THE LOST DECADE OF DEBT CRISIS

After a period of continuous economic growth following World War II, Latin America lapsed into the "lost decade" of the 1980s. The handling of the debt crisis was one of the key reasons for this poor economic performance. But to understand the current debt crisis, the roots of the problem must be explored.

When the price of oil skyrocketed in the 1970s, many international banks found themselves with large amounts of "petro dollars" deposited by wealthy OPEC countries. These banks were eager to lend the money at low, sometimes negligible, interest rates. But they needed credit-worthy countries to recycle this new-found money.

Past high growth rates and high per-capita incomes singled out a group of Latin American countries as tempting targets for international banks. Loans were also tempting to the many Latin American countries facing balance-of-payments problems resulting from inward-oriented industrialization. The governments of these countries were faced with the options of severe economic adjustment (a politically unpopular decision) or incurring new commercial bank debt, which was being pushed by aggressive bankers.

The politically less costly route was followed. Abundant nonconditional funds were lent to several countries such as Mexico, Costa Rica, Peru, and Brazil. Governments accepted more and more international loans to sidestep the structural problems of reorganizing their economies.

In August of 1982, Mexico announced that it was unable to meet its scheduled repayments, marking the beginning of the debt crisis (although smaller highly indebted countries were already in default). As the crisis unravelled many of the problems of the international banking system became apparent.

Banking regulations in the industrialized countries, at that time, did not deal with their banks' international operations, particularly if they were in currencies other than the bank's country of origin. Thus, a bank's international decisions were not part of regulatory policy. It was also believed, somewhat naively in retrospect, that loans to a sovereign country were low-risk, and there was little discussion of the dangers of bank overexposure.

The debt crisis clearly revealed the overexposure of the large banks, particularly those in the United States. Both creditor and debtor governments agreed that a large financial crisis had to be averted. But the way the crisis was dealt with remains questionable.

The priority of the creditor governments was to protect the overexposed banks by preserving the book value of sovereign loans. This meant that debt owed to international banks by Latin American countries was preserved at an artificial level. The operation of market forces, which would normally tend to devalue financial assets committed on unsound premises, were suspended to the banks' benefit.

The "Case-by-Case" Approach

The case-by-case approach was developed around the logic of preserving the book value of the loans overexposed banks made to overindebted borrowers. Book value could be maintained, according to US regulations, if interest arrears did not fall behind by more than 90 days. This required adjustment by individual Third World debtor countries to generate a trade surplus to meet interest payments. One of the main goals of adjustment became maximizing interest payments from debtor countries to guarantee a return on loans for commercial banks.

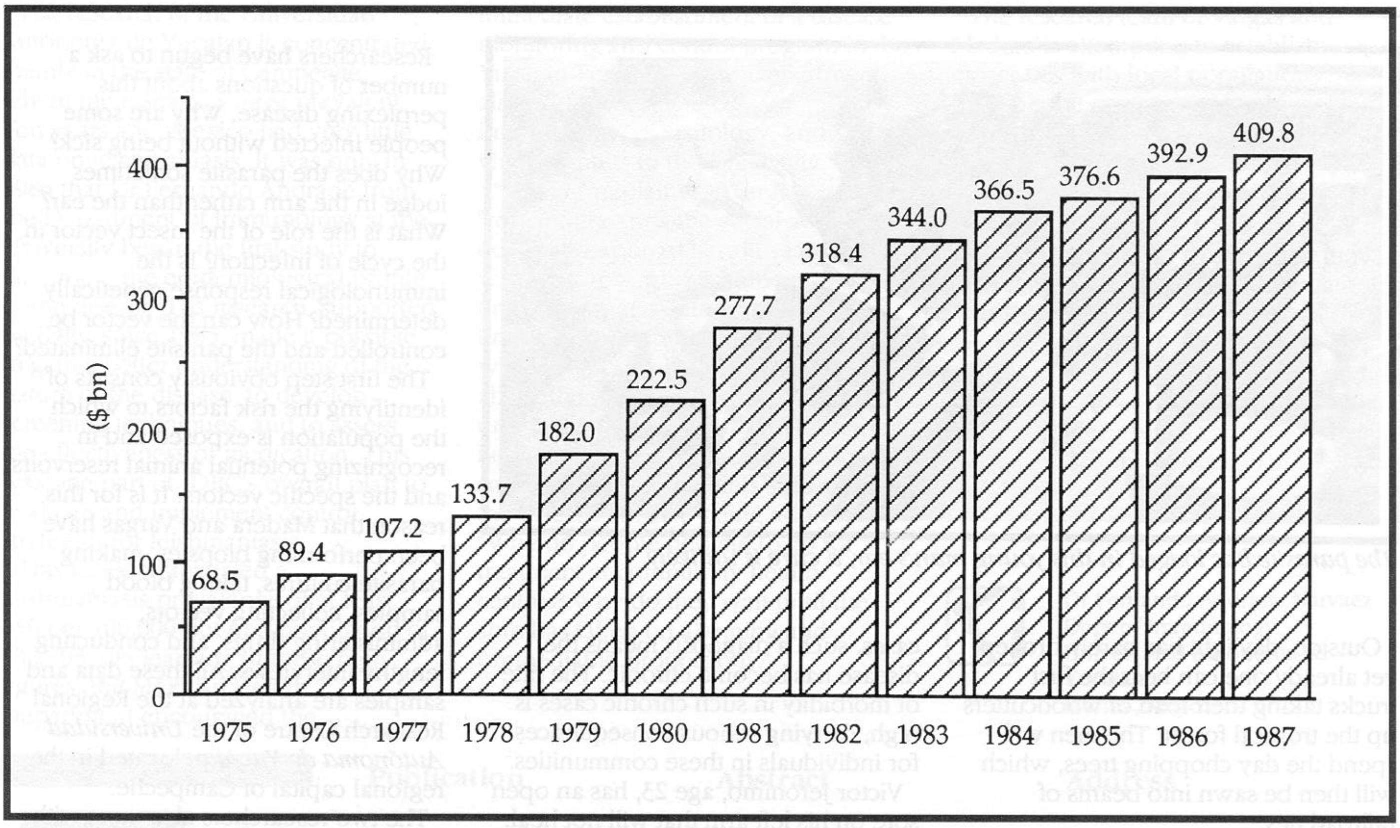
After inspection from the International Monetary Fund (IMF), the remaining financial gap in external obligations had to be met with "fresh" funds — more loans from multilateral and bilateral institutions and the commercial banks themselves. These loans were approved on the condition that structural reforms were made, thereby creating an environment for long-term growth. This method of refinancing was a tightly knit pattern of cross-conditionalities.

