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Escaping confrontation: Latin America's debt crisis in the late eighties

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Abstract

This is an evaluation of the current stage of the Latin American debt crisis, and of its likely outcomes. After characterizing the current stage as "pre-confrontational", consideration is given to the confrontation scenario as a natural estuary of current posture of debtors and creditors. Institutional changes required to defuse the confrontation and to set the stage for a more satisfactory outcome of the debt problem are then outlined.

Resumo

Trata-se de uma avaliação do estágio atual da crise da dívida externa latino-americana, e de seus possíveis desdobramentos. Depois de caracterizar o estágio atual como "pré-confrontacional", considera-se o cenário do confronto como um estuário natural das posturas atuais de devedores e credores. Mudanças institucionais requeridas para desarmar o confronto e encaminhar uma solução mais satisfatório do problema da dívida são então consideradas.

1. Introduction[1]

The Brazilian moratorium on interest payments to banks and the Citicorp decision to enhance its loan-loss reserves close a chapter on the debt drama ot Latin America. The heaviest players in the field have told the industrial countries and multilateral institutions that muddling-through as currently conceived is not working and that they are framing their own individual solutions to the debt-overhang problem. The institutíonal framework devised in 1982, which the Baker initiative sought to rescue in 1985 is now endangered. A new, more confrontational phase of the debt problem seems to be taking shape.

With Brazil's e decision last February, there are now at least eight Latin American countries (besides Cuba) which have declared moratorium on interest payments: Bolivia, Brazil, Costa Rica, Dominican Republic, Ecuador, Honduras, Nicaragua and Peru. Argentina, after coming close to calling a moratorium last January, has already failed twice to meet the quarterly targets of íts IMF programs. The 1987 Latin American debt scene is not entirely hopeless only because Mexico, in spite of record high rates of inflation, has managed to accumulate sizable foreign exchangs reserves, while

[1] Prepared for the Inter-American Dialogue. I am indebted for comments to an early version to the members of the Inter-American Dialogue Task Force on Debt and Trade, and to Dionísio Carneiro, Chris Canavan, Andre Lara-Resende, Pedro Malan, David Roberts, Paul M. Sacks, Richard Weinert and Rogério Werneck. The usual caveats strongly apply.

Chile, Colombia, Guatemala, Uruguay and Venezuela are muddling through more or less satisfactorily.

The next section attempts to characterize the current "pre-confrontational" stage of the debt problem. The confrontation scenario, which may be a natural estuary of current postures of debtors and creditors, is considered in Section 3. Institutional changes required to defuse the confrontation and to set the stage for a more satisfactary outcome of the debt problem are outlined in Section 4. The argument and conclusions are summarized in Section 5.

2. The antechamber of confrontation

Together with the depressed prices of U.S. bank shares, the secondary market valuation of Latin American debt reflects the poor judgement of financial market participante on the viability of current procedures to deal with the Latin American debt crisis. Table 1 reports the values observed over the last thirteen months in the New York secondary market for the debt of the major Latin American debtors.

Except for the peculiar case of Bolivia, only Colombia and Chile are now selling their paper for the same price as a year ago. Prices of other countries' debt paper have fallen dramatically. For Brazil and Ecuador, the plunge can be explained by their respective unilateral moratorium decisions. But the prices for debt paper of other countries, like Argentina and Mexico, which managed to finalize long-term agreements with their creditors under IMF supervision, also fell sharply.

Part of the explanation is in the Citibank's May 19 decision to set aside an additional US$ 3 billion loan-loss reserve to cover possible write-offs of third world loans. Citicorp chairman John Reed also has outlined plans to became a major player in debt-for-equity swaps, as a means of getting part of these loans off the bank's boaks. Other banks followed suit. As a result, the offer of loans in the swap market for Latin American debt now may grow from the present US$5 biliion in 1986 to some US$ 10 – to – US$ 15 billion a year, according to a Salomon Brothers estimate. Writing for The Christian Science Monitor (June 16, 1987, p. 21), David Clark Scott imputes the recent drop in the price of Mexican paper to the surge in loan supply cause by the Citicorp move.

