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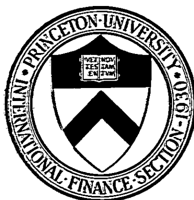
NEW APPROACHES TO THE LATIN AMERICAN DEBT CRISIS

JEFFREY D. SACHS



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NEW APPROACHES TO THE LATIN AMERICAN DEBT CRISIS

1 Introduction

Despite many years of emergency treatment, Latin America's debt crisis continues to deepen. Throughout Latin America, the debt burden grows while most economies deteriorate. Many countries are now suffering from an alarming mix of hyperinflation and hyperstagnation that has not been witnessed on such a wide scale since the disastrous experience of Central Europe in the 1920s. In many countries, economic instability is so acute that it is breeding political instability and threatening democratic governments. The collapse of democracy was the overwhelming legacy of Central Europe's economic crisis in the 1920s, and the same prospect looms in Latin America today.

As the crisis has deepened, we have learned that the "conventional strategy" for managing it is inadequate. When the crisis first developed, there appeared to be little room for maneuver. After world interest rates rose in the early 1980s and commodities prices collapsed, the debtor countries were caught in a financial squeeze and their creditor banks were caught in deep trouble. The creditor governments felt, perhaps rightly, that unless the debtor countries continued to pay the interest on their debts in full, the world financial system would be at risk.

Thus, full interest servicing and opposition to debt reduction became the hallmarks of the conventional strategy.[1] The conventional approach was also built on the hope that the crisis would prove to be a short-term liquidity

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This essay was originally presented at the Harvard Symposium on New Approaches to the Latin American Debt Crisis in September 1988. It was therefore written several months before the announcement in March 1989 of the new debt strategy of U.S. Secretary of the Treasury Nicholas F. Brady. Several of the ideas espoused in this essay, including the focus on debt reduction and negotiations, are part of the Brady Plan. No attempt was made to update the essay following the announcement of the plan. Nonetheless, the essay retains its relevance in view of the continuing uncertainties about the specific design of the plan and the very active public-policy debate surrounding Mr. Brady's proposals.

[1] The term "debt reduction" will be used to refer to any formula for restructuring the debt that leads to a reduction in the *present value* of payments that are due to the creditor. Thus debt reduction might mean a rescheduling with below-market interest rates, a cancellation of some part of the principal, or some combination of the two. In the conventional approach, all interest rates are kept at the market level *plus* a risk premium. Stretching out the time for repayment of principal or lending new money at market interest rates, which are the two main strategies of the conventional approach, *do not* reduce the present value of the debt that is due.

squeeze, so that the countries would readily be able to manage their debts in the intermediate term.[2]

Six years later, the banks are mostly out of deep trouble (a point we will see later), but the economic situation in the debtor countries continues to deteriorate. High world interest rates and low commodities prices proved to be longer lasting than was originally expected, and the management of the debt burden within the debtor countries proved to be far more intractable. The economic situation in Latin America has proved to be so serious that we can say that the current approach no longer serves the real interests of any of the parties to the crisis.

The debtor countries are clearly losing under the current approach because the debt-servicing burden is too high, but the creditors are losing too. The economic collapse and growing political polarization in the region mean that the creditors' hopes of being repaid are steadily diminishing. The commercial banks, for example, have experienced a sharp deterioration in the market value of their claims in Latin America as it has become increasingly evident in the marketplace that much of the Latin American debt will probably never be repaid.

And through various channels, many of which are not well understood by the general public, taxpayers in the United States, Europe, and Japan are providing more and more money to keep the "conventional approach" going. To an increasing extent, the creditor countries are supporting loans to the debtor countries that are then used to pay interest to the commercial banks. These loans are sometimes made directly (e.g. through the export-credit agencies of the industrial countries) and sometimes indirectly, through creditor-government contributions to the International Monetary Fund and the World Bank. In either case, we have a process by which taxpayers are picking up an increasing part of the interest-service burden of private commercial banks. But this is money spent with little evident return, since the long-promised economic recovery in Latin America has failed to materialize, while the loans from the creditor governments (and their taxpayers) continue to mount.[3]

[2] The most influential study in support of the conventional approach was Cline (1984). That study predicted a very sharp decline in the debt/export ratios of the major debtor countries by 1986, so that those ratios would be well below their 1982 levels. It also predicted a swift recovery in debtor-country growth and a quick return of the major debtor countries to market access in the international financial markets. Needless to say, all of those predictions proved to be very far from the mark.