The first step in cross-conditionality emerged as each lending institution tended to condition its participation in each specific "case" to the participation of other agencies. Each agency had a list of specific conditions to observe before loans were made. Often these conditions were based on philosophical or political preferences for which there was no clear-cut technical or professional basis. A complex game of simultaneous negotiations followed in which any one agency could hold either other agencies or the country hostage in exchange for agreements to meet certain conditions.

A second stage in cross-conditionality appeared in the implementation of the individual programs. The performance criteria of any one agency also became conditions for loans from other agencies. The straitjacket was made even tighter in the loan agreements of the commercial banks, which included as conditions for disbursements or rescheduling all possible conditions in other agencies.

Closer cooperation among donor agencies became inevitable in the 1980s and this was, to some extent, desirable. But in terms of extensive cross-conditionalities it was costly and often counter-productive for Third World countries. Debtor countries were forced to jump through a series of difficult and, at times, conflicting hoops to either reschedule their debts or qualify for multilateral loans and grants.

Meeting interest payments on commercial bank debt made debtor countries increasingly reliant on the cash flows of multilateral agencies. But these loans and grants were negotiated and disbursed only under tight conditionality arrangements. As expected, debtor countries have been straining to achieve policy reforms under these restrictive conditions. Noncompliance to the conditions of the lending agencies has become the rule and not the exception.



Latin America: the inexorable growth of the foreign debt. Source: ECLAC

The key question is whether long-term economic growth and stability can be achieved in the face of adjustments tailored to meet interest rate payments for commercial banks. The desire to maximize interest payments has proven incompatible with economic growth and stability in many countries, especially those shifting from an inward to an outward looking development strategy. The "lost decade" in Latin America is, in part, the result of preserving the book value of commercial loans at the expense of other goals like growth and stability.

Signs of Change

There have, however, been signs of change over the past few years. The banking industry is undergoing deep structural changes as financial markets are becoming more and more integrated. Competition has increased as Japanese and European banks have displaced North American banks from top world positions.

As a result, undercapitalized banks are seeking new strategies to raise capital and improve their portfolio. In terms of sovereign debt, these strategies include selling or securitizing debt at a discount, increasing loan loss reserves above the required levels, and debt swaps of various kinds. Market solutions for Third World debt have become the norm.

An example was the Brady Plan, named after former US Treasury Secretary Niles Brady, which explicitly supported market solutions. It enabled Mexico and Costa Rica to organize restructuring exercises involving debt reduction, with the full participation of the World Bank and IMF.

The logic of preserving the book value of commercial loans is over but its impact in terms of lost growth is not. The discussion, however, may reappear regarding multilateral debt, which up to now has not been formally restructured. As a consequence of the "case-by-case" approach and the relative sizes of the economies, more countries are facing serious levels of overindebtedness to multilateral agencies. Another round of debt crisis, this time primarily in small countries, may be in the making.

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