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A U.S. STRATEGY FOR LATIN AMERICA'S DEBTS

INTRODUCTION

The international debt crisis began in August 1982 when Mexico failed to make interest payments on its borrowed funds. Shortly thereafter, most other Latin American countries joined Mexico teetering on the brink of default. The International Monetary Fund's (IMF) attempts to deal with the crisis have failed to get to the roots of the problem. U.S. observers periodically have heralded the end of the crisis, only to see it rear its head anew. Latin American countries owe nearly $400 billion, with Brazil's debt at $104 billion, Mexico's at $98 billion, and Argentina's at $50 billion.

The debt crisis has economic and political aspects that affect vital U.S. interests. Continuing economic stagnation in Latin America, for example, has reduced the region's purchase of U.S. goods. U.S. exports to Latin America dropped from $41.9 billion in 1981 to just $25.2 billion in 1983. The Latin American debt, moreover, poses serious problems for U.S. banks, which fear huge defaults. More generally, an economically depressed Latin America is a heavy drag on the world economy.

The past five years have seen a dramatic spread of democracy in Latin America. After years of dictatorship, for example, Argentina, Brazil, Uruguay, and Guatemala, among others, have held free elections. Yet the economic hardships resulting from the debt crisis threaten this democratic trend. Leftists and communists, including Cuban dictator Fidel Castro, are using the debt crisis and U.S.

support for IMF austerity policies to drive a wedge between Third World debtors and "imperialist" America.[1]

The U.S., however, deserves very little direct blame for the debt problem. To be sure, many U.S. banks behaved irresponsibly in the 1970s by making vast sums of credit available to Latin American countries which were becoming ever less credit worthy. More at fault were attempts by the IMF to encourage private lending to less developed country (LDC) governments. The major blame lay with the socialist and statist economic policies of the recipient governments. These policies, as those elsewhere in the Third World, inhibit economic growth, investment, and entrepreneurism and almost ensure that loans from the West will not be used productively.

Once debt difficulties emerged, moreover, the IMF reflexively has attempted to deal with them through austerity measures. These wring short-term loan payments from debtor countries at the expense of long-term economic growth. The Reagan Administration's new Baker Plan, by contrast, correctly emphasizes the need of debtor countries to turn away from destructive statist economic policies and to allow the free market to work. So far, however, the Baker Plan lacks the detail necessary for drafting specific policy options. Further, the Administration wants the World Bank to administer the Plan but is uncertain whether the World Bank staff will cooperate. Even more serious could be the resistance of Latin American debtor countries to the Baker Plan's market-oriented structural economic changes that could threaten the entrenched bureaucrats and politicians who owe their power to government control of the economy.

The Reagan Administration should expand and flesh out the Baker Plan. It should establish standards to encourage debtor countries to move toward market-oriented policies. Specifically, a U.S. strategy for dealing with the Latin American debt should:

1) provide technical information, preferably through the World Bank, on how to privatize state enterprises;

2) explore the possibility of converting parts of the Latin American debt into equity shares in enterprises in debtor countries;

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1. J. A. Hobson in his classic study of imperialism wrote that: "The economic root of Imperialism is the desire of strong organized industrial and financial interests to secure and develop at the public expense and by the public force private markets for their surplus goods and their surplus capital." In democracies like the U.S., the public expense of giving large sums of money to multilateral lending institutions and debtors such as Mexico to enable repayment of loans to banks must be indirect through taxation upon income and property. J. A. Hobson, Imperialism (Ann Arbor, Michigan: University of Michigan Press, 1972).

3) encourage more trade between the U.S. and debtor countries, and among the debtor countries themselves, by reducing trade barriers;

4) spotlight and reward those countries that move toward market policies;

5) refuse to grant additional funds to multilateral lending agencies unless these funds are used to promote effectively market-oriented policies.

CAUSES OF THE CRISIS

U.S. and International Monetary Fund Policies

U.S. government-mandated interest rate ceilings in the 1970s, combined with high inflation and prohibition of interstate banking, prompted many U.S. banks to lend money overseas. As a result, in the late 1970s many U.S. banks made imprudent loans in developing countries. Most of the loan money went not to the productive private sector but directly to foreign governments, many of questionable stability or economic responsibility.

In the 1970s, the IMF sought to induce private banks to lend money to LDC governments promising implicitly to guarantee these loans against defaults. Such risk-free loans attracted billions of dollars into questionable investments.

