

The Role of the Commercial Banks in the Latin American Debt Crisis

■ *Tom Crowley*

Changes in the international financial system in the 1970s and 1980s produced a large increase in commercial bank lending to Latin America, despite the increased risks. This led to the emergence of the debt crisis which threatened the stability of the international financial system. This article examines the factors which led to increased lending and the banks' overexposure, how the banks responded to reduce this overexposure and the current debt status of Latin America. It concludes with a survey of the lessons to be learnt from the crisis.

Introduction

At the end of 1990, the total external debt of developing countries stood at US\$1,280 billion. This compares with a total external debt of US\$846 billion in 1982, the year when the debt crisis emerged. As this data reveals, the debt burden is extremely high for developing countries. This is especially true in the case of two groups of developing countries: severely indebted middle-income countries (SIMICs)¹ and the severely indebted low-income countries (SILICs).

These two groups can be distinguished by the fact that the SILICs, consisting mainly of countries of Sub-Sahara Africa

(SSA), owe most of their debt, approximately 80 per cent, to official creditors. While the SIMICs, consisting mainly of Latin American countries, owe most of their debt, about 60 per cent, to the commercial banks. This article is concerned with debt-distressed commercial borrowers of Latin America, which captured world attention in 1982, when they posed a serious threat to the international financial system.

By now, the changes in the conduct of global macroeconomic policies which precipitated the debt crisis are well known. In brief, the expansionary policies of the industrialised countries, after the first oil price shock of 1973, resulted in low real interest rates and high commodity prices. Under these circumstances, developing countries were able to sustainably expand their borrowing. The second oil price shock of 1979 led to a different policy response by the industrialised countries. They addressed this shock by pursuing restrictive monetary and fiscal policies. This in turn led to a rise in real interest rates and an ensuing world recession which led to a decline in commodity prices. These factors proved costly for developing countries, as they had to contend with higher debt service payments at a time when their foreign exchange earnings were constrained. During 1979-82 many Latin American countries relied increasingly on bank lending to service their external debt and cover their balance of payment deficits. This unsustainable situation eventually culminated in the debt crisis.

The purpose of this paper is to examine how the changes in the international financial system during the 1970s and 1980s, which were a response to changes in the global macroeconomic environment, contributed to the emergence of the debt crisis. Specifically, what needs to be examined is how the changes in the international financial system facilitated such a dramatic increase in commercial bank lending to Latin America in the 1970s, and subsequently, how the international financial system sought to resolve the threat posed to its stability during the 1980s.

The paper is divided into three sections. Section 1 examines the factors which facilitated bank lending to Latin America and resulted in banks' overexposure to these countries. Section 2 examines the banks' response to the debt crisis and how they successfully reduced their exposure over time. Section 3 examines the current status of the debt situation in Latin America and seeks to draw some lessons from the experience of the debt crisis.

1. The emergence of the commercial banks' overexposure to Latin America

From a financial perspective, two important factors led to the eventual overexposure of banks to Latin America. One was the unregulated nature of the Eurocurrency market while the other was the inadequacy of country risk analysis.

Development of the Eurocurrency market

The emergence of the Eurocurrency market provided the mechanism whereby the commercial banks could recycle the unspent surpluses of the Organisation of Petroleum Exporting Countries (OPEC) after 1973.² According to Lever and Huhne the banks were happy to undertake this role of recycling the OPEC surpluses, as they had developed the conviction that there was no risk in lending to foreign governments and therefore sovereign lending offered to be one of the most profitable areas in banking history.³ Indeed, the banks were reinforced by the approval and encouragement of their governments, who felt that such a recycling of surpluses was necessary to maintain the demand for their exports.⁴ Also, OPEC liked the role that the banking system had undertaken, as it supported the ability of their poorest customers to meet the oil price rises. A closer look at the Eurocurrency market is merited to establish why it was an unstable system on which to base sovereign lending.

Essentially, the Eurocurrency market is a market where banks trade in deposits and loans which are denominated in a currency other than that of the bank's location. The market had its origin in London. The US dollar was and still remains the main currency being transacted. The importance of the OPEC surpluses to the growth of this market is witnessed by the fact that the market's estimated worth increased from US\$1,000 billion in 1971 to US\$1,500 billion by 1981.⁵ The growth of the Eurocurrency market is seen as an important component of the internationalisation of capital which characterised the post-

World War II global economy. It was the mechanism which allowed banks to become involved in sovereign lending. However, according to Loxley the following have made this market, on which sovereign lending was based, an unstable one.

