown, a number of the developing countries in East Asia, South Asia, and Europe soon returned to sustainable growth. By contrast, many Latin American countries continue to suffer through severe economic hard times. The only other region that has suffered as long and as much as Latin America is Africa, largely because of the structural shortcomings intrinsic to its lower level of development.

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What Happened to All the Money the Debtors Borrowed?

Most Latin American countries did not use productively the bulk of the funds they borrowed during the past 15 years and failed to create needed debt servicing capacity. A large part of the money loaned by foreign banks in the early and mid-1970s was invested in large and inefficient state-owned companies or in showcase projects such as huge dams, luxury hotels, and sophisticated military weaponry. A substantial portion of the funds also was used to sustain high consumption, including vast subsidization programs. Brazil probably is the most notable exception, as it invested parts of its borrowings in productive economic infrastructure such as transportation, communications, and the development of domestic energy resources.

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In the late 1970s and the 1980s, the largest share of new borrowed funds was recycled out of the country. Because these infusions of foreign exchange propped up overvalued local currency exchange rates, they ended up

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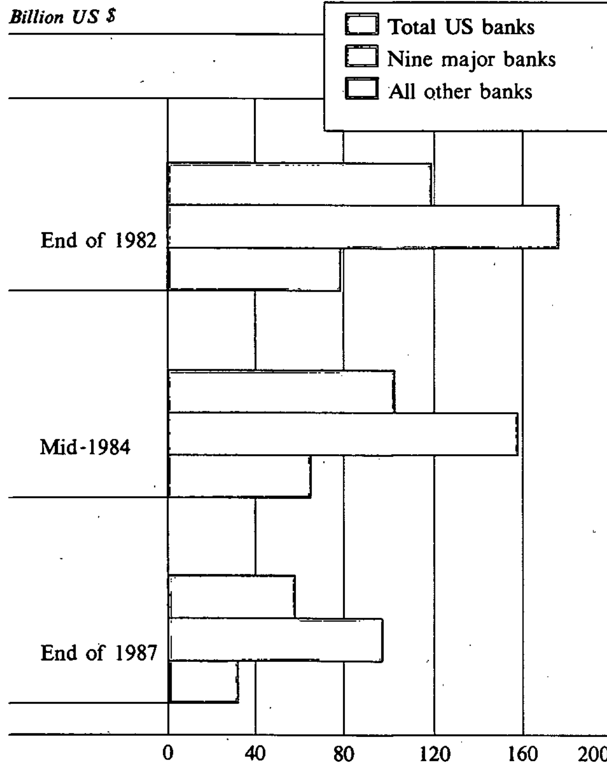
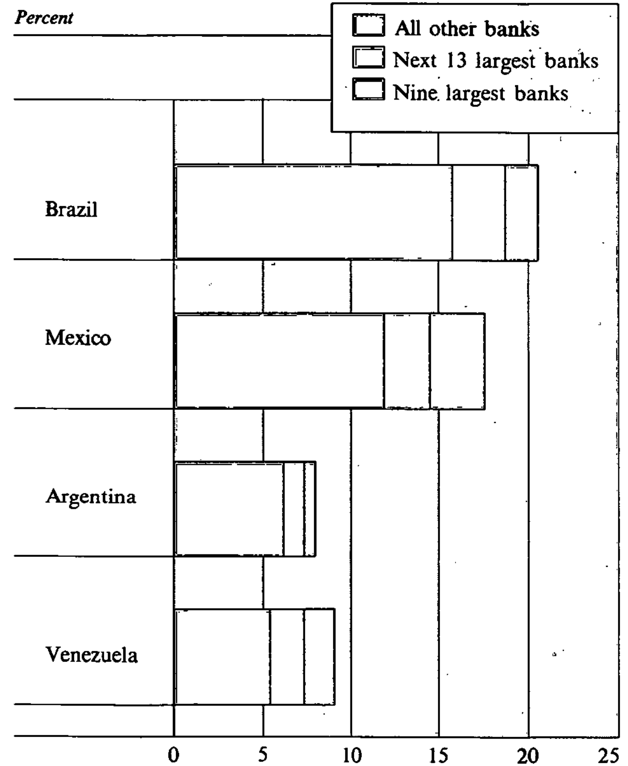
Figure 2
Exposure of US Banks in Latin America





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financing large-scale capital flight as public confidence waned and expectations of large devaluations grew. The exodus of funds from Mexico, Argentina, and Venezuela was especially heavy. Finally, as interest rates surged beginning in 1983, Latin America's debtors needed most of the new money they were able to borrow just to pay their swollen debt servicing bills.