Latin American Government Policies

The basic cause of the Latin American debt crisis was, and is, the economic strategies of these countries. They viewed the state and state-run or influenced enterprises as the engine of economic growth. In most cases, therefore, funds borrowed from U.S. banks went to finance high wages for state bureaucrats, to prop up inefficient state-owned or controlled enterprises, and to line the pockets of corrupt politicians. The power of the public sector grew at the expense of the private sector. Though the debt burden was growing, Latin American countries gambled that inflation would continue raging in the U.S., thus enabling them to repay their debts with cheaper dollars. They guessed wrong. Falling U.S. inflation rates are forcing debtors to repay their debts with near full-value dollars. Meanwhile, falling prices for such Latin American export commodities as oil, agricultural products, and minerals have caused revenue declines at the same time that real interest payments on loans increased.

TWO DEBT STRATEGIES

The IMF Austerity Approach

When the IMF has agreed to help a nation burdened with debt, its strategy typically has been to generate hard currency for debt payments. In exchange for receiving its loans, therefore, the IMF makes LDCs agree to adopt such austerity measures as currency devaluation, limiting the printing of money, and reducing budget deficits.

While some IMF loan conditions reflect sound economic policy, others tend to have negative long-term effects. For example, high taxes on the productive private sector discourage economic growth. Import restrictions meant to keep hard currency in the country can hinder economic growth by cutting off businesses from imports essential to productivity.

IMF austerity measures fail to get to the root of the debt crisis: the statist economic policies of the debtor countries. Austerity programs often provide a short-term solution at the cost of long-term economic growth. For example, until recently Mexico was able to meet IMF conditions and generate revenues for debt payments through increased exports to the U.S. Yet during this period, its domestic economy stagnated, inflation and unemployment continued to rise, real wages and investment fell, and the size of the public sector grew.

IMF loan conditions are resented by most LDCs as U.S. attempts, through the IMF, to squeeze interest payments out of poor countries for the benefit of big U.S. banks. During the last year, Latin American governments such as Argentina, Brazil, and Peru have refused to accept such conditions and have sought alternate ways of dealing with their debt problems.

The Baker Plan

In late 1985, U.S. Treasury Secretary James A. Baker unveiled a new U.S. approach to the debt crisis. Baker's program calls for comprehensive structural changes in debtor economies to promote growth. The Baker Plan, for example, encourages debtor countries to reduce the state's role in the economy by selling off state-owned enterprises and by providing tax incentives for private investments and productive economic activity. Exchange rates would be set by the market, and direct foreign investment and freer trade encouraged. In return, Baker called on U.S., Japanese, and European banks to advance $20 billion in new loans to LDCs in the next three years. The Baker Plan also envisions an expanded role for the World Bank. Besides new lending, the Bank would serve as the primary agent for promoting growth policies in LDCs in exchange for loans.

PROBLEMS WITH THE BAKER STRATEGY

The Continuing IMF Role

IMF austerity policies and free market, growth-oriented policies are often in conflict. If the IMF continues to loan money to debtor nations on the condition that austerity measures be implemented, the economic growth envisioned by the Baker Plan could be undermined.

Implicit Federal Guarantees for Private Bank Loans to LDCs

Private foreign banks are understandably reluctant to extend new loans to debtor countries. Banks will no doubt seek an implicit U.S. government guarantee to make good on such loans in case of default. In addition, already overexposed banks would likely drag the U.S. government deeper into the debt morass, putting added pressure on the government to cover much of the currently outstanding $400 billion in Latin American loans as well.

The World Bank

Baker's attempt to use the World Bank to promote market policies in LDCs is likely to encounter bureaucratic resistance. Historically, the Bank's lending policies reflect a commitment to centralized development planning and development through large industrial projects. These lending policies far overshadow the few successful attempts to make loans conditional upon adoption of market-based pricing and other nonstatist policies. While some mechanisms for market-based lending exist in the Bank, the tendency has been to ignore them.

It is doubtful, moreover, whether Bank personnel have the technical competence or commitment to apply growth policy guidelines to the particular circumstances of the various debtor countries. Typically, World Bank loans go to specific projects. Yet general loans not tied to projects may be precisely what LDCs need to help with the adjustment of shifting to a less statist economy. Example: A nonproject loan could provide a cushion to allow an LDC to cut taxes, because in the short run, tax cuts could lead to a drop in revenues; eventually, of course, lower taxes stimulate economic growth, which boosts tax revenues.