Market observers are also waiting for the beginning of the operations of the Japanese Banking Association, JBA Investment, the factoring company that the major Japanese banks have recently established in the Cayman Islands, pooling US$ 60 billion of their developing-country debt. The move by the Japanese banks received less attention than the Citibank decision, being interpreted merely as a tax shelter mechanism. But it JBA Investment starts to trade this debt actively, it will alter the tace ot the secondary market completely.

The argument that the secondary market is to thin to reflect the "fundamentais" ot the situation

has been proffered before, and undoubtedly 1oan trading prices are strongly affected, for example, by the existence of liberal debt-far-equity swap schemes, as shown by the value ot Chilean debt.

But the "fundamentals" seem also to be deteriorating. In 1984, Latin American countries managed to turn around their trade balances so remarkably that even the most extravagant projections ot a year before seemed pessimistic. Most important, three years ago, L.A. governments entertained the hope ot an early return to "voluntary" market access – provided that they behaved according to the rules of the game. The costs ot the external adjustment were viewed as an investment in reputation – a sort ot market carrot at the end of the recession stick.

This may still hold in the case ot some countries, but certainly not in Argentina or Brazil. After battling the banks and the IMF for nearly five years – and still unable to bring inflation and budget deticits under control – the governments at these countries are now realizing that the stabilization of their economies, which is a prerequisite tor their return to voluntary access to international capital markets, is nowhere in sight. Moreover, with dollar interest rates goinq up and the world economy sluggish, it will be a decade before closely watched indicators, such as debt-export ratios and interest-export ratios, will improve sufficiently to attract voluntary lending to these heavily indebted countries.

Today, it is the fear of being shut out of official bilateral and multilateral sources of finance and the regular channels of international trade, rather than the expectation of future economic gains, which is holding the debtor countries more or less in line. Even so, under these circumstances, these countries also will be increasingly reluctant to continue compressing domestic demand merely to keep current on foreign interest payments. Says Brazil's former finance minister, Mario Simonsen:

> One of the fundamental messages of the pump priming concept, namely, that indebted LDCs should treat transfere abroad as an investment to regain access to voluntary external credit, has lost any credibility. LDCs continue to Service their debts (with some notable exceptions, like Brazil and Peru) because they perceive that the cost of the present transfers abroad is lower than the costs of default. Yet one should recognize that once transfers are perceived as costs and not as investments, their acceptable limits are considerably narrowed (Simonsen, M., "The developing country debt problem", mimeo, 1987).

Another fundamental change is the Citicorp move. When the debt crisis erupted in mid-1982, the banks suffered a fall off in stock prices, but they were still able to obtain substantial spreads and fees in the first "concerted lending" packages. By throwing good money after bad to avoid immediate defaults, they hoped that the increased probability of being repaid was sufficient to justify the costs involved in providing new money. Faced with the lingering threat of a debtors' cartel, the banks were forced to reduce their spreads and fees in each new rescheduling as a means of keeping the allegiance of individual debtors to the case-by-case approach. However, in the oligopolistic context of the

rescheduling exercises, they were unable to prevent these reductions trom spreading system wide. The debtors'' cartel was averted, fout the banks' economic interest in continuing to play the game was dampened at each new rescheduling move.

In the recent Mexican negotiation, the bíq U.S. banks saw that, in practice, the Baker initiative would require them to become instruments of U.S. policy toward the Latin American debtors, irrespective of their own profit calculations. Forced by the U.S. government to accept the contingent lending provisions of the Mexican agreement and very large reductions in spreads, some of these banks began wondering whether they might not be better off trying to quit. Bankers tried to maintain that the Mexican deal was "exceptional" and "non-repetitive", but after the Brazilian moratorium, they found themselves extending some of the terms of the Mexican agreement to Argentina and the Phillipines. The glass was nearly full, but it was the last big drop of the Brazilian moratorium that forced some of these banks to start searching for alternativos to the rescheduling exercises.