What Risk Does the Latin American Debt Pose to US Interests?

Although international banks have reduced their vulnerability to possible defaults or moratoriums on debt payments in recent years, they still stand to suffer major financial setbacks if debtors undertake some form of coordinated debt action. Simultaneous suspensions of debt payments by several of the region's largest debtors—especially Mexico, Brazil, and Argentina—would cause serious liquidity, and in some cases solvency, problems for a number of US banks. The most severe difficulties would be faced by the largest banks, which hold the preponderant share of Latin American debt. The threat of insolvency for such large banks might prompt the Federal Reserve Bank to intervene—at sizable cost to the US Government—to stabilize the banking system.

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Because foreign debt contributes to Latin America's financial difficulties and general economic malaise, it has numerous other adverse effects on US interests. It reduces US trade and investment opportunities in the region. Poor economic conditions impede Latin America's progress in the war against narcotics trafficking, weakens the resolve of governments in the region not to sell arms to radical states, and adds impetus to the heavy flow of Latin American emigrants to the United States. At the same time, these conditions breed political and social discontent in the region and undermine efforts to consolidate democracy.

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How Important Politically Is the Debt Issue to Latin America?

Economic and debt problems have emerged as a major political issue in many Latin American countries and are important factors in national elections throughout the region. Politicians frequently cite the net outflow of financial resources caused by large debt payments as a major explanation for their country's deteriorating economic conditions. They also complain that, as a condition for providing new money, foreign creditors force them to adopt austere policies that discourage economic growth. Thus, a number of the region's leaders argue that the heavy debt burdens are stirring social unrest and imperiling their democracies. Some leaders, including Brazil's President Sarney and Peru's Alan Garcia, have used their countries' debt difficulties as excuses for their own mediocre performances. Others who have managed their economies more responsibly are unhappy with the sparse rewards from creditors.

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An ascendancy of new populist or left-of-center leaders already signals a potential hardening of policies on debt in the region. Venezuela's new President Carlos Andres Perez and Argentina's President-elect Carlos Menem have made debt their top priority and advocate a limitation of debt service payments. Although President Carlos Salinas of Mexico is committed to a generally moderate path, his policies may come under strong leftist attack if debt payments are not cut. Presidential elections are scheduled for November in Brazil, and several leftist candidates are among the frontrunners. By mid-1990, all major Latin American governments will have new leaders, and continuing economic deterioration could impel a decisive political shift toward economic populism and nationalism.

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Table 2
Presidential Transitions in Nine Highly Indebted Latin American Countries, 1989-90

Country	Date of Election	Date of Inauguration
Venezuela	December 1988	February 1989
Jamaica	February 1989	March 1989
Bolivia	May 1989	August 1989
Argentina	May 1989	July 1989
Brazil	November 1989	March 1990
Uruguay	November 1989	March 1990
Chile	December 1989	March 1990
Peru	March 1990	July 1990
Colombia	May 1990	August 1990

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The Need for Modifying the Debt Strategy

How Have the Latin American Economies Fared Since the Early 1980s?

Following a brief period in 1984 and 1985, when the major Latin American debtors seemed to have made significant progress in adjusting to their sharply swollen debt burdens, the debtors' financial positions as well as economic conditions weakened considerably. During the period 1986-88, exports by major debtors grew unexpectedly slowly and their current account deficits—which had been subdued if not eliminated over the previous two years—once again surged. Most of the Latin debtors, with the exception of Chile, have not significantly reduced their debt service ratios since 1983, the first full year of the Third World debt crisis.

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Domestic economic conditions of the region's debtors deteriorated because of external accounts difficulties and economic mismanagement. In nearly all major

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Table 3
Major Latin American Debtors: Economic Indicators