- It lacks regulation; indeed its growth owes much to a desire of US banks to avoid a strict regulatory environment (for example, limits on interest rates that banks could pay on deposits). In the 1960s as US credit expansion was curbed, banks found that Eurocurrency markets were attractive as they were free of regulations.
- As deposits are typically short term, with a maturity of less than six months, and loans are usually contracted for between three and eight years, the market is vulnerable due to a mismatch of maturities and changes in the interest rate. To deal with this problem, loans are “rolled over” every three to six months so that the interest charged is adjusted to changes in world interest rates. Thus, by using variable rates, the interest rate risk of mismatched maturities is passed on to the borrower.
- “Lender push” was encouraged by the syndication of loans. In order to reduce their exposure to a particular loan, banks participated in loan syndicates. In this way banks only bought a share of a particular loan.⁶ These loans were arranged by a group of “lead managers” – banks which would act as middlemen between developing countries and other smaller syndicate members. This business was especially lucrative for the lead banks which obtained a one-time syndication fee and usually levied a small fee for acting as a repayment agent. As a result, there was an incentive by lead banks to “push” loans in order to increase the fees they earned.
- The Eurocurrency market is also highly integrated into major money and financial markets. This is especially true for US markets as the Eurocurrency market competes against treasury bills for dollar savings. Thus, when the US raises its interest rates, the Eurocurrency market rates quickly follow suit and this makes the borrowers vulnerable to policy changes in the industrialised world, as happened after the second oil-price shock in 1979.

Many authors have argued against the wisdom of using the Eurocurrency market for financing development.⁷ They contend

that the short term finance provided by this market was not appropriate for long term development projects. Also, the role that the commercial banks played in financing balance of payment deficits represented a departure from the system which had operated since 1945, whereby the International Monetary Fund (IMF) was responsible for the orderly financing of balance of payment surpluses and deficits. The 1970s saw the commercial banks taking over this role from the IMF. Between 1973 and 1983, the commercial banks financed 44 per cent of Third World countries' current account deficits.⁸

Inadequacy of country risk analysis

Although the growth of the Eurocurrency market and its role in recycling OPEC surpluses provided the mechanism and funds for sovereign lending, it was the banks that ultimately decided how much funds would be made available to Latin America. In hindsight, it would appear that the banks made bad decisions. To understand why banks committed so much resources to Latin America, the process of bank lending needs to be examined more closely. Essentially, the banks' overexposure to Latin America was based on the premise that countries could not go bankrupt. It is interesting, therefore, to examine the country risk analysis (CRA) system which banks employed which led them to such a false conclusion.

In assessing a country's credit worthiness, a bank tries to determine the ability of the country to repay its borrowings. For sovereign loans a banker has to consider two risks: political risk and sovereign risk. Here we will only examine the assessment of sovereign risk.

Sovereign risk

The concept of sovereign risk relates to the economic or financial factors which would impede a borrower's ability to accumulate enough foreign exchange to meet debt service obligations on foreign loans. A country may face two problems in accumulating the resources to service its debt: it may become insolvent and/or illiquid.

Solvency refers to the debt servicing ability of a country over a long period. For a country to sustain its debt in the long term, it

is essential that the rate of growth of the economy in real terms should be as great as the real rate of interest on the debt.

Liquidity refers to a country's cash position. It is important that a country has cash to make payments which fall due, because this ensures the confidence of the international capital markets in a country. According to Lomax a country is liquid if the cash available from exports is adequate to meet all the cash requirements such as imports, service payments, and amortisation.⁹ Liquidity tends to be a more stringent constraint than solvency for an indebted country. This is because, while solvency relates gross national product (GNP) and export growth to the interest cost of debt, liquidity involves comparing cash available net of all financial outgoings which include amortisation and the possibility of a cash drain from the cancellation of a credit line. Liquidity problems can arise in two ways: A country can mismanage its liquidity policy leading to a loss of confidence by the market even though the underlying debt might not be problematic. Or a country may be moving towards insolvency which would mean that the market would be reluctant to provide funds.

However, all crises will show themselves eventually as liquidity crises although the initial causes may be either liquidity mismanagement or the development of a solvency crisis. An indication that a country may be obtaining a poor return on its debt programme and a signal of an impending solvency crisis is provided by the following ratios.

- Debt/GNP = total debt as a percentage of total GNP;
- Debt/exports = total debt as a percentage of total exports;
- Debt/service = interest repayment and amortisation as a percentage of total exports.

Upward movement in these ratios in the late 1970s and early 1980s indicated that a debt problem was emerging. It can be seen from Table 1 that during the early 1970s the debt ratios remained stable. However, they increased rapidly in the late 1970s and the early 1980s, after the second oil-price shock, which reveals that the debt situation was becoming more precarious. However, the banks continued to lend increasing sums of money to Latin America in the 1979-82 period (Table 2). It is appropriate, therefore, to examine what inherent weakness in the banking system led to such a paradoxical situation.

