THE SOLUTION TO THE CRISIS
(LATIN AMERICA)

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Special Section
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As the 1990s get under way, Venezuelans — and Latin Americans in general — are naturally wondering whether this is going to be yet another lost decade like the 1980s, or whether we can finally overcome the long-lasting crisis with which we have been struggling for several years and come to enjoy better economic conditions.

I. The Consensus Solution

The "consensus solution" to the crisis affecting all the Latin American countries (Venezuela among them) was spelled out at a recent meeting organized by the Interamerican Development Bank. A set of conditions which had to be present for the problem to be solved and for the region's economies to be able to achieve an acceptable economic performance was defined.

This "consensus solution" is composed of the following three key components:

1. A substantial and permanent reduction in foreign debt service costs.

2. Application of reasonable and coherent economic policies, with clear and well defined objectives for the short, medium, and long term

3. Availability of large-scale, sustained international financing in the years to come.

But for success to be achieved, all three of these conditions must be met in a harmonious and mutually supportive way. Like a tripod which can only stand if all three legs are in the right place, the "consensus solution" can only be expected to yield the desired results if all three of its components are fully in place, since each of them is a necessary, but not sufficient, condition for overcoming the crisis.

That is where those observers who argue that the crisis can be overcome if only the debt problem is solved, or if only the right economic policies are pursued, go wrong. Everything has to be done at once, in a consistent and mutually supportive way.

I.1. The Solution to the Foreign Debt Problem

The foreign debt problem can only be solved when conditions are created under which both debtors and creditors can come to a rational agreement on a plan whose implicit costs are equitably distributed. Among other things, the governments of the creditor countries will have to take a true and sincere interest in developing an effective way of attacking the problem; their role consists not only of providing essential financial and political support, but also of creating conditions that will bring the debtors and creditors closer together.

They must, for example, make a series of modifications in their banking regulations and provide tax relief so that a debt reduction plan will not bring excessive losses to the private creditor banks; that would make the banks much more willing to cooperate.

At the same time, the interference of the authorities in the relationship between debtors and creditors — which has weighted the scales in favor of the latter and against the former up to now— must come to an end. Only then will the banks be forced to cooperate more constructively in the search for a final solution to the debt problem: if they refused to do so, they would expose themselves to hostile action by the debtors, in the form of greater resistance to making debt service payments, or even full-scale temporary moratoria.

But for that to be possible, the debtor countries must be free of fear of official retaliation — such as a cutoff of financial assistance from the

multilateral or bilateral financial institutions —for justified actions they took against banks whose attitudes were negative or passive.

I.1.1. The Brady Plan: a Solution to the Problem?

A year after U.S. Treasury Secretary Nicholas Brady announced his intention of creating an alternative plan for the solution of the debt problem, through debt relief affecting both principal and service, we can well ask what advances have been achieved and whether we are justified in placing our hopes for a quick final solution to the problem in this initiative. One way to seek an answer to those questions is to examine the results of the first agreement between a debtor country and a group of its creditors under the Brady Plan. We refer to the Mexican agreement, signed on February 4 in Mexico city, in the presence of high financial officials and private bankers.

The Mexican Agreement

Under the agreement, Mexico renegotiated the terms of its foreign debt to private banks, amounting to approximately US$ 48.5 billion. This figure represents slightly less than half of the country's total foreign debt, which exceeds US$ 100 billion. Under the agreement, the banks can choose among the following three options:

1. Reduce the principal of the debts they hold by 35% and continue receiving annual interest payments on the remaining 65% at LIBOR plus 13/16%.

2. Maintain the principal at its present level, but charge a lower and fixed interest rate of 6.25%, rather than LIBOR plus 13/16%.

3. Grant new loans between 1990 and 1992 amounting to 25% of their previous credits, which would not vary and would continue to earn interest at LIBOR plus 13/16%.

According to official announcements, the first option (a 35% reduction of principal) was chosen for 41% of the refinanced debt; the resulting debt reduction is on the order of US$ 7.0 billion. Banks holding 47% of the debts at issue chose the second option and reduced interest rates. The third option, for new credits, was chosen by banks holding 12% of the current Mexican debt.