	1982	1984	1986	1988
Gross Domestic Product Growth (*percent*)				
Argentina	−5.4	2.4	5.4	1.0
Brazil	1.4	4.5	8.0	0
Chile	−14.3	6.3	5.7	7.4
Colombia	0.9	3.2	5.1	4.2
Ecuador	1.4	4.1	2.8	3.0
Mexico	−0.5	3.7	−4.0	1.1
Peru	0.7	4.7	8.5	−8.0
Venezuela	0.6	−1.4	6.8	4.2
Consumer Inflation (*percent*)				
Argentina	164.8	626.7	90.1	342.8
Brazil	100.4	188.8	132.9	583.9
Chile	9.9	19.9	17.4	12.7
Colombia	24.0	18.3	20.9	28.1
Ecuador	16.3	31.2	23.0	85.7
Mexico	58.9	65.5	86.2	114.3
Peru	64.5	110.2	77.9	667.8
Venezuela	9.6	12.2	11.5	29.5
Current Account Balance (*billion US $*)				
Argentina	−2.4	−2.5	−2.9	−2.3
Brazil	−16.3	0	−4.5	4.5
Chile	−2.3	−2.1	−1.1	−0.3
Colombia	−3.1	−1.4	0.4	−0.9
Ecuador	−1.2	−0.1	−0.6	−0.6
Mexico	−6.3	4.2	−1.7	−2.7
Peru	−1.6	−0.2	−1.1	−1.2
Venezuela	−4.2	4.5	−2.0	−4.9

debtor countries, decreased imports and slashed investment spending—often reflecting, in large part, flagging business confidence in government—have deterred economic growth. Furthermore, swelling budget deficits have caused inflation rates in some countries to soar. Throughout much of the region, economic growth has been insufficient to absorb new entrants to the labor force and to meet debt servicing obligations. Real wages have declined and living standards in many countries are below what they were at the beginning of the 1980s. 25X1

Why Has Economic Reform Not Come Easy in Latin America?

Many of the inefficient structural underpinnings of Latin America's economies have deep cultural and historical roots. State interventionist tendencies in many countries can be traced back several centuries to Spanish colonial practices. Moreover, most countries in the region embraced as their development model a protectionist, import-substitution path to industrialization some 50 years ago in reaction to the collapse in primary product prices during the 1930s. Implementation of this model also reinforced major government roles in productive activities because of the scarcity of private capital, the touted importance of economies of scale, and the perceived weakness of the private sectors. These policies continue to have many powerful adherents despite their failings in recent years and despite the growing recognition in Latin America that reform is essential to the region's future economic vitality. 25X1

Moreover, the consolidation of the statist-led, import-substituting development strategy created a network of influential interest groups strongly resistant to reforms. Labor, which has prized the large numbers of secure and well-paid public-sector jobs, has vigorously opposed cuts in government spending and the streamlining of state-owned companies. Parts of the business community have objected to liberalization of trade and foreign investment controls because of the advantages that protectionism has accorded them. Government officials, including retired military officers, have resisted privatizing state-owned companies because of the lucrative—and often not demanding—positions they hold through patronage. 25X1 25X1

How Has the Global Economic Environment Affected the Debtors?

Slow growth in world trade and soft commodity prices have impeded the efforts of many Latin American governments to export their way out of their debt difficulties. World trade growth of some 3.5 to 4

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Economic Reforms Recommended for Latin America's Debtors

Latin America's structural economic inefficiencies are the cumulative result of years of public-sector dominance, protectionist import and investment barriers, and nonproductive use of foreign loans. Governments in the region were not significantly pressed to change these policies until the early 1980s, when they suddenly had to cope with mushrooming debt difficulties brought on largely by soaring interest rates, a deterioration of their terms of trade, and a decline in new lending.

Against this backdrop, Western commercial creditors and multilateral lending institutions began to insist on economic reform programs as conditions for further financial assistance. They advised the debtors to undertake three general types of economic reforms:

- *Promotion of exports to strengthen external payments and to improve prospects for economic growth.*
- *Augmentation of other capital sources to replace borrowed foreign funds and to promote productive investment.*
- *Reduction of the role of government in the economy to promote economic efficiency and to facilitate internal price stability.*

To achieve greater export growth, debtors are urged to devalue their overvalued currencies and maintain competitive exchange rates. Because of their continued dependence on a few export commodities, many debtors also need to develop and diversify their export lines of industrial goods. By reducing their excessive import protectionism and adopting internationally acceptable export incentives, Latin America's debtor governments can reduce their policy biases against exports and help promote competitive manufactured exports.

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Latin American governments can augment their investment capital by expanding the levels of savings available from both domestic and external sources. Many debtor countries need to undertake financial reforms, which can range from simply freeing artificially low deposit interest rates to strengthening domestic capital markets, to encourage mobilization of domestic savings. Tax policies that encourage savings rather than consumption also can help. To expand inflows of non-debt-creating savings from abroad, debtor governments should provide policy incentives—including a stable investment climate—to attract more foreign investment and to induce repatriation of flight capital.

