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The Potential for a Latin American Debt Disaster

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Summary

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A major deterioration of the Latin American debt situation in the coming years is plausible and could inflict serious harm on US interests at home and abroad, according to three assessments undertaken [ ] by private-sector experts. Although all three assessments point to strong grounds for optimism in an easing of the debt problem during the balance of the 1980s, each draws attention to different critical points of vulnerability in current debtor-creditor relations that could cause debt conditions to unravel. Taken together, these analytically complementary expositions serve to underscore the fragility of the debt situation in Latin America and the large stakes at risk for the region and the US. Indeed, they note that several necessary conditions for a renewed financial crisis are already in place, including difficult economic conditions such as slow OECD growth and low commodity prices; the growing unpopularity of government imposed austerity measures among the Latin American people and commitments by their new civilian governments to increase living standards; and, foreign banks' resistance to new lending for beleaguered debtors coupled with banking regulations that prohibit a partial write down of bad loans. Finally, the assessments note that a renewed debt crisis in which key debtor countries invoke payments moratoriums would have alarming effects on the US banking system, the consolidation of democracy in Latin America, and US trade prospects. [ ]

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The Project

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This memorandum was prepared by [ ] South America Division, Office of African and Latin American Anaylsis. Comments and queries [ ] may be directed to Chief, South America Division, [ ].

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Although the experts did not unearth any startling worst-case possibilities their studies do cast fresh light on the potential for a Latin American debt disaster with some interesting and perceptive new analytical twists. In particular, the three experts point to several ways--not all of which are obvious--in which the Latin American debt bomb could be exploded, with serious repercussions in both that region and the United States in all cases. 25X1

Detonation from International Economic Shocks

Using a quantitative methodology, assesses the impact of a plausible worst-case triggered by international economic shocks on Latin American growth and debt. For purposes of comparison, his baseline outlook for the medium term calls for considerably higher Latin American growth than the dismal record of the past five years and for continued manageability of the debt problem. The international economic conditions underlying his base case assume 3 percent annual growth among the industrial countries, approximately 4 percent average annual inflation in the industrial countries, a nominal LIBOR lending rate of some 8 percent, and real oil prices hovering around $15 per barrel in 1986 prices. Against this baseline forecast, he analyzes the potential adverse effects of a plausible deterioration in the international environment. 25X1

The worst plausible case postulates a "hard-landing" for the overvalued US dollar and the international economy. A plummeting dollar would prompt the US Federal Reserve to increase interest rates by three percentage points and, consequently, precipitate a recession in the industrial countries that would reduce average annual OECD growth to 1.4 percent during 1987-1990. Using estimates of the elasticity of Latin American exports with respect to OECD growth and of increases in key debtor country interest bills, the worst plausible case has a devastating impact on Latin America's foreign exchange positions. If the Latin debtor countries absorb the foreign exchange squeeze with commensurate cuts in imports, they would suffer serious domestic growth repercussions. By calculating an elasticity of real output in Latin America with respect to import availability, his worst plausible scenario would result in a decline of annual GDP growth by about 3 percent for Brazil, Mexico and Argentina, with one-third of the decline attributable to slower OECD growth and two-thirds to higher interest rates (see table). 25X1

Because a renewed cash flow crisis could heighten the appeal of radical debt actions, also undertakes an evaluation of the effects of a debt moratorium, default, or repudiation on key Latin debtor countries' finances and growth. His quantitative analysis of the foreign exchange freed up by non-payment versus the foreign exchange lost through retaliatory disruptions to trade and new borrowings indicates that Latin American debtors on average would see their growth slow by one percentage point annually should they declare a moratorium. Thus, Latin American economic growth already depressed by external shocks would be set back still further by debtor moratorium responses. also finds significant the implication that industrial countries can wreak more havoc on Latin economies through their policy mismanagement than the debtor countries are likely to bring down on themselves by declaring a moratorium. 25X1

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Detonation From Inadequate Latin Economic Reform

In a second study, [redacted] foresees two worst-case outcomes for the region from a debt bomb explosion, each leading to undesirable political as well as economic consequences for the United States. She cautions that her assessment is not meant to be predictive but attempts to examine in a disciplined way what could happen "if". At bottom of both scenarios is the potential for the new democratic governments in Latin America to adopt misguided policies in efforts aimed at quickly improving the economic lot of their peoples. She argues that economic development is not only a shared goal of every Latin American country, but probably is the only dogma that enjoys overriding and across-the-board support in the region. The new democracies understand that they have to deliver economically or else face the prospect that they will be ousted like their military predecessors. [redacted] 25X1