3. The confrontation scenario

One way to solve the debt tangle might be simply to allow the markets operate and let the divestiture process run its course. Caught between an unresolved fiscal crisis and dismal prospects for dollar interest rates and world economic growth, Latin American governments will continue to be unable to honor their foreign debt commitments. Faced with the banks' reluctance to expedite new loans under the rescheduling agreements, they will continue to declare unilateral moratoriums, partial limitations or suspension of interest payments. Banks, as a consequence, will need to continue increasing their loan-loss reserves, while loan prices decline further. In the process, some of the more exposed and less lucrative banks might go under, while the more aggressive among the debtors may lose access to the regular channels of International trade and to official financing sources. Eventually, the paper of the big debtors will become cheap enough for the governments of these countries to be able to buy them back. Repeating the melancholic conclusion ot the debt-repudiations of the 1930s, one more chapter will then be closed in the history of International sovereiqn debt.

But such protracted confrontation is not in the interest of either side. Banks would be badly hit in this scenario, and the debtors' access to the facilities of International trade and to offícíal financing might be damaged for a whole generation. Nevertheless, under current institutional arrangements, debt devaluation through confrontation seems to be a natural outcome of present trends in debt renegotiations. Consider the prospects for Brazil's upcoming debt talks.

An important part of the strategy of banks following the Citicorp move is for debt-equity swaps for the debts in their books. It's a major hope the banks have of improving the market value of LDC debts, given the option of start trading in the secondary market. But the fiscal crisis that underlay

Brazil's February moratorium decisian should also limit the scope for such swap opportunities. This is a general point: one major reason that so many Latin American governments have already declared unilateral moratoriums is that they found themselves unable to operate the domestic transfer of resources – from the private to the public sector, which is a prerequisite for government's being able to buy from the export sector the foreign currency it needs to service the public sector external debt.

Too much of the debate in the past has focussed on the difficulties of the Latin American economies to generate sufficient trade surpluses to pay their interest, either because of general foreign-exchange constraints or an aggregate savings constraint. These are real enough, to be sure, but the analysis seems to assume that government budget deficits belong to some other department of the adjustrnent process. The reality is that since most of the external debt is of the responsibility of the government, budget constraints are central in any assessment of whether a country will be able to keep its interest payments current.

Swappinq external-public-debt-for-private-equity represents a net addition to the fiscal expenditures of any government because they require the government to retire its external debt. The oniy difference is that payments are made in domestic rather than foreign currency – a point that is immaterial when the relevant constraint is the capacity of the government to tax resources from the domestic private sector. Unless government budget deficits are brought under control, debt-equity swaps have little roam to grow. But in view af the importance of interest payments to explain these deficits, it's difficult to see how the deficits can be brought under control unless the burden of the external debt on government expenditures is first reduced significantly.

These discussions are generally couched in terms of the negative impact that such debt-equity swaps would have on domestic monetary aggregates, but this is only because the Central Bank is the government agency normally in charge of these operations. The arguments are in any case the main reason for the reluctancs of the Brazilian government to authorize public debt for private equity swaps. Instead, the Brazilian government is planning to offer to the banks the suspension of its current moratorium on interest payments, provided that 100% of the interest due in 1987 and 60% of the interest due in 1988 (plus an yet undetermined but positive fraction of the interest due in 1989 and 1990) is returned to the government in the form of new loans with *pari-passu* clauses linking their disbursements to the interest payments on the previous debt. Alternatively – and, in fact, preferably, frao the point of view of the Brazilian government – the banks may opt to swap their debts for long term securities with an interest payment, initially fixed in the range of 3 to 4 per cent per year, but later on floating upwards conditioned on the behavior of the Brazilian economy.

Brazil is also not accepting an IMF stand-by as a condition for an agreement with the banks. The reason is a fundamental difterence with the IMF on how to resolve the budget deficit issue, involving problems similar to these which are currently leading the IMF arrangement with Argentina

to the point of near rupture. Over the medium haul, there is much restructuring needed in the public sector , both to reduce the number of public employees and to close or privatize publíc-sector activities (eventually through public debt for public equity swaps!).

Fiscal reform looks good on paper, but it takes long to push through a Congress deeply involved in writing a new Constitution, and longer still to put in practice. In the short-term, it is dífficuit to find a better candidate for budget-cutting than interest payments on the foreign debt – particularly when public investment has already been pared to the bone and voters aren't very keen to pay higher taxes to service the foreign debt.

In summary, the prospects for the forthcoming debt negotiations under the current institutional framework are for a serious deadlock, from which the dismal scenario of debt devaluation should evolve naturally.