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The privatization, liquidation, or streamlining of poorly managed and inefficient state-owned corporations rank high among the measures recommended to reduce the government's often suffocating effect on Latin American economies. These state-owned enterprises have represented severe drains on limited government financial resources. The liberalization of government controls and regulations—including controls and subsidies on prices, trade, and credits—would boost entrepreneurial initiative and reduce misallocation of productive resources. Finally, by trimming their large budget deficits, many Latin American governments would sharply reduce inflationary pressures and encourage private investment by limiting the public sector's dominance of credit and capital markets.

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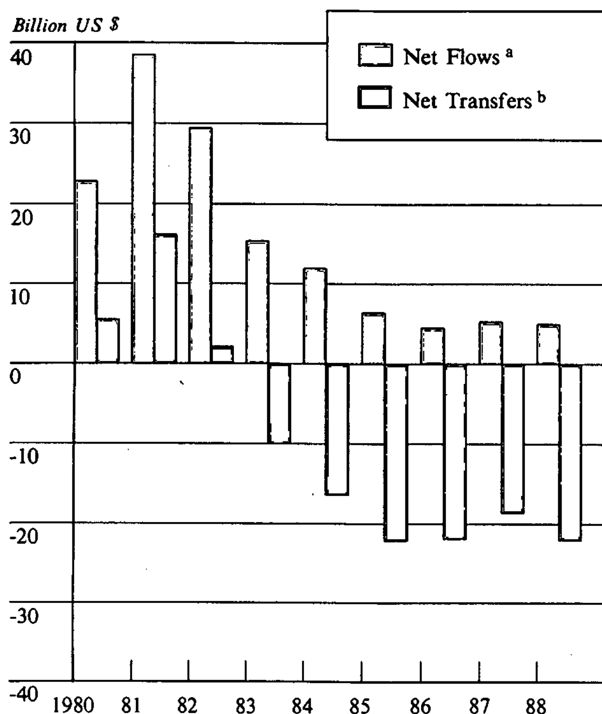
percent per year during 1982-88 was insufficient to stimulate major increases in Latin American export earnings. Moreover, most of the region's debtors rely heavily on sales of foodstuffs and raw materials and have been hurt by sluggish prices relative to other internationally traded goods. The prices of a number of leading Latin American export commodities—including coffee, grain, sugar, iron ore, and petroleum—remained below 1982 levels at the end of 1988. Most commodity analysts do not expect a major resurgence of these prices soon. Finally, trade protectionism has been on the upswing worldwide, according to the IMF, and may continue to rise, retarding growth of exports by debtor countries. 25X1

Although international dollar-denominated interest rates declined substantially and provided important relief to the region's large debt payments for several years after 1982, rates renewed an upward trend in 1987. The London Interbank Offerred Rate (LIBOR), the leading measure of international dollar rates, rose more than three percentage points from mid-1987 through early 1988. Many financial analysts are forecasting a continued rise in LIBOR into 1990. 25X1 each percentage point increase in interest rates raises annual debt service payments for Brazil and Mexico by $750 million, and for Argentina by $500 million. 25X1

Figure 3
Latin America: Long-Term Net Bank Flows and Transfers, 1980-88



[a] Net flows: Commercial bank disbursements minus principal repayments.

[b] Net transfers: Net flows minus interest payments.

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Why Has New Bank Financing Fallen Short of Debtor Needs?

Foreign commercial bankers generally have remained reluctant to commit new funds to Latin American countries over the past two years because of their lack of confidence in the governments' abilities to manage their economies and because of the confrontational stances taken by several debtors. The banks not only have refused to voluntarily lend new money to debtor countries in the region, but they have also increasingly resisted "involuntary" syndicated loans, which have required the participation of all commercial banks under pressure from the largest banks and the official creditor community. Instead, many international banks have buttressed their financial positions by boosting their loan-loss reserves, increasing their capital, and reducing their exposures in the region by writing off some debt and exchanging some for equity in Latin American enterprises. 25X1

Although most large international banks remain willing to provide some new money on a case-by-case basis, they generally tend to concentrate these funds in only a few of the largest debtors—Brazil and Mexico—where their stakes are high. A number of other banks, especially small- and medium-size banks, have opted not to participate in new loan packages for debtors in the region. There is also a growing sentiment among banks—large and small—that the debt problem has evolved into a political issue and that

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creditor governments and international financial institutions should provide substantially more lending or participate more fully in debt reduction schemes.