[3] A recent instance in which creditor-government taxpayers indirectly financed interest payments to the commercial banks was an October 1988 "bridge loan" of $3.5 billion from the U.S. Treasury to the government of Mexico. This loan was made in advance of the accession to office in December 1988 of the new Mexican President, Carlos Salinas de Gortari. It was intended to facilitate continued interest payments by Mexico to its creditors during the transition period, at

Under pressure from the creditor governments, the major debtor countries (Argentina, Brazil, and Mexico) have struggled against the odds to keep paying the interest bill on their bank debt, despite the obvious and profound damage that the heavy interest payments are inflicting on their economies. Why they continue to pay has been a matter of considerable speculation, though the answer is really quite simple. Centrist, reformist governments like those of President Raul Alfonsín and President Miguel de la Madrid *want to play by the rules* and to work harmoniously with the creditor governments of the United States, Europe, and Japan.

The real question is not why the debtors are trying so hard to play by the rules, but rather why the creditor governments are shaping rules that are often politically dangerous for friendly, reformist, and democratic governments. In particular, why do the creditor governments continue to oppose a reduction in Latin America's debt to realistic levels?

Fortunately, the situation is not as hopeless as it seems to many. Latin America can surely escape from the present downward spiral of political and economic instability. There are realistic solutions to the crisis, solutions in which all of the major parties to the crisis (the commercial banks, the debtor nations, and the creditor nations) can achieve a satisfactory outcome. What is needed most of all is not new technical ideas but political leadership in both the creditor and debtor countries to implement some of the good ideas that have already been developed in recent years.

Several new approaches are described in this essay. Despite the superficial differences among these proposals, almost all are based on a set of shared ideas. First, the debt-servicing obligations of Latin American countries should be reduced in a sustained and predictable manner. Second, the extent to which the debt burden is reduced should be decided on a case-by-case approach, one that recognizes, for example, that Bolivia can pay a smaller share of its debt than can Argentina, which in turn can pay less than Mexico and Brazil. Third, debt reduction should be granted only to those countries that are pursuing internationally supervised programs of economic reform. Fourth, in return for accepting a reduction in debt-service payments, the commercial banks should receive from the official creditors partial or full protection against further losses, perhaps through official guarantees on the debt that remains after a debt-reduction operation.

This basic approach is now enshrined in U.S. legislation, although that

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a point when Mexico was losing foreign-exchange reserves at a substantial rate. In the announcement of the loan, the U.S. Treasury declared that the money would be bridged to future lending by the international financial institutions, mainly the World Bank. Tellingly, the World Bank did not have any plans in place for lending on this scale at the time of the bridge loan, and a team from the World Bank was quickly dispatched to Mexico the following week in order to identify new projects that could "justify" the loan *ex post*.

important fact is not yet widely known. In the Omnibus Trade Act of 1988, the U.S. Secretary of the Treasury is directed to "initiate discussions with such industrialized and developing countries as the Secretary may determine to be appropriate with the intent to negotiate the establishment of the International Debt Management Authority," an agency that would restructure the developing-country debt along the lines just outlined. The Secretary must pursue such negotiations unless he determines (in a study presented to Congress) that such negotiations would have major deleterious effects on the world economy. This legislation alone would make it vital and opportune to study the options for debt reduction.[4] As I show in section 5, the international debt facility offers a feasible and fiscally responsible approach to the crisis.

In the first half of the essay, I document the shortcomings that have become apparent in the "conventional approach" to the debt crisis and emphasize in some detail how all of the parties to the crisis are now being hurt by the current stalemate. In the second half, I analyze the leading proposals for moving into a new management of the crisis. Considerable attention is directed to the various proposals for an international debt facility along the lines of the new trade law. The discussion is not comprehensive; rather, the focus is on the handful of current proposals that most realistically meet the needs of the debtor countries, the commercial banks, and the creditor nations.