But such assistance would be needed during the adjustment period. Once a debtor country has money in hand, it is questionable whether it will follow through on structural change. During the last few years, various LDCs have regularly failed to meet IMF conditions set in exchange for loans.

Using the World Bank to promote growth policies in debtor countries will be a formidable task. The U.S. cannot automatically dictate Bank policy. The appointment of former U.S. Representative Barber Conable as the new World Bank President is encouraging. Conable is well aware of the importance of the free market. As an early advocate of tax cuts in the 1970s, he understands that incentives are necessary for economic growth. But Conable will have to exercise strong and aggressive leadership if he is to move the Bank in the direction envisioned by the Baker Plan.

LATIN AMERICAN RESISTANCE

Debtor nations will probably resist growth policies strongly. Seasoned (and successful) bureaucrats and politicians in these countries rightly would view such policies as a threat to their approach to economic development, their political power structure, and their relationship with the U.S.

Western Statist Ideas

While Latin America's authoritarian past and culture may explain some of its resistance to free market ideas, many statist policies prevalent there stem from European and American economists who saw the Depression of the 1930s as a failure of market capitalism. When Latin American leaders sought advice from the industrialized world in the quarter century after World War II, they were often told that state direction, economic planning, and redistribution of wealth were necessary. For example, President John F. Kennedy's Alliance for Progress conditioned financial and technical assistance on national planning schemes.

Latin American Misunderstanding of Market Principles

A major source of statist ideas has been the U.N.-chartered Economic Commission for Latin America (ECLA). The famous and still current "dependency theory" of ECLA's Harvard-educated Argentine director, Raul Prebisch, warned that free trade led to impoverishment of the underdeveloped world and its dependency on the industrialized world for goods. In place of importing goods, argued such theorists, developing countries should produce their own products for their domestic markets. This strategy is known as import substitution. It turned out to be an extremely costly recipe for economic disaster. On top of it, foreign investments were often prohibited; they were, after all, "imperialistic." Instead, government borrowing was the only means to import foreign capital.

This economic philosophy, which contributed considerably to the debt crisis, is still widely accepted in Latin America, particularly

among intellectuals and university professors. It has spawned general mistrust of market principles.

Most Latin Americans still see the state as the primary agent of social and economic change. Individual initiative, freedom, and self-reliance are viewed as insufficient for economic growth. Most Latin American leaders have little principled concern for the dangers of state power. Occasional market-oriented reforms are allowed for short-term, practical economic reasons. Since many private businesses receive state subsidies and trade protection, even businessmen often lack the incentive to change the system. Such statist "pro-business" policies are often perceived as the essence of the "free market" and are rejected by many intellectuals and leaders in favor of even more statist policies of state ownership.

Threat to the Power Elites

A free market economic policy would take economic decisions out of the hands of the government and allow such decisions to be made by private businessmen and consumers. To denationalize industries, to privatize banking and credit, to reduce government regulations, to allow free trade and unrestrictive international capital flows, and to cut the portion of gross national product (GNP) consumed by the public sector would, by definition, reduce the power exercised by government elites and institutionalized interest groups. In cases such as Mexico, the ruling party's power is based on its ability to grant government jobs to its followers (bureaucrats then become the base of its power) and to punish businesses, private organizations, or individuals that challenge its authority.

The Left and the Debt Crisis

As the economic crisis deepens in Latin America and its people grow more desperate for solutions, the political opportunities for radical and communist parties will increase throughout the region. From their viewpoint, the Latin American debt crisis presents the possibility of greater cooperation among a diverse range of political groups against Western "imperialism." In Moscow's Kommunist the Argentine Communist Party leader writes "It is only now [in Latin America]...that communists, and social Democrats, Christian democrats and radical, and people with the most diverse political beliefs have gathered together in one hall. In this stronger coordination of positions on the problems of foreign debt lies our strength."[2]

The main targets of the Left are the labor unions which are nationalistic but not necessarily leftist. The debt crisis and the consequent economic hardships will, according to Communist Party

2. Kommunist, FBIS, Soviet Union, November 5, 1985, Annex, p. 7.

statements, provide the bridge with the increasingly dissatisfied workers. In Argentina and many other Latin American countries, labor support is intricately linked with political stability. For the newly established democracies who must support a hefty debt burden, Communist Party and leftist dominated labor unions would jeopardize the future of democracy. While the end of democracy in the region would not necessarily be ominous for the banks since leftist and communist regimes have yet to repudiate their debts, it would pose new security dilemmas for the U.S. and remaining democratic states in the region.