What Has Been the Response of Creditor Governments?
During the past year, industrial country governments have begun considering new approaches to the debt problem. Many became increasingly skeptical that the economies of major debtor countries could achieve substantial recoveries and support debt payments under continuing conditions of modest world economic growth and limited new external financing. They also were concerned about a growing potential for social and political instability and the threat to the tenuous trend toward democratization in the region. In the second half of 1988, the governments of Japan, with the Miyazawa Plan, and France, with the Mitterrand Plan, proposed multilateral schemes aimed at extending debt reduction to highly indebted, middle-income developing countries. The theme that new lending must be supplemented by greater voluntary debt reduction by bank creditors also became the key element of the new US debt initiative.

The Ideas Behind the New US Debt Initiative

What Are the Essential Features of the US Initiative on Debt?
The US debt initiative, announced on 10 March 1989 by US Treasury Secretary Brady, does not spell out definitive proposals, but rather comprises ideas, areas of emphasis, and suggestions to help strengthen the international debt strategy. The initiative builds on the fundamental principles of the past debt strategy known as the Baker Plan, which were:
- Economic growth is essential to the resolution of debt problems.
- Debtor countries will not achieve sufficient growth without credible economic reforms.
- Debtor countries will have a continuing need for financial support from foreign creditors.
- Solutions must be found on a country-by-country basis.

While the fundamental principles of the Baker Plan remain valid, the new US debt initiative attempts to strengthen the strategy in several ways:

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- The approach stresses voluntary negotiations between debtor countries and creditor banks to establish accelerated reduction of debt and debt servicing over three years. While the Baker Plan focused on new bank loans, the new US initiative focuses on reduced debt payments.

- The US initiative calls for redirecting official resources of the IMF and World Bank to guarantee debt-for-bond exchanges agreed upon by commercial banks and debtor governments. Both organizations would have to make special provisions to take on this additional and unusual function.

- While the approach maintains the IMF's and World Bank's central role in encouraging debtor policy reforms, stronger emphasis is placed on efforts by debtor governments to attract new foreign investment and repatriate flight capital.

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The US Treasury suggests the debt initiative is potentially available for 39 debtor countries. If all these countries participate, their combined $340 billion stock of commercial debt would be reduced by some $70 to $100 billion—20 to 30 percent—over three years. The 17 Latin American debtors among the 39 eligible countries owe $265 billion and would see their combined debt reduced by $53 billion to $80 billion.

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What Kinds of Debt Reduction Options Are Considered?
Debtor countries seeking to reduce their commercial debt burdens under the new US initiative have several options from which to choose:

- *Discounted debt-for-bond exchange.* Debtor governments can reduce their overall debt by exchanging existing loans at a significant discount for new long-term bonds bearing market-determined interest

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rates. The new bonds' principal would be fully backed by funds administered by the IMF or World Bank.

- *Par restructuring.* Debtor governments can exchange existing commercial debt for long-term bonds at par value but with a lower-than-market interest rate. This option would not reduce a debtor's outstanding debt but would lessen its interest servicing costs.

- *Debt buybacks.* A debtor government can directly purchase its outstanding debt at a substantial discount.

In addition, commercial banks continue to laud the debt-for-equity swap as an effective mechanism for reducing debt and will encourage debtor governments to maintain swap programs. Under this transaction, a commercial bank typically sells its loans at a discount to a multinational company, which transfers it to the debtor country for redemption in domestic currency at near or fullface value. The company then invests the proceeds in a business venture in the debtor country.

What Is Required of Industrial Country Governments?
For the new US debt initiative to succeed, it must have the full support of other key industrial country governments. The Group of Seven [1] industrial countries already have given their backing in principle to debt reduction for those Third World debtors that are committed to substantial economic reforms. These governments also have approved the use of IMF and World Bank financial resources to provide support to the various schemes for reducing debts and debt servicing to commercial banks, and have left decisions on implementing details to the two international organizations. Some creditor governments also would probably have to review their regulatory, tax, and accounting practices to determine whether additional measures are desirable to encourage bank participation in the new debt initiative.