Is there an alternative to this serious deadlock?

4. An alternative scenario

As a starting point it is useful to classify Latin American debtors according to two criteria: absolute size of external debt and degree of solvency. The large is the debt, the more problematic it will be for the creditors to try to deal in a non-conventional manner with an eventual debt overhang problem. The 1awer is the solvency, the more pressing the need for debt relief will be. Three groups of countries may be distinguished according to the first criteria: small debtors (total external debt less than US$ 5 billion), medium size debtors (debt between US$ 5 and US$ 25 billion) and large debtors (over US$ 25 billion in external debt).

Solvency is harder to grasp: elements to measure it are the debt/GNP ratio, the debt service ratio, per capita income, the absolute fall in GNP and fixed investment since 1980, the ability to keep current on interest payments while maintaining GNP growth and, last but not least, the secondary market valuation of the debt. Basic data is presented in appendix, from which the tentative five-way classification ín Table 2 is obtaineds countries with a low solvency index have their debts typically priced at discounts of 75% and over; mediuim-low solvency carries discounts higher than 55%; medium-medium solvency involves minimum discounts of 40%; medium-high, discounts higher than 25% and high solvency, discounts of less than 25%.

Table 2 reveals an interesting fact: countries with the lowest solvency indexes tend to cluster in the small external debt range. These countries tend also to be those with lowest per capita incomes in L.A. This should facilitate the task of providing debt relief, for the smaller and the weaker economies

are also those which are most in need of it. Total external public debt of the countries in Table 2 with small debts and low or medium-low solvency indexes (Bolivia, Haiti, Nicaragua, Costa Rica, Dominican Republic, Jamaica and Honduras – to which we add El Salvador and Paraguay) was US$ 22.7 billion in 1985, according to the World Bank. Peru, with an externaL public debt of US$ 10.5 billion, is the only exception to the general rule that the weakest debtors carry small external debts.

4.1. Debt relief in the small

The international community is already moving in the case of Bolivia, to permit this country to buy back its medium to long term debt to commercial banks at a deep discount. Forgiveness of principal and interest on official bilateral debt owed by the smaller and weaker countries is also being considered by a number of industrial countries.

Debt reconstruction through securitization is also been actively considered for some African countries. This involves swapping both official and commercial bank debt for long-term securities, with a fixed interest rate plus an annual redemption fund payment, allowing full repayment at maturity. In present value terms, these conditions imply a considerable loss over the face value of the debt which, however, is 1ower than the 75% discount at which the paper of the weakest economies are currently being sold in the New York secondary market. The new securities would carry an implicit guarantee of principal, as the transfers to the redemption fund would be effected by means of an automatic deduction from the sale proceeds of certain primary product exports, in the way which has been used by arrangement with the Federal Reserve Bank of New York for Paris Club credítors. Interest rate guarantees to final investors would have to be provided by the holders of the original debts themselves, opting to sell these obligations in the international capital markets. Multilateral institutions would not be asked to alter the terms and conditions of their outstanding debts, nor to provide guarantees for the principal or the interest of the new securities. However, they would be expected to assure positive net inflows into these African countries, by continuing their efforts to put in place new programs which would permit increasing disbursements over the period of securitization.

The interest of these initiatives is that they can be implemented essentially within the current institutional environment, as the dollar amounts involved are relatively small. There is apparently no need to establish new funds or new institutions, which might require complicated legislative action.

There is now strong intellectual support for the development of such debt relief schemes for the weaker economies and the political will to act in this direction is increasing in the industrial countries. Two problems are where to draw the line between small-and-poor and medium-and-not-so-poor countries, and how to prevent spillovers to the large countries.There is a political element in the first

problem, but the international community has already satisfactorily dealt with such classification problems in the past, and there is no reason why a workable solution could not be found to define entitlement criteria in this case as well. In Latin America, the borderline countries seem to be Peru, on the inside and Ecuador on the outside.

The spillover question is thornier and this is what has 1ed Martin Feidstein in a recent article in The Economist (June 27, 1987: 21-5) to recommend banks "to accept, for now, the de facto forgiveness entailed in the non-payment of interest by Bolivia, Peru and others with weak economies than to grant de jure forgiveness and risk the almost certain pressure for similar treatment from the major debtor countries".

