

K
NWC
ESSAY
91-1P

LATIN AMERICAN DEBT

By Cdr. Fred Bertsch

**NATIONAL DEFENSE UNIVERSITY
LIBRARY
SPECIAL COLLECTIONS**

Report Documentation Page

Form Approved
OMB No. 0704-0188

Public reporting burden for the collection of information is estimated to average 1 hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Washington Headquarters Services, Directorate for Information Operations and Reports, 1215 Jefferson Davis Highway, Suite 1204, Arlington VA 22202-4302. Respondents should be aware that notwithstanding any other provision of law, no person shall be subject to a penalty for failing to comply with a collection of information if it does not display a currently valid OMB control number.

1. REPORT DATE 1991		2. REPORT TYPE		3. DATES COVERED 00-00-1991 to 00-00-1991	
4. TITLE AND SUBTITLE Latin American Debt				5a. CONTRACT NUMBER	
				5b. GRANT NUMBER	
				5c. PROGRAM ELEMENT NUMBER	
6. AUTHOR(S)				5d. PROJECT NUMBER	
				5e. TASK NUMBER	
				5f. WORK UNIT NUMBER	
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) National War College, 300 5th Avenue, Fort Lesley J. McNair, Washington, DC, 20319-6000				8. PERFORMING ORGANIZATION REPORT NUMBER	
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)				10. SPONSOR/MONITOR'S ACRONYM(S)	
				11. SPONSOR/MONITOR'S REPORT NUMBER(S)	
12. DISTRIBUTION/AVAILABILITY STATEMENT Approved for public release; distribution unlimited					
13. SUPPLEMENTARY NOTES					
14. ABSTRACT see report					
15. SUBJECT TERMS					
16. SECURITY CLASSIFICATION OF:			17. LIMITATION OF ABSTRACT	18. NUMBER OF PAGES 16	19a. NAME OF RESPONSIBLE PERSON
a. REPORT unclassified	b. ABSTRACT unclassified	c. THIS PAGE unclassified			

SUMMARY

The Latin American region carries a heavy debt to export ratio. That ratio causes conditions which threaten U.S. national security interests.

High debt to export ratios cause domestic economic growth impediments and increase inflationary pressures. These in turn encourage higher taxes and duties, hamper investment, and discourage job creation. The end domestic result for Latin American countries is a decrease in general living conditions with a resultant increase in the instability of the government in power.

U.S. national interests are threatened by:

- Declining U.S. markets in Latin America
- Loss of U.S. domestic jobs
- Negative effects on U.S. trade deficit
- Increasing tensions between U.S. (creditor) and Latin American (debtor) governments
- Increases in drug production in Latin America in response to high unemployment
- Instability -- to include nuclear proliferation, terrorism, and population pressures -- in proximity to the continental U.S.

The goal of the U.S. is to bring about an orderly decrease in the debt and debt service of Latin American countries.

ISSUE DEFINITION

In an era of finite and declining resources which can be allocated, the U.S. must find ways in Latin America to:

- stimulate economic growth so that there is an improvement in capability to service outstanding debt.

- reverse capital flight so that new funds are available for investment

- reduce debt and debt service requirements

BACKGROUND/ ANALYSIS/CURRENT POLICY

Background Rapidly increased Latin American debt began in the early 1970s with the OPEC increases in oil prices. Some debt difficulties occurred in the 70s but the overall problem did not emerge until 1982 when most of Latin America had to reschedule external debt. Latin American debt was \$16 billion in 1970, rose to 161 billion in 1978, and then exploded to 360 billion in 1983. With the restructuring of debt in 1982/3, new capital became scarce but debt did increase to 441 billion by 1988. Since then overall debt has fallen slightly to 426 billion dollars. Dependent on the country, between 80 and 90 percent of all debt is privately held.

In the late 1970s and early 80s, exchange rates in most Latin American countries were overvalued. This

overvaluation of currency led to large trade deficits and capital flight. The world economy during that period was undergoing deterioration. Interest rates increased dramatically, economic activity declined, and real commodity prices plummeted.

Higher interest rates in creditor nations increased debt service burdens on the debtor nations. Declining economic activity caused real decreases in economies and thus real decreases in gross domestic product. Lower commodity prices resulted in lower export earnings in Latin American countries thereby lowering GDP.

The second half of the 80s saw a reversal of many of the adverse external conditions which Latin American debtor nations were facing. Interest rates on loans fell, world economic activity increased, and, because the dollar was depreciated, exports which were tied to the dollar became more competitive. Unfortunately, primary export product prices continued to fall. This led to a loss in export revenues with a resultant continued increase -- at a slower pace -- in debt ratios.

Analysis Debt held by foreign countries is difficult to deal with by debtor nations. Debt is held in currency other than domestic, and therefore, the claim against debtor nations represents a real claim which cannot be inflated

away. Actual goods and services must be delivered to generate foreign exchange necessary to retire and service debt. Resultantly, domestic living standards decrease.