Table No. 1 shows the effects of the new agreement for Mexico, in terms of reduction of net debt service payments (reduction of payments plus new loans).

Table 1

Results of the New Mexican Agreement (Approximate figures) (Billion US$)

Amount Negotiated:		48.5
35% principal reduction (41%)		19.9
Interest reduction to 6.25% (47%)		22.8
New loans (12%)		5.8
Option I: Principal Reduction (35% discount):		
Amount of resulting debt (19.9*0.65)		12.9
Debt reduction (19.9-12.9)		7.0
(1) Annual interest saving (7.0*LIBOR+13/16)		0.625
Option II: Reduction of Interest to 6.25%:		
Interest at LIBOR+13/16 (22.8*LIBOR+13/16)		2.05
Interest at 6.25% (22.8*0.0625)		1.43
(2) Annual interest saving (difference)		0.620
Option III: New Loans:		
New loans in 3 years (5.8*0.25)		1.5
(3) New loans per annum	0.5	
NET ANNUAL DEBT SERVICE SAVING ((1)+(2)+(3))		**1.745**

Note: In this case we assume the LIBOR rate will be 8.1875% in 1990. LIBOR + 13/16 will then be 9%.

The Mexican finance minister, Pedro Aspe, has stated that his country will save US$ 4.0 billion per year under the accord. This is much higher than the US$ 1.745 billion estimate shown in Table No. 1. The reason is that under the old agreement Mexico was obligated to pay annual maturities of principal to its foreign creditors amounting to US$ 2.154 billion between 1990 and 1994, which will no longer be due; no principal payments will now be required for the next 30 years, when the US$ 35.7 billion in bonds to be issued by the Mexican government and exchanged for preexisting bank debt under the first two options (US$ 12.9 billion under the principal reduction option and US$ 22.8 billion under the reduced interest option) mature. Pay-

ment of the face value of those bonds at maturity is guaranteed by U.S. Treasury zero-coupon bonds to be bought by Mexico under favorable conditions.

However, the savings generated by the elimination of the principal maturities for preexisting bank debt is not strictly attributable to the Brady Plan. If prior experience serves as a guide, even in the absence of that plan, Mexico would negotiated a new restructuring of its debts and obtained new grace periods which would have postponed the maturities in question for several years more.

Consequently, it can be said that the Brady Plan will yield Mexico a reduction of its debt service burden of only about US$ 1.745 billion per year in the early 1990s. While this is by no means an insignificant figure, it represents less than 20% of the country's former interest obligation. At the same time, the debt reduction so achieved comes to just US$ 7.0 billion, less than 7% of Mexico's total foreign debt. These calculations do not include the sums Mexico will have to lay out for the purchase of the zero-coupon bonds which will provide backing for the principal of its new bonds at their maturity.

Though it has unquestionably obtained more favorable terms than it would have gotten under agreements similar to those of the past, and it will have major savings that can now be channeled into its economy, Mexico has not by any means solved its foreign debt problem. On the contrary, its obligations and their service are still very high. And what is worse, future payment of debt service may well be difficult to assure and will be much more obligatory and inflexible than in the past. (See Section I.3 of this study)

The Possible Case of Venezuela

Venezuela has been engaged in negotiations with its creditors for a year, in an attempt to achieve a new agreement for its restructured public foreign debt of more than US$ 20.0 billion. These negotiations seek terms similar to those obtained by Mexico some months ago, since current conditions do not seem to be conducive to an agreement any more favorable than that.

Table No. 2 shows estimations of the effect for Venezuela of an agreement under terms similar to Mexico's. We assume the same options and the same distribution of the creditors' choices among them.

Table 2

Venezuela: Effects of an Agreement with the Creditor Banks Similar to the Mexican Agreement (Approximate figures) (Billion US$)

Amount Negotiated:	20.00
35% principal reduction (41%)	8.20
Interest reduction to 6.25% (47%)	9.40
New loans (12%)	2.40
Option I: Principal Reduction (35% discount):	
Amount of resulting debt (8.2*0.65)	5.33
Debt reduction (8.20-5.33)	2.87
(1) Annual interest saving (2.87*LIBOR+7/8)	0.26
Option II: Reduction of Interest to 6.25%:	
Interest at LIBOR+7/8 (9.4*LIBOR+7/8)	0.852
Interest at 6.25% (9.4*0.0625)	0.588
(2) Annual interest saving (difference)	0.264
Option III: New Loans:	
New loans in 3 years (2.40*0.25)	0.6
(3) New loans per annum	0.2
NET ANNUAL DEBT SERVICE SAVING ((1)+(2)+(3))	0.724

Note: As in Table No. 1, we assume the LIBOR rate will be 8.1875% in 1990. On adding the Venezuelan margin of 7/8%, we have a rate of 9.063%.