The trouble with this reasoning is that some of the major debtors – Brazil and Argentina, specifically – are already insisting in a non-conventional treatment for their external debts, as witnessed by Bresser Pereira's recent suggestion to swap up to 50% of Brazil's bank debt for securities and for President Alfonsin's expectation that interest rates on Argentina's debt should return to their "historical norm". The frustration over existing rules and the expectation of changed ones are already inducing a confrontational behavior on the part of some of the big debtors which is also very costly for the banks. New rules may be better than an unruly world.

4.2. Reciprocal conditionality in the large

The main difficulty at the moment to accommodate the big debtors in a major debt reconstruction scheme is clear enough: it is the sheer size of their debts *vis-a-vis* the banks' primary capital. In spite of recent provisions by U.S. banks, there is still not nearly enough financial space for a major debt securitization program for the big debtors, given the banks' unwillingness to take the deep "hair cuts" that would be involved. Neither there is the political will in the industrial countries to generate the resources needed to support a new international debt entity to buy bank debt and convey the discounts to the debtor countries.

Fortunately, as the classification of the big debtors in the "middle-middle" solvency range in Table 2 suggests, it is still not entirely clear that their debts cannot be dealt successfully through "Creative muddling through" (the words are Feldstein's) or "a strengthened Baker Plan" (in the words of William Cline[2]).

At stake is the need for a significant reduction in the negative transfer of financial resources (external financing minus net factor services) which Latin American countries have been experiencing since the early eighties. In 1979/80, according to ECLA data, these transfers were

[2] Cf. Cline, W. R. , "A quick fix that would be harmful", New York Times Op-Ed Page, ...

positive to the tune of 2 per cent of aggregate Latin American GNP. They then turned negative, to reach the value of -4.5 percent of GNP in the 1983/85 period. As a consequence, fixed investment in Latin America dropped from 23 to 17 percent of GNP between 1979/80 and 1983/85[3].

Resumption of steady growth in the region requires an increase in the fixed investment ratio to GNP of 5 to 6 percentage points from current levels and for this, according to some recent estimates for Brazil, the negative financial transfer to abroad would need to decline to the range of 1.5 to 2.0 percent of GNP. Assuming realislically that foreign direct investment will remain depressed until the domestic economy picks up, meeting this target in the 1988-90 period would require zero net transfers to official institutions (i.e., new loans equal to debt service) and new bank money to cover approximately 50 percent of interest owed[4].

Extrapolating these results for all of Latin America, the conclusion is that restricting net financial transfers to 1.5 to 2.0 of GNP would require net financial capital inflows in the order of US$20 to US$25 billion per year. This compares with a realized vaiue of US$3.7 billion in 1986 and projections of US$16.6 billion in 1987 and US$10.8 billion in 1988, according to the IMF[5].

Accompanied by a program of structural adjustment which would ensure higher exports and domestic savings over the medium run, the new financial commitments of the international community would be consistent with a sustained recovery of GNP growth rates and a decline of debt ratios in Latin America – provided that Libor stays in the range of 7 to 7.5 percent per annum, commodity prices are steady, and OECD growth does not drop much below 3.0 per cent per year.

Such "Creative muddling through" would manage to reestablish normal access of the large Latin American debtors to the International capital markets in the late 1990s, as suggested by Martin Feldstein's recent projections for Brazil in The Economist. This, however, means that, over the next ten years, the real alternative to massive debt securitization for the big debtors is a major medium-term concerted external lending program associated with meaningful domestic structural reforms.

Robert McNamara has proposed that such program should involve the following elements[6]:

i. Debtors and creditors should explicitly agree that the objective in dealing with the debt crisis is to achieve long term sustained growth at rates sufficient to achieve social justice and assure a democratic order;

[3] Basic data is from A. Bianchi, R. Devlin and J. Ramos, "The adjustment process in Latin America, 1981-86". Paper presented on the Symposium on Growth-Oriented Adjustment Programs. Washington, DC: World Bank and IMF, February 25-27, 1987. As processed in Table 3 of R, Feinberg and E. Bacha, "When supply and demand don't intersect: Latin America and the Bretton Woods institutions in the 1980s", mimeo, 1987.