Table 1: Debt ratios for selected countries (in percentages) for public and publicly guaranteed debt

| | 1970 | 1975 | 1978 | 1980 | 1981 | 1982 |
|------------------------------|-------|-------|-------|-------|-------|-------|
| Argentina^a | | | | | | |
| Debt/exports | 87.5 | 87.0 | 86.0 | 90.9 | 89.5 | 163.3 |
| Debt/GNP | 8.8 | 8.9 | 16.0 | 18.2 | 19.2 | 29.1 |
| Debt service | 21.5 | 22.0 | 27.0 | 17.7 | 18.2 | 23.3 |
| Brazil^b | | | | | | |
| Debt/exports | 103.7 | 140.0 | 208.0 | 171.3 | 166.1 | 212.5 |
| Debt/GNP | 7.7 | 11.4 | 14.8 | 16.3 | 17.0 | 18.6 |
| Debt service | 12.5 | 17.9 | 31.0 | 34.5 | 33.6 | 43.3 |
| Mexico^c | | | | | | |
| Debt/exports | 108.9 | 179.0 | 223.3 | 136.7 | 140.5 | 185.3 |
| Debt/GNP | 91.1 | 13.1 | 25.3 | 18.7 | 18.6 | 33.1 |
| Debt service | 23.6 | 24.9 | 54.9 | 31.9 | 27.9 | 33.9 |
| Venezuela^d | | | | | | |
| Debt/exports | 87.5 | 87.0 | 86.0 | 90.0 | 89.5 | 163.3 |
| Debt/GNP | 8.8 | 8.9 | 16.0 | 18.2 | 19.2 | 29.1 |
| Debt service | 21.5 | 22.0 | 27.0 | 17.7 | 18.2 | 23.6 |

a: p.257; b: p.277; c: p.329; d: p.361

Source: World Bank, (1986), *World Debt Tables, External Debt of Developing Countries*, Washington DC, World Bank, p.257, p.277, p.329, p.361.

Table 2: Disbursements of public and publicly guaranteed debt by the financial markets to Latin America and the Caribbean (US\$ millions) 1970-82

| Year | Amount | Year | Amount |
|------|----------|------|----------|
| 1970 | 1,407.0 | 1980 | 23,144.0 |
| 1975 | 8,065.0 | 1981 | 28,176.8 |
| 1978 | 24,682.4 | 1982 | 24,630.7 |

Source: World Bank, (1986), *World Debt Tables, External Debt of Developing Countries*, Washington DC, World Bank, p.250.

Reasons for increased lending despite increased risks

A number of reasons have been offered to explain the inadequacy of banks' analysis of the risks involved in sovereign lending.

- One reason is that there was no agreement as to what could be considered as “safe” ratios. Lomax suggests that the debt service ratio should not rise above 20-25 per cent,¹⁰ while Roddick states that bankers contend that 50 per cent is the cut-off point.¹¹ Thus, depending on the definition used, different authors suggest different levels for the ratios. Clearly, the lack of agreement on “safe ratios” highlights a weakness in early CRA to provide a sound measure of the risk inherent in sovereign lending. However, rising trends in the debt ratios should have indicated that a country may be heading towards a solvency and/or liquidity crisis.
- Carvounis points to the fact that it was during the 1970s that bankers first sought to assess country risk.¹² While in the corporate sector bankers received the views of rating agencies and had vast experience of analysing companies themselves, they had little experience of CRA. This led to a plethora of CRA models. The predictability of these models was questionable.¹³ The relatively recent emergence of CRA is evidenced by the fact that literature on the topic only began to appear in the late 1970s.
- Risk analysis undertaken tended to be on the level of individual countries. Few banks examined the international political-economic environment and its effect on the lending risk of individual economies. This was a costly oversight, as the fact that so many countries experienced difficulties at the same time provides evidence that factors in the external economic environment, (such as an increase in real world interest rates and a fall in commodity prices), were responsible to an important extent for the onset of the crisis.
- Information available to the bankers was also limited. While information was available from the World Bank, the Bank for International Settlements (BIS), the Development Assistance Committee (DAC) of the Organisation for Economic Cooperation and Development (OECD), and the International Monetary Fund (IMF), Holley points out that this information was deficient in both consistency and timeliness.¹⁴
- Bankers with whom the present writer has spoken have pointed out that the “herd instinct” played a key role in the increased exposure of many smaller banks. The feeling existed that if the larger banks found this a lucrative market

then they too should become involved. Of course, the smaller banks generally did not have the resources to undertake their own country-risk analysis.

- One of the main factors that undermined CRA was the underlying perception that countries cannot go bankrupt. Given that the world economy had enjoyed a period of uninterrupted growth after World War II, few bankers anticipated the recession of the early 1980s. As a result, most CRAs were based on the assumption that growth would continue and that Latin America would have continued access to western financial markets.