Debt represents a real drain of resources from debtor nations. In 1988 there was a net transfer of \$30 billion out of Latin America. Incurring additional debt burden as a means of spreading out burden over time is not an option because of credit unworthiness. Growth is a means of decreasing debt burden but cannot be used because growth requires increased imports of capital goods and intermediate products. Simply stated, there is not enough foreign exchange capital or foreign investment capital available for the imports.

Over the past seven years, debtor adjustment programs were expected to improve credit worthiness of debtors and allow a return to voluntary lending by creditors. This has not happened. Now there is real concern that conditions may deteriorate further. Investment has declined sharply. This in turn has effectively decapitalized the countries.

Many debtor nations have attempted to run trade surpluses to earn dollars to service debts. This is done primarily by depreciating their currencies to gain competitiveness, restricting imports, and expanding exports as much as possible. All of these actions end up being perceived as a

threat to world trade. Countries which use them often have their exports restricted in the U.S. markets. Restriction in turn lowers their ability to service debts.

There is also bad news on the creditor side of the equation. Private creditors are increasingly seeking to have taxpayers take over more of the creditor burden either through government expanded loans or guarantees.

Default on loans is also a very real problem. Default by debtor nations would make domestic capital scarcer as the loans are written off the books and the creditors value is decreased. Additionally, repudiation of loans could very well be the catalyst for a banking crisis of major proportions. Even if a banking crisis could be averted, the cost of money would likely increase dramatically and cause a slowdown of investment in the domestic U.S. economy.

The debt burden is increasing tensions between the U.S. and debtor nations. Impositions placed on debtor nation economies to deal with debt burden pose a threat to the governments of those nations. Fear of radicalization is growing. Debt reduction is required to ease political tensions and improve Latin American domestic markets. This in turn would allow the Latin American countries to buy more imports from their dominant trading partner to the north. Strengthening of U.S. Latin markets would improve our

balance of trade. Domestic market improvements in Latin America would have favorable impacts on environmental concerns, human development concerns, and technology transfer.

The impact of the debt crisis in 1981-3 caused measurable effects which could be extrapolated to the present situation should the burden not be reduced. In the United States, the Commerce Department has estimated that each \$1 billion in exports sustains approximately 25,200 jobs. During the 81-3 recession, declining U.S. exports to Latin America accounted for a loss of nearly 400,000 jobs and an additional 500,000 have been lost since. It is clear that economic progress in developing nations has both a direct and an indirect impact on the economic performance of the United States.

On a macro level, the U.S. economy is tied into the larger world economy. If the world economy takes a downward plunge, the U.S. economy suffers as markets are reduced, capital dries up, interest rates rise, and defaults go up.

Current U.S. Policy The U.S. has shifted from a passive policy of encouraging debt restructuring to one which writes down debt and helps refinance loans. Policy is now governed by the Brady plan which was announced in March of 1989.

In general, the plan calls for creditor banks to agree to voluntarily reduce the value of their claims by cutting principal or interest in return for guarantees on the remaining portions of their debt. During negotiations between banks and debtor nations, banks are presented with options for debt reduction. They may choose one of those options or they may decide to hold the total debt in the hope that they will ultimately be repaid.

The role of international financial institutions is to provide financing for guarantees. Financing can take the form of collateral on the reduced value of the debt or by giving debtor governments financial support directly for the repurchase of their debt.

Under the plan, debt would be handled on a case by case basis. Each debtor country negotiates separately with its creditor(s). Additionally, the plan stipulates that economic reforms under the supervision of the World Bank and the International Monetary Fund (IMF) must be put into place prior to a debtor country receiving relief under the plan.

Significantly, the Brady plan recognizes that when debt burden gets so high that it cannot be paid, it must be reduced before credit worthiness can be regained. It also recognizes that stretching out payments over time is

unlikely to help stimulate economies enough to restore property and reduce debt through growth.

The ways to reduce debt under the plan are:

- buybacks
- conversion of debts into bonds with lower principal or interest
- exchange of debt for equity

Under the buyback option, debtor countries use cash reserves to repurchase some debt from creditors at discounted prices. The discount price is available through secondary markets and is based on the expected return on the debt. For example, Brazilian debt sells for 33 cents on the dollar in the secondary markets. At that price, Brazil is able to retire 3 dollars of debt for every dollar it uses in a buyback. If Brazil qualified and desired, it could borrow money from the IMF, retire debt at a ratio of 3 to 1, and -- in the end -- owe the new debt to the IMF.

Debt conversion reduces debt by converting it into a new asset. Countries negotiate with their creditors to convert debt into new securities which require a lower servicing of the debt. This might be negotiated at lower interest rates in return for guarantees that the new debt would be safer than the old debt. This could be done with collateral through the World Bank.

