

The Debt Crisis at the Turn of the Decade*

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So far as Latin America is concerned,¹ the dominant economic happening of the 1980s was the debt crisis. Commercial bank lending came to an abrupt halt when Mexico was forced by reserve depletion to declare a temporary moratorium in August 1982. Without a flow of new bank loans, continued servicing of debt on the original contractual terms proved impossible everywhere except Colombia. The attempt to maintain debt service dictated fiscal deflation, devaluation, and the diversion of savings from investment into export surpluses. The result has been the 'lost decade': a decline in per capita income of almost 10 per cent (in place of a 40 per cent rise in the 1970s), a one-third fall in gross investment, and true hyperinflation for the first time anywhere since the aftermath of World War II.

The original debt strategy was based on a diagnosis of temporary illiquidity and sought to maintain debt service while providing partial interest recycling (euphemistically termed 'new money') so as to limit the need for peremptory adjustment. The implicit premise was that little was fundamentally wrong with the economic model that had produced quite reasonable growth from the end of World War II to the early 1980s: once the traditional levers of fiscal and exchange-rate policy had been re-set appropriately, Latin America would be able to generate a negative transfer, which would restore bankers' confidence, whereupon lending would recommence and growth could revert to its previous rate.

By 1985 it was obvious that matters were not working out that way, and so a new plan, the 'Baker Plan' was introduced. This contained no significant change in the financing provisions for debtor countries: they were still expected to pay interest service in full while principal was rescheduled and involuntary 'new money packages' provided partial interest recycling. What was new was the change in rhetoric, which now spoke of restoring growth, and the conditionality, which began to focus on supply-side policies like deregulation and privatisation. It was not evident to

me at the time (and I have no idea whether it was clear to the plan's authors), but in retrospect one can see the Baker Plan as challenging the traditional statist model of Latin American development. Policy reform had to go far deeper than raising taxes and restoring a realistic exchange rate.

Just over three years later, in early 1989, a new administration conceded that the Baker Plan had not worked. Its successor, the Brady Plan, changed the financing part of the strategy, to encompass debt relief (which again had to be described euphemistically to make it acceptable to bankers' ears, as 'debt reduction and debt service reduction'). The condition for debt relief remained policy reform on the lines developed under the Baker Plan, the logic being that policy reform needed financial support to succeed, while financial support without policy reform amounted to throwing good money after bad.

The key question is, of course, whether the Brady Plan is going to work — in the sense of allowing the debtor countries to resume robust growth — where its predecessors failed. It is already clear that it is unlikely to make a dramatic difference to the amount of debt service that debtors will need to pay to avoid confrontation with their creditors. In the outline agreement reached with its creditors, Mexico seems to have gained relief (i.e. a reduction in the present value of its contractual future obligations) of about one-third of its bank debt. But a substantial part of this relief will arise only as the debt is paid off in the distant future, and Mexico's negative transfer to the banks will decline by less than 20 per cent in the short run. The Philippines, the second country to settle, expects to get even less relief. Costa Rica, the third country to reach agreement, should get debt relief of about two-thirds as compared to its contractual obligations, but this will actually bring it no easing to its cash flow at all in the short run: indeed, the restructuring will require some *increase* in the negative transfer in the medium run (assuming that the economy continues to perform well, so that the contingent payments obligations are activated). Hence, if one believes that the debt problem has damaged the debtors primarily by siphoning away funds that would otherwise have been invested productively at home, one has little reason to be optimistic about the prospects of the Brady Plan.

The alternative view is that debt is important primarily

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¹ While debt is an important problem in other parts of the world too (notably in Africa, the Philippines, and part of Eastern Europe), this paper is restricted to Latin America.

because it is thwarting the entrepreneurial response that policy reform is intended to elicit. Mexico, for example, has undertaken an impressive range of policy reforms during the 1980s, in terms of curbing its fiscal deficit, achieving a competitive exchange rate (and hence a rapid growth of nontraditional exports), liberalising trade and foreign direct investment, privatising and in other ways rationalising the public sector, and deregulating [Williamson 1990]. Yet per capita income and real wages have, at least until recently, continued to fall. Mexican entrepreneurs have quite enough flight capital parked abroad to finance an investment boom, once they are convinced that Mexico has indeed turned the corner and that the policy reforms are going to stick. Catch-22 is that they will not draw that conclusion until *either* they see that other entrepreneurs have already drawn that conclusion *or* until they conclude that Mexico can get by in the medium run even without capital repatriation. In other words in order to succeed, the Brady Plan needed to provide enough debt relief to give assurance that repatriation of flight capital was unnecessary, whereupon repatriation could happen.