Since the onset of the debt crisis in 1982, banks have become much more concerned with improving CRA. The 1970s provided a learning experience which banks will utilise in the future. According to Loxley “only with generalised economic contraction, when credit-worthiness tended to decline across the board . . . did risk analysis departments gain prominence in bank decision making.”¹⁵

The threat to the international financial system

The events of 1982 posed an immediate threat to the stability of the international financial system. The commercial banks were extremely vulnerable to bankruptcy should any of the major debtors have repudiated their debt. Table 3 illustrates the overexposure of US banks to developing countries. In 1984, US banks' capital was approximately 65 per cent of their external claims on developing countries. By a combination of increasing their capital (for instance by increasing their loan-loss reserves) and diversifying themselves of claims on developing countries, the US banks reduced their exposure so that by 1990 their capital was more than two times their external claims on developing countries.

Table 3: Claims by US banks on developing countries relative to capital

| | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 ^a |
|---|--------------------|--------|--------|--------|--------|--------|-------------------|
| | (in US\$ billions) | | | | | | |
| External claims on developing countries | 140.8 | 128.8 | 118.6 | 108.8 | 93.2 | 78.8 | 67.7 |
| Total assets | 1413.0 | 1529.0 | 1613.0 | 1633.0 | 1670.3 | 1770.0 | 1802.3 |
| Capital | 92.2 | 105.4 | 116.1 | 129.2 | 135.6 | 145.2 | 147.0 |
| <i>Memorandum items</i> | (in per cent) | | | | | | |
| Capital to total assets | 6.5 | 6.9 | 7.2 | 7.9 | 8.1 | 8.2 | 8.2 |
| External claims on developing countries to total assets | 10.0 | 8.4 | 7.4 | 6.7 | 5.6 | 4.5 | 3.8 |
| Capital to external claims on developing countries | 65.5 | 81.8 | 97.9 | 118.8 | 145.5 | 184.3 | 217.1 |

a: first three-quarters of 1990

Source: IMF, (1991), *International Capital Markets; Developments and Prospects*, Washington DC, IMF, p.99

During the 1970s the banks had sought to reduce their exposure to individual countries when granting loans by maintaining a portfolio of loans to different countries. What emerged in 1982 was widespread debt servicing difficulties across Latin America at once, thereby rendering useless the banks' portfolio approach to reducing risks. This approach failed, as few banks had examined the international political-economic environment and were therefore caught unaware by the widespread debt difficulties experienced by Latin American countries.

2. Resolving the threat to the international financial system

Initially, the debt crisis was perceived as a crisis for the international financial system. The banks' overexposure to Latin America left them very vulnerable. Had any major debtor country defaulted on their debt many banks would have faced collapse and the stability of the international financial system could have been jeopardised. Therefore, the initial concern of

the banks in 1982 was to preserve the value of their assets. This was necessary as the banks had not sufficient loan-loss reserves to absorb defaults on loans by major debtors. To protect the value of their assets it became imperative that debt servicing be maintained.¹⁶ Seen in this context, it can be seen that the initial official response to the debt crisis was primarily concerned with averting an international financial crisis.

The first response to the debt crisis was to reschedule debt.¹⁷ This allowed for debt servicing to be maintained while at the same time debtor economies implemented deflationary policies in order to generate balance of payment surpluses which would provide the necessary foreign exchange to service their debt in the future. A major actor involved in the rescheduling process was the IMF. According to *The Economist* the IMF's main role was in protecting the interests of the banks.¹⁸ Indeed Loxley has criticised the IMF for protecting the banks while debtor countries had to bear the burden of the debt crisis by undertaking IMF-induced "austerity" programmes.¹⁹ Adjustment in debtor countries during the 1980s came at such a high cost, in terms of declining real per capita incomes, reduced expenditure on social services and so forth, that it has become known as the "lost decade" for development. Table 4 outlines that the adjustments undertaken by the heavily indebted countries (HICs) were growth impeding. This was especially true in the years 1982-85 where a reduction in the balance of payments deficit was at the expense of lower imports and lower investment. Also, average growth in the HICs fell from 1.3 per cent in the 1978-81 period to a negative rate of growth of 1.9 per cent in the 1982-85 period. However, improvement is witnessed at the beginning of

Table 4: Economic indicators for the HICs 1978-91

| | 1978-81 ^a | 1982-85 ^a | 1986-89 ^b | 1990 ^b | 1991 ^b |
|---|----------------------|----------------------|----------------------|-------------------|-------------------|
| Economic growth: | | | | | |
| per capita real GDP (%) | 1.3 | -1.9 | -0.05 | -0.4 | -0.5 |
| Investment/gross capital formation (% of GDP) | 25.3 | 18.8 | 19.6 | 19.9 | 20.3 |
| Import volumes (annual changes in %) | 5.7 | -10.8 | 4.3 | 9.4 | 9.9 |
| Balance of payments current account (US\$ billions) | -32 | -16.2 | -9.5 | -23.8 | -25.4 |

a: IMF (1986: 185-215) b: (1992: 111-131)

Sources: IMF, (1986), *World Economic Outlook*, Washington DC, IMF, April, pp.185-215; IMF, (1992), *World Economic Outlook*, Washington DC, IMF, May, pp.111-31.

the 1990s, where an increase in both investment and imports indicate that these economies should face better prospects for growth in the 1990s.