Debt-equity swap is a debt reduction measure that helps stimulate the debtor nation's economy. The debtor nation repurchases outstanding debt using local currency. The seller is then required to invest that money into the debtor nation. The interest here is that the seller is likely to be a third party who purchased the debt at a deep discount from the originating bank and now sells it at a higher rate to the debtor nation albeit in local currency. The problem with this arrangement is that when the new investment is made, it increases the monetary supply within the country and results in inflationary pressures. To reduce that effect, the debtor nation is expected to float a bond issue to help soak up the monetary increase. The end result is trading international debt for domestic debt. Because local debts tend to carry higher interest rates than the original bank debts, interest payments may rise instead of fall.

The most significant point in the Brady plan is that it states that overall debt must actually be reduced and gives a framework through which initial negotiations can start.

Several problems arise with the Brady plan. Major objections appear from creditors. The first is a reluctance to provide some of the funds for debt reduction transfers. This reluctance stems from a wariness at having already been stung once. The second objection is to the request of the Brady plan for creditors to voluntarily amend the terms of

their agreements through waivers. The banks do not embrace the waivers which will expedite debt reduction. The last objection is that banks have to record losses just as other companies do. As they are responsible to their stockholders, they are reluctant to voluntarily reduce debt.

Other problems have also surfaced. Banks are effectively encouraged to hold out as long as possible in the hopes that another creditor will reduce debt and thereby drive up the secondary price of the remaining debt. Any agreement to reduce debt must put the bank in a better position than if it remained with the original debt. As banks holdout, the secondary price of the debt increases to approach 100% as credit worthiness is restored. Therefore, banks are unwilling to be the first to negotiate debt reduction. This is known as the free rider effect.

Despite the difficulties discussed above, there are real possibilities within the framework of the Brady plan. Combined with a new awareness of markets provided by our southern neighbors and the emphasis of President Bush's recent proposal to develop a trading bloc in the Americas, the Brady plan should begin to have some of the desired effects.

RECOMMENDATIONS

The Brady plan gives real promise. Some debtor nations are complying with the economic reforms which must be monitored under the plan. While they do dampen the domestic living standards among some of the populace, they have not produced the Draconian effects which have caused riots in the past. This is encouraging because reform paves the way for debt reduction under the plan.

As evident from the creditors' objections to the plan, it is vital to get real debt reduction started in order for the plan to gain the momentum which could cause free market economies to kick in and make further debt reduction a possibility. I recommend the following additional changes be made to U.S. to start debt relief.

Mandatory participation The U.S. Treasury Department must make participation by all banks in debt reduction mandatory. The percentage of debt held by each creditor would determine the percent of debt reduction required of each bank. This would result in equivalence of reduction for each and overcome stockholder objections. The free rider effect would decrease also.

Favorable treatment for creditors The U.S. Treasury Department must give creditors full scope of flexibility to gain advantage from debt reduction. These should include,

at the least, favorable treatment under tax laws for write-offs. Present accounting practices under U.S. tax laws allows the write-off of only the current value of the investment being written off. This means that a bank would only be allowed to deduct the debt reduction at the secondary market value. The write-off should be allowed at face value for maximum incentive.

Reasonable accounting practices The U.S. should stop allowing banks to carry high-risk and "troubled" loans on their books at face value. Requiring banks to write loans down to actual market worth would be a "stick" to encourage debt reduction negotiations.

Creditor rank order and preference U.S. policy should require a rank order and payback preference program to encourage creditors. Under this system, banks which participate in debt reduction would take priority in repayment guarantees over banks which do not participate. Other creditors would not be paid until the renegotiated loan had been fully serviced or repaid. All other creditors would share equally in whatever payments were left after the senior (renegotiated) loans had been serviced. This would give creditors real incentive to participate.

Creditor consolidation Smaller creditors should be encouraged to sell their debt on the secondary market or to

consolidate it with larger creditors. This would create a stronger cartel of creditors with which to deal and reduce free rider effects.

Capital flight reversal It is essential to reverse the capital flight from Latin America. U.S. contributions to this should include removing subsidies to U.S. producers that reduce competitiveness of Latin producers and opening U.S. markets to goods from Latin America under the Enterprise for the Americas.

Target debt relief Debt reduction should be targeted to the level of debt which can be supported by individual countries. The target should provide sufficient relief to allow for sustained growth while ensuring that the remaining debt can be serviced.

CONCLUSION

The Brady plan and Bush administration's position holds out real hope for Latin American debt reduction. With a continent rich in natural resources and resilient economies despite repeated abuse, debt reduction can be achieved and GDP can grow so that debt which remains can be serviced. Once debt is reduced, credit worthiness can be restored and stretchout programs can be instituted. Under those

programs, vibrant and growing economies can outgrow their debt problems.