As discussed for the Mexican case, the net annual savings generated under the Brady Plan would be 725 million dollars. Still, the savings is considerably larger in comparison with the payments the country would otherwise have to make under the February 1987 restructuring agreement, since that agreement called for growing amortization payments, from US$ 1.050 billion in 1990 to US$ 1.650 billion in 1994.

As mentioned above, the elimination of these payments is not a result of the application of the Brady Plan as such, since it would have been contained in any restructuring arrangement that emerged from the negotiations with the banks, even in the complete absence of the Treasury Secretary's proposal.

As in the Mexican case, an agreement of this

kind would yield a significant saving for Venezuela; even greater in relative terms than for Mexico, since the percentage of total foreign debt covered by the agreement would be higher. But the remaining debt service load would still not be reduced to a level that might be described as desirable and which the country could absorb without major difficulties; it would still impose an excessive burden on the economy and restrict its development potential.

From the foregoing analysis we conclude that the steps taken to date by the economic authorities of the industrialized countries to solve the foreign debt problem have been relatively insignificant, and there does not seem to be any possibility of a turn for the better in the near future. Consequently, we feel a solution to the foreign debt problem is still very far away.

I.2. Realistic Economic Policy on the Part of the Debtor Countries

The second component of the "consensus solution" depends essentially on the Latin American countries themselves. Their economic authorities need to become fully conscious of the urgency of adopting correct economic policies to achieve fiscal and monetary discipline, supported by rational foreign exchange and trade policies, and in general, the creation of permanent conditions under which all the economic forces will be led to engage in more responsible economic behavior. It is only in the context of clear, credible, and permanent rules of the game that the investment so desperately needed to put the Latin American economies back on the path to consolidation and development can be expected to flourish.

This is all the more important in the context of the rapid changes taking place in the world today. Recent events in Eastern Europe, advancing economic integration in Western Europe, the creation of other great supranational markets such as that of the United States and Canada, and the consolidation of important new economic areas such as the Western Pacific, are generating enormous investment opportunities which will undoubtedly compete with Latin America and undercut its ability to attract capital. Therein lies the importance of becoming fully conscious of the new conditions in the world and exploring ways by which to take the greatest possible advantage of them and prevent the negative consequences they might bring with them.

We will not go into detail in the analysis of these ideas, since it is not the central theme of this study. But it must be said that it is essential for the Latin American countries to pursue greater economic integration, in the search not only for an expansion of their internal markets, but also to enhance their ability for the efficient production of the goods for which they have comparative advantage and which will enjoy a large and growing worldwide demand.

The achievement of this goal requires the adoption of homogeneous, complementary, rational, and permanent national policies. The aim of those policies must be to create, among other things, conditions conducive to the domestic investment of both national and international capital. That is the only way to put an end to the climate of uncertainty and negative expectations which has made potential investors reluctant to invest and has led individuals to send their savings abroad to protect them against inevitable inflation and devaluation in their national economies.

Nevertheless, this perverse and paralyzing pessimism can only be overcome if new, realistic, coherent, lasting, and credible economic policies are supported by the third component of the "consensus solution." Latin America needs a flow of funds into the region from a variety of permanent sources, many of which now provide it with little or no capital.

I.3. Future Financial Assistance

There is precious little discussion on the third basic component of the consensus formula, but it is just as important as the other two. How are the essential new investments to be financed when both public and private foreign credit for Latin America is so severely restricted and the demand for funds on the world markets so strong?

The obvious first place to look is the very large pool of Latin American capital invested outside the region. But it will hardly be easy to bring it back. Its owners will be interested only in attractive local opportunities whose potential financial yield is not only competitive with what they can now earn abroad, but high enough to compensate for the added risk of investment in Latin America.