The subsequent official response to the debt crisis, the Baker Plan of 1985, was to promote adjustment with growth. This was similar to the rescheduling approach to the debt crisis, except that it involved US\$29 billion of new lending to the indebted countries. It also marked a departure from the original approach to the debt crisis in that it acknowledged future adjustment in developing countries should involve growth, thereby implicitly acknowledging the debt crisis was such for the debtor countries as well as the banks. Ironically, both these approaches resulted in debt distressed countries becoming increasingly indebted.

Both rescheduling and later the Baker Plan bought time for the banks which allowed them to reduce their exposure to the debtor countries. According to Heller the banks had in 1987, by establishing substantial loan-loss reserves, significantly reduced the risk of systemic failure that might have endangered the international financial system.²⁰ Indeed, the reduction of the banks' exposure to Latin America facilitated their participation in the 1989 Brady Initiative. The idea behind this initiative was to reduce the oppressively large debt servicing burden, thereby freeing resources for urgently needed imports and economic growth. This approach to the debt crisis acknowledged that all the debt could not be repaid in full, and therefore part of it should be written off. The remainder of this section looks at the procedures and innovative measures that the banks employed to reduce their exposure to Latin American debtors.

The secondary market for debt

The secondary market is one where banks sell loans at a discount. The market arose from the banks' desire to manage and offload their non-performing debt after 1982. The price of debt on this market is a reflection of the percentage of the face value of the debt which the market expects to be repaid. For instance, if Brazilian debt is sold at a discount of 50 per cent this would be analogous to saying that only half of the debt is expected to be repaid.

The secondary market has been an important mechanism in allowing banks to manage their risks by increasing the liquidity of their assets. In fact, the market has proven quite profitable and, over time, institutional investors have been attracted to it. Its profitability can be illustrated using a simple example.

Suppose Brazilian debt has a face value of US\$100 million and carries an interest rate of 10 per cent. If this is sold on the secondary market for US\$50 million, then, provided Brazil continues to service this debt, the purchaser of the debt will obtain a return of 20 per cent on the investment, *ceteris paribus*.

Trading volume on the secondary market has increased greatly since 1985 and is estimated to have exceeded US\$100 billion by 1991. This increased volume of trading has added greatly to the efficiency of the market and the liquidity of debt as an asset. Trading, however, has been concentrated in four Latin American countries, with Argentina, Brazil, Mexico and Venezuela accounting for 80 per cent of total trading.²¹

The emergence of the market has provided a mechanism which would allow debt reduction. The fact that debt is traded at a discount has prompted debtors to argue that it is not fair that they should be required to service the debt at face value. The existence of this market, therefore, adds weight to debtors' demands for debt relief.

Loan-loss provisioning

Loan-loss provisioning is the process by which banks set aside resources or increase their reserves against the possibility of some loans not being repaid. The provision is debited against the profits of a bank for the year in which they are made. These profits are set aside in a reserve account which is debited as and when expected losses materialise. If, on the other hand, loans prove sound, these reserves are re-added to profits. Thus, provisioning plays a crucial role in determining the tax liability, profitability and capital adequacy of banks.

Banks in different creditor countries face a diversity of supervisory, accounting and tax regulations governing loan loss provisioning. According to Abbott the level of provisioning has tended to be higher in continental Europe than elsewhere.²² This is because in Europe banks are allowed to offset provisioning for unrealised losses against current tax liabilities. However, in Japan and the US, only a specific proportion of provisions is allowed to be offset against tax liability. Thus, Japanese and American banks have tended to carry lower provisions. Table 5 highlights the major differences in the way reserves against developing country debt are treated by various countries.