[1] The Group of Seven is comprised of Canada, France, Italy, Japan, the United Kingdom, the United States, and West Germany

In addition, the US Treasury has stated that it intends to look to Japan, and perhaps other wealthy countries such as West Germany and Taiwan, to provide additional fresh funds to debtor countries. Japan, for example, already has pledged at least $4.5 billion in new loans to developing country debtors, including some in Latin America, in collaboration with the IMF and World Bank programs to reduce debt and debt servicing.

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What Is Required of the IMF and World Bank?
The IMF and the World Bank will play a crucial role in the new US initiative by facilitating debt and debt service reduction and by continuing to encourage policy reforms by debtor countries. For this purpose, the two organizations have agreed to set aside portions—amounting to a total of some $24 billion—of their loan resources that are conditioned on recipients' policy performances. The IMF stated it would allow member countries to allocate about 25 percent of their standard borrowings from the Fund to support debt-principal reductions—such as collateralizing the principal of discounted debt-for-bond transactions or replenishing reserves following discounted debt buybacks. The Fund will consider additional loans in some cases to support reductions in interest rates for new bonds. Likewise, the World Bank agreed that 25 percent of its structural adjustment lending to a country could be used for debt reduction over three years and, when justified, additional resources could be made available for support of interest payment reductions.

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The steering committees of the IMF and the World Bank reaffirmed their view in early April that financial assistance from these two major international financial institutions should be linked to sound economic policy performance on the part of debtor governments. Accordingly, those governments that wish to participate in the new US initiative would have to subscribe to an economic reform program with the IMF and World Bank, including measures that improve the foreign investment climate or encourage citizens to bring back capital they had sent abroad.

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Will the Costs to Industrial Country Taxpayers Rise?
The new US debt initiative does not contemplate additional direct costs to US taxpayers, or those of most other industrial countries, except Japan. The initiative does not call for any tax changes to ease the costs of debt writeoffs—something commercial banks desperately want. Some creditor governments, such as Bonn and Tokyo would like to see the IMF's funds substantially boosted, which would require additional budgetary outlays for all member governments, but agreement on such a step probably will not be concluded for at least another year or two. Tokyo is the only creditor government that has pledged some of its own funds—at least $4.5 billion—to supplement the $24 billion so far set aside by the IMF and World Bank.

Indirectly, the effects of the initiative's debt reduction schemes on taxpayers will be mixed. On the one hand, financial losses by commercial banks—and their shareholders—may result in the banks' paying less in taxes than they otherwise would. On the other hand, reduced burdens of debt owed to commercial banks may make it easier for the Latin American debtors to meet their obligations to official creditors. Moreover, improved Latin American financial conditions could lead to fewer loan "bailouts" by industrial country governments, less recourse to Paris Club debt relief, and reduced dependence on large-scale balance-of-payments assistance from the IMF and World Bank.

What Impact Does the US Initiative Have on International Banks?
In the short term, the US initiative may hurt international banks. Banks participating in reductions of debt and debt servicing generally will incur financial losses, although many, including US institutions, already have taken some steps to prepare for this contingency—by strengthening their reserve-loss provisions and reconstructing their capital bases—and probably have already suffered much of the expected related decline in their stock prices. Official support for bond exchange schemes also could soften the impact of losses for highly exposed large banks.

Over the longer haul, banks could derive substantial benefits. Many banks view some debt reduction deals as advantageous because they believe the value of their remaining outstanding debt will be enhanced. Moreover, if debt reduction contributes to an eventual strengthening of the Latin American economies and a more rapid return to creditworthiness, the region could once again become an attractive investment outlet for commercial banks. For this to happen, the new US initiative will also have to encourage debtors to implement sustained economic reforms.

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Implementing the US Debt Initiative

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Will Creditor Banks Agree to Much Debt Reduction?
International banks will agree to some reduction of Latin American debt and debt servicing, but the size and pace of the reductions remain questionable. The banks probably will accept at least 20-percent debt reductions over three years, especially considering that the secondary market prices—that is, the resale values—of most of these loans are very low. Moreover, creditor governments appear committed to the initiative's success and probably will provide the banks sufficient incentives through the IMF and World Bank to encourage debt reduction on that scale.

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The banks are balking, however, at the much larger demands for debt reduction of 40 to 50 percent made by some of the region's major debtor governments. For example, the committee of creditor banks negotiating with Mexico blamed the government's excessive demands for obstructing an early agreement on a debt reduction package. Many bankers maintain the IMF and World Bank are unlikely to devote sufficient financial resources to support debt and debt servicing reductions on the scale sought by Latin American governments.