So far leftist optimism may be premature. The June 1985 Havana meeting for debtors called by Fidel Castro failed to produce a collective response among Latin American leaders against the West. Now with interest rates falling and the terms of debt repayment easing, Castro's efforts to create solidarity among debtors seem even less likely.

Debtor Unity

The Cartagena Group of eleven nations, the so-called Latin debtor's club, has sought a united front against creditors. The Group calls for interest rate reductions, a cap on the amount of export earnings used for debt service, and more new lending than envisioned by the Baker Plan.

Thus far, the debtors have been unable to force substantial changes in repayment terms. This is because the banks have themselves successfully acted as a bloc, offering individual credit-hungry debtors attractive rescheduling terms and at the same time threatening to cut debtors off from vitally needed credits. The individual debtors, even those as rhetorically radical as Argentina, have adopted their own economic programs to meet creditor demands. Argentina introduced a new currency, the Austral, promised not to print new paper money to cover budget deficits, and for the time being, has frozen wages and prices. The result: inflation has dropped from nearly 2,000 percent in June 1985 to around 25 percent currently. Brazil recently introduced similar reforms. These debtor countries are unlikely to risk these politically difficult and hard-earned gains, and endanger future access to hard currency, by militant collective action with their less well-off neighbors. For this reason, the radical position taken by Peruvian President Alan Garcia to limit debt payments to 10 percent of exports has failed to engender a collective movement despite the public endorsements of Garcia's action by almost all the Latin American debtors.

The oil price plunge has further fractured debtor unity since some debtors benefit and others are harmed by it. The most recent Cartagena meeting, called by oil exporters Mexico and Venezuela to formulate a response to the oil price crisis, failed to produce a consensus on the necessary course of action. Paradoxically, the Group

agreed to support any unilateral "action taken by a debtor against its creditors." This was a disappointment to Mexico, which had hoped to elicit concrete support for an interest rate cap.

RECOMMENDATIONS

Latin American debtor countries can help themselves economically by restructuring their economies along market principles, with sharp reductions in the size and scope of government. The U.S. can help them in a number of ways. Among them:

1) The Administration should develop standards to determine the degree to which debtor countries are adopting market-oriented policies.

While the Baker Plan's emphasis on promoting market-oriented policies is laudable, much more detailed guidelines need to be developed. Such guidelines should focus on debtor countries' policies toward taxes, foreign investment, trade, state-owned enterprises, and business regulations. The advantages of the market approach, along with the disadvantages of statism, should be highlighted. Since change will be slow, special attention should be given to what constitutes acceptable progress. Initially these principles should be based on the strictest market philosophy. Application to the circumstances of each country would be made later. The more the international debate focuses on the principles of economic growth, the better for the forces of free enterprise.

2) The World Bank should make information on how to privatize state enterprises available to debtor countries.

Debtor countries wishing to privatize costly state-owned enterprises face technical and political difficulties. For example, there must be guarantees that the transition not unduly disrupt essential services. Resistance from employees and customers of state enterprises, politicians, and state bureaucrats must be overcome. For example, attempts by Argentina's President Raul Alfonsin to privatize such state enterprises as the telephone company and several oil and steel companies met with resistance within his own cabinet and political party.

Techniques and strategies for privatization have been developed in the U.S. and Britain. Successful privatization efforts have yielded valuable lessons. Yet much of this information is unavailable and unknown in debtor countries. The World Bank itself has experts knowledgeable in these matters. Until now, however, their services have been underutilized. The Bank should devote substantial resources and efforts to the collection and distribution of information on privatization.

3) Banks should explore the possibility of capitalizing the Latin American debt.

A partial solution to the debt problem would involve banks forgiving loans owed by debtor countries in exchange for equity shares in state-owned, Latin American enterprises. Along these lines in Chile recently, Bankers Trust was able to convert Chilean foreign debt notes into local currency, which was then applied to the purchase of a private pension fund. Although in this case the debt was converted into private equity, it set the stage for conversions of debt into public equity. Such a solution would not only ease the debt crisis but would jibe with efforts to privatize state enterprises: portions of such companies could be set aside for debt liquidation efforts. Certain U.S. regulations would have to be changed to permit U.S. bank participation. Three-party deals also might be worked out where the banks sell portions of their Latin American loans (no doubt at less than face value, as a means of writing down these bad loans) to other private companies. Such companies would in turn forgive these debt portions in exchange for shares in the LDC state companies. Newly privatized companies with shares held by private foreign companies also would have better access to much needed capital for expansion and modernization.