In fact, announcement of the agreement between Mexico and the banks last July stimulated enough capital repatriation to allow the authorities to reduce the domestic interest rate by over 20 percentage points, which would have given them the chance to redirect something like 5 per cent of GDP from internal debt service to restoring some of the public expenditures that have been savagely squeezed in recent years (including infrastructure, health, and education). This was the best news since the debt crisis started. It is a tragedy that subsequent foot-dragging by the banks has jeopardised the momentum that seemed to be building up, and sent interest rates in Mexico inching up again. At this stage one just has to hope that final agreement will soon be reached and that it will turn out that the damage is reversible.

The case of Costa Rica is even clearer, inasmuch as the agreement offers Costa Rica no cash flow relief at all. It cuts contractual obligations to the level that Costa Rica can afford to pay, which is the same as the level that it has been paying. The hope is that this will remove the threat of future disruption and so restore confidence.

Mexico and Costa Rica are not the only countries in Latin America that have implemented policy reforms sweeping enough to merit support through the Brady Plan. Bolivia and Chile have, in fact, gone even further in modernising their economic model. Colombia, Jamaica and Uruguay are also serious candidates. Venezuela too has made major reforms, though it started only a year ago. Policy reform is even more recent in Argentina, and its success can even less be taken for granted. But the best way to help policy reform there, as well as in countries that have not yet

started, is to show that agreed debt restructurings that offer debt relief are available to countries that persist with policy reform. Limiting debt relief to those countries with an established record of policy reform is one key element of the Brady Plan that makes good sense.

Another key feature of the Brady Plan, which arises from its historical background as an attempt to buy debt relief from the banks on a voluntary basis, is its retention of an important element of choice for each bank, notably a choice between furnishing debt relief and continuing to recycle a part of the interest (e.g. by 'new money'). One can argue that it might have been better to develop sanctions to force banks to fall in line with official decisions on the magnitude of debt relief that a country needs. If the Brady Plan fails, that issue will doubtless be reopened in another two or three years time. But in the interim it is vastly more constructive to ask what changes might help the Brady Plan to succeed.

The simplest change would be to enlarge the sums available from the IMF and World Bank to support debt relief operations, but this also appears to be a lost, or at least an unpromising, cause. Three alternative, evolutionary changes look more hopeful.

(1) At the moment only the commercial banks are being asked to provide debt relief. There are good reasons for continuing to exempt the multilateral development banks. But a lot of debt is also owed to export credit agencies of the developed countries, and there is no very convincing reason as to why this should be treated more leniently than the bank debt. The simplest approach would be to forgive the same proportion of this debt as banks choosing debt reduction are required to forgive. Alternatively, a similar proportion of the debt could be converted into local currency terms, to be spent in future years on projects in the environmental, educational or social fields agreed to be of mutual interest to creditor and debtor.

(2) At present the IMF and World Bank are earmarking separate funds for debt reduction (buybacks or principal collateralisation) and for interest support (interest collateralisation). Like most earmarking, this is leading to inefficiency: most immediately, the Philippines is being thwarted in its desire to use the full funds that it has been voted in the way that seems mutually most advantageous to it and its creditors, which happens to be buybacks. This earmarking should be quietly abandoned forthwith.

(3) There is still a problem of getting potential free-riding banks to participate in Brady-style debt restructurings. The most potent incentive to a bank to participate is eligibility for tax relief. At present European banks are generally eligible for tax relief on provisions whether or not these are used to grant relief to the debtor, while American banks get tax relief only

when debt relief is granted. The European practice encourages provisioning but gives no incentive to translate this into debt relief, while the American practice gives no incentive to provision and therefore leaves banks in a less favourable position to grant debt relief. Stephany Griffith-Jones (1989) suggests getting the best of both worlds by granting contingent tax relief on provisions, the relief being withdrawn retroactively if a bank fails to participate in an agreed debt restructuring.

Those of us who have concluded that profound policy reforms were needed to change the traditional Latin model of development can take heart from the reform movement sweeping Latin America. But well-intentioned reform programmes often come to nought

unless they can show some clear results fairly early. The sort of definitive resolution of the festering debt crisis offered by a Brady-style restructuring buttressed by the three suggestions advanced above appears precisely the sort of result that is needed to encourage reformers to persist.

References

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