Table 5: Conditions relating to loan loss provisions against developing country debt in selected countries

| Country | Inclusion in capital | Tax deductibility | Mandatory requirements |
|----------------|----------------------|-------------------|------------------------|
| Canada | No | Up to 45% | Yes |
| France | Yes | Yes | Yes |
| Germany | No | Yes | No |
| Japan | Yes ^a | No ^b | No ^c |
| Switzerland | No | Yes | Yes |
| United States | Yes ^b | No ^c | No ^c |
| United Kingdom | No | Yes | Yes |

a: Non-tax deductible only

b: Up to 1% of existing loan can be tax deductible

c: Mandatory provisioning required for selected countries, tax deductible

Source: World Bank, (1990), *World Debt Tables 1990-1991: External Debt of Developing Countries*, vol 1, Washington DC, World Bank, p.88

Levels of provisioning

At the onset of the debt crisis, provisions for bad debts by the commercial banks tended to be very low. This made them very vulnerable. Time gave the banks an opportunity to consolidate their positions by building up reserves against bad debts. May 1987 proved to be a turning point in the way banks viewed the crisis. At this time Citicorp, the largest bank involved in sovereign lending, set a precedent by dramatically increasing its loan-loss reserves to US\$5 billion. Other banks followed suit. By increasing their reserves, banks acknowledged that quite a significant proportion of their loan portfolio was not worth its face value.

Westlake has argued that by 1991 some banks' provisions were excessive. He points to the fact that Midland Bank had provisions of 57 per cent on its debt, while the same debt was traded at a discount of 55 per cent.²³ Indeed, the high level of provisions has made the secondary market for many banks quite profitable.

The effects of provisioning

Abbott has outlined three effects of provisioning:²⁴

- Provisioning strengthens the banks' balance sheets and reduces the threat that bad debts pose to the banks

- Provisioning has made banks less willing to provide new money and engage in rescheduling exercises. As banks are able to absorb debtor default, they no longer feel obliged to supply debtors with new money. Also, according to the IMF, highly-indebted countries found it difficult to raise new commercial loans because of the lack of flexibility in the provisioning requirements of creditor countries.²⁵
- Increased provisioning has made it attractive for creditor banks to engage in debt reduction activities since the losses which they would otherwise have sustained have been substantially reduced.

However, it should be noted that increased provisions do not reduce the overall liability of the debtors. It does however signal that the loans are risky and are worth considerably less than their nominal value.

Swapping third-world debt

The financial community has been very innovative in its approach to the debt crisis. A number of financial instruments have been developed in conjunction with the secondary market for debt, which have enabled banks to reduce their exposure to developing countries. Some have also allowed for debt and debt service reduction. The most important of these instruments is the debt-equity swap, though others exist which employ the same principle such as debt-peso swaps, debt-debt swaps and debt for nature swaps.

Debt-equity swaps

These involve the purchase by a firm, usually foreign, of sovereign debt at a discount from the bank holding it. The foreign firm then presents the debt to the central bank in exchange for local currency which is then used to buy equity in a company of that country. The result is the conversion of existing debt into equity, wiping out the interest and amortisation obligations and substituting an equity obligation instead.

Effects of debt swapping

Dezeri has highlighted the following benefits and problems involved in swapping debt:²⁶

- Swaps are an effective means of cancelling foreign debt, of eliminating foreign interest payments, and therefore conserving international reserves.
- Debt-equity swaps attract much needed foreign investment and contribute to the privatisation efforts undertaken under the auspices of structural adjustment programmes.
- They have proved to be an efficient means for attracting back “capital flight”.
- They allow banks to rid themselves of non-performing sovereign debt.
- They provide foreign investors with a cheap way of financing foreign investment.
- Swaps, however, may induce inflation and higher interest rates. This can occur as follows: the central bank of a country may increase the money supply in order to pay back the debt in domestic currency, or else the central bank may borrow domestically in order to pay back the debt. This would mean that external debt is being substituted for internal debt which may be more expensive, as interest rates tend to be higher in developing countries due to distorted markets.
- Debt swaps may induce economic and political fears in relation to foreign control as a country is selling its capital stock and natural resources to non-residents at a discounted price.

Swaps have offered some help in alleviating the foreign debt difficulties of Latin American countries. Swaps, however, form only part of the solution since the use of such instruments is constrained by their potential inflationary impact. Thus the benefits are relatively small vis-à-vis the debt problem.

During the 1980s, banks have successfully employed swaps, the secondary market for debt and increased loan loss provisions to mitigate the threat to the international financial system.

3. Recent developments and some lessons to be learnt from the debt crisis

Is the debt crisis over?

In the sense that the debt crisis was originally perceived, that of a threat to the international banking system, the crisis has been over for some time. The average developing country exposure of the commercial banks of the industrialised world had fallen from 83 per cent of equity capital in 1987 to 21 per cent of equity capital in 1991.

Fiddler maintains that from the viewpoint of the debtors the debt crisis may not be over.²⁷ Table 6 reveals that there have been improvements in income, investment and inflation in recent years. However, most of this recent economic recovery in Latin America is accounted for by Argentina, Chile, Mexico, and Venezuela. The apparent lesson provided by these countries, according to the World Bank is that sound economic policies together with debt reduction, which are promoted under the auspices of the Brady initiative, have led to economic recovery.²⁸ The rapid fall in interest rates during 1991 and 1992 is also responsible for the improved outlook. This fall has produced the beneficial effect of reducing debt servicing burdens and has encouraged capital inflows into Latin America as low returns in the US have forced investors to seek the higher returns available in Latin America. While the prospects for the above mentioned countries are good, some Latin American economies still remain overloaded by debt.