The repatriation of flight capital depends on the adoption of economic policies capable of creating

secure investment opportunities and new financial engineering schemes to channel returning funds into high-yield, low-risk Latin American securities offered on the regional and international markets.

But very little capital will be repatriated in a permanent way (rather than for purely speculative purposes) in the absence of the belief that the conditions which make it attractive to bring these funds back will persist over time. The creation of such favorable expectations, in turn, will largely depend on the degree of foreign debt relief and the assurance that the region will have access to international capital in the years to come.

This means that the position taken by certain public officials and spokesmen for private international financial institutions, that the responsibility for creating the conditions under which flight capital will be motivated to return lies almost entirely with the countries themselves, is oversimplified and unrealistic. Those governments and institutions must also play an important part in achieving that goal.

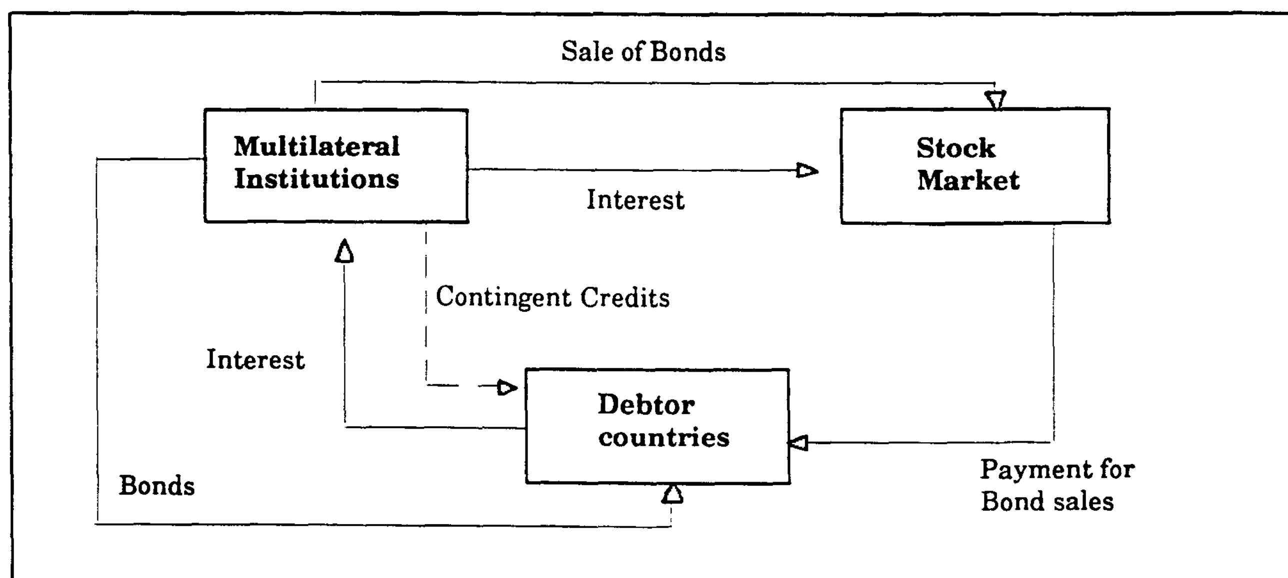
The Role of the International Financial Institutions

International financial institutions like the World Bank or the Interamerican Development Bank could also play a crucial role in bringing about a favorable climate for investment by providing the Latin American countries with access to international development financing. Not only must they continue to provide direct funding in the years to come, but they could also help to make Latin American securities acceptable to the world markets.

How could they do this? We have been proposing actions along these lines for years. One possibility is for countries seeking foreign private capital to issue dollar-denominated bonds to be transferred to the international financial institutions; the latter would then offer those securities on the world's financial markets and guarantee service payments.

The institution in question would collect the funds for interest payments from the debtor country and make the payments to the creditors. At the same time, it would provide the debtor countries with contingent lines of credit to guarantee interest payments; they would be activated when the debtor countries found themselves temporarily unable to pay. (See the diagram in this page.)