2 The Debt Crisis after Six Years

The Latin debt crisis has been managed since 1982 by the creditor governments, the international financial institutions (the IMF and the World Bank), and the money-center banks. From the inception of the crisis, the creditors have displayed optimism with respect to its outcome. Each debtor nation has been given the same message: if it continues to play by the rules (i.e. to make interest payments in a timely fashion, and to abide by IMF programs), it will receive new loans, promptly regain normal access to the international capital markets, and enjoy brisk economic recovery.

Despite six years of contrary evidence, the official optimism remains.[5] But

[4] The U.S. Secretary of the Treasury must submit a progress report concerning the International Debt Management Authority to the Congress within six months after the enactment of the Act (i.e. no later than February 1989), and a final report after twelve months of the enactment of the Omnibus Trade Act (i.e. by August 1989).

[5] The communiqué of the Group of 7 nations at the Toronto Summit is a case in point. The leaders of the Group of 7 affirmed that the current "market-oriented, growth-led strategy based on the case-by-case approach remains the only viable approach for overcoming [the] external debt problems [of the highly indebted middle-income developing countries]."

after approximately $150 billion of net resource transfers from Latin America to the creditor world since 1981, the promised benefits of faithful adherence to the creditor rules of the game have yet to materialize. The very procedure for debt management seems to have broken down. Contrary to creditor-government rhetoric, *most* Latin American governments do not receive *any* new loans from the commercial banks. The new loans they do receive are too small, too late, and too unpredictable to support economic recovery. No Latin American government has yet regained "normal access" to the capital markets. And almost no country in Latin America has enjoyed an economic recovery.

Outside observers of the crisis may be excused for believing much of the official optimism, for it is often conveyed in the press. Consider, as an example, this excerpt from the *Wall Street Journal* (Aug. 17, 1988):

> But many bankers and government officials reject gloom about the international debt outlook. While they concede a lack of leadership in the U.S. and in some debtor countries, they counter that in the two most important debtor countries—Mexico and Brazil—there have been substantial economic reforms, and that Mexico has had considerable success in building non-oil exports, to reduce reliance on a single export.

This point of view is doubly remarkable. First, the allegedly favorable situation in Brazil and Mexico is enough to dispel "gloom about the international debt outlook" for these bankers and officials even though Brazil and Mexico are only two of forty or so countries in the world in acute debt difficulties. Second, the optimism about Brazil and Mexico somehow neglects Brazil's current inflation, which hit 938 percent for 1988, as well as Mexico's deep political crisis, which is in part centered on widespread public opposition to continued payments on the foreign debt.

A bleaker assessment of Latin America's situation is conveyed by the data in the sections below, where I examine the economic situation of the debtor countries, the status of the Baker Plan, and the politicization of the debt issue in Latin America.

Economic Indicators

Table 1 shows recent changes in GDP and inflation in several important debtor countries, as well as the change in their per capita GDP since 1980. A first conclusion is inescapable: the economic crisis of Latin America is intensifying rather than diminishing. Argentina, Brazil, and Peru are on the brink of a hyperinflation; Ecuador is also in sharp crisis, with a rapidly rising inflation rate and falling output.[6] Mexico has recently stabilized its inflation

[6] Inflation rates in these four countries from June to August 1988 were much higher than even those in the table, with annual inflation rates reaching nearly 1,000 percent per year in Brazil and Peru, and 700 percent in Argentina.

TABLE 1

CHANGE IN PER CAPITA GDP AND INFLATION RATES FOR SELECTED LATIN AMERICAN COUNTRIES

Country	% Change in GDP (1986-87)	Growth in Inflation [a] (Dec. 1987-June 1988)	% Change in GDP (1980-87)
Argentina	−0.3	386	−14.7
Brazil	0.7	640	3.8
Ecuador	−6.2	77	− 7.3
Mexico	−0.8	99	− 9.1
Peru	3.8	363	− 4.2
Venezuela	−1.0	9 [b]	−20.4

[a] Rates of price increase expressed at an annual rate.
[b] Nov. 1987 to May 1988.