[4] These are approximately the external financing targets in the Macroeconomic Control Program of the Brazilian Government for the 1987/91 period. For more detail on the estímates, see Winston Fritsch, "Brazil growth prospects: domestic savings, external finance and OECD performance interactions". Paper presented at the IEFG/CEPER Conference on Macroeconomic Interactions between North and South. University of Sussex, 18-20 September 1987.

[5] Cf. International Monetary Fund, World Economic Outlook. Washington, DC; April 1987, Table A41, pp. 169-70.

[6] Cf. "Transcript of Inter-American Dialogue Task Force Meeting on Debt and Trade". Washington, DC, August 3-4, 1987, mimeo, p. 24.

ii. Each dehtor country should prepare its own long-term growth program taking social, political, and economic conditions into account. This program should include structural, procedural and financial reform measures;
iii. There rnust be an active leader external to the countries and the commercial banks which promotes agreement and progress in resolving the debt crisis. This leader would nurture the reform process in debtor countries, encourage debtor initiative, help clarify the sources of funding and similar tasks.

At an operational level, these stabilization-with-growth programs should differ from current IMF supported stabilization programs in several respects:

i. Current IMF programs are based on a set of "financial exercises", through which performance criteria are established for domestic credit and budget deficits of the program countries. As the G24 recently recommended to the IMF, these exercises should be supplemented by a set of "growth exercises", through which the foreign finance requirements to support adequate economic growth in the program countries would be determined[7].
ii. The principle of "reciprocal conditionality" – or "reciprocal commitments" – should be introduced in these programs. In the same way that domestic credit and budget deficit limits are an obligation of the program countries, the foreign credit requirements in the "growth exercises" would be an obligation of the creditors, both private and official. The level of funding to which the banks would be committed would be part of the negotiations, which may as a result require a special arbitrator. Failure to comply with these requirements would authorize the program countries to an automatic capitalization of their external debt service. Since the interest bill on past debt would normally be larger than the new funds, in practice this could be achieved simply by a contractual setting off procedure – or a *pari passu* clause – linking interest payments on past debts to the release of new money tranches. In line with the "menu approach", rather than participating of the interest financing program, banks could opt to swap their debts for an "exit bond" carrying an interest rate consisient with the net financing requirements of the debtor country.
iii. The principle of contingency lending first introduced in the 1986 Mexican package should become a standard feature of these new lending programs. Interest rate capping and financial compensation for commodity price shortfalis should ensure that the growth targets of the program are not compromised by adverse external shocks.

[7] Cf. "Group of 24 Report Focusses on Fund's Role in Promoting Adjustment with Growth", IMF Survey, August 10, 1987.

iv. The policy review process should be less intrusive and more respectful ot the member countries' sovereignty than the highly visible quarterly IMF missions of present programs. Current procedures have tended to generate more heat than action, and could profitably be replaced by a periodic consultation mechanism, directed at an evaluation of the direction and intensity of the adjustment effort. Creditors' compliance with theír share in the program would also be part of the review procedure.

A critical requirement of this new collaborative framework is the leadership and arbitration role which should be played by an international organization, either the World Bank or the IMF. In the recent past, the IMF came to be seen in debtor countries as a collector agency for commercial banks. The institution is now under new leadership and has apparently changed its perception on the nature of the debt crisis. The Bank, on the other hand, has a less tarnished image than the Fund in debtor countries, and for this reason might be better placed to play the role of an active leader. If the Bank would act more independently of the U.S. government, its effectiveness in this capacity might be significantly improved. Successful negotiations would also be facilitated by increased funding for the Bank, since at the current Bank tunding levels, new money for the debtors would have to come disproportionately from commercial banks, a scenario which these banks would not seem as equitable. A stronger presence of the Japanese government in the Bank should provide it with both more capital and more independertce from the U.S. government.