Table 6: Economic indicators for Latin America 1990-93 (%)

| | 1990 | 1991 | 1992 | 1993 |
|---------------------------------------|-------|-------|-------|------|
| Real per capita GDP growth | - 2.1 | 0.8 | 0.6 | 2.1 |
| Gross capital formation (as % of GDP) | 19.7 | 20.8 | 21.2 | n.a. |
| Inflation | 648.3 | 162.5 | 140.0 | 25.3 |

Source: IMF, (1992), *World Economic Outlook*, Washington DC, IMF, May, pp.111-13.

Whether the recent economic recovery in parts of Latin America is sustainable remains to be seen. The outlook is positive provided the pace of reforms and debt reduction are maintained. Sustained recovery from the crisis also requires that Latin American countries do not experience an adverse movement in their trading position or in interest rates.

Another debt crisis?

A recent trend since 1990, which has accompanied the economic recovery in certain countries of Latin America (Argentina, Mexico, Chile and Venezuela) has been improved access to international capital markets. In the region as a whole, capital inflows increased from US\$5 billion in 1989 to over US\$40 billion in 1991.²⁹ This development has led to worries that these new capital inflows could lead to another debt crisis, which followed the large capital inflows of the late 1970s and early 1980s. Fiddler points out that there are significant differences between these inflows and those in the late 1970s and early 1980s, which should reduce the risks of a rerun of the debt crisis.³⁰ Some of these differences are:

- Currently, governments are balancing their budgets and controlling inflation while previously budget deficits and inflation were increasing.
- The structure of capital inflows is also different from that which existed in the late 1970s where capital inflows were largely in the form of bank loans, with interest rates floating along with US rates. Now, there is a more varied mix of capital inflows including equity, more borrowing at fixed interest rates and direct investment. In 1991 equity inflows accounted for approximately US\$20 billion of the US\$40 billion in private capital inflows.³¹ This signals a return to the situation which prevailed before the upsurge in commercial bank lending, where equity was the most important source of external finance. Equity as a source of finance offers the advantage that it does not create a debt and dividends, unlike interest payments, are only paid in the event of investment success. Also, much of the new debt consists of fixed rate bonds rather than floating rate debt.

One problem facing recipient countries, is that quite a significant proportion of these new capital inflows are of a volatile short term

nature (money attempting to capture profits from interest rate differentials or foreign exchange market inefficiencies). One estimate suggests that Mexico's dependence on such short term capital, to cover its current account deficit, makes up between a third and a half of its total capital inflows.³² Dependence on short term capital to finance balance of payments deficits carries risks similar to those of bank lending, as this type of capital can flee as quickly as it arrives.

Some lessons of the debt crisis

If another debt crisis is to be avoided some important lessons must be drawn from the experience of the 1980s.

One of the most important lessons from the point of view of external financing of developing countries is that short term volatile capital is a poor alternative to long term, fixed interest rate financing. The experience of bank lending, based on the Eurocurrency market, has amply illustrated this fact. It is to be hoped that this lesson will be remembered by Latin American countries who are regaining access to the international capital markets. In essence, financing development using short term bank loans (or any other source of short term volatile capital) is analogous to purchasing a house with a bank overdraft. Capital inflows in the form of long term equity participation proves to be a much more stabilising form of foreign finance. If external borrowing is necessary then, ideally, it should be of a long term maturity and carry a fixed rate of interest. Fixed rate bonds and official development finance usually meet these criteria.

The 1980s have also provided an important learning experience for the banks. An important lesson is the necessity of improving the CRA system employed by banks so as to include the external political-economic environment which has proved to be an important factor in determining a country's creditworthiness.

The 1980s should have also banished the popular myth that countries cannot go bankrupt. If a country becomes so heavily indebted that it cannot repay its debts, then it will not repay them. The only viable response then is that both debtors and creditors share the burden of bad debts. This implies that banks should have sufficient loan loss provisions established to meet such bad debts, if and when they arise. This would mitigate the threat to the stability of the international financial system that

any future debt problem would pose. It would also expedite the sharing of the burden between debtors and creditors. Because of a lack of sufficient loan loss reserves in 1982 the debtors had to bear the burden of the crisis until such time that the banks had built up their reserves and were, thereby, able to write down some of the debt.