SOURCE: GDP per capita from CEPAL (1988).

rate (down from 200 percent in 1987), but the success of that stabilization program remains fragile in view of a deepening recession, political uncertainty, the sharp cuts in real wages in the past few years, and the intense and rising demands of people whose living standards have plummeted in the past decade.

Most of the major debtor countries are in the throes of a deep recession, and GDP per capita in many countries is expected to continue to decline. According to outside forecasts in the fall of 1988, per capita GDP in Brazil was expected to fall by about 2 percent in 1988, in Mexico by 4 percent, in Peru by 10 percent, and in Venezuela by 2 percent. In Argentina, per capita income, which was expected to fall sharply, might in the end rise slightly because of the rise in Argentina's export prices as a result of the U.S. drought in the summer of 1988. These widespread declines follow nearly a decade of continuous economic decline. Throughout Latin America, per capita GDP is now far below the levels of 1980. In Bolivia, the most extreme case of collapse, per capita income at the end of 1987 had fallen to the level of about 1965.

Even countries sometimes termed "economic success stories," such as Chile and Uruguay, are successes only in relative terms. Between 1980 and 1987, per capita output declined by 2.4 percent in Chile and 10 percent in Uruguay.[7] Colombia is the *lone* bright spot in Latin America in terms of per capita income growth, with an increase of 9 percent between 1980 and 1987.[8]

Nor do the prospects look much better for the debtor countries to regain

[7] The data are from CEPAL (1988).

[8] Remarkably, despite its growth and the timely servicing of its debt throughout the entire 1980s without a single rescheduling, Colombia remains severely constrained in its access to international loans, belying the standard creditor assertion that "good behavior" is rewarded by

creditworthiness in the financial markets. The debt/export ratios have not fallen below the high 1982 levels that prompted the crisis in the first place. On the contrary, as seen in Table 2, in most countries the debt/export ratios have risen sharply since 1982 and remain far above the levels that would be compatible with a return to normal access to the international capital markets during the next five to ten years. Indeed, contrary to the early expectations that creditworthiness would be restored by 1986 or 1987, the World Bank now puts the target date for renewed creditworthiness at "within the next five to seven years."[9]

TABLE 2

DEBT/EXPORT RATIOS OF SELECTED DEBTOR COUNTRIES [a]

(in percent)

Country	1982	1984	1986	1987 [b]
Argentina	405	461	536	554
Brazil	339	322	425	471
Chile	333	402	402	370
Colombia	191	254	198	235
Ecuador	239	259	333	464
Mexico	299	292	413	366
Peru	269	356	497	551
Venezuela	84	158	322	278

[a] Average gross external debt as a percentage of exports of goods, services, and private transfers.
[b] Projections.

SOURCE: *World Financial Markets* (1987).

Debt-servicing conditions also deteriorated in 1988 because of the sharp rise in U.S. interest rates. The key LIBOR rate, on which most international bank loans are based, rose by more than 3 percentage points between January and December 1988, and each percentage-point increase in interest rates added approximately $3 billion of interest-servicing costs.

The Baker Plan

The Baker Plan for "growth-oriented adjustment," the conventional approach to debt management, has six basic components:

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a quick return to the international credit markets. During 1988, Colombia attempted to raise new loans in order to refinance about $2.1 billion of principal falling due. The commercial banks were unwilling to refinance the maturing debt, pressing Colombia to settle for a partial refinancing instead. As of the end of 1988, the final terms of the refinancing were still in doubt, but there were indications that the bank creditors would agree to lend Colombia approximately $1.7 billion of the amortization payments coming due.

[9] See World Bank (1988, par. 34).

1. Interest payments on commercial-bank debt should be made on a timely basis at full market interest rates.
2. Principal payments due on commercial-bank debt and bilateral official debt should be rescheduled.
3. New lending by the commercial banks should be undertaken to refinance a portion of the interest due.
4. Debtor countries should submit to conditionality under the supervision of the IMF and the World Bank.
5. The international financial institutions (including the World Bank, the IMF, and the Inter-American Development Bank) should extend new loans on a high-conditionality basis.
6. Innovative financing arrangements (e.g. exit bonds, debt buybacks, and debt-equity swaps) between the banks and the debtor countries may be entered into on a "voluntary basis" as part of a "menu of options."