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Will the Banks Be Willing To Lend New Money?
International banks probably will not be willing to extend large amounts of new money to Latin American countries under the new initiative, especially

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given current regulatory and tax rules. Many banks are discouraged by the continued lack of determination by various Latin governments to implement economic reforms and are wary of future confrontational debt policies in the region. In addition, most commercial banks see new loans to Latin American debtors as costlier as a result of the recent increase in their loan-loss reserves against debt exposures in the region.

Commercial bank loans probably will be extended only to Mexico and Brazil, where bank stakes remain high, and to a select few small debtors demonstrating strong commitment to economic reform. Elsewhere, Latin America's access to commercial funds generally will be limited to short-term trade credits. Part of the slack left by reduced commercial bank loans may be taken up by a rise in lending from international financial institutions, such as the World Bank and the InterAmerican Development Bank, although these organizations are unlikely to become major lenders.

What Happens Next in Formulating a Coordinated Creditor Strategy?

The US Treasury will continue to work closely with key creditor and debtor governments, the commercial banking community, and the international financial institutions to work out the details of a revised strategy. Third World debt will be a focus of discussion among the Group of Seven leaders at the Paris Economic Summit in mid-July—as well as a series of meetings with both developing and industrialized countries in the next few months. Because of the diversity of views, progress on the new strategy is likely to be slow and take many months. In the short term, the US Treasury is trying to encourage debtor countries, such as Mexico, Venezuela, and Uruguay, to pursue negotiations with commercial banks that incorporate the ideas of the US initiative.

Are Latin American Debtors Responding Favorably?

Latin American leaders have welcomed the shift in the debt policies of the industrial countries from emphasis on new money to outright reduction of debt and debt servicing. They view the US initiative as a significant breakthrough, noting that it recognizes that Latin America's debt load is too heavy to be repaid, that debt reduction is necessary to rekindle economic growth, that the problem has become more urgent than earlier believed, and that new debt should be treated differently from old debt.

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The Latin American debtors' optimism for the initiative has been tempered, however, by several concerns that are generally oriented around three groups. Mexico and Venezuela, two countries targeted by the US Treasury as priority beneficiaries because of their urgent financial needs and willingness to implement crucial domestic reforms, have expressed doubts that debt relief under the initiative will be nearly large enough or available soon enough. The second group—comprising Colombia, Chile, and Uruguay—is concerned about the initiative's impact on countries like themselves that have managed their debt responsibly and do not need bank relief. They are wary that debt reduction for several poor performers might discourage new lending to the entire region. Peru, Argentina, and, to a lesser extent, Brazil—representing a third group—object to the economic policy reforms they are required to implement as too demanding and fear, accordingly, that they will be excluded from the initiative, at least for now.

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What Are the Prospects for Increased Inflows of Foreign Investment or Repatriation of Capital Flight?

Foreign investment flows probably will recover gradually in the coming years from the low levels of the mid-1980s but not enough to offer substantial financial relief to the major Latin American debtors. A number of governments—such as Mexico and Venezuela—have expressed a desire to attract substantially more foreign investment and have taken some steps to improve the investment climate. Nevertheless, significant resurgence of investment probably will not occur until the region's debtors mount sustainable recoveries from their current recessions and show substantially improved economic management.

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In the past year, capital flight has again become a serious drain on the financial resources of Latin America's major debtor countries and probably will

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continue to plague several countries whose governments will fail to undertake responsible policies. Even when debtor governments turn their flagging economies around, they will not be able to count on a timely and substantial repatriation of capital. Many Latin American investors will want to see a sustained track record of sound economic management and political stability before bringing their funds back into the region. Some investors will be slow to repatriate capital for fear of retroactive taxes or penalties for past violations of currency exchange controls. Some private studies also indicate that as much as a third of flight capital has been used to buy less liquid assets—mostly real estate—that cannot be easily repatriated.