5. Summary and conclusions

The main points of th is paper can be summarized as follows:

i. The current stage of the Latin American debt problem can be described as pre-confrontational. With the decision taken by the Brazilian government, there are now eight Latin American countries (besides Cuba) which have declared an unilateral moratorium on the interest payments of their foreign debts;

ii. Partially as a consequence, the price of Latin American debt in the New York secondary market took a deep plunge in the last twelve months. An additional explanation for the recent drop in market values is the Citicorp decision to set aside a sizable loan-loss reserve to cover possible writeoffs of third world loans. Citicorp has also outlined plans to become a major player in debt-for -equity swaps;

iii. Three years ago, Latin American governments entertained the hope of an early return to voluntary market access. The costs of the external adjustment were viewed as an investment in reputation, as there seemed to be a market carrot at the end of the recession stick;

iv. This conception is no longer entertained in most Latin American debtors. Nowadays, it is the anticipated costs of exclusion from the regular channels of international trade and official financing sources which is holding the Latin American countries more or less in line. Under these circumstances, these countries will be increasingly reluctant to continue compressing domestic demand for the purpose of keeping current on foreign interest payments;

v. The Citicorp move also marks a definite change in the negotiating stance of some of the big U.S. banks. Through the rescheduling agreements, they managed to avert the creation of a debtors' cartel. But their economic interest in continuing to play the game decreased at each new reduction of spreads in successive reschedulings. In the recent Mexican deal, these banks saw that the Baker initiative would require them to become instruments of U.S. external policy, irrespective of their own profit-making calculations. The glass was nearly full, but it was the last big drop of the Brazilian moratorium, which forced the banks to start searching for new alternatives to the rescheduling exercises;

vi. An apparent option to solve the debt tangle would be simply letting the markets operate and the divestiture process run its course. Latin American governments will most likely continue to be unable to honor their foreign debt commitments. Banks will need to increase loan-loss reserves further, whíle market prices continue to drop. Some of the more exposed and less lucrative banks may go under, while the more aggressive among the debtors may lose access to the regular channels of international trade and official financing. Eventually, the big debtors' paper will become suffíciently cheap for the governments of these countries to be able to buy them back;

vii. Such protracted confrontation between creditors and debtors do not seem to be in the best interest of either. However, under current arrangements, debt devaluation through confrontation seems to be a natural estuary of the present trends in debt renegotiations. This is is illustrated by the Brazilian case;

viii. The debt-equity swaps which interest some of the banks represent a net addition to the Brazilian government fiscal expenditures, as they require the government to retire its external debt. The fact that payments are made in domestic instead of foreign currency is immaterial, as the main constraint is the capacity of the government to tax away resources from the domestic private ssctor. Unless government budget deficits are first brought under control, public debt for private equity swaps have little room to grow. But in view of the importance of interest payments to explain these deficits, it is difficult to see how the latter can be brought under control, unless the burden of the external debt on government expenditures is first reduced significantly;

ix. Brasil is also insisting in its position of asking banks either to accept interest refinancing at zero spreads or to swap their credits for long-term securities at low interest rates. Moreover, Brazil does not want to accept an IMF stand-by as a precondition for an agreement with the banks;

x. The prospects for the forthcoming debt negotiations under the current institutional framework thus seem to be for a serious deadlock, from which the dismal scenario of debt devaluation through confrontation could evolve naturally;

xi. Imagining a realistic alternative requires country differentiation. In Latin America, the countries with the lowest solvency ratings tend to cluster in the small external debt range (up to US$5 billion total external debt), These countries also tend to be those with lowest per capita incomes. This should facilitate the task ot providing debt relief, for the smaller and the weaker economies are also those most in need of it;

xii. The international community is already moving in the case of Bolivia. Debt reconstruction through securitization is also been actively considered for some African countries. The interest of these initiatives is that they can be implemented essentially within the current institutional environment, as the dollar amounts involved are relatively small. Two problems are where to draw the line between small-and-poor and medium-and-not-so-poor and how to prevent spillovers to the big debtors;

xiii. The main difficulty of accommodating the big debtors in a major debt reconstruction scheme is the sheer size of their debts *vis-a-vis* banks' capital. Fortunately, it is still not entirely clear that their debts cannot be dealt successfully through an enhanced Baker Plan. At stake is the need for a significant reduction of the negative transfer of financial resources which these countries have been experiencing since the ear1y eighties;