These six components are, in principle, to be tailored to each country according to a "case-by-case" approach. In the eyes of the creditor governments, the most important element of this approach has been that the debtor countries remain current on their interest payments.

Tables 3 through 6 describe the status of the Baker Plan. As seen in Table 3, the approach has broken down almost completely for many of the smaller debtor countries. For seven Latin American debtor countries (Bolivia, Costa Rica, Dominican Republic, Ecuador, Honduras, Panama, and Peru), the process of conventional debt servicing and new lending has by now collapsed: these countries have suspended debt-servicing payments (either partially or fully) to the commercial banks for more than one year. Among the large countries, Argentina also ran up considerable arrears to the commercial banks during 1988, but it has stated its intention of clearing the arrears in a timely manner.[10]

A "new-money package" is the misleading name often given to the third component of the Baker Plan—the commercial-bank lending that is supposed to be available to the debtor countries. The name is misleading because, as stressed below, the amount of new loans is invariably *less* than the money the country repays to the banks in debt servicing. On top of that, the new loans, meager as they have been, in practice have been available only to the big players (Argentina, Brazil, Chile, Mexico).[11] New-money

[10] As described below, the official creditors seem intent on putting enough new money into Argentina to make it possible for Argentina to clear most of the arrears with the private banks.

[11] Note that Brazil was the only country in Table 3 to receive "new money" in 1988. While a few of the smaller countries have once or twice been able to get a "new-money package" since 1982, only the large countries have been able to draw repeatedly on new bank lending. Even for the large countries, the lending has been far from routine. Typically, the loan packages have taken several months, and sometimes more than a year, to negotiate. The negotiations are

TABLE 3

STATUS OF DEBT NEGOTIATIONS FOR SELECTED LATIN AMERICAN COUNTRIES

Country	New-Money Package [a]			Commercial-Bank Arrears [b]		
	1985	1986	1987	1986	1987	Aug. 1988
Large countries:						
Argentina	Y	Y	Y	Y	N	Y
Brazil	N	N	N	N	Y	N
Chile	Y	Y	N	N	N	N
Mexico	Y	N	Y	N	N	N
Venezuela	N	N	N	N	N	N
Small countries:						
Bolivia	N	N	N	Y	Y	Y
Costa Rica	N	N	N	Y	Y	Y
Dominican Republic	N	N	N	Y	Y	Y
Ecuador	Y	N	N	N	Y	Y
Honduras	N	N	N	Y	Y	Y
Panama	N	Y	Y	N	Y	Y
Peru	N	N	N	Y	Y	Y
Uruguay	N	N	N	N	N	N

[a] Y indicates there was a disbursement in the calendar year from a concerted loan agreement. N indicates there was no disbursement.

[b] Y indicates the country had arrears at the end of the period shown. N indicates it did not. These data do not indicate how long the debt service had been in arrears.

SOURCE: New-money data from IMF; arrears data from Institute of International Finance in Washington (except for Dominican Republic, which is from World Bank).

packages are hard to put together and require the active participation of the U.S. government to close each deal.[12] The Treasury saves its energy and political clout for the large debtors, so that the smaller countries end up with little or no bank financing.

almost always fractious, with constant breakdowns, threats, and posturings that unsettle the financial markets and undermine stabilization programs.

[12] As has long been recognized (see e.g. Sachs, 1984), the new-money packages pose a "collective action" problem for the banks. The bank lending might make sense for the banks as a group (e.g. as a way of avoiding outright default), but each individual bank would like to keep its own money out of the loan package in view of the debtor country's lack of creditworthiness. To overcome the collective-action problem, the loans typically have a "concerted" character such that every bank is called upon to put in new loans in proportion to its outstanding claims on the country. Even with this kind of equal sharing, the packages are hard to cobble together, since the obligation to extend new loans in proportion to outstanding exposure is not legally binding on the banks, but rather part of a negotiated deal that each bank may or may not accept. The U.S. Treasury has often had to put tacit or explicit pressure on individual banks to get them to adhere to these overall agreements.