Her first scenario, dubbed the "high-level debt bomb detonation," closely resembles the first [redacted] analysis, but the second scenario spotlights a distinctly different but equally pertinent prospect. According to the high-level case, a debtor country finds it cannot meet its payment obligations as a result of a collapse in oil prices or some other adverse external event and, consequently, takes unilateral measures--such as a payments moratorium--that earns political points domestically but inflicts serious harm on creditors. By contrast, in her second scenario, a "low-level" detonation occurs in an international economic environment--including moderate OECD growth--much as it exists now. Although debt obligations are manageable, [redacted] Latin governments squander their opportunity to make important adjustments and reforms necessary to strengthen their economies. Accordingly, they fail to implement orthodox stabilization policies, to cut fiscal deficits, to get rid of state-owned enterprises, to increase and diversify exports, and to liberalize foreign investment restrictions. As a result, Latin American debtors sink deeper into an economic morass, their image in the eyes of world economic officials worsens, and so do their abilities to climb out of their debt difficulties. Except for trade credits, international creditors no longer would consider major lending to countries in the region. [redacted] 25X1

Deteriorating financial and economic conditions in the region under both scenarios, [redacted] probably would lead to a reversal of the democratization process and the rebirth of authoritarian governments. Although the exact process would vary from country to country ([redacted] Latin American countries can tolerate for a while a period of economic deterioration--as they already have), pressures by interest groups for jobs and improved living standards would eventually build and create social unrest, opening the way for more authoritarian governments that base their legitimacy on maintaining order and decisive action. She notes that the countries now being visibly destabilized by the debt crisis are Peru and Mexico and the countries that are vulnerable but not in immediate danger include Brazil, Argentina, Ecuador, and Uruguay. Chile is vulnerable politically, but for reasons not related to debt. [redacted] 25X1

Detonation Caused by Banks' Shareholder Suits

[redacted] 25X1
creditor actions also could trigger a worst-case Latin American debt scenario. This scenario

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might arise in connection with a shareholder's suit over bank participation in a lending package designed to provide additional funding to Latin debtors. He notes that some key money-center banks in the United States are highly vulnerable to such developments because of the heavy concentation of Latin debt inside their portfolios and because of US banking regulations that require full write-down of non-performing loans in the event that interest arrearages reach a certain level. In his view, Latin America's need for additional financial resources will inevitably create tensions between these money-center banks, which are willing to provide funds to keep their interest payments current and protect the value of their assets, and regional banks, which may be under pressure from directors and shareholders to reduce their exposure to the area. 25X1

In this worst-case scenario, the shareholders of a regional bank that was planning to provide additional funding for a Latin American debtor sue the bank's directors for not protecting bank capital. The case would go before a judge whose regional perspective was sharper than his national perspective and who might uphold the suit. News of a successful suit barring commitment of additional funds to the Latin American borrower would prompt a suit or suits by blocks of shareholders in larger banks, enjoining their directors not to participate in an additional lending package. The failure of American banks to contribute would precipitate a collapse of the package since banks outside the United States would be unwilling to agree to disproportionate increases in their commitments. Such a collapse would then result in an accumulation of interest arrearages for the debtor because of its inability to service its loans in a timely manner and, subsequently, lead to a decision by US regulators that loans to that country are non-performing. 25X1

Furthermore, 25X1 in a worst-case scenario, a crisis starting in one Latin American debtor country might well spread to a number of others. The vision of Mexico, for example, ceasing to service its debt would put tremendous pressure on governments in Argentina, Brazil, and Chile, who are enduring the effects of large net resource transfers abroad, to cease payments. 25X1 were repudiations of external payment obligations to include the five major Latin American borrowers--Argentina, Brazil, Chile, Mexico, and Venezuela--the solvency of major money-center banks would be threatened. 25X1

Implications for the United States

The worst-case events 25X1 clearly would have far reaching negative effects on US interests at home and in Latin America. Should several Latin American debtors be forced to--or choose to--withhold debt servicing payments, many US and foreign banks would have to write down substantial amounts of their Latin American loans and suffer sizable financial losses. 25X1

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Latin American GDP Growth Under Alternative Scenarios, 1987-1990

Worst Plausible Cases

Country	Baseline Scenario	External Shock	Debt Moratorium	Combined
Argentina	3.5	0.4	2.5	-0.6
Brazil	6.0	3.1	5.0	2.1
Mexico	3.5	0.7	2.5	-0.3
Rest of Latin America	3.8	0.8	2.8	-0.2

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