Both the country and the agency involved would obviously have to study the investments to be funded in this way very carefully; they would have to determine whether the projects justified new borrowing and whether the country would reliably be in a position to honor its additional obligations. The institution would also supervise the use of the credit, making sure it went into specified development projects, and would see to it that the debtor countries maintained rational economic policies designed to minimize the risk of being unable to serve their obligations in the future.



By providing credible guarantees to potential bond purchasers, this arrangement would broaden the region's access to international capital of all kinds: from private sources, banks, institutions, and individuals. It would also make it more attractive to bring national flight capital back.

Relatively little money would be needed to fund the contingent lines of credit opened to guarantee the bonds, since agreements between the institutions and debtor countries would minimize the likelihood of default. Funds would therefore be freed for direct financing to the Latin American countries.

Potential Obstacles

A number of potential problems might undermine the viability of a scheme such as this. One of them is the proliferation of Latin American bonds in the world financial markets, as existing bank debt is increasingly converted into securities. That could severely limit, not only the viability an arrangement such as the one proposed here, but the Latin American countries' access to the world securities markets for a long time to come.

Several debtor countries are about to obtain a reduction of their outstanding debts or debt service obligations through this kind of conversion under the latest agreements with the creditor banks. Many of the banks which accept the new bonds will offer them on the market in an attempt to liquidate their exposure, thereby increasing the amount of such securities on the market very considerably from its current low level.

Table 3

Foreign Debt of the Four Most Heavily Indebted Countries of the Region as of December 31, 1989 (Billion US$)

	Total	Bonds*	% In Bonds
Argentina	60.11	5.35	8.9%
Brazil	117.65	2.00	1.7%
Mexico	94.29	1.32	1.4%
Venezuela	35.64	3.9	3.9%
TOTAL	307.69	12.57	4.1%

* Includes internal holdings of dollar-denominated bonds
Source: Merrill Lynch

In the case of the four most heavily indebted countries of the region, external obligations in the form of foreign currency-denominated bond represented only 4.1% of total foreign indebtedness at the end of 1989.

As a result of the new Mexican agreement, that country will issue more than US$ 35.0 billion in bonds. If Venezuela reaches an agreement with its creditors similar to the Mexican accord (see Table No. 2), there would be another bond issue amounting to US$ 17.6 billion. Should Argentina, Brazil, Peru, and other Latin American countries issue additional large volumes of bonds under the terms of future debt renegotiations, it is easy to visualize the enormous increase in the volume of Latin American bonds in a short space of time.

As indicated above, a large part of those bonds will go on the market, since the banks which receive the issues will want to liquidate all or a major portion of their positions. Consequently, a very large volume of Latin American bonds will be in circulation throughout the world, and that could bring very serious consequences for the region.

First of all, it would turn into a major obstacle to future restructurings of payments on their remaining obligations: when the bonds spread through the international investment community, the debtor countries will no longer have a compact group of banks with which to negotiate for new payment terms. They will be forced to make their payments on time, regardless of their financial condition, or find themselves suddenly excluded from the international securities markets.

One way to overcome these problems could be to apply for loans with which to make interest payments at their maturity. But there will be very little opportunity for that in the future, since the chief source of such credits -- the private international banks -- will not meet the Latin American countries' credit needs for a long time to come. The upshot will be rigid payment obligations for the countries of the region, which might well undermine their access to needed development financing.

In the second place, the international financial markets might raise their assessment of the risk attaching to the Latin American bonds: the more of them are in circulation, the lower will be the perceived probability of payment. Not only would

such a perception depress their market prices, but it would also lead purchasers of future issues to demand deeper discounts, unless the bonds carry an ironclad guarantee. But if they do, the amount of funds needed to back them up will be so large as to limit the scale on which this financing alternative could be applied, and thereby restrict Latin America's future access to external capital.

II. Conclusion: Future Difficulties

As the preceding discussion shows, a great many problems remain to be solved before Latin America can overcome its crisis and resume progress in the development process. Those problems can only be solved with the enthusiastic participation not only of the Latin Americans, but also of the many other parties directly involved. If the passive behavior shown by many of them continues into the future, the chances of success will be very slim.

How much longer can Latin America bear its crisis? We think very little. So it is essential for all concerned to take the immediate and decisive action needed to prevent a tragedy of incalculable proportions.