xiv. Preliminary calculations indicate that the resumption of investment rates necessary to sustain GNP growth in Latin America will require a decline of negative net financial transfers to abroad from 4.5 percent of GNP in 1983/85 to 1.5 to 2.0 percent for the remaining of the decade. At 1986 dollar interest rates, this translates into a net financial capital inflow requirement of between US$20 to US$25 billion per year over the next few years;

xv. Accompanied by a program of domestic structural adjustment which would ensure higher exports and domestic savings over the medium run, such "creative muddling through" can be expected to reestablish normal access of the large Latin American debtors to the international capital markets in the late 1990s. Until them, concerted external lending associated with domestic structural reforms is the only realistic alternative to a major program of debt securitization;

xvi. The principle of "reciprocal conditionality" – or "reciprocal commitments" – should be part of these programs. Since the interest bill on past debt would normally be larger than the new funds, in practice this could be achieved simply by a contractual setting off prccedure – or a *pari passu* clause – linking interest payments to the ralease of new money tranches;

xvii. A critical requirement of this new collaborative framework is the leadership and arbitration role which should be played by an independent international organization. If the World Bank, with the support of the Japanese government, would act more independently of the U.S. government, its effectiveness in this capacity would be significantly improved.

Table 1

Market values for L.A, debt, July 1986/August 1987

Country	% Face Value				
	Jul 1986	Nov 1986	May 1987	Jul 1987	Aug 1987
Argentina	65	64	55	48	47
Brazi1	74	73	61	58	47
Bolivia	8	--	--	10	12
Chile	67	67	68	67	66
Colombia	82	--	--	82	82
Ecuador	62	--	--	42	38
Peru	20	13	--	10	13
Mexico	57	56	58	53	51
Venezuela	75	74	72	68	65

Sources: July 1986, November 1986 and May 1987: Merrill Lynch, according to Business Week, June 15, 1987, p. 31. July 1987: Merrill Lynch, according to The Economist, July 18, 1987, p. 61.
August 1987: Salomon Brothers, simple average of bid and offer prices.

Table 2

A tentative taxonomy of Latin American debtors

Solvency index	Debt size		
	Small	Medium	Large
Low	Bolivia Haiti Nicaragua	Peru	--
Medium-low	Costa Rica Dominican R. Honduras Jamaica	--	--
Medium-medium	--	Ecuador	Argentina Brazil Mexico
Medium-high	Panama Uruguay	Chile	Venezuela
High	Guatemala	Colombia	--

NOTE; Insufficient information is available to classify El Salvador and Paraguay, both of which with total external debts ot less than US$2 billion. Basic data from the World Bank, World Development Report 1987 and from the same sources as in Table 1.

Appendix

Basic data for the construction of the solvency index

Country	Per capita income 1985 (US$)	Annual change GDP	Percentage in 1980/85 investment	External long-term debt as % GNP 1985	New York loan prices as % face value (8/1987)
Haiti	310	-0.8	0.0	30.0	--
Bolivia	470	-4.5	-9.5	136.8	12
Honduras	720	0.6	-2.7	73.2	40
Nicaragua	770	0.2	0.2	185.2	6
Dominican R.	790	2.2	-2.7	62.2	43
El Salvador	820	-1.8	-2.1	42.5	--
Paraguay	860	1.4	-8.8	59.6	--
Jamaica	940	0.5	2.1	171.9	40
Peru	1010	1.6	-16.5	74.9	13
Ecuador	1160	1.5	-7.2	61.5	38
Guatemala	1250	1.4	-9.0	20.8	73
Costa Rica	1300	0.5	-1.9	113.6	35
Colombia	1320	1.9	0.6	33.3	82
Chile	1430	1.1	-13.5	123.9	66
Brazi1	1640	1.3	-5.5	43.8	47
Uruguay	1650	-3.9	-19.1	58.4	69
Mexico	2080	0.8	-9.1	52.8	51
Panama	2100	2.4	-9. 4	71.0	60
Argentina	2130	-1.4	-13.8	56.4	47
Venezuela	3080	1.6	--	46.1	65

Sources: World Bank, World Development Report 1987, except for loan prices which are the simple average of bid and offer prices estimated by Salomon Brothers.