Footnotes

1. The SIMIC group is composed of Algeria, Argentina, Bolivia, Brazil, Bulgaria, Congo, Core D'Ivoire, Ecuador, Mexico, Morocco, Nicaragua, Peru, Poland, Syrian Arab Republic and Venezuela.
Another grouping which includes the major commercial debtors in Latin America is the IMF's grouping of heavily indebted countries (HICs). The fifteen HICs consist of: Argentina, Bolivia, Brazil, Chile, Colombia, Cote d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia.
2. According to Carvounis some US\$49 billion in so-called petrodollars found their way into western banks between 1974 and 1976. Of the OPEC surplus of US\$240 billion in 1979 some US\$96 billion were deposited in western banks. See C. Carvounis, (1984), *The Debt Dilemma of Developing Nations*, Westport, Quorum, p.45
3. H. Lever & C. Huhn, (1985), "Debt and danger", in A. Farman, ed, (1988), *The Developing World*, Dublin, DESC, p.265
4. Evidence of this is provided by Lomax who quotes from a speech by G. William Miller, US Secretary of the Treasury, at the 1979 IMF/World Bank annual meeting: "We all recognize that private markets will . . . have to play by far the major role in channelling financing from surplus to deficit nations". D. Lomax, (1986), *The Developing Country Debt Crisis*, London, Macmillan, p.25
5. J. Loxley, (1986), *Debt and Disorder: External Financing for Development*, London, Westview Press, p.67
6. This made negotiations in the 1980s difficult as each loan could involve a large number of banks.
7. See C. Hardy, (1979), "Commercial bank lending to developing countries: supply constraints", *World Development*, 7(2) pp.189-97; H. Lever & C. Huhn, (1985), op.cit.; J. Loxley, (1986), op. cit.; A. Seira, (1979), "The world economy, external debt and prospects for development financing", *World Development*, 7(2), pp.125-33
8. J. Loxley, (1986), op.cit., p.9.
9. D. Lomax, (1986), op.cit., pp.63-4
10. Ibid., p.74
11. Indeed Roddick points out that in 1981 Mexico had a debt service ratio of 65.5%. This is different from the figure in Table 1 and highlights the difference in data produced by different sources. Roddick's figure is higher as it includes all debt, not just public and publicly guaranteed debt. See J. Roddick, (1988), *The Dance of Millions: Latin America and the Debt Crisis*, London, Latin America Bureau, p.29.
12. C. Carvounis, (1984), op.cit., p.48
13. For a review of the various approaches to sovereign risk analysis see S. Heffernan, (1986), *Sovereign Risk Analysis*, London, Allen and Unwin.
14. H. Holley, (1987), *Developing Country Debt: The Role of the Commercial Banks*, London, Routledge and Kegan Paul, p.19
15. J. Loxley, (1986), op.cit., p.74

16. The US banks were subject to strict rules on assets in their portfolios, especially loans with interest in arrears. If interest payments fell more than 90 days in arrears US banks were obliged to take such interest into profits only on a cash rather than an accrued basis. After 180 days loans were classed as "value impaired" and required the allocation of loan loss reserves out of profits.
17. Rescheduling consists of extending the maturities on the principal of a debt and also the grace period before interest payments have to be made. It is often associated with refinancing whereby new loans are made available so the debt servicing can be maintained.
18. *The Economist*, "Sisters in the wood: a survey of the IMF and the World Bank", 12 October 1991, p.31
19. J. Loxley, (1986), op.cit., p.117
20. H. Heller, (1987), "The world debt crisis after five years. Where do we stand? Where do we go?" *World of Banking*, 6 (6), pp.26-9
21. World Bank, (1991), *World Debt Tables 1991-1992: External Debt of Developing Countries*, Washington DC, World Bank, p.23.
22. G. Abbott, (1989), "Loan loss provisioning", *Intereconomics*, 25 (25), pp.233-40
23. M. Westlake, (1991), "Bulls buoyed by Brady bonanza", *Banker*, Oct. pp.50-4
24. G. Abbott, (1989), op.cit.
25. For instance, a country may have a mandatory level of provisioning which its banks have to undertake against developing country debt. The higher this mandatory level, the more expensive it would be for banks to give a loan to a developing country, as loan loss provisions must be written off against profits. See IMF, (1991), *International Capital Markets: Developments and Prospects*, Washington DC, IMF, p.70
26. K. Dezeri, (1990), "Debt equity swaps: solution or illusion?", *Savings and Development*, 3(14), pp.219-30
27. S. Fiddler, (1992), "Nightmare begins to fade", Latin American Finance and Investment Survey, *Financial Times*, 6 April 1992
28. World Bank, (1991) op.cit.
29. A. Nicholl, (1992), "Solution passes the test of time", *Financial Times*, 30 July 1992, p.4
30. S. Fiddler, (1993), "A rerun of the debt crisis", Latin American Finance and Investment Survey, *Financial Times*, 29 March 1993
31. A. Nicholl, (1992), op.cit., p.4
32. S. Fiddler, (1993), op.cit., p.1.