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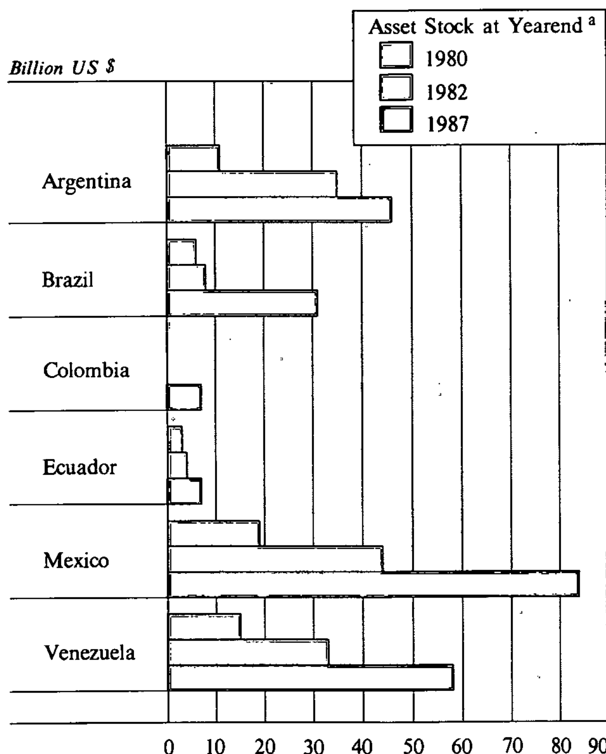
Figure 4
Latin America: Capital Flight



[a] Compounded values excluding assets built from capital before 1977. The compounded values assume a pretax return of six-month dollar LIBOR on the annual flight capital outflow estimates.

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How Much Will the US Initiative Help Latin America's Debtors?

The initiative would offer significant help if it succeeded in encouraging debtor governments to implement stronger economic reforms and if it supplemented, rather than replaced, new commercial lending. The reforms will be essential for the major debtors to become more internationally competitive and return to sustainable development and growth paths over the long run. In the shorter run, reduced debt servicing payments could provide financial breathing room for some economically pressed Latin American governments. Indeed, debt concessions may help to bolster the political standings of the administrations involved.

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The benefits of debt servicing reduction would be partially or wholly neutralized, however, if it discouraged new lending, as some bankers fear. In 1987 and 1988, Argentina, Brazil, Mexico, and Venezuela paid out a combined average interest bill of $27 billion. Accordingly, a 20-percent reduction would trim these payments by $5.5 billion. In the same two years, however, these four countries received a combined net $7.5 billion annually in new loans. It is clear that, at the extreme, some major debtors could find themselves in worse financial positions under the new debt initiative if commercial banks used it as an excuse to cease providing new money.

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What Would Happen If Nothing Further Were Done?

If Mexico City gets little or no debt reduction following its high expectations, it very likely would declare a moratorium on its debt payments and probably accuse Washington of insincerity in its stated wish to help Mexico. Moreover, many other debtors who closely monitored the Mexican debt reduction talks as a test case probably would follow suit in what could become

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Table 4
Selected LDC Debtors: Effects of Commercial Bank Debt Reduction

	Total Official and Commercial Debt	Reduction Implied To Obtain Creditworthiness [a]	Total Commercial Debt	Alternative Reduction Scenarios		
	Billion US $			*20 Percent*	*30 Percent*	*50 Percent*
Argentina	58	32	35	7.0	10.5	17.5
Brazil	120	40	76	15.2	22.8	38.0
Costa Rica	5	1.3	1	0.2	0.3	0.5
Mexico	104	33	69	13.8	20.7	34.5
Morocco	22	10	5	1.0	1.5	2.5
Uruguay	5	.03	2	0.4	0.6	1.0
Venezuela	35	11	26	5.3	7.8	13.0
Philippines	30	6	12	2.4	3.6	6.0

[a] The amount of debt reduction needed to bring the debtor within the desired creditworthiness levels was derived by comparing each debtor's actual total debt to GDP, total debt to exports of goods and services, and total interest payments to exports of goods and services ratios to levels desired by creditors, which are 40 percent, 200 percent, and 20 percent, respectively.

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a regionwide movement. If Venezuela fails to gain significant help—whether or not Mexico did—it too would almost certainly impose a full suspension of payments, and President Perez would try to spearhead a Third World debtors' movement.

If Brazil does not reap benefits from the new debt initiative this year similar to those expected by Mexico and Venezuela, the Brazilian congress probably will pass legislation suspending at least some interest payments. If a leftist wins November's presidential election, even stronger action may be taken. As time passes, and if the new debt initiative eventually proves to be beneficial to Mexico and Venezuela, Brasilia may reconsider its options and institute stronger economic reforms to qualify for similar concessions. If Argentina does not receive creditor treatment similar to that accorded Mexico or Venezuela, President Menem probably would formally suspend interest payments, withdraw Buenos Aires further from the international financial community, and try to go it alone.

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