Such a plan would meet with much initial resistance from all sides. Banks would be reluctant to sell loans at less than face value. Debtor countries dislike foreign ownership of equity in their domestic enterprises. But given the fact that both the debtor governments and the imprudent banks are in part responsible for the current crisis, this solution would be equitable and would not require the U.S. taxpayer to foot the bill.

4) There should be a new emphasis on freer trade between the U.S. and the debtor countries.

Free trade, essential for economic growth, is crucial for debtor countries. To gain the hard currency needed to pay debts as well as to invest in future growth, these countries must export. If the U.S., the major market for many debtor countries, erected protectionist barriers, these countries simply could not earn the needed funds and would default. Free trade must be a two-way street. Latin American countries must open their markets more to U.S. goods. The U.S. should offer to negotiate Free Trade Areas with any Latin American country that desires completely open markets.

5) Debtor countries should attempt to promote freer trade.

Latin American countries have harmed themselves not only by restricting the import of U.S. goods but by keeping their markets closed to each another. After World War II, Western European countries formed a common market to promote their own economic growth

and freer trade with one another. The Latin countries, in contrast, have made only half-hearted efforts to liberalize trade. The U.S. should promote freer trade between the debtor countries as a major part of its debt strategy and a condition for U.S. assistance. President Febres Cordero of Ecuador is currently seeking freer trade with his fellow Andean Group countries of Bolivia, Chile, Colombia, and Peru. The U.S. should aid this effort. The U.S. should also focus attention on the Latin American Free Trade Association, which includes Argentina, Brazil, Chile, Mexico, Paraguay, Peru, Uruguay, Colombia, and Ecuador, and encourage this group to move ahead with their stated aim of trade liberalization.

6) The good debtor nations should be pointed to as good examples.

When debtor countries follow growth-oriented policies, the Administration should praise them publicly, noting their achievements, encouraging imitation by others, and increasing state visits and other forms of prestige boosting. If necessary, economic changes beyond the Baker Plan, such as special trade arrangements, should be made.

Currently Ecuador stands out as most deserving of such treatment. Ecuador's President Leon Febres Cordero is committed to free market principles and has sought not more handouts from banks or multinational lending agencies, but rather, direct foreign investments.

7) The Administration should not grant additional funds to the World Bank or to other multilateral development banks.

The current debt crisis is not caused by a past lack of international lending. To the contrary, the staggering size of the debt indicates that too much was lent irresponsibly. The World Bank actually has a surplus of funds. Additional funds or loan commitments to multilateral development banks will contribute little to the resolution of the crisis and might well be counterproductive, perpetuating irresponsible lending.

The Administration should support replenishment only if the World Bank, under its new President, can carry out the Baker Plan's growth-oriented policies. In the long run, if debtor countries adopt such policies and invite direct foreign investments, the World Bank itself could be privatized. Since most of the Bank funds are currently borrowed on the market, the Bank would simply take the next logical step and become a private concern.

CONCLUSION

Imprudent lending practices of the U.S. banks and U.S. banking laws that drove capital overseas themselves were in part responsible for the Latin American debt crisis. Yet the growing magnitude of the debt, which has reached around $400 billion, stems primarily from the statist economic policies of the debtor countries themselves. Restrictions on direct foreign investments, costly import substitution schemes, inefficient state-owned industries, high taxes, and counterproductive state regulation of the market have led to the need for massive government borrowing as well as to the waste and squandering of such borrowed funds. The only long-term solution to the debt crisis is to move the Latin American debtors away from socialist policies and toward market-oriented growth policies.

A shift away from destructive IMF-imposed austerity measures and toward the growth-oriented market policies envisioned by the Baker Plan offers some possibility for meaningful economic change. The IMF should work with the World Bank to promote such market policies. And the new World Bank President, Barber Conable, should make implementation of the Baker Plan philosophy his top priority.

The Latin American debt crisis poses a serious threat to the U.S. and the world economy. Dealing with this crisis is a formidable task. Yet the causes of the crisis are known and the market policies necessary to solve the problem are clear. The debtor countries themselves now recognize the folly of many of their socialist policies. If the Reagan Administration, the World Bank, and the IMF work with Latin American leaders to promote and implement market policies, the debt problem could be solved once and for all.

Esther Wilson Hannon
Policy Analyst

and

Edward L. Hudgins, Ph.D.
Walker Fellow in Economics